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EVALUATING INVESTMENTS TO ENHANCE NET RETURNS



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How do you consider the tax consequences of your investment decisions and evaluate how those decisions improve the tax efficiency of the portfolio or cause tax drag that can impact your net returns?

For many high-income Canadian investors, tax is likely the single largest cost they face. That's why tax-related considerations should be integrated throughout the portfolio construction process rather than simply layered on as an afterthought.

Expectations are rising. No longer is it sufficient to have a two-dimensional mindset comparing pre-tax manager value add (or alpha) relative to risk. Instead, we need to move to three dimensions and consider both pre-tax value-add along with the tax efficiency enhancement or tax drag creation caused by portfolio activity. Both of these things together determine the net return that a manager delivers to a client, and that is what should be assessed relative to the risk taken.

WHY INCOME TYPE MATTERS FOR NET RETURNS

The core concept to understand is that investment income type matters. How an investment return is characterized has a meaningful impact on the net return to an investor. In Canada there are a number of different types of investment returns. Broadly speaking, they fall into three categories:

Capital Gains

which are the most tax efficient investment return for most high-income Canadians and which can either be realized or deferred.

Canadian Dividend Income

both non-eligible and eligible where the income is grossed up and then tax credits are received and generally for a high income Canadian this is more tax efficient than Other Income.

Other Income

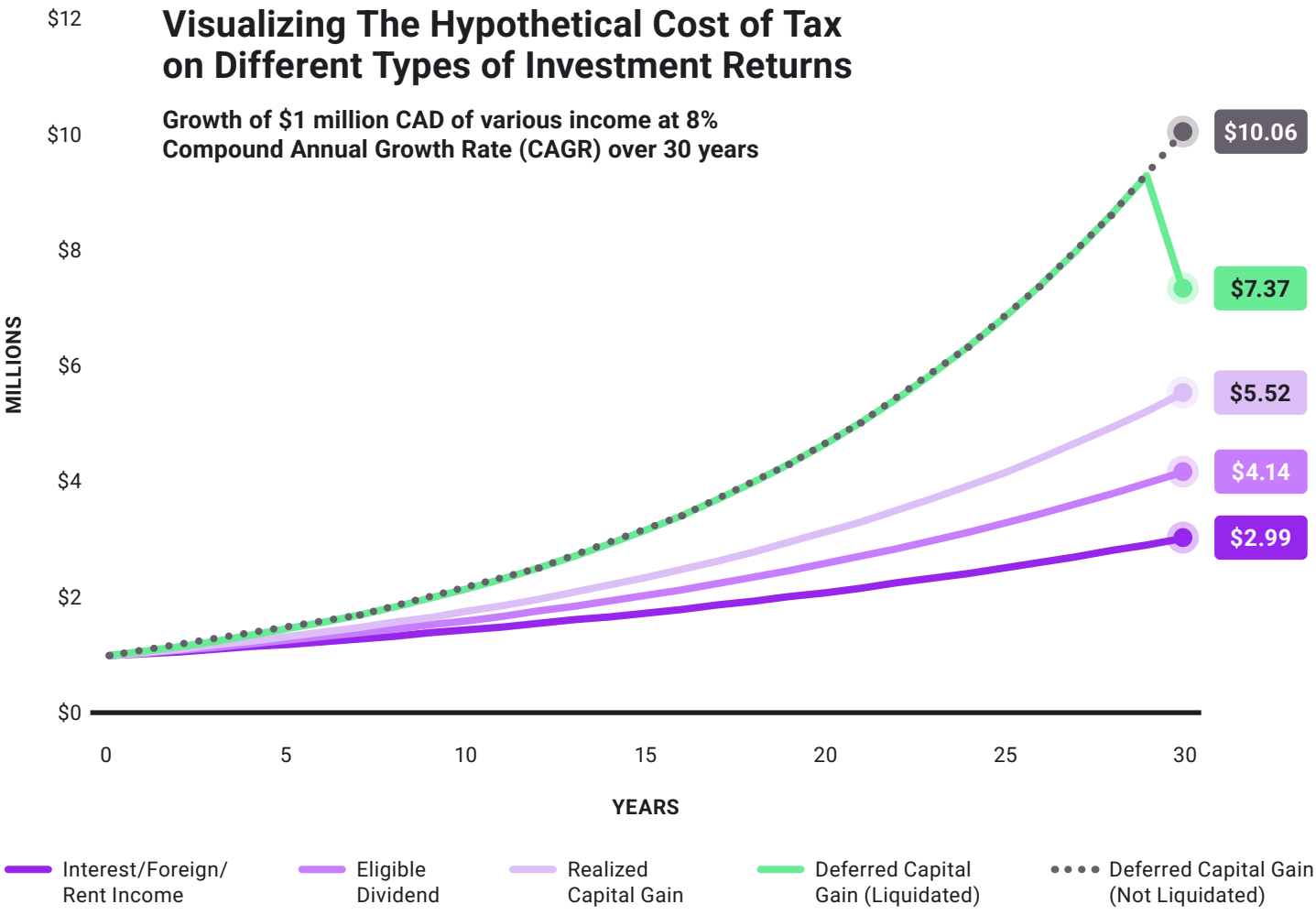
which covers things such as interest income, foreign income and rental income among others.

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Generally speaking, investors in taxable accounts could benefit from prioritizing investment strategies where the majority of returns come from capital gains, particularly if those gains can be realized on a deferred basis. The impact is material; the tax consequences can be significant and the ability to have uninterrupted compounding by deferring the taxation of investment return can meaningfully improve an investor's net wealth.

PUTTING THIS INTO PRACTICE

To make this practical, here is a simplified example showing how a $1,000,000 investment earning an 8% return compounds over 30 years depending on how the investment return is characterized. In this example, we assume that income is reinvested after-tax at the same rate of return each year and that the investor is in the highest Ontario marginal tax bracket.



Source: Picton Mahoney Asset Management. For illustrative purposes only. Based on tax rates for an Ontario resident in the highest marginal tax bracket in 2026. This content is for informational purposes only and is not intended to provide specific financial, investment, tax, legal or accounting advice specific to any person, and should not be relied upon in that regard. Tax, investment and all other decisions should be made, as appropriate, only with guidance from a qualified professional.

In this example, as we move from interest income, to dividend income to capital gains, the wealth accumulated is vastly different. If we earn the 8% return as fully taxable interest income, our wealth grows to less than $3,000,000. Based on the assumptions used in the scenario above, the investor with deferred capital gains could accumulate more than $10,000,000 in net wealth. The deferred tax will eventually have to be paid, but even on a post-liquidation basis the investor earning deferred capital gains could have more than 2.4x more wealth than the investor earning interest income.

While the above example makes clear the importance of income characterization, it is somewhat unrealistic to think that there would be two comparable investments that have completely different income characterization. It is more realistic to think about the impact of small changes at the margin.

Here are some changes that a tax aware manager might make to improve net returns:

01

Where it makes sense, avoid high income securities, such as high dividend stocks, so that more returns come from capital gains and less returns come from investment income.

02

Identify ways to realize losses to offset realized gains to reduce tax payable today, so that more capital remains invested and is able to compound over time.

03

Where applicable, prioritize deferring capital gains so that your capital has the opportunity to continue compounding without interruption.

As an example, let's consider the additional wealth that could potentially be accumulated by an investor allocating into U.S. equity following these three principles as compared to an investor that is not tax aware.

In this example, we have two portfolios. Both portfolios earn the same 8% annualized pre-tax return over a 10-year period. However, the portfolio in scenario 1 considers income characterization and seeks to improve net return by reducing foreign income, realizing losses and deferring gains. The portfolio in scenario 2 on the other hand does not consider the impact of income characterization and so experiences tax drag from foreign income and realized capital gains. The difference in net wealth accumulation post-liquidation is 37%.

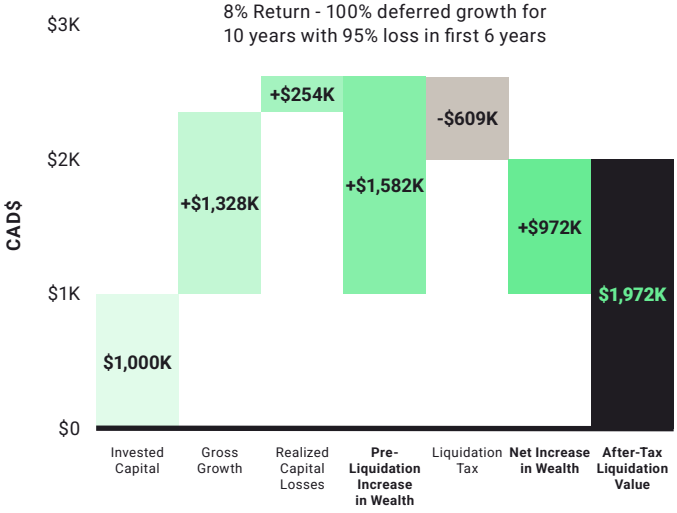
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The Structural Path to Potential Optimization of Net Wealth

$1 Million capital invested with 8% gross annualized return over 10 years;
Scenario 1 resulted in 35% better Net Increase in Wealth After Liquidation compared to Scenario 2.

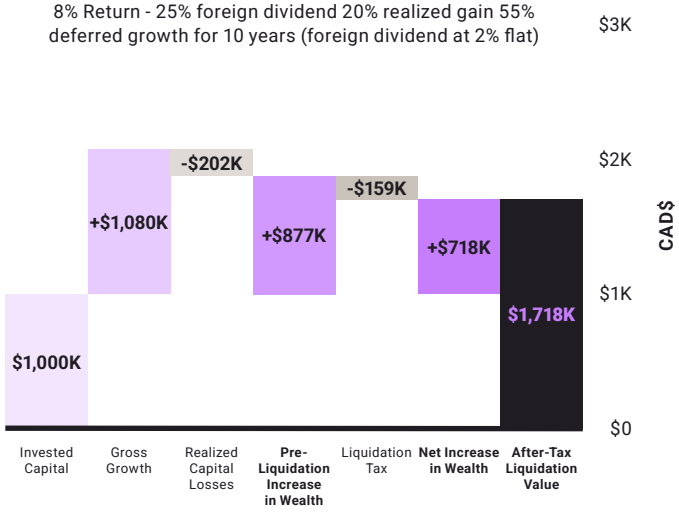
SCENARIO 1

8% Return - 100% deferred growth for 10 years with 95% loss in first 6 years



SCENARIO 2

8% Return - 25% foreign dividend 20% realized gain 55% deferred growth for 10 years (foreign dividend at 2% flat)



SUMMARY COMPARISON (C$)

	SCENARIO 1 DEFERRED	SCENARIO 2 BLENDED	ADVANTAGE (SC1)	% BETTER
Invested Capital	$1,000,000	$1,000,000	–	–
Gross Growth	$1,327,577	$1,079,617	$247,960	23%
Taxes Payable (Reduction of taxes payable on other income)	$254,220	(-$202,261)	$456,481	–
Pre-Liquidation Increase in Wealth	**$1,581,797**	**$877,356**	**$704,441**	**80%**
Liquidation Tax	(-$609,480)	(-$158,898)	(-$450,582)	–
Net Increase in Wealth	**$972,317**	**$718,458**	**$253,859**	**35%**
After-Tax Liquidation Value	**$1,972,317**	**$1,718,458**	**$253,859**	**15%**

For illustrative and discussion purposes only. This hypothetical example does not represent actual or projected fund performance or portfolio holdings, and is not a guarantee, promise, or prediction of future results. No representation is made that similar results will be achieved, actual results will vary. Tax results depend on each investor's individual circumstances.

Assumptions for scenarios: $1M invested • 8% gross annualized return • 10-year horizon • Ontario investor at highest marginal tax bracket (53.53%). Scenario 1 (Deferred): 95% at-risk capital loss over Year 1-6 + 100% deferred capital gains Year 7-10. Scenario 2 (Blended): 25% foreign dividend + 20% realized capital gain + 55% deferred capital gain annually.

This example makes it clear, how returns are earned matters. Taxes quietly erode returns and improving the income characterization profile of an investment portfolio can meaningfully improve net results. After all, it's not what you earn but what you can keep.

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