

Understanding Series T

Why this cash flow mechanism may not be the ideal solution in retirement



When faced with where and how to generate cash flow for retirees and other income seekers, many advisors may turn to Series T versions of their favourite mutual funds. Doing so allows them to provide clients with what they have deemed to be a suitable asset mix, with the added benefit of delivering high, recurring distributions.

How does Series T work?

Series T was designed to provide investors a potentially more tax-efficient tool with which to receive monthly cash flows relative to setting up a systematic withdrawal plan (SWP). The thinking? As markets rise over time, instead of selling their investment holdings to finance current expenses and realize capital gains or losses upon disposition, investors could retain their holdings and instead draw from their initial capital in the form of a distribution. Through the magic of taxation on distributions, which effectively reduces their adjusted cost base (accruing a deferred capital gains liability to be paid in the future), cash is distributed without them needing to sell any units.

The intended tax efficiency of Series T comes via tax deferral. Each month, when the fund pays its Series T distributions, the cash flow over and above what the fund generated organically is deemed to be return of capital (ROC), which is not immediately taxable. For example, if a fund collects 3% from coupon interest on its bond holdings yet distributes 8% (as is typically the figure) to its Series T investors, the differential of 5% is deemed to be ROC. Once all of the investor's initial capital has been distributed back to them over the course of several years, any future distributions are then deemed to be capital gains, which are taxed accordingly in the year received.

Does the tax efficiency hold up in all market environments?

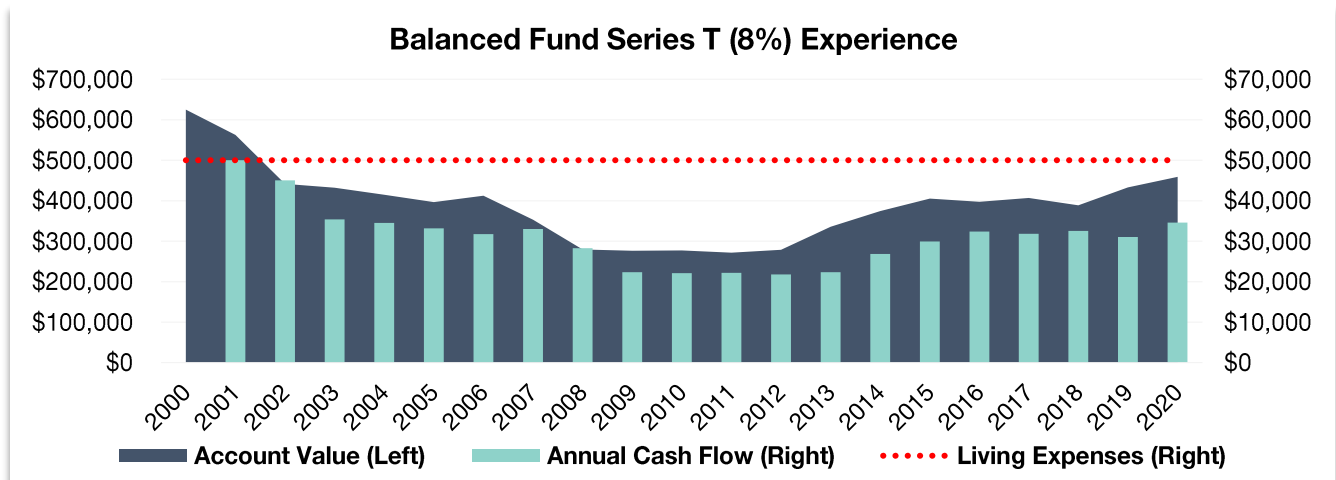
The simple answer is no. Remember, there is no disposition (sale) of units associated with Series T distributions. When markets are falling, it may be more beneficial for investors needing cash flow to sell units and crystallize a capital loss to offset other current or future capital gains (i.e., such as utilizing a SWP). In flat markets, the tax consequences are the same, regardless of whether Series T or a SWP is used.

Are Series T distributions consistent?

Fund companies tout the consistent recurring cash flows investors receive from Series T of their mutual funds, but those distributions only remain consistent on an intra-year basis (i.e., January-December distributions remain the same for any given calendar year, with the exception of any year-end special distributions). While the payout percentage (8%) remains consistent, the actual dollar amount distributed to investors is recalculated each year, based on the December 31 net asset value of Series T of the fund. Market volatility, therefore, can and does result in considerable cash flow variability in dollar terms from one year to the next. As a result, an investor must either adapt their standard of living based on the current year's cash payouts, or their advisors will need to continually shuffle around the portfolio (and potentially assume greater investment risk) to help ensure the fixed dollar needs of the client are being met.

Case study #1 – Balanced Fund Series T Experience (2000-2020)

Below is a real-world example illustrating the shortcomings of Series T and is based on the 20-year period ended December 31, 2020. Assuming an investor started retirement in the year 2000 with annual cash flow needs of \$50,000, some quick math, based on an 8% payout, would dictate the initial investment requirement in Series T would have been \$625,000. Let's also assume this investor chose a balanced fund with 70% exposure to US equities and 30% exposure to Canadian bonds. As displayed in the graph below, year 1 (2001) would have been the only year in this investor's 20-year retirement period within which they actually received the full \$50,000 in cash flows from the fund. Because of the poor performance of this balanced fund through 2002, coupled with the ongoing cash flow being taken out, subsequent years' payouts were significantly hindered. In fact, the average payout over this time frame would have been just \$31,000, and for five consecutive years, from 2009-2013, this investor would have only received roughly \$22,000 per year (less than 50% of the amount they required).



Example for Illustrative Purposes Only

Source: Morningstar Direct. Example of Balanced Fund performance is modeled using 70% S&P 500 TR Index (CAD) and 30% FTSE Canada Universe Bond Index, gross of fees, rebalanced annually.

The use of hypothetical, simulated returns comes with inherent risks and limitations. Simulated returns are not the returns of any particular account or portfolio, they are produced with the benefit of hindsight through the retroactive application of a model. No representation is being made that any investor will, or is likely, to achieve gains or losses similar to those illustrated.



Are mutual funds with Series T managed towards an income/return target?

In almost all instances, the answer is no. Keep in mind that all the various series offerings of a mutual fund are invested in the exact same pool of underlying securities (the portfolio). A fund manager cannot manage Series A or F to provide 4% cash flow while also managing the portfolio to deliver 8% to unitholders of Series T. Further, delivering a yield of 4% net of fees in and of itself can be challenging in a low interest rate environment, let alone generating 8%! Investors need to be aware that Series T payouts are almost never sustainably generated and the underlying investment strategies of the fund are often run independently of cash flow targets.

Why isn't Series T the silver bullet for retirement cash flow?

Series T could make for a simple and elegant solution for certain investors, particularly if they believe that markets will steadily rise for many years to come. In those situations, investors could generally enjoy a steadily increasing cash flow through time. That, however, might be an overly simplistic and naïve assumption. The more likely scenario is that there will be many bumps in the road, and in certain years (hopefully not all), investors may receive less than their required cash flow.

Simply put, Series T is just an “add-on” feature. It's an accessory of a mutual fund that is not necessarily representative of how the fund manager actually invests the portfolio or what they strive to achieve for investors overall. For investors who are retirees, they need to concern themselves with consistent cash flows from an investment portfolio *with downside protection*. In other words, the manager needs to be focused on sequence of return risk.

What is sequence of return risk?

Sequence of return risk refers to the risk of market corrections happening in the early years of retirement while the retiree is simultaneously drawing cash flows from their portfolio. The combination of market losses and cash distributions/withdrawals leads to less and less capital being available to participate when the market rebounds. These instances can lead to catastrophic outcomes, such as a considerably decreased standard of living or the very real possibility of running out of money, as demonstrated in the following case study.

Case Study #2 – Drawdowns in the Early Years of Retirement

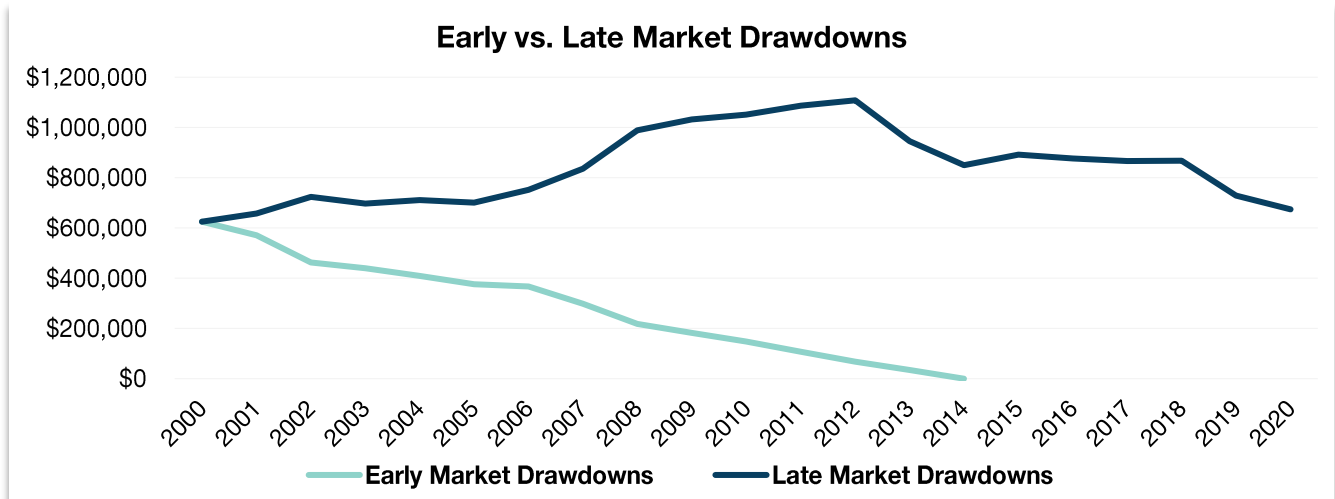
Like in our last scenario, we once again use a 70% US equity and 30% Canadian fixed income allocation over the 20-year period ended December 31, 2020. We also assume an initial investment of \$625,000 and the requirement of \$50,000 of cash flow per year (8%). However, in this scenario, when the Series T cash flows fall below the required \$50,000 in a given year, the investor additionally sells units to achieve the necessary \$50,000 that year.

The teal line shows the experience of the hypothetical portfolio for the 20-year period ending December 31, 2020. In this example, performance in the early years was quite poor for US equities, as this is when the dot-com bubble burst and the market value of many technology companies fell considerably. As a result of weak market performance in the earlier years, coupled with \$50,000 annual withdrawals, the blue line runs itself to \$0 in 14 years. In other words, if this was a retirement



portfolio starting at age 65, the retiree would have run out of money by age 79 and would have been completely dependant on CPP/OAS thereafter.

The dark blue line reverses the order of the calendar year performance, such that the worst results come at the end of the 20 years (i.e., it assumes that the performance in 2001 actually occurred in 2020, 2002 occurred in 2019, 2003 occurred in 2018, etc.). Under this reversed scenario, when market drawdowns happen towards the end of retirement, the portfolio and its associated longevity are far, far healthier, showing just how important it is to invest in a solution that seeks to minimize drawdowns in the early years of retirement.



Example for Illustrative Purposes Only

Source: Morningstar Direct. Example of Balanced Fund performance is modeled using 70% S&P 500 TR Index (CAD) and 30% FTSE Canada Universe Bond Index, gross of fees, rebalanced annually. Early market drawdowns data is reflective of the actual blended index results for the 20-year period ended December 31, 2020. Late market drawdowns data is reflective of the same string of blended index results over the same time frame but reverses their order.

The use of hypothetical, simulated returns comes with inherent risks and limitations. Simulated returns are not the returns of any particular account or portfolio, they are produced with the benefit of hindsight through the retroactive application of a model. No representation is being made that any investor will, or is likely, to achieve gains or losses similar to those illustrated.

Why is Series T unlikely to solve for sequence of returns risk?

Again, Series T is just an “add-on” feature of a given mutual fund that spits out an arbitrary cash-flow figure and isn’t necessarily reflective of how the fund’s portfolio is managed. Nearly every mutual fund offering available today is managed in perpetuity (i.e., they do not generally have predetermined end dates) or they are not designed to only accept investors of a certain age, such as retirees. As a result, the portfolio manager’s game-plan is, in essence, to grow capital forever. This results in the fund being focused on long-term opportunities for everyone, rather than minimizing drawdowns in a retiree’s first few years of decumulating assets from their investment portfolio.

If a manager implements strategies intended to carefully manage risk and targets more defined outcomes, both the cash flows and the longevity of the portfolio are likely to improve.

Talk to your dedicated Guardian Sales Representative to learn more about our solutions specifically created for retirees.



This communication is for educational purposes only and does not constitute investment, legal, accounting, tax advice or a recommendation or solicitation to buy, sell or hold a security. This information is not intended for distribution into any jurisdiction where such distribution is restricted by law or regulation.

The use of hypothetical charts is not meant to represent the performance of any particular investment and is not intended to predict or project investment results. The charts are based upon certain assumptions, estimates and/or projections, the anticipated results of which are inherently subject to uncertainties and contingencies. No representation is being made that any investor will, or is likely, to achieve gains or losses similar to those illustrated. There are frequently material differences between hypothetical performance results and the actual results achieved by a particular fund's investment strategy. Past performance may not be indicative of future performance.

The opinions expressed are as of the published date and are subject to change without notice. Assumptions, opinions and estimates are provided for illustrative purposes only and are subject to significant limitations. Reliance upon this information is at the sole discretion of the reader. This communication includes information concerning financial markets that was developed at a particular point in time. This information is subject to change at any time, without notice, and without update. This communication may also include forward looking statements concerning anticipated results, circumstances, and expectations regarding future events. Forward-looking statements require assumptions to be made and are, therefore, subject to inherent risks and uncertainties. There is significant risk that predictions and other forward-looking statements will not prove to be accurate. Equity markets are volatile and will increase and decrease in response to economic, political, regulatory and other developments. The risks and potential rewards are usually greater for small companies and companies located in emerging markets. Bond markets and fixed-income securities are sensitive to interest rate movements. Inflation, credit and default risks are all associated with fixed income securities. Diversification may not protect against market risk and loss of principal may result. Certain information contained in this document has been obtained from external sources which Guardian believes to be reliable, however we cannot guarantee its accuracy. Index or benchmark performance is shown for comparison purposes.

Guardian Capital LP manages portfolios for defined benefit and defined contribution pension plans, insurance companies, foundations, endowments and investment funds. Guardian Capital LP is a wholly owned subsidiary of Guardian Capital Group Limited, a publicly traded firm, the shares of which are listed on the Toronto Stock Exchange. For further information on Guardian Capital LP and its affiliates, please visit www.guardiancapital.com. Guardian, Guardian Capital and the Guardian gryphon design are trademarks of Guardian Capital Group Limited, registered in Canada and are used under license.

Publication Date: September 2022

