The Internet Wealth Builder

Volume 24, Number 44 Issue #21944 December 16, 2019

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BUILDING WEALTH

The Internet Wealth Builder

Editor and Publisher: Gordon Pape
Associate Publisher: Richard N. Croft
Website: www.buildingwealth.ca

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Final issue of 2019.
Next issue:
January 6, 2020

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BORIS WINS BY A LANDSLIDE

By Gavin Graham, Contributing Editor

The result of the U.K. general election on Dec. 12 was a massive win for incumbent prime minister Boris Johnson and the Conservative party.

Campaigning on the slogan of "Get Brexit done", Mr. Johnson smashed the so-called Red Wall of traditional Labour-voting seats in the Midlands and the North, winning an 80-seat majority with 364 seats in the 650 seat U.K. parliament.

The Conservatives won a 7% swing from Labour, condemning the opposition party to its worst result in over 80 years, with only 203 seats. Constituencies which had not voted Conservative since World War II, or in some cases since the 1920s and 1930s, went Tory with swings of 10-15%, as seats which had voted Leave in the 2016 referendum chose the party that promised to deliver on that result.

As I noted when discussing the U.K. political scene a couple of months ago, Mr. Johnson was forced to call an election as he lacked a majority in parliament to pass the withdrawal agreement he had negotiated with the EU in October.

In a major miscalculation, the Remain-supporting Liberal Democrats and Scottish Nationalists (SNP) agreed to allow parliament to be dissolved without a two-thirds majority, as required by the Fixed Term Parliament Act. They calculated they would benefit from Labour's unpopularity under its hard-left leader, Jeremy Corbyn. He had refused to take a clear position on Brexit to avoid alienating either Labour's traditional working-class seats in the North and Midlands, which voted to leave in the 2016 referendum, or the London and major city based Remain supporters who dominate the party.

The SNP certainly benefited from the election, taking 48 of the 59 seats in Scotland, up 13 from 2017 as Labour's vote collapsed there too. The Liberal Democrats were unable to attract enough Remain supporters from Labour, ending up with only 12 seats, one fewer than in 2017. Their leader, Jo Swinson, was defeated when she lost her Scottish seat to the SNP. Interestingly, the Conservatives, who have been almost non-existent in Scotland since the 1980s, are now the second largest party there with seven seats and 20% of the vote, more than Labour.

After three and a half years of uncertainty since the referendum in June 2016, the U.K. now has a Conservative government with the biggest majority since the days of Margaret Thatcher in the 1980s. Boris Johnson has a clear mandate to exit the EU on Jan. 31, as promised.

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Boris wins – continued from page 1…

Mr. Johnson has pledged to negotiate a new trade agreement with the EU by the end of 2020, while ensuring that the U.K. is no longer a member of the EU customs union or single market. The withdrawal agreement envisaged a customs border running down the Irish Sea to ensure that there was no physical border between Northern Ireland and the Irish Republic. With the size of this majority, Mr. Johnson can ignore protests from his former allies in the Democratic Unionist Party, who supported Theresa May's minority government from 2017-19.

Now the same commentators who claimed Mr. Johnson could never re-negotiate Theresa May's flawed withdrawal agreement to escape EU regulations are saying that it will be impossible to work out a complicated trade deal within eleven months. They point to the seven years it took Canada to agree a deal with the EU, but they forget that Mr. Johnson has shown, both with the withdrawal agreement and now with his smashing election victory, an ability to be flexible enough to obtain his objectives by surrendering a few minor issues. Investors should not bet against him getting a reasonable deal by the end of next year.

So what does this mean for your investments? In October I recommended buying the iShares MSCI United Kingdon ETF (NYSE: EWU) at US$32.14. I described it as a defensive way to play developments in the U.K., given that 70% of the revenues and earnings are derived from outside the U.K. through exports and overseas subsidiaries. Plus, the U.K. market is reasonably priced. It hasn't risen in the three years since the Brexit vote and yields almost 5%.

With the Conservative victory, the market took off. The pound rose over 2% against both U.S. dollar and the euro on the news and on Friday the mid-cap FTSE 250 shot up 5% to a record high. The EWU ETF rose 3% to $34.10, the smaller rise being due to its overseas exposure. It's up about 6% since being recommended two months ago and remains a Buy as pent-up money flows into the U.K.

Contributing editor Gavin Graham has enjoyed a long and successful career in money management and is a specialist in international securities. He held senior positions in financial organizations in London, Hong Kong, and Toronto. He is a Trustee of the Royal Medical Foundation Investment Committee. He divides his time between Toronto and the U.K.

STOCKS UP – THANK THE FED

By Gordon Pape, Editor and Publisher

With two weeks to go in the year, it looks like the major North American stock indexes are headed for their best showing since 2013. As of the close on Friday, the S&P 500 was ahead 26.4% for the year, after having hit a new record closing that day. The Dow Jones Industrial Average had gained 20.6% to that point, while Nasdaq was up 31.6%. Here at home, the S&P/TSX Composite wasn't quite as robust but the gain of 18.7% was certainly respectable.

These are remarkable results for a year that did not look promising at the outset. Stocks had taken a big tumble in December 2018, a month that usually sees equities rise in what's come to be known as the Santa Claus Rally. The unexpected plunge shook investors and raised all kinds of question marks about what lay ahead in 2019.

The turnaround was triggered in large part by a change in direction at the U.S. Federal Reserve Board. The Fed has already raised its rates three times in 2018, but it was the fourth hike of a quarter-point Dec. 19, and an indication of at least two more to come in 2019, that prompted the market meltdown.

President Donald Trump was furious at the move, lambasting the theoretically independent Open Market Committee for its actions and demanding a roll-back. He got it. In January the Fed abruptly changed direction and put rates on hold, effectively admitting it had been wrong about the direction of the U.S. economy. That pause lasted a few months. Then in late July the Fed announced the first of three quarter-point cuts, almost reversing the increases of 2018.

The Washington Post called it a "year of humility" for the central bank.

It appears we're now in for a prolonged pause, which could last through all of 2020. In its December statement, and comments from Chairman Jerome Powell, the Fed indicated it is not inclined to take any further action unless something unusual occurs.

"The Committee judges that the current stance of monetary policy is appropriate to support sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2% objective," the statement said.

Of course, Fed policy isn't the only thing that drives stock markets. But in 2019, it played a critical role in reversing a downward trend and pushing U.S. markets to big gains. So, what about 2020? Historically, in the years after the Fed has lowered rates and then paused, stock markets have done well. We're about to find out if that still holds true.

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AS THE YEAR TURNS

Contributing editor Shawn Allen joins us this week with a look back at 2019 and how his picks have fared. Shawn has been providing stock picks on his website at www.investorsfriend.com since the beginning of the year 2000 and has a great success record. He is based in Edmonton.

As 2019 winds down, it's time to reflect on the year that was. Among the stocks I cover for IWB, some have performed well in 2019 to date and some have not.

The top performers were the following. (All figures are as of the time of writing).

WSP Global, up 48%
Costco, up 45%
Alimentation Couche-Tard, up 28%
American Express, up 27%
Canadian Western Bank, up 23%

The biggest laggards were:

Ceapro, down 22%
FedEx, down 1%
Canadian Tire, unchanged
Linamar, up 2%
Melcor Developments, up 7%

Back in January I wrote that: "For the S&P 500 in 2019, analysts project earnings growth of 8% on an operating basis and 10% on a GAAP basis. In my judgement, that is somewhat optimistic. Given that view and given that the p/e ratio started the year at the relatively neutral level of 18, my overall outlook for the S&P 500 is about neutral."

As it turns out, the S&P 500 Index is up a hefty 25%. But, trailing year earnings are up only 2%. Therefore, the vast majority of the rise in the S&P 500 this year has been due to investors bidding up the price of stocks in relation to earnings. The p/e ratio rose from 19.2 to 23.6.

Looking ahead to 2020, I note that the forecast is for the S&P 500 earnings to rise by 11%. In isolation, that would support a similar 11% rise in the market. However, the p/e ratio is at about 23, which is around the top end of its normal range. Overall, I would expect the S&P 500 to increase only modestly at best in 2020.

I also wrote in January that: "For the remainder of 2019, my top pick is Canadian Western Bank. Despite its gains in January, it is still trading at a very low valuation. The market should recognize its earnings stability and its increased geographic diversification." As it turned out, CWB is up 9% since then and 26% overall in 2019 to date.

My final prediction was: "I also expect Alberta to end this year on a more optimistic note as there should be some progress on the pipelines front." That turned out to be wishful thinking. However, since Alberta is now in a very pessimistic mood, I will double down and make the same prediction of increased optimism again for 2020.

SHAWN ALLEN'S UPDATES

Canadian National Railway (TSX: CNR, NYSE: CNI)

Originally recommended by Tom Slee on May 6/02 (#2218) at C$12.98, US$8.31 (split adjusted). Closed Friday at C$118.72, US$90.01.

Background: Canadian National Railway Company was created on June 6, 1919 and is now celebrating its 100th anniversary. Today, CN rail operates across Canada and down through the central U.S. to the Gulf of Mexico with 20,000 route miles of track. About two-thirds of CN's revenues and profits are from Canada and the rest from the U.S.

Performance: CN is currently up 17.4% in 2019 to date. Over the longer term, CN has seen excellent and relatively steady gains.

Recent earnings and volume growth: Revenue per share growth in the third quarter was 6%, which is a decline from the prior double-digit levels. Adjusted earnings per share growth was 11% in the latest quarter which was also a decline from recent higher levels. Revenue tonne miles in the most recent quarter were down 1% while they had risen about 2.5% in the first and second quarters.

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Shawn Allen's updates – continued from page 3…

Rail traffic statistics show that Canadian rail car loadings, which had been running noticeably above the 2018 levels in the first half of the year, declined to about the 2018 level in the third quarter and then declined below the 2018 level since the end of September (and with a sharper drop in the recent two weeks due to the strike at CN).

Recent events: CN experienced an eight-day strike in November. This, along with slowing traffic, is expected to result in fourth quarter earnings about 20% lower than the 2018 level. In December, it announced it will take some traffic from CP rail due to a $125 million investment it is making to serve Teck Resources.

Valuation: Analyzed at C$118.86 or US$90.13. CN's return on equity (ROE) is extremely strong at 24% and it has been steady at about that impressive level for the past eight years. The price to book value ratio at 4.6 is high but reflects the attractive return on equity level. The p/e is moderately high at 19.6. The dividend yield is modest at 1.8% and reflects a conservative payout ratio of 35% of earnings.

Dividend: CN's latest annual dividend increase, effective with the March distribution, is a hefty 18%, to $0.5375 cents per quarter ($2.15 per year) for a yield at the current price of 1.8%.

Conclusion: CN is a very high quality and predictable company. However, it is facing lower earnings in the current quarter and its traffic has slowed.

Action now: Continue to Hold. Any material dip in the share price would be a buying opportunity.

Melcor Developments Ltd. (TSX: MRD, OTC: MODVF)

Originally recommended on Sept. 30/13 (#21335) at C$19.33. Closed Friday at C$13.11, US$9.96).

Background: Melcor has three lines of real estate business. First, it is a land developer. It buys raw land, which it holds for some years and eventually develops, mostly into residential home building lots although some is developed into local retail shopping areas. Second, the company also develops retail, office, and industrial buildings. Third, it then rents these developed buildings to tenants, mostly via its 53% owned REIT, which also trades separately.

The great majority of its assets are in Alberta, but 13% are in the U.S. (Phoenix and Denver), where it owns seven office buildings and has recently begun developing and selling residential home building lots.

Performance: Melcor's share price has been relatively flat after it declined sharply with oil prices in 2014 and 2015. The share price was down 20% in 2018 to $12.29. It is up 6.7% in 2019 to date.

Recent earnings: Earnings tend to be very cyclical and lumpy by nature. This is due to changes in demand for its single-family home building lots but also to somewhat irregular sales of commercial land and buildings. Therefore, year-over-year changes in earnings are not that meaningful. Having noted that, adjusted earnings per share rose 13% in 2018 but are down 29% in 2019 to date.

In 2018, residential lot sales in Canada were down 18% and the average price was down 5%, while the total lot sales including the U.S. operations were up 10%. Residential lot sales for Canada in 2019 are down 53% while the price per lot was up 3%.

Valuation: Analyzed at its recent price of $13.11. The dividend is attractive at 3.7% and represents a payout ratio of only 31% of adjusted trailing earnings. The interim adjusted p/e is ostensibly quite attractive at 8.5 but is less relevant due to the cyclic nature of earnings. The ROE is poor at 4.9% and has been at similar levels for the past four years. The book value per share is $32.06, which leads to a very attractive price to book value ratio of 0.41. In effect, this indicates that each $1 of equity value on the books is selling for just $0.41.

Outlook: It is clear that Melcor's residential lot sales in Canada will be down sharply in the fourth quarter. Partially offsetting this there may be strong lot sales in the U.S. The rental income portion of the business continues to be stable despite some lower rents and possible higher vacancies but offset by additional developed space. Earnings will likely increase at least moderately in 2020 compared to the weak results this year.

Conclusion: Melcor appears quite attractive in terms of the opportunity to buy a company with very solid real assets and proven management at a price of just $0.41 on the dollar of its book value per share. However, due to its low ROE and cyclic nature it cannot be considered to be a high-quality company.

Action now: Continue to Hold. Be aware that this is a very thinly traded stock. It's best suited for investors willing to hold for the long term.

BHP Billiton plc (NYSE: BBL).

Originally recommended on Feb. 6/18 (#21809) at $42.75. Closed Friday at $46.59. (All prices in U.S. dollars.)

Background: BHP Billiton is a huge Australia-headquartered global mining and petroleum exploration

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and extraction company. In Australia, it has six mining operations and three offshore petroleum operations. In the Americas, it has six mining operations, and two offshore petroleum operations. In addition, it has an onshore petroleum operation in northern Africa.

The company has about 72,000 employees and contractors. Iron ore is its main product, accounting for almost half of its operating earnings in fiscal 2019, with the remainder relatively evenly split between copper, coal, and petroleum. Sales into China represented 55% of revenue in fiscal 2019 and Asia in total represented 82% of revenue.

Performance: This stock has historically been volatile due to commodity prices and production levels. It's currently up 8% in 2019 to date. But it is roughly unchanged since the start of 2018. And the price remains well below peaks reached in 2007 and 2011.

Recent developments: A $10.8 billion sale of on-shore U.S. petroleum assets closed near the end of October 2018. Proceeds were used for a special dividend and a large buy-back of shares.

Dividend: This company pays a dividend twice yearly. The trailing year annual amount was $2.66 per share for a yield of 5.7%. But note that, unlike almost all North American companies, BHP tends to adjust its dividend down or up with earnings.

Valuation: My analysis is based on $45.13 per share for the American Depository Receipts trading as BBL. The price to book value ratio does not seem unreasonably high at 2.5 considering that much of the assets may have been developed many years ago at lower costs and there is negligible purchased goodwill on the books. The dividend yield is attractive at 5.7% but is less reliable given that the company adjusts its dividend up and down with earnings. The p/e ratio is attractive at 12.9. The return on equity is very good at 18% for fiscal 2019. Given the commodity nature of this company, its earnings are inherently volatile and unpredictable. Therefore, the value ratios can change unusually quickly.

Outlook: Earnings in the short term are unpredictable given the heavy dependence on commodity prices.

Action now: Continue to Hold. This stock is a best suited to investors seeking exposure to a diversified global non-precious-metals mining company. Investors should expect the stock performance to depend on world economic growth and on commodity prices.

Aecon Group (TSX: ARE, OTC: AEGXF)

Originally recommended by Tom Slee on Feb. 3/14 (#21405) at C$15.48, US$13.79. Closed Friday at C$17.26, US$13.18.

Background: Aecon Group Inc. is a major Canadian construction company that builds, repairs, and upgrades large infrastructure and industrial projects and in some cases finances and operates infrastructure. Infrastructure projects include roads and bridges, pipelines, transit light rail, hydroelectric projects, tunnels, airports, and much more. Industrial projects include oil sands operations, LNG plants, plant maintenance turnarounds, nuclear reactor repairs and upgrades, electricity transmission and distribution lines, water and sewer line construction, and more.

Performance: The stock has mostly oscillated between about $17 and $19 for the past year and is currently at the lower end of that range. SNC Lavalin exited the market for fixed-price construction services and this should benefit Aecon. The stock very briefly rose above $21 on that news in July but then quickly fell back.

Recent earnings: Earnings per share are up sharply in 2019 to date. However, looking back ten years the earnings have been volatile with no sustained upward trend.

Dividend: The board of directors approved a 16% increase in the quarterly dividend for 2019, raising it to $0.145 per share ($0.58 per year). They have been raising the dividend fairly regularly since 2007 but there was no increase in 2017 or 2018. The stock yields 3.4% at the current price.

Valuation: Analyzed at its recent price of $17.16. The dividend is reasonably attractive at 3.4% and represents a sustainable payout ratio of 47% of trailing earnings. The p/e ratio is reasonably attractive at 13.9. The price to book value is modest at 1.3. The ROE is reasonably good at 9.8% which is a sharp improvement from the low to mid-single digit levels of 2014 through 2017.

Conclusion: Aecon's earnings have increased sharply in 2019 and should increase moderately in 2020. Government infrastructure projects and the withdrawal of SNC Lavalin from this market are factors in its favor. It remains a cyclic company and faces cost overrun risks.

Action now: Continue to hold.

- End Shawn Allen

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GAVIN GRAHAM'S UPDATES

Honda Motor Company (NYSE: HMC)

Originally recommended on May 5/13 (#21318) at $40.24. Closed Friday at $29.22. (All figures in U.S. dollars.)

Background: Honda is Japan's third largest automaker and one of the ten largest automakers in the world, as well as the largest motorbike manufacturer globally. It sold 5.3 million autos and 20.2 million motorbikes in the year ended March 31. It also makes power tools, ATVs, and has recently expanded into business jets.

Performance: The stock is up 8% from the last review a year ago, but still down by a quarter from its original recommendation. In part this was due to the lengthy changeover to new models in 2015-17, as well as the strength of the yen eroding the earnings of its overseas operations.

Recent developments: Consolidated sales revenue fell 1.8% to ¥7.7 trillion in the six months to Sept. 30 on lower sales volumes, especially in the U.S. and China. Consolidated operating profit was down 8% to ¥472 billion ($4.3 billion), and Honda lowered its guidance for the fiscal year ending March 31, 2020 by ¥80 billion to ¥690 billion ($6.3 billion) primarily due to the stronger yen.

Honda announced earlier this year it was closing down its only European plant in the U.K., principally because of its small scale, with an output of only 175,000 vehicles this year. It also announced this month that it would phase out diesel vehicles in Europe by 2021 and all its models for sale in the continent would be electric or hybrid by 2022, as it launched the new all electric Jazz model.

Dividend: Honda pays four quarterly dividends of ¥28 ($0.21) a share, which gives it a yield of 2.9%.

Action now: Honda has been a disappointing performer, though others such as Ford have done worse. It was recommended for its exposure to emerging markets through its motorbike side and recently its strong move towards electrification. With slowing global growth and rising tariffs, it's time to sell. With dividends, the total return is breakeven.

Toronto-Dominion Bank (TSX, NYSE: TD)

Originally recommended by Tom Slee on Feb. 11/07 (#2706) at C$34.98, US$29.80. Closed Friday at C$74.31, US$56.33.

Background: TD is Canada's second largest bank by market share (21%) and market capitalization and is the sixth largest bank in North America. It has over 1,100 branches in Canada and is ranked first or second in most retail financial products. It has 1,250 branches (which it calls stores) in the U.S., and leading positions in four of the top ten metropolitan areas on the east coast.

Performance: The stock hit a 52-week high of $77.96 in November but has retreated from that level for reasons discussed below.

Recent developments: As I described in the most recent update on TD, its 43% owned U.S. discount brokerage TD Ameritrade (NDQ: AMTD) followed the lead of rival Charles Schwab (NTSE: SCHW) by removing trading commissions on equities, ETFs, and options last month. This was estimated to cost it around 15-16% of its revenues (about $275 million), with a corresponding negative effect on TD itself. As a result, I moved the recommendation to Hold until the aftereffects were clear. I noted that retiring TD Ameritrade CEO Tim Hockey had stated that the company was ready to consider any capital transaction that made sense, whether an acquisition or merger.

This month, such a deal materialized as Schwab agreed to take over TD Ameritrade in a deal worth $26 billion. TD is swapping its 43% stake for a 13.4% stake in the enlarged Schwab, which will be by far the largest discount brokerage, with $5 trillion in assets and 24 million client accounts.

While the two companies have approximately 12 million customers each, Schwab's clients have much larger accounts, with $3.8 trillion in assets against TD Ameritrade's $1.3 trillion. TD CEO Bharat Masrani said: "We believe TD will benefit from having an ownership stake in a more diversified firm with a stronger growth profile." He went on to note that TD had done very well through its ownership of discount brokerages, "doing things which were sometimes unusual in nature but turned out to be terrific for the bank."

TD has reached what has been described as an elegant solution to the fees it receives on the $103 billion in cash in TD Ameritrade's customer accounts, on which it earns 0.25% per year, generating $275 million in revenue up to 2023. This is being replaced by a new deal starting in July 2021, which will see TD earning a lower 0.15%, while Schwab can reduce the balance by $10 billion a year until it reaches a floor of $50 billion. The deal runs for 10 years until 20131.

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Gavin Graham's updates – continued from page 6…

While this will generate lower revenues for TD, it enables it to keep a substantial portion of what is a very profitable business, while relieving Schwab of the need to raise fresh capital to bring the deposits onto its own balance sheet straightaway.

The deal is expected to close next year, subject to regulatory approval, and cost $1.6 billion in integration costs. The process could take up to three years and Schwab estimates it could reap as much as $4 billion in financial benefits, mostly through cost reductions as it eliminates some of the 28,000 head count of the two firms.

Most analysts expect TD to sell its stake in Schwab, which it can do from 2021. Schwab's share price has risen 30% from $35 just after it announced the removal of commissions to $49.50 the week after the deal was announced, making TD's stake worth around $8 billion.

In the same way as it used the $1.1 billion raised from listing TD Waterhouse in 1999 to fund the takeover of Canada Trust in 2000, it would not be surprising to see TD use the proceeds of any sale to make another strategic acquisition.

TD stock fell from $77 to $73 after the removal of commissions in October but is up slightly from that level. It becomes a Buy again, as it has found a satisfactory solution to the changing landscape of the U.S. brokerage industry.

Action now: Buy.

YOUR QUESTIONS

TFSA rules

Q – What are the TFSA rules when young Canadians are out of country in the U.K.? - Cynthia M.

A – Non-residents of Canada may not open a TFSA, but they can keep one that's already open. No new contributions are allowed while they are abroad and contribution room does not accumulate. They can make withdrawals, but they can't replace those funds while still abroad. Also, there may be tax liabilities for withdrawals, depending on the country in which they reside. – G.P.

TFSA tax trap

Q – I am new to investing. Until recently, I only invested in mutual funds. Now that I am retired I have decided to do some direct investing through my TSFA. At the moment, my TSFA is invested in Canadian mutual funds.

I would like to expand my TSFA investments into U.S. income securities. Are there any tax implications from investing in U.S. securities within my TSFA? – Roger R.

A – Yes. Any dividends from a U.S. company will be subject to a 15% withholding tax. This is because the U.S. does not recognize TFSAs as "retirement accounts". Dividends paid to RRSPs and RRIFs are not subject to this tax.

This is especially frustrating because there is no way to recover that money. Since it is paid into a registered plan, you cannot use the foreign tax credit when you file your tax return. That money is simply gone. So, in this case, Tax-Free Savings Accounts are not really tax-free.

When Canada and the U.S. get around to renegotiating the tax treaty, this might change. But for the foreseeable future, it's the rule. You'd be better off earning your dividend income from Canadian companies. – G.P.

PRICE NOTICE

This is a final reminder that the price of a one-year membership in the Internet Wealth Builder will increase by $10 (plus tax) on Jan. 1. The new rate will be $219.95 plus tax. Quarterly and monthly rates will be adjusted accordingly.

You can beat the increased by renewing before year-end, no matter when your membership expires. Call 1-888-287-8229 or go to www.buildingwealth.ca/subscibe.

That's all for this issue and for 2019. The IWB is going on hiatus for a few weeks (we publish 44 times a year) to allow our staff to enjoy the holiday season. We will see you again in the New Year on January 6. Happy holidays to all our readers and thank you for your support.

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