The Stan Clark Financial Team's

PERSPECTIVES

An excerpt from "Perspectives" - Volume 4 – Issue 12

Asset allocation

Asset allocation: Your most important investment decision

By Elaine Loo - Associate Investment Advisor

Your first, and probably most important, decision about investing is how to divide your money into different types of assets. This is called asset allocation. Here, and in the next several articles, we will discuss asset allocation: What it is, the various types, and how they differ. And finally, how do you decide what the best asset allocation is for you?

There are many ways of classifying assets, so it can be confusing. For example, mutual funds can be broken down into hundreds of different groupings. So, it's easy to lose sight of what's important. Some typical mutual fund groupings might be "Canadian-balanced," or "U.S. small-cap growth."

But the most basic division is by asset class. Almost everything can be broken down into one of two types: equities or fixed income. And if it's not one of these, it is usually a blend of the two. These two asset classes are often called stocks and bonds, which are the most common types of each.

Equities and fixed income are so different from each other that the balance between them dramatically affects the risk and return of your portfolio. Because the balance is so important, you need to focus on it first. But to do that, it helps to know what they are and how they are different.

Equities represent ownership in a business. When people think about equity, the first thing that usually comes to mind is the equity they have in their home. Equity in your home is the value of your home, less whatever mortgage you might owe on it. When you own shares in a company, the concept is the same. The value of a stock is the value of a business, less any debt the business might have. Owners of shares also own the profits of the business.

With fixed income, rather than being an owner, you are a lender. Usually with fixed income, the investor is paid a fixed rate of interest. The income and principal can be guaranteed by government, or an obligation of a company. Fixed income can also vary by the term – meaning how long it is before they have to return your money. Fixed-income investments include things such as T-bills, bonds and term deposits.

In the next article, we'll talk more about asset allocation. We'll look at how these two basic types of assets differ in risk and return and why it's so important to get the mix right.

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PERSPECTIVES

An excerpt from "Perspectives" - Volume 5 – Issue 1

Asset allocation

Asset allocation: Risks and returns of equities vs. fixed income

By Jocelyn Johansson - Associate Investment Advisor

Previously, we introduced the concept of *asset allocation* – how you divide your money between the different types of assets. We also introduced the two main types of assets: *equities* and *fixed income*.

In this article, we'll discuss the risks and returns of equities versus fixed income.

Equities represent ownership in businesses. Their main source of returns is the profits or earnings that those businesses make. But, for any company, future profits are always uncertain. That's because every company faces competition. It's a dog-eat-dog world – and usually it's hard to know who will be the diner and who will be the dinner! However, if you look at all the companies *together*, the total profits are much more stable. One company's decline tends to be another company's gain. So, in total, the earnings of the entire economy are much more stable and reliable than those of any individual company.

Still, aggregate earnings do fluctuate. One of the main causes of this is the business cycle: the ebb and flow of the economy as it expands and contracts. The normal course of the economy is expansion. Contractions usually last six to nine months, and occur two to three times in a decade. That means that, 80 percent of the time, the economy is expanding.

Company profits tend to fall when the economy contracts. But they typically recover quickly. This is because companies adjust to contractions, and restore profits by cutting costs. Over longer periods, profits can rise at a different pace than the economy, depending on how the economic pie is split between wages, profits and taxes. Improvements in productivity are a key to increasing profits faster than the economy.

Stocks trade at prices that are a multiple of expected earnings, commonly known as the *price-to-earnings ratio*. Over the past 100 years, this multiple has averaged around 15 times earnings. But the multiple varies over time. During optimistic times, stocks trade at a higher multiple. During pessimistic times, stocks trade at a lower multiple. Add human psychology to the mix, and you will get huge swings in stock prices from one year to the next. But, over the long term – five to 10 years or longer – the swings mostly cancel each other out. This levelling leaves equity investors with returns that are linked to the overall profits the companies have made.

With fixed income investments, the returns you get are usually set when you invest. For government bonds, the returns tend to be just slightly above the expected inflation. The risk is that the actual inflation may be higher than expected, maybe even higher than the entire return of the bond. In this case, you would lose purchasing power. For fixed income investments that are *not* government-guaranteed, the return is usually higher – allowing for the risk that the principal and interest might not be paid.

In our next issue, we'll discuss the actual historical returns for both equities and fixed income over the past 100 years.

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An excerpt from "Perspectives" - Volume 5 - Issue 3

Asset Allocation

Asset allocation: Stocks vs. bonds over the past 100 years

By Sylvia Ellis - Senior Estate Planning Advisor

In Aesop's fable of the tortoise and the hare, slow and steady wins the race. But is that really how it works in life? When it comes to investing, slow and steady can be a recipe for near-certain losses.

Think of *The Tortoise and the Hare* as a story about asset allocation – of fixed income investments, which appreciate slowly and appear reliable; and of stocks, which can appreciate strongly and quickly, but appear risky. Which is your best bet? The answer depends on what kind of race you're running.

The past 100 years have been wildly volatile: inflation, deflation, a deep depression, explosive growth, two World Wars, embargoes, assassinations and pandemics. We often forget how frightening things seemed at the time. Although the world may seem scary now, it's likely that the period ahead won't be all that different from at least some of the periods we've experienced in the past. History repeats itself; you just don't know which part of the past you're going to get! But, by studying history, you can get a good feel of the range of possible outcomes going forward.

Data from the University of Chicago show that, over the past 100 years, if you owned equal amounts of every U.S. stock excluding the smallest 20 percent, you would have enjoyed average annual growth of 11.3 percent, for an inflation-adjusted (real) return of 8.1 percent. Over the same period, fixed-income investments averaged 4.4 percent, or real returns of just 1.2 percent per year. So, the real returns from equities were nearly seven times higher than those of bonds. If you started with $100,000 in bonds, this would have grown by about $29,000 after 20 years using real returns. That same amount invested in stocks would have grown by $410,000 – 14 times as much!

Aren't stocks much riskier than bonds? Yes and no. The stock market is volatile in the short term, making stocks seem risky. But, if you invest for the longer term – more than 10 years – history shows that down markets have almost always been more than offset by up markets, giving reliable returns for stocks after inflation.

Inflation actually makes bonds riskier than stocks over the long term. The return during the worst 10-year period for bonds was 10 percent lower than that for the worst 10-year period for stocks. The chance of losing money over any 10-year period was seven times greater for bonds than it was for stocks. Over any 10-year period, stocks did better than bonds 89 percent of the time. And, over 20-year periods, stocks beat bonds every time – and never failed to beat inflation. So, based on history, it seems that the longer your investment horizon, the less risky stocks are, and the riskier bonds become.

The key take-away here is that one type of asset isn't always better than the other. How long you can invest for is critical in determining the right mix for you. If you only have a few years to invest, then your money should be mostly in fixed income. If you have savings earmarked for needs five to 10 years or more from now, consider investing some of it in stocks.

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Asset allocation

Asset allocation: The best asset mix for your needs

By Heather Guzak - Associate Investment Advisor

We've been discussing *asset allocation* for a while now. To review, asset allocation is the mix between equities and fixed income. We've learned that the risks of each asset class depend on the length of time you can invest for.

So, how do we determine the best mix for your needs?

Those are five critical words right there: *best mix* and *for your needs*. Everyone's different and everyone has different needs. In particular, we need to consider: a) how much you need; and, b) when you need it.

We've analyzed the risks, returns and effects of inflation over the past 100-plus years to figure out the best mix for every time period. As we've said before, money that you need in the short-term should mostly be in fixed income. And money that you don't need for a long time can go mostly into equities. But life is more complex than just now versus a long time from now. What about those times in-between?

The fact is, people have needs at all stages of their lives. The challenge, however, is: How do you adjust for that? The Stan Clark Financial Team has developed our own software to calculate your overall best mix.

Here's how it works. First, we do some planning to figure out how much money you'll likely need from your portfolio each year for the rest of your life.

Our program then creates a hypothetical portfolio for each need. Each "portfolio" will have its own asset mix, based on how long it is until the money is needed. Now we know how much money to put aside today to pay for each need – and how much of each should be allocated to equities. We then add all these hypothetical portfolios together to calculate an *overall asset mix*. The resulting overall mix is optimal for you, based on your own specific needs.

For example, let's say you are planning to retire in three years. You expect to need $50,000 from your portfolio in that first year of retirement. If you were to carve off a separate portfolio to fund that need, how would you invest that portfolio? Three years isn't very far away, so we wouldn't want to put much of it into equities. For a conservative investor, our program would suggest putting only 14 percent of it into stocks.

Let's say you need a bit more the next year: $51,500. This would be four years away – so you could put a bit more into equities for the portfolio to provide for this need. Our program would suggest 21 percent in equities.

Our program does this for every year for the rest of your life. It then adds up all the money you'd need to set aside, and all the amounts that should be invested in equities to meet your needs. The result is an overall best mix for your total portfolio. In this example, it might come out to 64 percent in equities. We call this the *needs-based equity target*, because it determines the best mix equity target, based on your needs.

This is the mix that makes the most sense, based on objectively looking at history and your needs. But we also need to consider how comfortable you are with the risk of holding that percentage in equities. In the next issue, we'll talk about how we find your comfort level with risk.

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The Stan Clark Financial Team's

PERSPECTIVES

An excerpt from "Perspectives" - Volume 5 - Issue 5

Asset allocation

Asset Allocation: Finding your comfort level when stocks fluctuate

By Sylvia Ellis - Senior Estate Planning Advisor

We've been discussing the topic of asset allocation – the mix between equities and fixed income – for some months. We've learned that the risks of each asset class change according to the length of time you invest. Last month, we examined the unique way that the Stan Clark Financial Team looks at the timing of your needs to figure out the best mix for you.

In this issue, we'll talk about how we consider your comfort level with stock market fluctuations in order to find the right mix for you.

We know that markets will always be volatile. Understanding your comfort level with fluctuations will help ensure you have a mix that allows you to weather the downtimes. We also take care to avoid setting a mix that will cause you to worry.

To assess your comfort level with fluctuations, we take you through a series of questions. Although your personal comfort level is subjective, we try to make it objective by using a clear process. All of your answers are scored. We use an average of those responses to determine your overall tolerance to volatility.

The questions are divided into six parts:

The first three parts are simple rules-of-thumb. Although everyone is different, we can categorize them into general groups. For example, people in their 30s would typically have a higher allocation to equities than people in their 70s. Another example: People more interested in high long-term returns would have a higher equity mix. People who prefer to avoid short-term price swings would typically want less in equities.

The next three parts look more in-depth at the three dimensions of volatility tolerance: 1) *risk behaviour*, 2) *your attitude towards volatility*, and 3) *your financial capacity to withstand fluctuation.*

1. The first of these sections, risk behaviour, consists of a series of questions about different areas of your life. For example, do you like to take chances? Have you ever borrowed to invest? People who like to take chances will usually be more comfortable with the fluctuations associated with equities.

2. The next section evaluates your attitude towards fluctuations in your portfolio – and the trade-off between risk and return. For instance, are you willing to accept higher than minimum risk for slightly higher returns? Or, do you prefer your portfolio to be very safe, not risking any principal in the short-term, even though this may result in low long-term returns? People with an accepting attitude toward volatility with equities can have more of their portfolio invested as such.

3. The last section examines your financial ability to withstand fluctuations in your investment portfolio. For example, would you have enough income to cover an unanticipated expense, or would you need to dip into your long-term investments? People who have a greater financial capacity to withstand fluctuations tend to have more in equities.

Each of these six sections provides us with a different estimate of the percentage of equities you could best tolerate. We then average all of these to come up with an overall volatility tolerance number.

The next step is to compare this to the best mix determined by your financial needs – as we discussed last month – to come up with an overall Equity Target. We'll talk about this in our next issue.

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An excerpt from "Perspectives" - Volume 5 - Issue 6

Asset allocation

Asset Allocation: Your best mix – putting it all together

By Sylvia Ellis - Senior Estate Planning Advisor

Asset allocation is the mix between equities and fixed income. We've been devoting a lot of time to this subject, because it's probably the most important decision when it comes to investing. Equities and fixed income are fundamentally different from each other. And the mix between the two will have a significant effect on the risk and return of your portfolio.

Previously, we've pointed out that returns from stocks are much higher than from bonds. The risks of each are also very different, and they may not be what they seem. We've learned that the risks of each asset class depend on how long you can invest for. In the short term, bonds are safer and stocks are riskier. But in the long term, the opposite is true. Stocks are safer and bonds are riskier. So, what's the right mix for you?

During this series on asset allocation, we've discussed two distinct approaches to figuring out that right mix. The first method, which we called *needs-based*, is numbers-oriented. It essentially compartmentalizes each of your future needs, such as retirement, education expenses, vacations, etc. And then, based on when those needs occur, we determine your best mix to meet them. Remember: Needs that occur further down the road can be invested more in equities – to maximize returns. And shorter-term needs should be invested in guaranteed fixed income. This makes sure the funds are available when you need them.

The second approach we use is what we call *volatility tolerance*. This is more feelings-oriented. It bases your mix on your comfort level with price fluctuations. We look at things like general rules-of-thumb, risk behaviour, attitude towards volatility, and financial capacity.

Each of the two methods produces a suggested asset mix. Then we combine these two mixes to come up with your *best overall mix*. But first – it's important to know what each number means.

Think of the numbers-based method as what you should do if you were completely objective. Now think of the feelings-based method as what you are able to do, given that being comfortable with your investments is important, too. You can now see that your best mix is a combination of the two: the mix you should have – but limited to what you can have.

Based on your needs, we factor in when and how much money you need. Let's say that this mix comes out to 80 percent. Again, this is purely numbers based. Before determining your best mix, we must also consider your volatility tolerance. Based on your answers, let's say your volatility tolerance comes out to 60 percent. So, your best mix is somewhere between 60 and 80 percent. In talking this over with you, we would typically suggest averaging the two numbers together – but within a limit, so we don't go too far above your volatility tolerance. In this case, your best mix might be around 70 percent.

Needs-based target: 80%

Volatility tolerance: 60%

▶ Best mix: 70%

In conclusion, the best mix for you is based on a combination of your needs and your volatility tolerance. This ensures that your investment strategy is properly customized to you. Things change over time, and your best mix can also change. That's why it's important to have regular reviews to make sure you stay on track.

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