Pearlstein's Corner

Wealth Management
Dominion Securities

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"We want the highest rate of return with the least amount of risk."

About a year ago, I was meeting with a busy professional couple in their late 50s. When I asked about their investment goals, that's what they said. And let's face it, isn't that what we all want?

But the challenge with that goal is the last word: risk.

If you've ever looked at your investment portfolio statement and panicked, you probably held too much risk.

But what exactly is risk? The simplest definition of risk I've come across is **"If you're counting on it, it's a risk."**

There are Many Types of Risk

We can divide risk into five broad areas:

Day-to-day risk includes Economic, Political and Business, while Environmental and Communication risk rounds out the list.

When you drill down, you'll realize that this covers thousands of unpredictable possibilities, far more than anyone can plan for. An event like 9/11 occurs and the market dives. The U.S. government raises interest rates and the market reacts negatively. Then positive employment numbers are followed by encouraging manufacturing figures and the market recovers. It's like watching bungee jumping!

You can't anticipate every risk event, or its effect. However, you can be certain that there will be events, both positive and negative.

I can help you build a portfolio that offers you some protection on negative events, while giving you opportunities to benefit from the positive events.

Short Term Vs. Long Term

If you're strictly following short-term events, you'll seesaw between a state of panic and euphoria. That only produces sleepless nights.

More realistically, you'll want a portfolio that is configured for a longer timeline, which varies depending on your age and investment goals.

When working with clients, I typically review several decades of past economic and investment cycles to bring a realistic perspective to wealth planning and various types of risk.

This Economic Cycle is a Few Months Away of Being the Longest in 140 Years

Right now, we are three months away from surpassing the longest business expansion in North America. No one can tell you when it will end. However, many studies have shown that when debt gets close to or above a country's Gross Domestic Product (GDP) – the goods and services it produces – growth slows even when interest rates are low. Debt is currently over two times world GDP which should send alarm signals.

Today, the U.S., China, and Japan account for half the world's debt. The first two are supposed to be the big engines of growth. Meanwhile, Europe's economy is just above stall speed and it too has a huge debt pile. The problem is global growth is slowing even after ten years of close to zero rates. All that extra debt hasn't helped. It inflated financial assets and U.S. equities, but still growth slowed to 2% per year.

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My view is the Federal Reserve and the Bank of Canada recently raised rates in order to be able to lower them again, since we are in the late innings of this economic cycle. Getting interest rates right is like trying to land a jumbo jet on an aircraft carrier in stormy seas.

If central banks are having difficulty navigating the growth of the world's economies, what's an individual investor supposed to do?

The Pearlstein Relative Fixed Equity Ratio (PRFER): an Asset Allocation Strategy That Manages Risk in Good and Bad Times

PRFER is a straightforward framework that accounts for each individual's risk tolerance. The idea is simple. I work with clients to create portfolios that have three buckets of investment types.

The first, which should account for about 30% of your portfolio's value, is a safety bucket that contains bonds, GICs and savings accounts. The principal and income are safe. However, such investments are vulnerable to future inflation.

The second, which should also hold about 30% of your portfolio, is a growth bucket that includes equities. These investments potentially generate capital gains and dividend income and also provide a partial hedge against future inflation.

Over long periods, equities have been shown to outperform fixed income investments by a wide margin. The safety of the fixed income holdings in bucket one and the growth potential of the stocks in bucket two work in tandem to fortify your overall investments against the ongoing volatility of market cycles.

The third bucket, representing approximately 40% of your portfolio, is where we can fine-tune your investment savings to reflect your risk tolerance. How you choose to allocate that portion of your savings – I call it the vary bucket – is tied directly to your age, your investment horizon and what's happening in your life.

The composition of the investments in that bucket will also reflect what's going on in the markets or the broader economy at a particular point in time. The point is that PRFER allows for flexibility when it comes to risk and return.

So, review your asset mix now before things slow down to gain peace of mind by mitigating risks and controlling the variables that can be managed. Stock markets and interest rates are always going to be cyclical because that is their nature.

It pays to better equip yourself and your family with the right allocation to avoid making panicky or impulsive short-term financial choices.

My New Podcast is up

Listen to my podcast and learn how you can benefit from the PRFER framework for your portfolio. Click on www.markpearlsteinwealthmanagement.com and then the white arrow under Listen Now.

Questions? I look forward to hearing from you. Call me at 416-733-5257 or email mark.pearlstein@rbc.com.

Do you know someone who should read this?

Some of my clients have mentioned that they've shared my newsletters with other family members, friends or colleagues. If you know someone who might benefit from this, why not pass it on?

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