Portfolio advisor

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10 Principles for Surviving Market Volatility

The financial markets have recently experienced higher volatility amid sluggish global economic growth, the ongoing European sovereign debt crisis, and the U.S. debt downgrade. While the current market volatility may not be anywhere near as severe as it was in 2008-2009 during the financial crisis, it is nonetheless unsettling coming so soon afterwards. With that in mind, here are 10 guiding principles that can help you minimize the impact of the current market volatility and stay focused on your long-term goals.

1 Have a plan for volatility

Volatility is a normal part of investing and is, in fact, always present to some degree. However, it's usually during periods of heightened volatility when the markets decline 10% or more in value – a "correction" – that investors really take notice. While it's difficult to predict exactly when higher volatility will occur, it's inevitable that it will at some point. As a result, it's important to have a plan to deal with it in advance – a plan that minimizes the impact of volatility and guides you through periods of higher volatility.

Learn more principles ⇨

Continued from cover

2 Keep your sense of perspective

As the table below shows, after every major bear market, the markets have recovered and posted positive returns. So far the current correction looks mild in historical terms – and may simply be a normal correction to the longer-term bull market we have experienced since early 2009. As the RBC Investment Strategy Committee has noted for the past several quarters, such a correction was expected to occur at some point. For the Strategy Committee's most recent market outlook, please contact us.

Bear markets since 1980 (S&P 500 Index)

Start	Decline	Duration (months)	One-year return (from end)	Two-year return (from end)
Feb. 13, 1980	17.1%	1	33.2%	40.7%
Nov. 28, 1980	27.1%	21	51.8%	50.2%
Aug. 25, 1987	33.5%	3	18.8%	37.7%
July 16, 1990	19.9%	3	29.1%	58.5%
July 17, 1998	19.3%	2	37.9%	36.7%
March 24, 2000	49.1%	31	22.2%	17.7%
Oct. 9, 2007	56.0%	17	66.6%	93.3%
July 8, 2011	16.3%	2	-	-

3 Find your risk/return balance

One way you can manage volatility is by striking the right balance between lower risk and higher return potential in your investment portfolio. Here are three factors you need to consider when deciding on the appropriate balance for you:

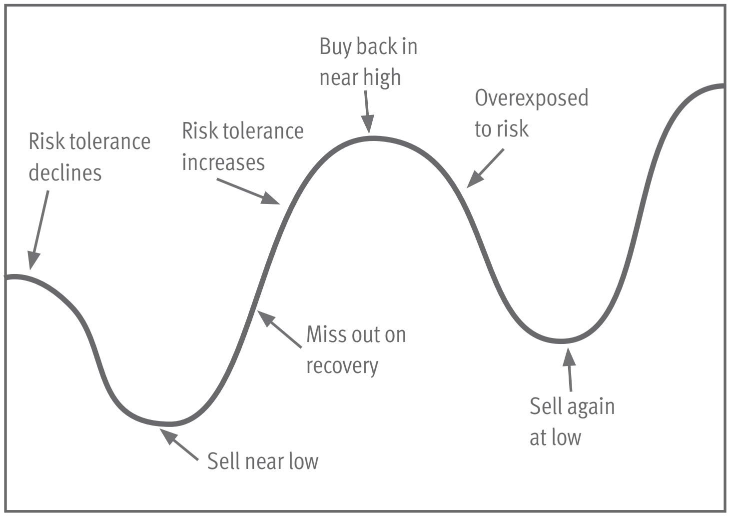
1. **Your return objectives.** Establish your return objectives based on your personal goals, such as how much retirement income you need or what assets you would like to pass along to your family. It's important to be realistic about the returns you can expect, as aiming too high usually means taking on too much risk.
2. **Your investment time horizon.** Over shorter time periods, the markets (especially the equity markets) fluctuate in value, sometimes significantly. However, over longer time periods, these fluctuations tend to smooth out. As a result, if you have less time to invest, you should take less risk by reducing your exposure to equity markets. But if you have more time, consider increasing your exposure to benefit from higher long-term growth potential.
3. **The "good night's sleep" factor.** Regardless of your investment time horizon, you still need to be comfortable with the risk you are taking. Some people simply don't like taking much risk with their investments – even if they're daredevils outside the realm of investing.

4 Stay inside your risk comfort zone

There's a natural – but counterproductive – tendency for investors to stray outside their normal risk comfort zone depending on the prevailing market conditions. During market downturns, investors tend to become more risk-averse and may reduce their exposure to the markets, hoping to limit their losses. Conversely, during market upturns, investors often move into riskier investments, not wanting to miss out on the higher returns. As a result, investors can get trapped in a vicious cycle that leads to higher risk and poorer performance, as shown in the chart below. A better approach, as discussed in Principle #3, is to decide on your risk tolerance in advance based on your return objectives, investment time horizon and personal comfort with risk – and stick with it.

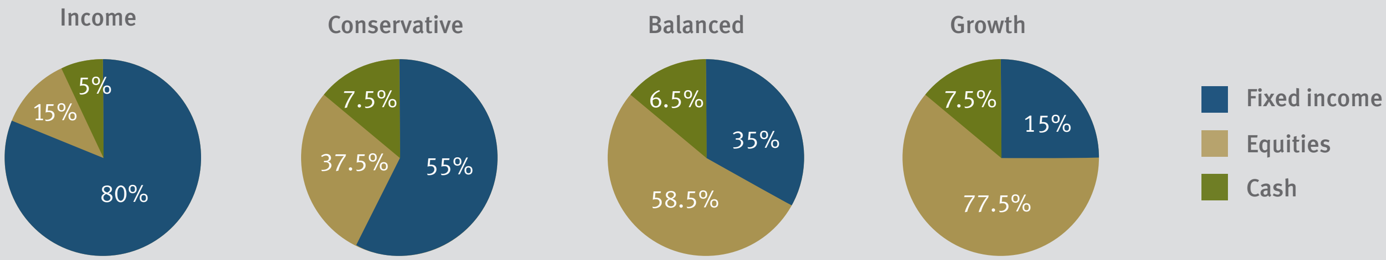
A vicious cycle

Letting your risk tolerance fluctuate with the markets can reinforce a cycle of buying high and selling low.



RBC recommended asset allocation

Currently, we are recommending higher-than-usual allocations to cash, reflecting the current economic uncertainty, and lower-than-usual allocations to fixed income, reflecting a negative fixed-income outlook.



5 Remember the golden rule of investing

Long considered the "golden rule" of investing, diversification remains the best way you can reduce investment risk. As you may know, diversification in simple terms involves investing in a number of different investments – across different asset classes, industry sectors, geographic areas, investment styles, etc. This way, you can minimize the impact of poor performance, both from a single investment and groups of investments with similar characteristics.

Diversifying helps take the guesswork out of investing

Which groups of investments will do better in a given year? As the following chart shows, it can be difficult to predict. By diversifying, you don't have to guess.

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Highest Return	TSX 28.3%	S&P 500 33.4%	S&P 500 28.6%	TSX 31.7%	US BONDS 11.6%	US BONDS 8.4%	US BONDS 10.3%	MSCI EAFE 38.6%	MSCI EAFE 20.2%	TSX 24.1%	MSCI EAFE 26.3%	MSCI EAFE 11.2%	CAD BONDS 6.42%	TSX 35.05%
	S&P 500 23.1%	TSX 15.0%	MSCI EAFE 20.0%	MSCI EAFE 19.74%	CAD BONDS 10.2%	CAD BONDS 8.1%	CAD BONDS 8.7%	S&P 500 28.7%	TSX 14.5%	MSCI EAFE 13.5%	TSX 17.3%	TSX 9.8%	US BONDS 5.24%	MSCI EAFE 31.78%
	CAD BONDS 12.3%	US BONDS 9.7%	CAD BONDS 9.2%	S&P 500 21.0%	TSX 7.4%	CAD T-BILLS 4.7%	CAD T-BILLS 2.5%	TSX 26.7%	S&P 500 10.9%	CAD BONDS 6.5%	S&P 500 15.8%	US BONDS 6.0%	CAD T-BILLS 3.33%	S&P 500 26.46%
	MSCI EAFE 6.39%	CAD BONDS 9.6%	US BONDS 8.7%	US T-BILLS 4.8%	US T-BILLS 6.0%	US T-BILLS 3.3%	US T-BILLS 1.6%	CAD BONDS 6.7%	CAD BONDS 7.1%	S&P 500 4.9%	US T-BILLS 4.8%	S&P 500 5.5%	US T-BILLS 1.80%	US BONDS 5.93%
	US T-BILLS 5.1%	US T-BILLS 5.2%	US T-BILLS 4.9%	CAD T-BILLS 4.7%	CAD T-BILLS 5.5%	S&P 500 (11.9)%	TSX (12.4)%	US BONDS 4.1%	US BONDS 4.3%	US T-BILLS 3.2%	US BONDS 4.3%	US T-BILLS 4.4%	TSX (33.0%)	CAD BONDS 5.41%
	CAD T-BILLS 5.0%	CAD T-BILLS 3.2%	CAD T-BILLS 4.7%	US BONDS (0.8)%	S&P 500 (9.1)%	TSX (12.6)%	MSCI EAFE (16.0)%	CAD T-BILLS 2.9%	CAD T-BILLS 2.3%	CAD T-BILLS 2.6%	CAD BONDS 4.1%	CAD T-BILLS 4.4%	S&P 500 (37.0%)	CAD T-BILLS 0.63%
Lowest Return	US BONDS 3.6%	MSCI EAFE 1.8%	TSX (1.6)%	CAD BONDS (1.1)%	MSCI EAFE (14.2)%	MSCI EAFE (21.4)%	S&P 500 (22.1)%	US T-BILLS 1.0%	US T-BILLS 1.4%	US BONDS 2.4%	CAD T-BILLS 4.0%	CAD BONDS 3.7%	MSCI EAFE (43.38%)	US T-BILLS 0.16%

CAD BONDS – TSX DEX Universe Overall Bond (C$)
TSX – S&P/TSX Composite (C$)
US T-BILLS – Citi U.S. 3-Month T-Bill (US$)
S&P 500 (US$)
MSCI EAFE Net of Taxes (US$)
US BONDS – Barclays US Aggregate Bond (US$)

INDEX LEGEND
CAD T-BILLS – TSX DEX 91-Day T-Bill (C$)

6 Set the right asset allocation

The starting point for diversifying your portfolio is setting your overall asset allocation between the three major asset classes – equities, fixed-income and cash. Your asset allocation is primarily responsible for establishing the balance between reducing risk and enhancing return potential. Your target asset allocation is based on factors such as your age, and need for income, growth and security. From time to time, your asset allocation should be adjusted to reflect current market conditions and any changes in your individual situation or goals.

7 Diversify by industry sector and geographic area

Another way you can diversify your portfolio – particularly its equity component – is by industry sector. Different sectors of the economy can perform differently at different times. For example, equities in the Technology sector may go up or down less than equities in the Energy sector in any given time period. Diversifying by sector often means diversifying by geographic area as well, particularly in Canada where the equity markets are heavily concentrated in just a few sectors – the Energy, Resources and Financial sectors. To diversify properly by both sector and geographic area, you need to look beyond Canada's borders.

Continued on back

Continued from page 3

8 Stay disciplined

Once you have established your investment plan, it's important to stick with it, especially during periods of market volatility when it can be most difficult to do so. Remember that your plan should be designed with volatility in mind – before it happens (see Principle #1). That said, there is a natural tendency for investors to want to move into safer investments during market downturns, hoping to avoid further losses. Unfortunately, this can result in needlessly locking in losses on investments likely to recover. A better approach is to stay disciplined, maintain the appropriate level of diversification, and only make changes after a careful assessment.

9 Turn volatility into opportunity

While some investors view a market downturn as a "selling opportunity", others see it as a "buying opportunity". Market downturns are usually broad, taking down both the good and the bad. As a result, it can be an opportunity to add high-quality investments – those most likely to recover strongest – to your portfolio at a discount.

10 Take positive action in negative markets

Often the best advice during a period of market volatility is to sit tight and wait for it to pass. However, there are some positive steps you can take to help build and protect long-term wealth, despite what the markets are doing. Here are a few strategies to consider:

The spousal loan strategy

With this strategy, you make a properly documented, formal loan to your lower-income spouse, which your spouse uses to invest. The investment income is taxed at your spouse's lower tax rate, resulting in potentially significant tax savings. While your spouse has to pay you annual interest, which you pay tax on, the Canada Revenue Agency has currently set the interest rate at an historic low of 1% (which you can lock in for the term of the loan). With a properly designed spousal loan strategy, you achieve overall family tax savings.

Family trust

Through a family trust, you can provide funds for the benefit of your lower-income children or grandchildren, while reducing your family's taxes. Capital gains earned on assets you give to the trust, when used for the benefit of the trust beneficiaries, are taxed at their lower rate. With a prescribed rate loan to the family trust, all future investment income, including interest and dividends (not only capital gains), are taxable to your children and grandchildren. The investment income may not be taxed at all, especially if they earn no other income, due to their personal tax exemption amount.

Guaranteed insurance solutions

- Participating Whole Life Insurance provides a guaranteed cash value, plus dividends that can be accumulated on a tax-deferred basis to increase the guaranteed cash value. You can also take out tax-free bank loans using the policy as collateral, and the bank loan is paid back with the policy proceeds when your estate is settled.
- Segregated funds guarantee 75%-100% of your principal at death or maturity, minus any proportionate withdrawals.† If the fund's value is higher, then you or your designated beneficiary get that back instead.
- There's also a special type of segregated fund (Guaranteed Minimum Withdrawal Benefits) that can pay you guaranteed income for life. Even if the market value on your plan drops to zero, the plan continues to guarantee payments for life.

> **Get insight into today's market volatility**
>
> For our latest outlook for the global economy and markets, ask us for a complimentary copy of *RBC Wealth Management Global Insights*.

Please contact us for more information about these and other strategies to build and protect wealth.

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