Portfolio advisor

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After the storm

Rebuilding your wealth

The storm metaphor is very appropriate for what's happened to the markets – and to investors – over the last year. During a particularly bad storm, people tend to take shelter. After the storm, they usually assess the damage – to their homes, their property or, in this case, to their investment portfolios. Then they make plans to repair it.

SIGNS OF LIFE

Both the economy and financial markets are showing signs of life after a storm that swept away over $500 billion in household wealth and 400,000 jobs in Canada. With property values firming, the stock market bouncing back 40% from its March low and the Bank of Canada predicting an end to the recession this quarter, it looks like the worst of the storm is over.

While this is welcome news, simply waiting for the markets to continue improving is just one way to rebuild your wealth after the Financial Crisis. There are other ways you can and should rebuild your wealth.

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ASSESS THE DAMAGE

If you haven't already done so, now is the time to take a good, hard look at where you stand after the storm. The big questions are:

- How much wealth have you really lost?
- What impact does this have on your personal and financial goals?
- What exactly do you need to do to get back on track?

In assessing your post-storm net worth, consider all your various savings, investment and retirement accounts, Canadian and foreign real estate, safety deposit box holdings, as well as any other major personal or business assets. You should also consider your liabilities, including debt and taxes.

An updated Financial Plan with a detailed net worth statement will prove indispensible in accurately assessing the "storm damage" – and recommending steps to fix it.

RE-EVALUATE YOUR RETIREMENT PLANS

In assessing the storm damage, you may come up with a long list of things you need to fix. For many people, the top item will be their retirement plans, especially for those who were just about to retire or have recently retired. This time has been called the "retirement risk zone" because any serious market downturn will inevitably have an outsized impact on your retirement savings.

You can largely avoid the retirement risk zone by shifting to a more conservative investment mix as you approach retirement (more bonds, less stocks). However, most pre-retirees and retirees typically hold a certain percentage of stocks for long-term growth. If you have been caught in the retirement risk zone, you may have some potentially difficult choices to make – but there are also some positive steps you can take.

Keep the money coming in

You have several options: You can delay your retirement date and continue working full-time, gear down to part-time work or consulting instead of retiring outright, or return to the workforce in some capacity if you are already retired. Many Baby Boomers had already intended – before the Financial Crisis – to continue working, partly for financial reasons, partly to continue doing what they love. The recent downturn is prompting many who were on the fence to delay full-blown retirement and sock away a few extra years of savings.

Top-up your tax-advantaged plans

Consider making the most of your tax-advantaged plans as soon as possible. That means catching up on any and all unused contribution room in your Retirement Savings Plan (RSP) and, if you have one, your company pension. Many employers match pension contributions (as well as non-registered plans such as company stock savings plans), so make sure you're taking full advantage. In addition, there are certain types of pensions (e.g. Individual Pension Plans) that allow your company/employer to make additional tax-deductible contributions to make up for poor performance.

You should also consider the new Tax-Free Savings Account (TFSA) if you haven't opened one yet. With an annual contribution limit of $5,000, it may not seem like much at first. But if you stick with it, it can grow into a meaningful amount over time because your investment earnings are not taxed (and neither are withdrawals).

Buy time for your portfolio to recover

If you are already retired, you can give your portfolio more time to bounce back by drawing on your retirement income sources in a certain order. Consider starting with those less sensitive to the markets, such as GICs, and those without tax advantages, such as taxable non-registered accounts. All else being equal, your taxable savings typically don't grow as fast as your non-taxable savings like your RSP or Retirement Income Fund (RIF) because they don't offer the same opportunity for tax-deferred compound growth.

Eliminate bad debt

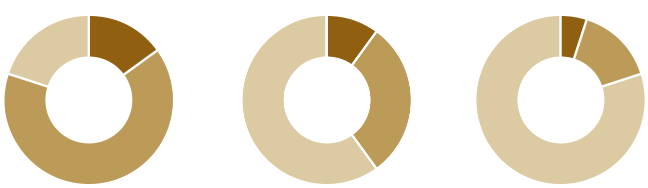
If you have any high-interest credit card or credit line balances – which you may be carrying simply as a convenience rather than out of financial necessity – pay them off right away. Refinancing your "good" debt, such as mortgages, may also be an attractive option, particularly with today's extremely low interest rates. What's more, there are some good debts that can actually build wealth – and later we'll explore one called the Spousal Loan Strategy.

Please contact us for assistance when re-evaluating retirement plans in light of the market/economic downturn.

RETUNE YOUR INVESTMENT PORTFOLIO

Up to 90% of your portfolio's returns can be attributed to your overall asset allocation between the three major investment asset classes: stocks, bonds and cash. Your ideal asset allocation is largely based on your investment goals and comfort level with risk. Generally, for long-term growth, you would favour stocks, while for security or income, you would favour bonds.

Even in normal market conditions, your actual asset allocation can stray from its ideal range over time, as different asset classes tend to perform differently. During periods of unusual market volatility, this effect is amplified, making it even more important to ensure your portfolio is properly rebalanced now.



Income	Balanced	Growth
Cash 15%	Cash 10%	Cash 5%
Bonds 65%	Bonds 30%	Bonds 15%
Equities 20%	Equities 60%	Equities 80%

Source: RBC Dominion Securities *Portfolio Strategy Quarterly* (Summer 2009).

Revisit your comfort level with risk

When the markets are continually rising, investors can get lulled into a false sense of security and take more risk than they are really comfortable with. Conversely, when the markets plunge, investors get more risk-averse, which can manifest in panic-selling. Your "real" risk tolerance is probably somewhere in the middle. With markets returning to "normal", now is a good time to reassess your real comfort level with risk.

Find systematic ways to avoid emotional investing

Investors are often told to "be rational": don't let your emotions get the best of you, don't panic-sell, don't follow the herd, don't get euphoric, and so on. Indeed, emotional reactions to the market's ups and downs cost the average investor, as the following chart shows.

20-year returns as of December 31, 2008	
Average equity fund investor	1.87%
Inflation	2.89%
Barclays Aggregate (Bond)	7.43%
S&P 500 Equity Index	8.35%

Source: "Quantitative Analysis of Investor Behavior, 2009," DALBAR, Inc. Returns include reinvestment of dividends, but do not assume any transaction costs, taxes, management fees or other expenses.

Of course, you can't simply tell investors they're being irrational and really expect them to snap out of it. What might be more helpful is an approach that gives you ways to behave more rationally, addresses your own irrational tendencies and, in fact, helps you take advantage of others' irrational tendencies.

Dalbar, the investment research firm noted for its annual report on investor behaviour, suggests two ways to approach this problem: one tried-and-true and the other somewhat novel. The tried-and-true technique of Dollar-Cost Averaging gives you an easy, systematic way to invest while taking advantage of market swings. You invest a certain dollar amount in a certain investment on a regular basis. When the price is low, you buy more. When it's higher, you buy less. The effect over time is to reduce your average purchase price. In fact, Dalbar's research shows that investors who utilize Dollar-Cost Averaging outperform the average equity fund investor by some 90% (based on 20-year S&P 500 Index returns as of December 31, 2008).

Dalbar also suggests an approach called "Purpose-Based Asset Management." The idea is that you divide your portfolio based on different purposes, such as funding your retirement or saving for a new sailboat. Then you set an appropriate risk

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tolerance for each portion. You probably don't want to jeopardize your retirement, so a more conservative risk tolerance may be appropriate for that component of your portfolio. A sailboat, on the other hand, is purely discretionary and you may be willing to accept greater risk in the hopes of upgrading from a dinghy to a catamaran. Having this approach in place, the report suggests, can help prevent panic-selling when the markets plunge: you know you're already taking less risk in your core retirement portfolio, and a dinghy instead of a catamaran could be worse.

There are other systematic ways to avoid the pitfalls of emotional investing. For example, many investors find it helpful to simply put their investments at arm's length. Instead of making your own investment decisions, you delegate these decisions to professional managers. Alternatively, you can follow a "guided" process that largely automates your decisions for you. Please contact us for more information.

THINK OUTSIDE OF THE INVESTMENT BOX

Wealth-rebuilding opportunities you may not know about

›› Family Trust

Instead of funding your children's (or grandchildren's) educational costs using your after-tax dollars, you can fund them through a family trust – and reduce your family's taxes. When properly structured, the income earned on assets held in the trust is taxable to your children or grandchildren at their lower tax rate when used for their benefit. Each child can potentially earn up to $10,000 of tax-free interest income annually from the trust (varies by province), assuming they have no other income.

›› Spousal loan strategy

With this strategy, you loan money to your lower-income spouse at an interest rate set by the Canada Revenue Agency (CRA). Your spouse then uses the loan to invest and, so long as they pay you annual interest, any investment income is taxable at their lower rate. Currently, the CRA-prescribed rate is at a generational low, making this an ideal time to consider this strategy.

›› Estate freeze

This is a tax-deferral strategy where you "freeze" the value of an asset at its current market value, pay any taxes due on capital gains now, while transferring the responsibility for future taxable capital gains to your beneficiaries. If you own a business, now may be an opportune time to consider this strategy, due to depressed market values on many businesses.

›› Tax-exempt insurance

Many people are surprised to learn that you can hold investments within certain life insurance policies, and that any investment income earned within the policy is exempt from taxes (similar to an RSP). You can allow the investment income earned within the policy to accumulate for your estate or, if required, you can take out tax-free loans against the policy for current income. While you do have to pay insurance premiums, for most qualified individuals, this cost is far outweighed by the potential tax savings.

Please contact us for more information about these and other wealth-building ideas.