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Risk – and what you can do about it

It doesn't take a financial crisis to know the importance of managing the risks to your family's financial security – but when the markets are ever-changing, it helps to know time-tested strategies to protect the wealth you've worked to build. In this report we examine three key risks to your wealth, and how you can address them.

1. Investment risk – nothing ventured, something lost

It's often said (usually in jest) that the safest place to invest your money is under your mattress. But in fact, stuffing your money under your mattress isn't entirely risk-free. Of course someone could steal the money, but there's another risk: inflation risk. If there's inflation (and there usually is), the things you need will cost more in the future. Even if you do nothing, your money won't have the same purchasing power and, in real terms, will lose value.

The point is, when it comes to managing your money, there are several types of risk (like inflation risk) that may seem less obvious than the one most investors focus on – market risk. Here are some others (by no means an exhaustive list):

Credit and interest rate risk

Investments like Guaranteed Investment Certificates (GICs) and Canadian government bonds are generally considered safe investments – about as safe as they get. However, even these safe, fixed-income investments face certain risks. For example, if interest rates go up, the market value of your fixed-income investments typically goes down. Similarly, if the credit rating on your bond issuer falls, then the value of the bond could also fall.

Currency exchange rate risk

Canadian investors will be very familiar with the impact of fluctuating U.S./Canadian exchange rates on their U.S. investments. A higher Canadian dollar means your U.S. investments are worth less in Canadian-dollar terms. (Conversely, a lower Canadian dollar means they're worth more.)

Psychological risk

When it comes to investing, we're often our own worst enemies due to our natural – but counterproductive – psychological responses. People tend to be overly optimistic when it comes to investing, and overestimate the likelihood of positive results. They also tend to be overconfident

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and believe unpredictable events like market downturns can be controlled, for example, by timing the market (i.e. selling at the exact right time) – despite the fact that even the pros can't consistently do this.

Another common aspect of investor psychology is "herding," where investors simply follow other investors (even if it's off the edge of a proverbial cliff). This commonly manifests in panic-selling at the worst possible time during a market downturn – at the bottom, when the panic is greatest.

2. Retirement risk

Whether you are approaching retirement or have already retired, there are several risks that can affect your retirement savings.

Not saving enough

Many pre-retirees underestimate how much money they will need to fund their retirement. On the other hand, you may not need the often-cited million-dollar-plus nest egg – depending on your situation and expectations for retirement. The first step to determining exactly how much you will need is to get retirement savings and income projections based on different variables, including your annual savings, rate of return, different retirement dates, amount of income withdrawn and life expectancy.

Outliving your retirement savings

People are generally living longer, healthier lives. Once they reach age 65, Canadians can now expect to live another 20 years, and there's no reason to think this positive trend won't continue with ongoing medical, health-care and lifestyle improvements. This means you can reasonably expect to have more years to fund in retirement compared to your parents or grandparents. As a result, you may need a larger nest egg. You should also consider investment strategies that provide some growth to increase the longevity of your savings, as well as solutions that can provide income for life such as annuities and guaranteed withdrawal benefit products.

Spending too much too early in retirement

Generally retirees spend more early in retirement when they're more active, then scale back their spending. If you have more than enough for retirement, this may not be an issue. However, if your budget is tight, it's important to leave enough of your nest egg untouched early on to continue growing. Taking too much early on has a magnified effect – you lose the extra money you've withdrawn, plus the potential future growth on that money.

Retiring in a bear market

There's a similar effect when you retire in a bear market. If you start drawing on your savings at the same time they're down due to the markets, there's a compounded impact on the future growth of your savings. This is a tricky situation to deal with as you may not have much control over your retirement date (and you

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certainly have none over the timing of a bear market). Aside from delaying your retirement date if possible (or desirable), you could draw income from other sources, earn income from part-time or contract work or simply save more in the first place to create a buffer against this potential risk.

3. Adverse event/liability risk

It makes sense to sit down at some point and put some contingency plans in effect to protect yourself and the people you care about.

Tax risk

Especially if you are responsible for a significant amount of wealth, you face a higher tax burden, both during your lifetime and when your estate is settled. Insurance can address many tax liabilities related to your estate. You may also consider insurance to cover potential U.S. estate taxes on U.S. property. During your lifetime, there are several strategies that can help, including income-splitting through a family trust. This helps transfer the tax liability for investment income to lower-income family members, who may be able to earn a certain amount of income tax-free, potentially reducing your family's overall taxes.

Legal risk

Again, with greater wealth comes the potential for greater legal risk, whether it's a divorce settlement, a lawsuit or business-related. Consult with your lawyer to ensure that you have sufficient legal arrangements in place to cover any risks you may face. These may include shareholder's agreements if you have business partners, prenuptial agreements if you're bringing significant independently earned wealth into a new marriage, or provisions in your estate plan to ensure any children from your first marriage receive their inheritance if you marry again. Insurance strategies can help here too; for example, they can fund a shareholder's agreement or protect against lawsuits.

Health risk

All of us face health issues at some point in our lives, and it's important to make sure you're properly protected should the worst happen. Of course, this means having adequate life insurance in place. In addition, you should consider the impact that poor health, injury or disability can have on your income and your savings. Critical illness and disability insurance can help in these situations by providing funds should you be faced with any number of serious but survivable health conditions. As well, you (or a loved one) might require specialized care at some point that is not covered by government health-care. Long-term care insurance can help fund expenses like a live-in nurse or care at a private facility.

We can help you identify the risks facing your family and help you address them with a wide range of strategies. For more information, please contact us.

Key strategies to manage investment risk

Hold a diversified portfolio

Diversification works because different investments tend to perform differently. For example, when stocks in one sector tend to go down, stocks in another sector tend to go up. Diversifying by sector, geographic area and asset class (stocks, bonds and cash) is key to managing many investment risks, including inflation, exchange rate, credit, interest rate and market risk.

Rebalance at regular intervals

Diversification is not a one-time thing. Markets change, as do your personal circumstances. Rebalance your portfolio on a regular basis to ensure it reflects your current comfort level with risk and your needs for growth, income, liquidity and capital preservation. It's especially important to revisit your diversification after significant milestones in life.

Give your risk tolerance a periodic reality check

When markets are going up, investors tend to build up a greater appetite for risk. Not surprisingly, when markets go down, investors suddenly lose their appetite, but by then it can be too late. Set your risk tolerance based on your long-term goals and give it a periodic reality check to make sure it hasn't drifted too far up or down with the markets.

Factor in extreme events when assessing risk

Both the "tech wreck" of 2000-2002 and the financial crisis of 2007-2009 were considered extraordinary events, perhaps even once-in-a-lifetime events, yet both occurred in the same decade. While certainly an unusual occurrence in historical terms, such a confluence of extreme events should be factored in when setting your risk tolerance.

Invest in what you (and your advisor) understand

The 2007-2009 financial crisis was largely caused by risky or "sub-prime" mortgages being repackaged into more complex investments that were marketed as relatively safe investments. For investors, an important lesson here is that you should understand what you are really investing in. That doesn't necessarily mean more complex investments should be completely avoided – just that they should be transparent and that you should understand them.

Avoid emotional investing

Making investment decisions based on emotional reactions is one of the main reasons why individual investors tend to underperform the market benchmarks. Instead of making emotional decisions in the heat of the moment, it's better to make decisions based on rational criteria and your long-term goals.