# Sudden financial liquidity—what now?

Wealth Management
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Receiving a large financial sum as the result of a liquidity event is a wonderful thing, but it's not always blissful. Often, it raises other worries.

Unless you've won the lottery, the gain usually happens as the result of a life-changing event, such as selling your business, receiving an inheritance or reaching a divorce settlement. Not surprisingly, these payouts are typically accompanied by strong emotions, such as fear of change, loss of control and lack of certainty. And none of these emotions are conducive to the wise and careful management of newly acquired financial holdings.

Your anxiety may be further heightened if you don't have a traditional pension plan in place. If that's the case, you'll need to make regular withdrawals from your portfolio for income purposes, and (depending on the market) the timing of those withdrawals could have a significant impact on your results. If you draw down capital too quickly, or if investment returns are poor, you may run out of money.

So what can you do to reduce your anxiety and avoid making unwise decisions?

Over the years, we've developed a **four-step process** we use to help people prudently manage financial sums stemming from sudden liquidity events. By following this process, we can help you develop a financial plan, control for market volatility, apply your plan strategically and continue to manage your plan while taking into account your changing needs over time.

"Our purpose in working with families is to help them find natural simplicity within all the complexity life can bring."

## Step 1: Financial planning

The first step in our process is to develop a financial plan. The plan sets out your financial goals and circumstances, including your desired returns, estimated timelines and risk tolerance.

To do this, we start by conducting an analysis of your cash flow. By tracking cash going in and cash going out, we can determine your spending rate. We then use this rate to calculate the minimum amount you'll need in returns, while taking into account your draw rate, taxes, fees and inflation.

## Step 2: Asset allocation

Next, we turn our attention to asset allocation, which can help control market volatility. This is an important step as volatility is one of the biggest threats to any financial plan, especially when you're relying on a one-time payout to get you through retirement.

This risk management process is often misunderstood. As stated in *CFA Magazine* (Nov/Dec 2008) when describing the seminal investment book, *Security Analysis:*

"[Many] suffer from the misconception that trying to make serious money requires that one take serious risks. In fact, the converse is true. Avoiding serious loss is a precondition for sustaining a high compound rate of growth."

"We believe that effective counsel is a skillful blend of art and science."


In its simplest form, asset allocation is the tradeoff between two asset classes: fixed income and equities. Fixed income and equities are affected by different market factors and tend to move in opposite directions. Historically, returns on equities are higher than fixed income vehicles. But they also tend to be more volatile.

The goal of asset allocation is to carefully combine these two asset classes so that you get the benefits of both through diversification.

In fact, studies typically indicate that asset allocation (as opposed to securities selection, for example) accounts for about 90% of investment results!

In our opinion, asset allocation analysis should start with a portfolio with 65-75% in fixed income and 25-35% in equities. Historically, this asset mix has proven very efficient over time.

You'll note that the "starting point" asset mix has approximately three times the amount of fixed income as it does equities. This ratio provides upside potential from the equities, while also having sufficient fixed income to cushion volatility during poor market conditions. In fact, because of this diversification, this asset mix has exhibited less volatility than bonds alone over five-year rolling periods (Source: 2009 Ibbotson SBBI Classic Yearbook, Chapter 2: The Long Run Perspective).

The process of determining asset allocation isn't easy. Many advisors and financial tools suffer from historical bias. They base their recommendations on historical performance and relationships, but there's no guarantee that historical patterns will repeat or that current relationships will hold in the future.

In contrast, we believe that effective counsel is a skillful blend of art and science. While we use historical performance and relationships as a base, we also mix in our own view of market conditions as well as your personal circumstances and objectives.

In our experience, this method provides you with a much more tailored and responsive approach than simply applying the same historical data and recommendations to everyone.

### Step 3: Implementation

Once we determine your asset allocation, we then consider the specifics of implementation.

As you'll be using your portfolio for income, we want to structure it to provide sufficient dividends and interest to offset the draw rate as much as prudently possible. This is a more reliable strategy for achieving your financial plan's target return than relying on price appreciation alone. It's also particularly useful during periods of weak equity markets, as your income can continue to support your living expenses.

"Out of clutter, find simplicity."
– Albert Einstein

On the equity side, we have many different investment styles to choose from. Each will impact how your portfolio behaves over time in generating returns. For example, if you need cash flow, we can tip the portfolio towards dividends. When interest rates are low, generating income through equity-based dividends is also a helpful approach. As a bonus, when volatility is a concern, dividend stocks tend to be less volatile than the broader market.

On the fixed income side, we also have difficult choices to make. Unfortunately, this is a challenging time to be a fixed income investor as yields are very low. In addition, interest rates could rise at any time, causing bond prices to adjust downwards.

Fortunately, we can apply strategies to mitigate these risks. A "laddered" strategy takes advantage of rising yields by systematically staggering bond maturities over a set holding period. (For example, a five-year laddered strategy could have 20% of the bonds coming due each year, with the principal being re-invested in new five-year bonds.) This strategy also provides a high level of cash flow predictability.

Portfolio diversity can also help. Annuities provide a predictable and competitive yield that can be used as part of the fixed income component. Low volatility ("Low Vol") equity strategies are also now available to investors. As the name implies, the objective of these investment vehicles is to generate equity-like returns with a controlled level of volatility.

At this stage, we must also consider how to implement your investment strategy over time. Staging in funds (i.e. staggering your investment over time) can help avoid stress on the portfolio (and the investor) if markets are weak when we start.

As you can see, these decisions are complex and often challenging to implement. Fortunately, we're experienced in taking a balanced approach that takes into account not just market indicators but also our deep experience and your unique needs. Having this wealth of experience and know-how on your side will give you the confidence to transition positively through this sudden change in your circumstances.

## Step 4: Management

As economic and market conditions change, we'll need to adjust your portfolio accordingly. Likewise, changes to your personal circumstances may also necessitate adjustments. Consequently, keeping in close communication is essential.

## What now?

If you're expecting or have received a financial sum as the result of a liquidity event, feel free to give us a call. Not only do we have the relevant skills, knowledge and experience to guide you, we can also remain objective during a time of heightened emotions.

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