

The Fortnighter



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Like just about every investor I've ever spoken to, I own life insurance. It's simple term insurance and, depending on one's opinion, this has either been a very smart or a very dumb investment on my part.

In the "smart" category, for a modest monthly sum, insurance has allowed me to protect myself and my family from financial disaster for many years. In the "dumb" department, I have put tens of thousands of dollars into a product that I've never collected a dime on (knock on wood).

Life insurance is about probabilities – and as such it shares something in common with the global pandemic. My demise, on any given day, would be a very low probability event – something in market lingo we call a "tail risk" or a "black swan" event.

Recently, I've been asked by several clients whether we could have done "anything more" to mitigate the impact of the pandemic on portfolios. It's a good question – and the answer, I believe, lies in "the probabilities". Yes, people have been discussing pandemics for years, but the ability to predict its actual timing and magnitude was basically zero. The COVID-19 pandemic is a classic "tail risk" or "black swan" event.

The next issue is whether an investor could or should protect their portfolios against the disruption caused by such an event. On the "could" side, the mechanics are actually pretty straightforward, using vehicles like S&P 500 "Put Options". Of course

buying protection (the Puts) comes at a cost – just like my insurance premiums. And because we can't predict when a tail-risk event occurs, we have to pay that premium indefinitely. Over time, this would reduce your portfolio's return to below zero. The Put seller is "The House" in a sense – the odds are against you.

Another reason why insuring our lives makes sense and buying portfolio insurance doesn't – once my beneficiaries collect on my life insurance, I don't get to bounce back in 6 or 12 months (!) Not to make light of the trauma we experienced in February and March, but our portfolio's assets are still there. As we have seen over and over again, portfolios recover.

If outright portfolio insurance makes little sense, are there other risk-reducing strategies that do? Yes, and it's our old friend diversification – actual assets that reduce volatility by having a low or negative correlation with our stocks. Investments like government bonds, gold and hedge funds, to name just a few.

Consider these 4 questions: 1) Were you able to resist the urge to sell in the first quarter? 2) Did you have enough liquidity on hand to meet your needs? 3) Are you participating in the market rebound? And finally, 4) Is your portfolio's long-term return still in line with your investment target? While there's no definitive answer here, if you can answer "Yes" to all four, chances are your portfolio "insurance" is about right.