Lindsay
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Accepting the uncontrollables

Understanding the relationship between your goals and historical rates of return

In our last newsletter, I discussed a number of life lessons. One of these was to focus on the controllable factors in our life, and come to terms with the uncontrollables. One of those uncontrollables is rate of return. Simply put, we must accept the fact that over the long-term, certain portfolio allocations will deliver a given rate of annual return. This is the basis of all long-term financial planning.

What does that mean to you, the investor? Well, it means you must align your financial goals in accordance with these expected rates of return. If we want to restructure our portfolios, we must accept that restructuring may have an impact on our expected rate of return. That in turn may have an impact on whether we actually meet our goals.

Let me clarify what I mean by way of a general example. Let's say you have a retirement income target in mind, but your portfolio isn't large enough to support that income. What you need is strong growth. So you build a portfolio of 80% equities and 20% bonds. Historically, such a portfolio has returned 9.5% per year (see chart).

Now let's imagine the stock market suffers a prolonged downturn. After seeing your portfolio drop dramatically, you decide to move your entire portfolio into bonds. That's fine, but you must accept a lower rate of return. Historically, an all-bond portfolio has only returned 6.0%, which means your portfolio won't be large enough to support your retirement income target. You'll have to save more, or revise your income target downward.

Let me be clear here: I'm not saying you *must* accept a particular portfolio allocation. What I am saying, however, is that rates of return are an uncontrollable – we must build our financial plans around them. If we have a firm financial goal, we

Asset allocation	Historical rate of return (1928-2001)
equity portfolio	
40% Canadian equity 40% international equity 20% bonds	9.5%
balanced portfolio	
20% Canadian equity 20% international equity 60% bonds	7.7%
bond portfolio	
100% bonds	6.0%

must choose a portfolio allocation that allows us to reach our goals given the historical rates of return for various model portfolios. If we're not happy with the volatility that allocation exposes us to, we have two choices: (a) modify our rate of saving, or (b) modify our goals. Here are two case studies that illustrate this concept in action.

Case study #1: Joe

Joe is a 40 year-old CA who makes $150,000 a year. He contributes $13,500 to his RRSP each year, and has managed to accumulate $210,000 in his plan. His goal is to retire at age 60, earning $80,000 per year after tax indexed at a 3% rate of inflation.

Joe wants to know if he's on track to reach his goal. We show him how various portfolio allocations will impact his ability to reach his retirement income goal. If Joe builds an *equity portfolio* (see above), he should earn an average of 9.5% per year. Given his time horizon, he would have a shortfall of $778,000. That means Joe will have to save an additional $11,150 a year to reach his goal, or accept a lower income in retirement.

If Joe decides to build a *balanced portfolio*, he could expect an annual return of 7.7%. That

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More money than brains...

A sampling of the gifts over the years in the Robb Report's annual "Ultimate Gift Guide":

- a sterling silver tennis ball can: $1,750*
- the "world's most expensive bow tie" in 24-karat gold with 22 carats of inlaid diamonds: $140,000
- a man's BMW logo ring: $2,750
- a small cashmere throw rug with the Mercedes-Benz logo imprinted on it: $2,000
- your own personal bowling centre (installed): $75,000
- a mink coat for a Cabbage Patch Kid: $400
- a jewel encrusted 24-karat gold-plated gumball machine: $100,000
- a crocodile-skin chewing gum holder: $250
- one-on-one with Michael Jordan or a shift on the ice with Wayne Gretzky: $100,000 - $2.5 million.

* *all figures in US dollars*

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portfolio would be less volatile than an equity portfolio, but it would also result in a savings shortfall of $1,940,000. If Joe still wanted to meet his income target, he would need to save an additional $33,700 a year.

If Joe decides to hold only bonds in his portfolio, he could expect an annual return of about 6%. Such a portfolio would result in minimal volatility, but it would also result in a savings shortfall of $3,100,000. Joe would need to save an additional $65,000 per year to attain his retirement goal.

Joe faces a number of decisions. He can either stick to his income goal and accept volatility, or minimize volatility and make up the shortfall with additional savings. Either way, Joe has to accept the uncontrollable – the historical rates of return for his various portfolio allocations.

CASE STUDY ONE		
Joe:	• 40 year-old chartered accountant • income goal: $80,000 per year • current savings: $210,000	
Return	Outcome	Comment
9.5%	$778,000 shortfall Would need to save an additional $11,150 per year	–
7.7%	$1,940,00 shortfall Would need to save an additional $33,700 per year	1.8% difference in return results in client having to invest 67% more every year
6.0%	$3,100,00 shortfall Would need to save an additional $65,000 per year	3.5% difference in return results in client having to invest 83% more every year

Case study #2: Mary

Mary is a recently retired 65 year-old. Over the years, she has saved $550,000 in her RRSP and $330,000 in her non-registered portfolio. Mary will rely on these funds, along with her CPP payments of about $6,500 per year, to provide her with retirement income. Mary has determined that to live the lifestyle she desires, she needs to have $51,000 in income after tax (indexed at a 3% inflation) every year.

Again, we ran through a number of scenarios with Mary, and showed her some of her options when it comes to allocating her portfolio.

If Mary decides to build an equity portfolio, she can expect an average return of 9.5% per year. This allocation would allow Mary to achieve her retirement income goal.

If Mary wants to reduce volatility, she may decide on a balanced portfolio. Her expected return has declined to 7.7%, which means an income of $42,000 per year.

As Mary gets older, she may decide to minimize volatility even further, and move all her assets into bonds. Such an allocation would give her an expected return of 6%. That means an income of about $34,500 per year.

As I explained above, there's no rule that says Mary *must* choose a particular allocation model. What she must do, however, is align her portfolio with a mix that meets her needs. If Mary feels she needs an income of $51,000 per year, she must build an equity portfolio and accept short-term volatility. If Mary feels reducing volatility is important, she can build a bond portfolio, but she must accept a lower retirement income.

CASE STUDY TWO		
Mary:	• recently retired 65 year-old • income goal: $51,000 per year • current savings: $880,000	
Return	Outcome	Comment
9.5%	no shortfall	–
7.7%	Would only receive $42,000 per year	1.8% difference in return results in an 18% drop in income
6.0%	Would only receive $34,500 per year	3.5% difference in return results in an 32% drop in income

These examples demonstrate how understanding historical rates of return can clarify our financial planning. By aligning our portfolios with our goals, we can take control of our financial future.

If you'd like to discuss this in more detail, please don't hesitate to give us a call!

The best time of my life

An excerpt from *A 5th Portion of Chicken Soup for the Soul*

It was June 15, and in two days I would be turning thirty. I was insecure about entering a new decade of my life and feared that my best years were now behind me.

My daily routine included going to the gym for a workout before going to work. Every morning I would see my friend Nicholas at the gym. He was seventy-nine years old and in terrific shape. As I greeted Nicholas on this particular day, he noticed I wasn't full of my usual vitality and asked if there was anything wrong. I told him I was feeling anxious about turning thirty. I wondered how I would look back on my life once I reached Nicholas's age, so I asked him, "What was the best time of your life?"

Without hesitation, Nicholas replied, "Well, Joe, this is my philosophical answer to your philosophical question:

When I was a child in Austria and everything was taken care of for me and I was nurtured by my parents, that was the best time of my life.

When I was going to school and learning the things I know today, that was the best time of my life.

When I got my first job and had responsibilities and got paid for my efforts, that was the best time of my life.

When I met my wife and fell in love, that was the best time of my life.

The Second World War came, and my wife and I had to flee Austria to save our lives. When we were together and safe on a ship bound for North America, that was the best time of my life.

When we came to Canada and started a family, that was the best time of my life.

When I was a young father, watching my children grow up, that was the best time of my life.

And now, Joe, I am seventy-nine years old. I have my health, I feel good and I am in love with my wife just as I was when we first met. This is the best time of my life."

Joe Kemp

Vancouver is #2

Vancouver is known for two things: its natural beauty and the rain. But now, Vancouverites can add another item to the list: second best city in the world. Mercer Human Resource Consulting evaluated 215 cities from around the world based on political stability, safety, economics, culture, freedom, schools, transit and other factors. Here's a snapshot of their results.

1. Zurich, Switzerland
2. Vancouver, Canada
2. Vienna, Austria
5. Sydney, Australia
5. Auckland, NZ
5. Copenhagen, Denmark
5. Frankfurt, Germany
12. Toronto, Canada
20. San Francisco, USA
20. Ottawa, Canada
23. Honolulu, USA
23. Montréal, Canada
26. Tokyo, Japan
26. Calgary, Canada
39. London, UK
44. New York, USA
62. Milan, Italy
70. Hong Kong, China
128. Mexico City, Mexico
159. Moscow, Russia
162. New Delhi, India
213. Baghdad, Iraq
215. Brazzaville, Congo

The benefits of an employee profit sharing plan

An EPSP can put more money in your pocket!

Did you know that an employee profit sharing plan (EPSP) is an excellent way for professionals, small business owners and key employees to reduce employee-associated costs and increase available retirement assets at the same time?

Formally established under the Income Tax Act, EPSPs allow companies to establish a special purpose trust from which all compensation for the owner, his or her family, and any participating employees is paid. At the end of the year, these funds are allocated to the plan participants.

BENEFITS OF AN EPSP

So why would a company choose to use an EPSP? The answer is simple. An EPSP eliminates the need for Canada Pension Plan (CPP) or Employment Insurance (EI) contributions from the employee or the employer. In addition, payments from an EPSP are considered eligible RRSP and/or pension earnings – which means payments from an EPSP can earn RRSP contribution room much like regular earnings can.

Another benefit of an EPSP is its ability to earn enhanced returns on retirement savings without taking on additional risk to do so. Currently, CPP contributions earn a return of about 1%. But the savings generated by an EPSP can be invested in comparable low-risk investments earning better returns. As an added bonus, EPSP participants enjoy a higher degree of independence from federal government programs. Participants won't lose prior contributions, of course, but in an age of uncertainty about the long-term viability of the CPP, that little degree of independence can bring considerable peace of mind.

Here's a case study that will highlight the benefits of this powerful strategy.

CASE STUDY

Bob and Cathy own a small manufacturing firm. They have 10 employees, three of which are key employees. Bob and Cathy are considering an EPSP for themselves and their key employees, so they decide to test the plan out on their own. They each contribute $40,000 of profit sharing income to the EPSP trust. Since Bob and Cathy are owner operators, they are not required to make EI contributions, so there are no savings there. That said, the EPSP does allow them to save $3,604 each in CPP contributions ($7,208 in total). Bob and Cathy then decide to invest this extra $7,208 in a 10-year Government of Canada coupon bond offering a compounded annual yield of 5.5%. At maturity, their investment will have grown (with very little risk) to $12,312.

Now that Bob and Cathy are confident about the benefits of this plan, they decide to offer it to their three key employees. Each employee will save $1,965 in EI contributions (includes contributions from both the employee and the employer), as well as the $3,604 in CPP contributions mentioned above. Plan members are given the option to invest $5,569 on their behalf in an RRSP holding a government bond (or in an individual pension plan with full indexing holding the same instrument). After 10 years, their $5,569 investment will grow to $9,512.

As you can see, an EPSP can put more money in your pocket. It's a great way to reduce your employee expenses and increase your retirement assets too – a win-win situation that makes sense for many owner operators. Make sure to give us a call for more details!

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