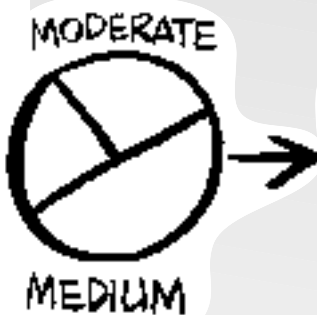


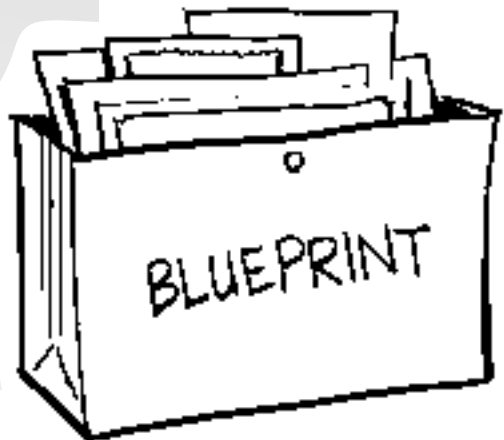
Developing a Blueprint



Decisions and consequences; taking stock of resources, evaluating options and establishing priorities; tax planning and planning for liquidity; diversification; risk and volatility; investment-quality risk, market risk, inflation and taxation; the risk/reward tradeoff; assessing risk tolerance



So, it's values first and goals second as Jack meets with a financial planner and prepares to assemble a financial plan. Clive, meanwhile, is preparing to revise his existing plan to meet his family's needs for the next 10 years and more. Clive's wife Ida wants to support a favourite charity and would be advised to look into developing some sort of charitable gifting program. By the way, it looks like Jack might want to seek help in putting his personal financial documents in order ...



Let's talk a little more about how people form goals. Like most people in their twenties, Kate really doesn't have specific long-term goals in the sense of knowing exactly where she wants to be when she is 55. She vaguely imagines she will have a family at some point, but basically she wants to make lots of money, invest her earnings to make a lot more money, and be able to retire rich at a young age. She measures success in terms of exceeding sales goals, earning bonuses and landing promotions. With her simple tastes in clothing and lifestyle, she manages to live frugally and finds she usually has a nice sum of money left in her budget at the end of the month that could be invested.

Kate prides herself on her common sense and purposefulness - for example, she grabs the business section of the newspaper first, bypassing entertainment, sports or fashion. And lately, she has been perusing the real estate section as well. Why should she continue to rent her apartment and line her landlord's pockets every month? The time has come to put some money aside toward a down payment on a modest home. If she can be a homeowner by the age of 30 - or why not 28, that's three years away - that would be a major accomplishment. Maybe she could even get a place that would be big enough to rent out the basement. That would be extra income. And she

could convert one of the bedrooms into a home office, and write off part of the home for tax purposes... well, that's a few years away still. But the decision has immediate investment-planning consequences, in that she has to find a way to incorporate an element of liquidity - that is, ensuring that she has cash or investments that are easily convertible into cash - into her investment mix to ensure she has funding for a down payment on a home in three years.

And recently there developed another reason to rethink her full-speed-ahead attitude to investing. Her boyfriend and rock-climbing buddy Murray had taken a bad fall while out on a local hike. He will recover, but it got Kate to thinking about the consequences if she fell and suffered a long-term injury. What if she couldn't work for a year or more? Her goals of early retirement and financial independence might be dashed. It might be practical, she was thinking, to take out some disability insurance.

Jack is now an hour into his second meeting with his new financial advisor. In the first meeting he had handed over the dog-eared file folder that represented a complete, if unwieldy, accounting of his financial state of affairs and otherwise had a good long talk about his plans for retirement. Now, he was asking, How's it looking?

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The planner pauses for a moment, looks Jack right in the eyes and tells him, "To be honest, Jack, the time has come for you to establish priorities". It is unrealistic, he is told, for him to expect that he can both embark on a significant retirement-savings plan and at the same time put aside enough money to put his children through school, given his current income and rate of savings. It's his decision, he is told, but it looks as if he may have to rethink the idea of footing the bill for his children's education. What good will it be to spend so much money on their college education that he ends up with inadequate retirement savings and becomes a burden on them once he retires?

Not only will Jack have to rethink the dream of fully financing the college education, but he has received more sobering news. His company pension plan is decent, but not extravagant, he has been told, and it will be supplemented by whatever government pensions are available when he retires. But right now he has no other major assets besides his townhouse. Unless he starts on a relatively aggressive investment and savings program right now, it is unlikely that he will be able to maintain his current standard of living when he retires - let alone afford green fees a few days a week.

For Jack, the news represents a real wakeup call. Is paying for college completely out of the question, he asks, or are there any other options for me?

Well, the advisor tells him, one idea is to take on that overtime project he have been offered and put the extra income into an RRSP. With the tax savings, he can then put money into an RESP for his daughter - and further benefit from the federal government program that provides grants for RESPs up to the age of 17.

But his children, and he, will have to face the fact that they will have to earn most of their own tuition and living expenses on their own, with little help from



their father. They may have to take part-time jobs now during school, work during the summer and accept, perhaps, that they will have to go to the local college and live at home. This wasn't their first choice, but they will have to live with it, it appears. The simple fact is that establishing priorities and facing reality means that some goals may have to be modified.

Jack has now taken several important steps in developing a financial blueprint for his future. He has taken stock of his resources, discussed his values and goals with a financial planner and considered preliminary options that would enable him to meet some of those goals. He must now evaluate a full set of options, develop a financial plan, put the plan into action and then commit himself to maintaining the plan.

Let's leave Jack for now and check out how Kate is proceeding in her quest to develop her own financial blueprint.

It's another Saturday morning and as usual Kate was sitting at the local coffee shop with her old high school girlfriends. This time it wasn't her clothes that they were ribbing her for - it was her lack of party spirit. She had to admit that now that she was putting in so many hours at work, she didn't stay out till all hours as she did when she was

five years younger. They began teasing that she had become boring, a fuddy duddy. Besides her rock climbing, they said, she had become just like her parents, conservative and never taking risks. At this point, Kate felt she had to explain herself.

Just because she is sensible and hard-working does not mean she lives a boring, unchallenging life, she argued. On the contrary, she takes risks every day, and not only with her rock climbing. At work, she's on commission-only, which means she can't put all her eggs in one basket - in other words, focus all her energy on one possible huge sale and risk having it fall through. So, she spends some time each month on the easy sales, which have lower value but provide her with a safety net.

It was on the cliffs, Kate corrected them, where she takes care to minimize risk. She makes sure she has high-grade, appropriate climbing equipment, is familiar with the landscape and knows of an escape route - a Plan B - that is available if the going gets unexpectedly rough.

The parallels to choosing investments are obvious. Diversifying, selecting investments that are of good value and are suited for the purpose they are intended, ensuring downside protection in case of slips in the market - those are

factors Kate will be considering as she builds an investment portfolio. Our fearless Kate is smart enough to know that being aggressive doesn't mean ignoring risk - rather it means understanding and dealing with it.

She's smart - and getting smarter, especially now that she is learning to define her terms more precisely. When a mutual-fund company announces a new fund manager, Kate discovers, that has the potential to affect the quality of the investment she is considering. It's referred to as investment-quality risk, and it is one of four identifiable types of risk investors should be prepared to deal with. Besides investment-quality risk, the other three types are market risk, interest-rate risk and purchasing-power risk.

Most investors would define risk as the chance of losing their original capital. This is a real concern and often is a result of the first type of risk... investment quality. However, other important considerations are explained in the other types of risk. Let's look at them individually.

What is investment-quality risk? Simply put, it's the risk of earning poor returns or your whole capital on new unproven investments or established investments that are now poor choices due to executive mismanagement. Not all investments, even in the same class,

are created equally, and the investor that makes an effort to understand these differences in quality will go a long way towards managing investment-quality risk. Individual stocks can range from blue-chippers like IBM to highly speculative ventures such as far-away gold mines. Two equity mutual funds with relatively similar recent market performances may start to go their separate ways with a change in fund management. Even top performers may start to slide if those good returns are attributable to, say, temporary gains from low-grade corporate bonds. It is therefore essential to assess the quality of any present or proposed investment and not be blinded by sales hype or rapidly increasing valuations.

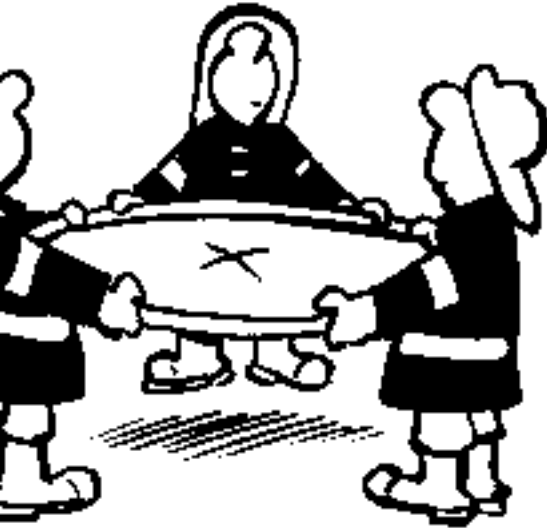
The second type of risk is market risk. It is defined as the chance that an investment will drop in value because of changes in the market in which it operates. For example no-one is ever right 100 per cent of the time in predicting future performance of stock markets. There is no such thing as a sure thing. Even markets that have all the earmarks of a good bet can be dragged down by other influences.

This is an important distinction from investment quality risk, because all high quality stocks or mutual funds will fluctuate in value according to prevailing



market conditions. "Volatility" is the measurement that gauges the comparative fluctuation of different funds or stocks - that is, given the same market conditions, how much a fund's or stock's price rises or falls. When analysts are assessing the volatility of a particular investment, it becomes an objective measurement, determined by

potential to show strong growth over the long term, she is going to make money, so she is prepared to live with the volatility. Jack has to be wary of volatility, because he has less time to recover from large price drops. And Clive, even though he has learned to deal with fluctuations in the market, knows he is wise to keep most of his money away from highly volatile investments for the same reason.



measuring the size and frequency of swings in value in a fund or stock in a particular period of time. Ratios of investment returns to volatility can be plotted on a graph to compare performance over time of different products.

Investors have to ask themselves how much volatility they can bear. Kate, with her long investment horizon, understands that if she hangs on to an investment that is volatile over any short-term period but has the

Third on our list is interest-rate risk. This can become a factor in a variety of ways. Investors with a heavy concentration of fixed-term investments such as GICs may find themselves worrying about their renewal rates if through lack of planning the GICs all come due at the same time when interest rates happen to be low. Clive must be wary of this as he transfers RRSP-protected investments to RRIFs or annuities before the end of the year in which he turns 69. Purchasing fixed-term investments with varying maturity dates is the wise way to deal with this risk.

An investor has NO control over the effect of general interest rates on both bond and stock markets. A period of rising interest rates will have a dampening effect on the value of both types of investments. Stock-market investors who anticipate a prolonged period of high interest rates may want to sell

some of their stocks and take advantage of high returns on fixed-term investments.

Finally we have the risk of loss of purchasing power. The twin evils associated with this are inflation and taxation. Some types of investments are taxed less favorably than others, so while an instrument like a GIC may represent less of a risk of loss of capital, its interest income is taxed at a higher rate than other investments. A given level of income from interest puts less money in your pocket than income from dividends or capital gains.

The inflation factor is more commonly understood. Any investment that does not keep pace with inflation represents a loss in purchasing power. This is a concept that Clive understands quite well by owning his own business. Over the years he has had to continually increase his prices to keep pace with rising costs.



Clive knows that rising costs are a fact of life and that the money he receives from the eventual sale of his business will have to generate increasing returns through his retirement if he and Ida are going to be able to maintain a comfortable lifestyle.

Clive also understands that the capital they wish to leave as a legacy for their children and grandchildren will not buy as much twenty years down the road as it will today. He therefore intends to invest a portion of the sale proceeds from the business in products that should grow in value over time.

Investors who understand these four different types of investment risk and plan accordingly will end up with a better-protected portfolio than investors who act less purposefully.

It is generally accepted that the greater the potential reward offered by any investment, the greater the risk of capital loss. This is known as the risk/reward tradeoff. Investments with little risk of capital loss, such as Canada Savings Bonds or GICs, normally provide a rate of return not much higher than the prevailing inflation rate. More speculative ventures however, such as internet stocks can double in value in a very short time frames but can also lose more than half their value just as fast.

No-one ever willingly puts money into something that is risky and earns low returns, but then no-one can predict the future. Yesterday's winners can become tomorrow's losers. Investors can only study past performance and rely on the wisdom of experienced and

knowledgeable advisors to make their best guess on future trends. Sure it's a guessing game, but smart investors can learn to make wise guesses and become successful most of the time. You'll never eliminate risk entirely, but you can evaluate it and manage it.

Kate may find herself comfortable with an equity investment with high potential returns and relatively high risk, because she has the time to recover from any declines associated with volatility, so she may choose to invest in a few good mutual funds or stocks. But she has the luxury of knowing that even if she invested in something that was low-risk and low-return, over 30 years with compounding she would still do quite well.

From the foregoing discussion, it is clear that the term risk has a variety of meanings and like any term that is used often, its definition becomes imprecise. In discussing investments whose value rises and falls, it is usually more useful to speak in terms of volatility.

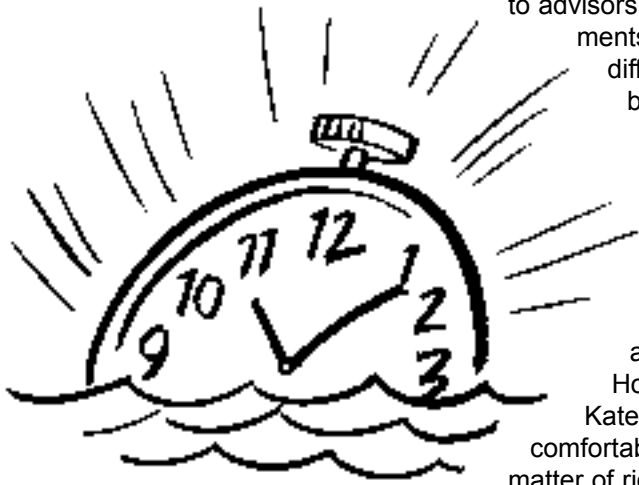
Jack and Clive would both be advised to stay away from putting too much money in highly volatile ventures, given

that their investment horizons are a lot shorter than Kate's, although Clive, with his substantial assets, could afford to gamble a little for fun without hurting his overall position. He might want to diversify his holdings, with most of his money in lower-risk, medium-return vehicles and perhaps a modest amount in higher-growth stocks or mutual funds, to preserve the estate values that he and Ida wish to leave.

Jack has the finest line to tread. He needs decent returns,



given that he is only going to be in accumulation mode for another 15 years or so, but he can't have too much volatility, since he can't afford to start over if his investments perform poorly. He must accept some risk, for example in



semi-aggressive mutual funds, and hope for high returns. Sitting still with low-return, low-risk products won't get him where he wants to go.

Remember Jack's pondering of the Rule of 72 as he studied the effects of compound interest? He was looking at two different investment approaches with different rates of return. The two extremes are high yield with high volatility or low yield with low or no volatility. Can he live with the potential ups and downs of a mutual-fund investment, given that he will probably make money more quickly? Or should he go for the no-risk GIC with its predictable but modest return? That's the risk/reward tradeoff in a nutshell.

Risk vs Reward is another major factor to consider as Kate, Jack and Clive make investment choices. They can listen all day

to advisors recommend investments associated with different levels of risk; but what about their personal levels of comfort with these choices?

The trait that is vital here is the investor's risk tolerance. The question is, How much risk are Kate, Jack and Clive comfortable with? This is not a matter of right or wrong, of a person who likes challenges being right or smart or one who doesn't being uniformed or misguided. After all, it is the investor's money and future at stake, and he or she has every right to take whatever steps are necessary to maintain a sense of comfort. If the investor cannot sleep at night worrying about her investments, then the portfolio has too much risk.

It is only common sense in this discussion to note that an informed investor makes better choices. But a balance must be struck here. Some investors become so involved in studying the market, reading and watching daily stock market reports and reacting to every sensational newspaper headline that they lose sleep because they are over-informed. A more reasonable approach would be to educate yourself on the basics of the economics of the

investment markets - enough to make decisions on investments recommended by a professional - but being smart enough to let the professional do the daily monitoring while you keep informed enough to understand the broad picture.

In practice, determining the investor's risk tolerance can be accomplished as simply as asking whether a proposed plan "feels right," or alternatively there are questionnaires that have been devised to rate an investor's willingness to accept risk.

A typical rating system might invite the investor to rate priorities as to their importance, as follows:

a) Avoiding any decline in their portfolio over a one-year period;

b) Staying ahead of inflation over three years;

c) Accepting variability in monthly returns of their overall portfolio; and

d) Avoiding decline of 5 per cent in their overall portfolio in any year.

Using a number of similar questions and enquires risk tolerance is assessed in gradients, with low risk tolerance matched with a plan for Conservative Income and Growth, and high risk tolerance with a plan incorporating

Maximum Growth.

Again, the perspective of time is important in deciding if risk tolerance is a major factor for Kate, Jack or Clive. Even if Kate were determined to be highly risk averse (which she isn't), then she could still go with low-risk vehicles such as GICs or very conservative mutual funds and watch them grow over time. If she follows even this conservative investment program with discipline, it's safe to assume she would still become a wealthy woman in 30 or 40 years. But since she is willing to accept some risk, she could live with a selection of more aggressive investments, as her long investment horizon works to her advantage and in the end her portfolio should be worth substantially more.

Clive has always been relatively aggressive as an investor but he is entering a phase in his life where portfolio growth will be less important than income or preservation of capital. His shorter investment horizon means he will have less time to recover from market drops, and since he will also be withdrawing funds from his portfolio, a more cautious approach is warranted.

Jack has been told, based on his responses to his advisor's risk questionnaire, that he is quite risk averse. But as discussed earlier his circum-

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stances dictate that he may well have to proceed more aggressively to reach his projected retirement goals. In his case, his needs and his risk tolerance aren't a good match. He may have to lower his expectations for retirement or else be prepared to get stressed out worrying how his money is doing.