Building a Portfolio

Developing a plan that meets specific needs; more on taxes and liquidity; defining financial security; today's retirement realities; evaluating investment products

It's news to Jack that insurance should not be considered a luxury or an afterthought but rather be thought of as an important component of an overall financial plan. Kate and Clive, meanwhile, at different stages in the life cycle, approach insurance from different points of view but are both aware that at the appropriate time insurance matters should be thoroughly reviewed. Now, let's examine a pretty basic question: what is financial security today?

When building an investment portfolio there are three main considerations: Liquidity, Income and Growth. Generally speaking growth is the main focus during our working years as we save for our eventual retirement and our income needs are met by employment earnings. During retirement the focus switches to income to met our cashflow needs. Liquidity is a continuing need to provide for near term purchases and unexpected expenses.

A well planned portfolio therefor includes investments to meet these three considerations and the flexibility to move easily between them as circumstances change. Taxation is a fourth ongoing consideration and the wealthy ensure that investments other than RRSPs minimize their tax liabilities by focusing on dividend and capital gains instead of interest income.

Now let's see what Kate's up to. Today she has her Things To Do notepad out again and she is reminding herself that she wanted to check out housing prices on an upcoming weekend. Buying her first home is still three years away in her plans, but a decision on putting aside a fund for that down payment has to be made now. This is a consideration of liquidity - ensuring that she has cash or investments that are easily convertible into cash on hand in three years. It would be convenient if she put all of her available investment money into mutual funds that would grow over this time frame, but three years is a short time from an investment perspective and in this period her invested capital could be worth less than she started with. Putting some money into a three-year term deposit,a money market fund or a cashable GIC would better suit her home-buying plans.

Similarly, Clive would be wise to keep extra cash or cash-equivalents on hand, given the state of his wife's health. He's got the long-term-care policy kicking in, but he has to be prepared to make emergency expenditures if the need arises.

Keeping a portion of his assets liquid will meet such requirements and eliminate the market risk of having to sell an investment during a downturn.

Another reason for Clive or anyone else to hold onto cash would be to take advantage of market volatility and buy investments when they drop in value.

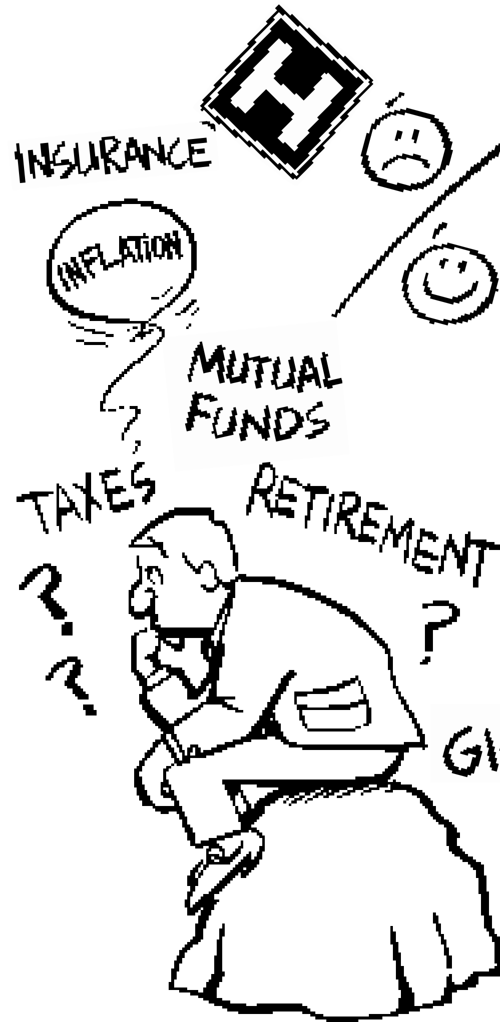
The number-one goal of each of Kate, Jack and Clive as they make investment-planning decisions is financial security. But what is financial security in practice? It means having enough money to maintain your desired standard of living

through illness, incapacity or retirement. But it's a different world for Kate, planning ahead today at the age of 25, than it was for Clive, planning for his retirement a generation ago. He assumed he would stay associated with his business until he was 70 and he further acknowledged back then, that life expectancy for a man was his early 70's. Today Canadians are retiring younger and living longer, which means they have to make more during their shorter careers and invest their savings more profitably to enable them to have enough to retire on.

The actual numbers are worth scrutiny. The average retirement age is now 62. Many will stop working full time much younger, in their mid-50s or even at 50. Further on down the life path, Canadians are living much longer than they did a generation ago. Each year, several thousand Canadians reach the age 100 mark. At the end of the 20th century, the average male could expect to live to 78 years of age, while the average female could reasonably expect to see 81.

All this means that in many cases, Canadians can expect to work only half their adult lives and live off their retirement savings the second half.

Surveys indicate that barely half of all Canadians have faith



that today's key public-pension programs will survive until they retire. Already, many recent retiree's find that they are unable to manage on their retirement funds. A whole new industry has sprung up, with new retiree's forced to take part-time work with seniors employment agencies - and often performing chores for "senior seniors."

In some of those cases, the "unretirement" is by choice. But many go back to work reluctantly, for the extra cash.

It is generally estimated that a person needs 70 per cent of their pre-retirement income to maintain a similar standard of living after retirement. For Jack and Kate, the new world of early retirement and long years of post-retirement means that prudence is called for more then ever before to maximize the return from their investments while ensuring safety and being prepared to monitor and rethink earlier commitments if necessary.

When it comes time to sit down and make choices, investors may find their minds reeling at the huge variety of investment vehicles available. The old lineup - from fixed-return GICs and bonds to more volatile, variable-return stocks, futures, and mutual funds - has been significantly expanded as more and more firms introduce new products such as strip bonds, segregated funds or hybrid products such as stock-linked GICs. The new investments may offer opportunities to reduce or defer taxes, minimize risk or fine-tune a portfolio by focusing on specific targets or needs (such as a grandchild's education), but as with any new product, it's best to study the characteristics and behaviour of the newcomer to ensure it will actually meet your needs.

One potential problem is that if a new vehicle is simply too good, especially if it was devised to take advantage of a tax loophole, the tax man may make note and step in to close the hole. It's another reason to exercise caution.

With each new investment product comes various performance or other claims, trumpeted loudly by the vendors - but beware, for there may also be downsides. Each of our investors may have their own concerns with a new product. Clive, who will be living off the income from his investments will want to know if there is a regular stream of income generated by any new investment. And if it’s treated as dividend, interest or capital gains? Also how will a large unexpected capital gain affect his quarterly tax installments? If there is a large unplanned distribution in one year, it may trigger a clawback of his Old Age Security or his age credits.

Jack has to know that with any new product there are either guaranteed returns or a conservative expectation of returns - he can't afford to hold an investment for three years or more with no gains at the end. Kate will want to know the potential volatility of any product so she can take advantage of it with her long term monthly investment program.