



## FINANCIAL PLANNING III

# ASSET ALLOCATION: Re-balancing act part of post-holiday tradition

By PETER MERRICK

The single most important thing an investor can do to achieve financial goals is to allocate investment assets wisely.

Many Canadians planning for their financial futures find themselves spending sleepless nights worrying about which mutual fund to buy and sell, which stock to own, which one to dump; should they buy bonds now or should they put derivatives into their investment portfolio?

The type of investment planning this article will address is referred to as asset allocation. This means that as an investor, you allocate proportions of your liquid assets into different asset classes. In asset allocation your investments can be in one or a combination of these three categories:

- 1) **Equities**—ownership in companies;
- 2) **Fixed Income**—money invested in GICs, bonds, and mortgages or;
- 3) **Cash**—that is money invested in T-bills, chequing and savings accounts.

Studies have shown that asset allocation is the single greatest determinant of investment performance. It's been shown that approximately 80 per cent of the total-long term return of an investment portfolio is due to the asset allocation.

Unaware of this, many people



Merrick

blindly sink money into this or that investment without ever formulating an asset allocation model that is in sync with their financial goals and investment personality.

As a fee planner, I share with my clients as I share now with my students studying to become certified financial planners, that once you've determined your personal and financial goals and have formulated a plan to achieve these goals, it's wise to allocate your current and future investment assets in equities, fixed income and cash. It's like keeping your money in separate pockets—but not in the same pair of pants.

All asset classes move in cycles. Each asset class has its own cycle. Typically, when one or two asset classes are performing well, the other asset classes may not be performing as well. By

having a well defined asset allocation you are making your financial ride smoother.

Let's go through an example of asset allocation diversification and how this can work for the typical investor. Let's imagine a set of twins, Gwen and Joan. Both are 40 years of age.

Gwen invests \$10,000 in a 7-per-cent bond which matures in 20 years. Joan also invests \$10,000 for 20 years but separates the money into five, \$2,000 investments. The first investment loses everything, the second earns nothing, the third earns 4 per cent, the fourth earns 7 per cent, and the fifth earns 15 per cent.

At age 60, Gwen's investment has grown to \$38,697 while Joan, who has practiced asset allocation, has grown her initial investment to \$46,853.00. This is the true power of asset allocation.

Let's imagine you had put all of your liquid assets into technology stocks at the end of the bull market of the 1990s, like many people. Then in the middle of 2000, the very foundations of the technology sector in the stock market began to crumble, free falling into negative territory. You would now be hurting, and possibly both your life and your financial goals would be set back. With asset allocation it does not need to be this way.

Along with asset allocation, regular re-balancing of your portfolio is an essential element of

long-term investment success. Re-balancing is a fundamental part of the process of reaching your financial goals in the most effective way while lessening the overall instability of your total investment portfolio.

An example of how effective re-balancing can be is illustrated in a study conducted by T. Rowe Price of Baltimore, Maryland, a top investment manager.

### The single greatest determinant of investment performance.

What T. Rowe Price did was construct two \$10,000 model portfolios made up of 60 per cent equity, 30 per cent fixed income and 10 per cent cash.

Using historical data spanning a 25-year period from the end of 1969 to September 1995, T. Rowe Price invested one portfolio using the original mix and never re-balanced at all.

The identical portfolio invested at the same time was re-balanced every three months to the original target allocation of 60 per cent equity, 30 per cent fixed income and 10 per cent cash.

At the end of the 25 year and nine-month period the re-balanced portfolio grew from \$10,000 to

about \$145,000, the untouched portfolio grew to \$141,000.

By following a disciplined re-balancing asset allocation approach to investing, you are joining the ranks of the world's greatest investors by buying low and selling high.

You do this by constantly trimming the asset classes which have done well and replenishing the asset classes that have decreased in value.

From time to time, as your life changes, and so do your financial and life goals, it is also important to re-evaluate your asset allocation mix.

What makes the asset allocation approach, *the* approach to long-term investing is it eases the turbulence that happens while investing and empowers you to stay the course to achieve your life and financial goals.

When it comes to achieving your life and financial goals, it should never be about market timing, it's about time and having the right asset allocation for you.

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## THE POWER OF: Personal benchmarking

By CHRIS REYNOLDS

Over the past few years we have seen constant turmoil in the markets which has led to fear and irrational behaviour. Most of us invest to accomplish a dream—a bigger house, a cottage, a child's education or a comfortable retirement.

So how do you keep your focus on why you are investing in the first place and what your investments are suppose to do for you? One method is called personal benchmarking.

Personal benchmarking is a method of understanding the over all long-term returns that you need from your investments to actually achieve your financial dreams. It is easy to say I want the very best returns, but unless you are willing to

take more risk with your hard earned money, these returns may be unachievable.

For example, if you plan to retire in 10 years—based on your current portfolio and the amounts you plan to invest over the next 10 years—what rate of return do you need to achieve that goal? (If you need help calculating this figure just let us know and we would be happy to provide).

Let's say you need a six-per-cent annual compound rate of return to achieve your



Reynolds

goal—that becomes your benchmark. Once you have established a portfolio that will return six per cent on average per year—then each year you compare your actual returns to your benchmark.

Some years you will be ahead and some years you will be behind—but as long as you are not too far away from your personal benchmark each year you probably have the right mix in your portfolio.

How does this help?

Far too often, people are not comparing their investment portfolio to the returns

they need but to what the media is saying, what advertisements are promising or what friends and neighbors claim they are getting.

As advisors, we hear all the time from clients who say "I just read in the paper about a fund that did 40 per cent last year—let's buy that" or: "My neighbour is getting much better returns than me—what can we do differently?"

This keeping up with the Jones' syndrome is bound to lead to disappointment and loss for all parties concerned.

It means that decisions are now not made around solid investment management principles, but by chasing the new hot investment idea.

By far, the safer way to proceed involves the use of benchmarks.