John Ambrose

# Asset Allocation: Meet Dr. and Mrs. Mertz

Many people retiring today face low interest rates and increasing life expectancies. John Ambrose, our newest Financial Planning columnist offers advice on constructing an investment portfolio to suit one dentist's retirement circumstances.

To help us to understand how and why asset allocation works, we'd like to introduce you to one of our clients, Dr. Frank Mertz. Dr. Mertz, a dentist and his wife, Edna, both aged 60, are currently considering retirement. Dr. and Mrs. Mertz have decided they want to devote more time to improving their golf games. However, they wish to stay close to their families (so they don't want to sell the family home) and most important to them, they want freedom from making daily investment decisions. Dr. and Mrs. Mertz have asked us to review their investment portfolio and to develop a new asset mix designed to allow them to live off their investment income until they are required to establish a registered retirement income fund. (Revenue Canada requires that individuals convert their RRSPs into Registered Retirement Income Funds at age 69). As we decide how their assets should be allocated, we need to look at the state of North American equity markets at this time.

The disturbing economic environment of the "stock market bubble" has passed. Now we see a generally healthy economy. Steady growth in GDP, low unemployment, low interest rates and a strong housing demand indicate investor comfort. Investors are buying stocks for their capital gain potential rather than for dividend yield and are also waiting for more evidence that growth will continue at low interest rates. When they are convinced, higher stock prices may follow.

Should Dr. and Mrs. Mertz consider a cautious approach or anticipate the growth envisioned by some? Let's review their situation. They are in good health with a $1.5 million non-registered portfolio, a registered retirement savings plan worth $1 million, a home worth $500,000 and no liabilities. Currently the couple invests in cash and short-term bonds for "safety." Their expenses, excluding income taxes, are $100,000 per year. Their taxable and non-taxable registered portfolio totalling $2.5 million generates an annual return of 2.5 percent, which represents $62,500 before taxes or about $50,000 after taxes. This means that their after-tax income falls short of their expenses by about $50,000. Therefore, they should consider a change in asset allocation to allow for more growth and capital gains.

### Stocks Allow Growth, Bonds Dampen Volatility

If Dr. and Mrs. Mertz maintain their retirement lifestyle and their investment portfolio, their net worth will fall, since their spending will exceed income. A prudent mix of equities in their portfolio can provide higher total returns. Higher returns can allow either growth in net worth or a higher allowable living expense, or a blend of the two. Naturally, this strategy is not risk-free.

Risk means the possibility of price changes and is a natural, but uncomfortable, part of investing for long-term growth. Adding bonds to the portfolio can help dampen this volatility, and may be more suitable in the non-taxable registered account.

With a mix of 60 percent equities, and the same annual expenses of $100,000, the Mertz's portfolio could grow by $20,000 annually based on an expected total return after tax of $120,000 as shown in the table. Of course, this strategy involves greater risk. Increased volatility raises the potential for higher returns from capital gains, but makes the portfolio rely less on dependable dividends and interest.

Should Frank and Edna Mertz change their asset mix?

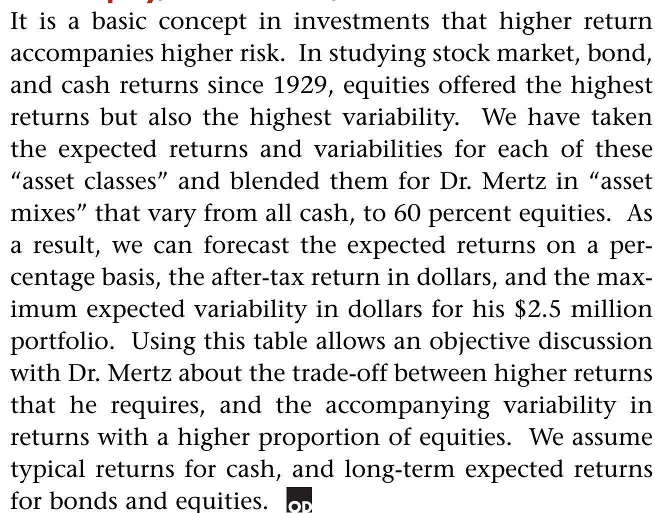
Investing in short-term bonds with no longer-term bonds or equities seems overly cautious if markets are strong. The Mertz family has a life expectancy and therefore an investment horizon of 20 years or more. We expect that the 60 percent mix of equities will provide more total return with tolerable risk controlled by the 40 percent mix of cash and bonds. However, if equity markets weaken, and interest rates rise, their "overly-cautious" strategy may suddenly seem prudent. As shown in the table, an all-cash portfolio provides the least risk, $12,000, from adverse market moves — but also the least total return, $23,000.

As the table shows, Dr. and Mrs. Mertz have to hold a higher proportion of equity for more return. This means more risk. The client must address this trade-off and be comfortable with it.

Dr. and Mrs. Mertz are pondering entering the equity markets and are concerned whether another stock market slump or collapse could occur. Recent high oil prices are containing economic growth and with that the likelihood for higher interest rates. At the same time, economies have become less dependent on oil due to conservation measures and thus less sensitive to higher energy prices. It seems likely that moderate growth at low interest rates will continue for the next six months.

We expect that the S&P 500 Index should outpace the S&P/TSX Index because of greater profitability and growth opportunities in the U.S. market generally. For example, the profitability of companies in the S&P 500 Composite Index averages 16 percent for 2004, but companies in the S&P/TSX composite average only 12 percent. As well, the proportion of companies with long-term continuous growth is higher in the U.S. than in Canada, partly because of the higher percentage of resource companies in the Canadian market. Portfolios that blend bonds and selected equities will provide the right balance of return and risk for a client's needs. Portfolios that include equities of good companies with a blend of growth and value characteristics such as price to earnings are likely to perform consistently well. In this case, such portfolios avoid short-term variations, and follow longer-term growth patterns. Portfolios with longer-term sustainable growth realize gains and accumulate wealth without higher trading costs.

What will Dr. and Mrs. Mertz do? They have decided to consider their options. We shall revisit them in a few months to tell you what they decided and how their portfolio is doing.



### More Equity, More Return, More Risk

It is a basic concept in investments that higher return accompanies higher risk. In studying stock market, bond, and cash returns since 1929, equities offered the highest returns but also the highest variability. We have taken the expected returns and variabilities for each of these "asset classes" and blended them for Dr. Mertz in "asset mixes" that vary from all cash, to 60 percent equities. As a result, we can forecast the expected returns on a percentage basis, the after-tax return in dollars, and the maximum expected variability in dollars for his $2.5 million portfolio. Using this table allows an objective discussion with Dr. Mertz about the trade-off between higher returns that he requires, and the accompanying variability in returns with a higher proportion of equities. We assume typical returns for cash, and long-term expected returns for bonds and equities. OD

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| Equity Mix % | Optimal Total Pretax Return % | Long-term After-Tax Return | | | Maximum Variability during Market Turmoil +/- |
|---|---|---|---|---|---|
| | | Interest.+ Dividends | Gains | Total | |
| Cash only | 1.9% | $23,000 | - | $23,000 | +/- $12,000 |
| 0% | 4.5% | $58,000 | $12,000 | $70,000 | +/-$190,000 |
| 30% | 6.3% | $45,000 | $60,000 | $105,000 | +/-$250,000 |
| 60% | 7.3% | $30,000 | $90,000 | $120,000 | +/-$290,000 |