Retirement Portfolio Fundamentals

Many people invest for their retirement by maintaining a portfolio of RRSP or RSP eligible investments. These investment assets take three forms: equities, fixed-income securities, and mutual funds. Each of these asset classes has a place within a well-balanced portfolio. Dividing investments across the different asset classes diversifies the portfolio and serves to protect the portfolio from the inevitable ups and downs of the capital markets.

EQUITIES

Equities are common or preferred shares, representing an ownership interest in a company. Equities are traded on the major stock exchanges (Toronto Stock Exchange, New York Stock Exchange, etc.). They can be purchased by individuals who have trading accounts with a brokerage or investment house, which will charge them a fee for each trade based on the number of shares and price per share; or through an online/discount brokerage, which generally charges a flat rate per trade. Both types of accounts can be set up to be RSP eligible. Online RSP accounts are referred to as "self-directed" because there is theoretically nobody providing the investor with advice as to what equities to buy or sell.

Equities are the most volatile of the common investment vehicles. A company's shares can be affected by a number of factors, many outside the control of the company. World events can cause market turmoil both generally or within a specific sector. The destruction of the twin towers in New York City was a prime example of this. Capital markets all over the world were adversely affected in the short term – but the airline sector in particular was affected in the long term and this was reflected in share prices.

Most serious individual investors try to diversify their equity portfolios with a mixture of assets. They may hold stocks from different sectors – energy, technology, consumer goods, etc. They may hold a mix of equities for growth; and bonds or dividend-bearing stocks for income. Diversification is important as it lessens the effects of market volatility within your portfolio.

FIXED INCOME SECURITIES

Fixed income securities generate a predictable, hence "fixed", income stream based on interest or dividends. Fixed income securities include bonds, debentures, GICs, and preferred shares.

The most common fixed income security is a bond. A bond is a certificate issued by a government or company that declares a debt that the issuer promises to repay to the holder by a certain maturity date, plus a coupon that specifies a fixed amount of interest. Bonds are generally issued by public companies to raise money for large expansion projects that require capital investments; or to fund acquisitions. Likewise governments issue bonds to fund either ongoing programs or large infrastructure projects. Though bonds are traded on the capital markets, the face value of a bond tends to remain relatively stable – unlike the rise and fall of share prices. Investors buy bonds because of their stability and their generation of income through their coupons/interest payments.

Though corporate bonds can be part of an RSP, usually government bonds – especially the still popular Canada Savings Bonds (CSB) – cannot be held in an RSP.

Another popular fixed-income investment is a Guaranteed Income Certificate (GIC), which are commonly issued by banks. With GICs, unlike equities, the capital investment is protected. Though the interest rate may vary – some GICs have their interest rate determined by overall stock market performance (linked to the S&P or TSX stock indices) – the initial capital investment cannot decrease in value. Therefore they are a very low risk, income generating investment.

MUTUAL FUNDS

The most common investment vehicle is a mutual fund, available through investment dealers, insurance companies, your local bank or credit union, and directly from fund companies. In the simplest terms, a mutual fund is an investment pool that holds a variety of stocks, bonds, or money market instruments. Mutual funds are managed by trained, knowledgeable professionals, who theoretically know more about the ups and downs of the capital markets than individual investors.

With the thousands of investment options available to them, mutual funds are highly specialized in terms of their investment strategy. They might be focused on Canadian equities or dividend paying stocks or small-cap companies. Some, the equity-based funds, are geared to growth, while others, the fixed income funds, are geared to providing income. Mutual funds are broadly broken down into three types:

- Fixed income funds – primarily investing in debt such as bonds, Treasury bills, short-term notes. Lowest risk. Offers very little increase in capital, but steady returns in terms of income.
- Equity funds – primarily investing in the common shares of companies in Canada, the U.S., or internationally. Highest risk. Historically equity funds offer the best return over the long term, but can be subject to volatile fluctuations in value, hence are regarded as a higher risk.

- Balanced funds – a mixture of common shares, bonds, and short-term investments. Medium risk. A balanced fund will outperform an equity fund when the markets are falling, but an equity fund will outperform a balanced fund when the market is rising.

Each mutual fund has a certain risk element to them and the tendency is that the higher the risk, the better the return. By their very nature – holding hundreds of different securities – mutual funds are more diversified than an individual investment portfolio of equities.

There are two basic costs involved in purchasing and holding mutual funds. There is a fee charged for the buying or selling of mutual fund shares – sometimes called the “load”. The load covers sales commissions and other costs of distribution. There is also an annual fee – a percentage of the holdings – to pay the cost of the portfolio management.

GROWTH vs INCOME

Each of the asset classes offers different opportunities for capital appreciation – or growth – and income. Growth is at the core of our capital markets. People invest in common shares not based on what a company is doing today, but on what the company is projected to do in the future. Investors ask:

- How much will the company grow in the short term, or in the long term?
- Is the projected growth internal (organic) from expanding sales or external through mergers and acquisitions?
- How effective will management be at managing that growth?

Companies that continue to grow, expanding income and profits, will tend to please the market and be rewarded with a steady increase in stock price. But companies on an aggressive growth curve are also taking huge risks. When these risks are successful, they and their investors are rewarded. When these risks fail, the market can punish them with a devastating fall in share price. Investors need a strong stomach and a good sense of timing to get out in time to take a profit and not get caught in a downturn.

The other side of the investment coin are income investments. This can be a simple as a GIC at a fixed interest rate – the safest and lowest return investment that you could possibly make. Bonds, with their fixed coupon/interest rate also provide stable returns over a prescribed period of time. Both of these fixed income investments provide a balance to the volatility of equities and equity based mutual funds.

On the other hand, dividend-bearing, blue-chip equities though still somewhat risky are typically less volatile than non-dividend paying companies. Dividends can provide a guaranteed return on a quarterly basis that can form an income stream – or, as often happens in a dividend-based mutual fund, the dividends can be re-invested, increasing the capital component, which in turn increases the total dividend output. Though not guaranteed, dividends also have a tendency to increase – a bonus for the long-term investor.

As John D. Rockefeller said, “Do you know the only thing that gives me pleasure? It’s to see my dividends coming in.”

RISK/RETURN

ASSET CLASS	RETURN	RISK
Equities (shares)	Highest possible returns	Highest risk
Fixed income	Lowest possible returns	Lowest risk
Mutual funds	Average possible returns	Average risk

Everybody’s tolerance for investment risk is different and changes, or should change, with age. Younger investors tend to take higher risks and generally they can afford to take higher risks. Theoretically, when you are young, you can take a “flyer” on an individual stock and if it doesn’t work out, you have plenty of pre-retirement time to recover. The younger the investor is, the more likely they are to invest in high-risk, high-return equities and the less fixed-income investments they’ll hold. On the other hand, somebody approaching retirement age should be moving out of equities and into dividend-based mutual funds or fixed income investments.

As a rule-of-thumb, an investor should take their age and treat that number as the percentage of their investment portfolio that is held in cash or fixed-income investments. So somebody in their mid 20s, might invest 25% of their portfolio in fixed-income securities and 75% in individual equities or higher risk/higher return mutual funds. But an investor in his/her mid 60s would want to hold 65% of their retirement portfolio in cash or cash equivalent investments (bonds, GICs, etc.) and only 35% in lower risk/lower return mutual funds, because they don’t have the earning years left to recover from any volatility in the equity market.

YOUR PORTFOLIO AFTER RETIREMENT

Once you have reached retirement age, your portfolio mix should reflect the fact that the assets you have at retirement need to last you for the rest of your life. At this stage, high-risk equities or mutual funds are simply too risky. Instead, you need to shift your portfolio into low- or no-risk investments such as high-grade corporate or government bonds, preferred shares that are dividend earning, GICs, RRIFs, and annuities.

A RIFF (Registered Retirement Income Fund) is a tax deferral vehicle that is available to RRSP holders. Currently you are only allowed to contribute to RRSPs until the year you turn 71. At that point you can convert your RRSPs into RRIFs, from which you are required to withdraw a certain amount each year, at which point income tax is due. Once a RRIF is established you cannot add to it, although you can have more than one RRIF. RRIFs generally follow the same rules as RRSPs and include a provision for self-direction.

Annuities are purchasable from life insurance companies and guarantee an income stream to the beneficiary. The annuity can be purchased either by a lump sum payment or by a series of installments paid out by the purchaser during the accumulation phase of the annuity. The commencement of the distribution phase of the annuity is set in advance and the payouts continue typically until the death of the policy holder or in the case of a joint annuity until the death of both annuitants.

Hopefully with prudent savings and careful investment management, you can accumulate a balanced retirement portfolio of assets that can provide you with an income stream to augment your CPP/QPP and/or OAS (Old Age Security) along with any corporate or public sector pension plan. The goal is to have sufficient funds to maintain a lifestyle adequate to your needs.