Should You Be Selling Your Winners?

“It’s tough to sell winners and buy laggards, but it’s smart.”

That is the lesson from MarketWatch’s, “Force yourself to rebalance your portfolio.”

Good advice. But difficult for most investors to follow.

Human Nature is to Ride the Winners

> *The basic human instinct when an investment gamble has been paying off is to let it ride; rebalancing involves culling winners and putting the proceeds into laggards in order to follow a plan.*

It is hard for investors to sell successful investments and move the proceeds into underperforming areas. But that is the correct strategy much of the time.

Note that I (nor MarketWatch) am not talking about individual (non-diversified) investments like stocks. There are way too many variables that impact individual stock performance and often market leaders can maintain their edge for lengthy periods. Rather, we are talking about markets, as a whole, and asset classes and sub-classes.

Take Emotion Out of Investing

> *That is why, ideally, rebalancing is done unemotionally, based on a schedule set either by how far off-plan a portfolio gets, or by regular calendar intervals. The bigger the portfolio, the more these differences matter, creating more need to rebalance on a scheduled basis; experts note that average investors with moderate portfolios can get away with rebalancing every year or two, or when the portfolio is*

5 to 10% off-target.

Take the emotion out your investment decisions. Adhere to a predetermined fixed plan for reviewing your portfolio. Rebalance as necessary.

As the above quotes states, reviews can be based on how much the actual asset allocation deviates from your target allocation. Or it can result from regular calendar intervals.

Personally, I would factor in the volatility of the portfolio (a.k.a., portfolio risk, portfolio standard deviation). The riskier the portfolio, the greater the frequency of monitoring. I would also review the portfolio in the event of a material event.

A key takeaway from the embedded quote should be: "average investors with moderate portfolios can get away with rebalancing every year or two, or when the portfolio is 5 to 10% off-target." Moderate refers to portfolio investment risk.

The more you rebalance your portfolio, the greater the transaction fees (and potential triggering of taxable capital gains). Your investment goal should be cost minimization, so watch out for too much trading. If you decide to rebalance every month, expenses will impair long-term performance.

As well, the higher your portfolio risk, the greater the acceptable asset allocation variance. The article recommends 5-10%, a good range for moderately risky portfolios like an S&P 500 index fund. But what if your equity allocation consists of small African mining companies? Perhaps they can fluctuate up and down 30% each year. Do you want to be buying and selling the shares every time they get 10% from target allocations? No.

Momentum Investing

Browne, of FundX, follows a strategy of investing in funds *and ETFs that have the hot hand, trying to ride category leaders in the areas that look best*

As a side note, I want to mention momentum investing. Not quite what Browne is doing, but it came to mind when I read the quote.

If you are nimble, perhaps you can take advantage of short term movements. But there are a lot of traders out there playing this game. If you want to trade, trade. If you want to invest for the long-term, might be best to not worry about momentum investing.

I do not like momentum investing, although I will admit to following this path on occasion in my youth.

I do though, to some extent, tactically invest. But I prefer to do so using longer term trends, rather than simple pricing anomalies or short-term movements. And I prefer to utilize diversified investments (e.g., index funds) to take advantage of macro-economic trends, rather than guessing if Apple will continue to outperform over the short-term. Also, for clients, I recommend building a strong overall core portfolio, then utilizing tactical moves to augment the core. Not tactical as a stand-alone strategy.

I would caution readers that tactical asset allocation requires a fair amount of investment expertise and experience. If you wish to go this route, I strongly suggest working with a competent advisor.

How Much to Invest Abroad?

Individual investors may reap diversification benefits by investing internationally.

The level of benefit is based on many factors – cross-country correlations, major industries, domestic companies that operate globally, etc. Over time, global diversification benefits have fallen. However, investing outside your home country is still worthwhile.

The question then, how much should you invest abroad?

This question was asked of a panel in The Wall Street Journal. Some good responses. I will comment on a few and include my own view of the world.

My Thoughts (Since No One Asked)

The global market is 100%. Your domestic market is a piece of the pie. The U.S. is the largest financial market with about 33% (plus or minus – you actually may see some claim it as high as 46%, but that is too high) of global market capitalization. Canada has only about 4% of the global market share.

Some experts recommend investing in line with relative global weightings. So roughly 33% in U.S. equities, 4% Canada, etc. Fine by me. An easy way to do this is to simply purchase a global equity fund. For example, the Vanguard Total World Stock ETF (VT) or iShares MSCI All Country World Index (ACWI) ETF (ACWI).

Both are extremely inexpensive and do an excellent job of replicating the global equity markets in reasonable weightings. I use "reasonable" as global equity funds tend to overweight U.S. equities. In this case, both Vanguard and iShares invest about 48% in U.S. equities. The higher weighting in funds versus actual real world weightings has to do with investable assets and a slight U.S. bias. Not a huge issue if you are looking for one single fund to invest in. Canada's weighting sits at its proper 4%.

Some experts recommend home country bias when investing. If you live in Canada, instead of 4%, you might want to invest between 10 and 20% in Canadian equities.

Why? Your life is tied to your domestic financial markets. If you live in Canada, you are paid salary in Canadian dollars (CAD). Your debt is in CAD. Interest rates, inflation, unemployment, are all tied to Canadian-centric events. What goes on in Canada impacts Canadians disproportionately to world events. As a result, you may want to have greater exposure to Canadian equity markets.

I might add that some experts make the exact counter-arguement. That you should underweight your home market because of all the other impacts.

Me? I do not mind using either relative global weightings or home country bias. I think you need to consider other factors (what is your home market, debt load, other investments, cash flow requirements, etc.) before choosing one or the other. For many individuals who do not want currency and interest rate impact, a home country bias may be preferable. For younger investors, relative global weightings may prove better.

So what do the experts from The Wall Street Journal say? And bear in mind these folks are speaking as U.S. based investors. What might make sense for Americans may not be optimal for Aussies, Channel Islanders, or Malaysians.

Gus Sauter: Keep a Home Country Bias

> *In my view, investors should have a home-country bias because they face risks that are peculiar to their home country.*

> *So, an investor should invest a significant portion in their home country, but invest enough internationally to take advantage of diversification.*

Gus does not provide a suggestion for Aussies. But at 3% global weighting, a home country bias would probably put Australian equities at 10 to 20%. But some would say that more like 30 to 50% is suitable. Too high for me, but just letting you know.

As an aside, I have heard Gus speak a couple of times. Sharp guy.

Manisha Thakor: Don't Think About Where a Company is Based

> *As the consumer class around the globe continues to blossom, growth rates in emerging markets continue to eclipse those at home.*

Good advice. You need to consider the prospects for your home market versus foreign markets.

Also the region in which you live. If you live in Argentina, what goes on in Chile has more significance in your home market than what is happening in Germany. Conversely, Poles need to monitor the German market very closely given physical proximity and trade partnerships.

> *So the real question I think is: What is a non-U.S. investment?*
>
> *To date, corporate domicile has typically been the litmus test for the categorization of an investment as domestic or international. Going forward, I think it's important to pay attention to the source of revenue and profit generation*

So, so true.

Is Apple an American company? Much of its manufacturing is in China. Its customers surround the globe.

Is Nestle a Swiss company? Is Samsung only South Korean? HSBC solely British? Obviously not. These companies operate globally and derive much of their revenue outside their domestic markets. Yet if you look at each country's main indices, Nestle, Samsung, and HSBC dominate the domestic weightings.

As an aside, you can actually create an internationally diversified portfolio by strategically choosing domestic companies.

Frank Holmes: Anticipate Before You Participate

> *when you combine non-U.S. stocks, U.S. stocks, real-estate securities and commodity-linked securities, the resulting portfolio historically outpaced any individual asset class with less volatility.*
>
> *understand the typical price movements of an asset class before you invest.*

Not quite sure what Frank's point is here. Whenever you prepare a portfolio you must consider historic returns and volatility (i.e., risk). That really is the whole point of diversification. Adding non-correlated assets to try and enhance overall portfolio returns while maintaining the risk level. Or reducing portfolio risk while maintaining the existing expected return levels.

Charles Rotblut: No Crystal Ball? Then Best Diversify

> *unless a person has a working crystal ball, it is impossible to predict where one should invest right now to maximize returns for the next 10 years. By mixing domestic equities with foreign equities, an investor increases the odds of being allocated to the right geographic region at the right*

> *time.*

Diversification spreads out the risks. Unless you are certain of the future, hedge your bets.

> *by diversifying internationally, an investor's wealth won't solely be dependent on the strength or weakness of the U.S. dollar.*

This is a two-edged sword. If your cash needs (living income, debt repayment, etc.) are in your home currency, investments in foreign currency denominated assets might be risky. But if you do not have these concerns, owning assets in a different currency may add value.

The Other Experts

Mostly dross. But you can see that there is no consensus on how much to invest outside your domestic market.

If you have a decent risk appetite and long time horizon, look to higher levels of non-domestic equities. Especially in emergent (and smaller) markets.

If you have substantial liability exposure to your domestic currency or you require income flows in local currency, then focus on a significant home bias.

Recession Babies?

Younger investors should be willing to take on the most investment risk.

This is due to the classic risk-return tradeoff from Investing 101. The greater the risk assumed, the higher the expected return over time.

However, young investors today are shying away from risk in their portfolios.

Why is this the case?

Is it because young investors were “recession babies”?

Recession Babies

A good term, possibly coined by Bill Finnegan in this Wall Street Journal article.

> *“We had Depression babies,” says Bill Finnegan, a senior managing director with MFS Investment Management, a Boston-based asset manager. “Now I think we have recession babies.”*

Given the tough economic conditions and volatile markets over the last decade plus, many young investors have no memory of bull markets and strong economic growth. All they see is high unemployment, a tough job market, and high student loans. Maybe their parents are out of work. Perhaps these young investors still live at home due to a lack of money.

Fully understandable that these “recession babies” are risk averse.

And for any aged investor, I normally recommend maintaining a 3 to 6 month emergency reserve in cash to protect against tough times and unforeseen circumstances.

Better to Earn Little in Safety, Than Nothing at All

Recent market history reinforces this low risk approach. As the article states,

> *A 27-year-old who started investing right out of college has*

> *seen a 0.5% annualized gain from a Standard & Poor's 500-stock index mutual fund—less than the 1.85% returns of an ultrasafe money-market fund.*

As a result of poor equity market returns, young investors have moved into very low risk assets.

> *According to a June MFS survey, investors in their 20s held 30% of their non-401(k) portfolios in cash—four percentage points higher than the average for all investors. The survey found that 40% of investors in their 20s agreed with the statement: "I will never feel comfortable investing in the stock market."*
>
> *An October MFS survey showed that young investors held 33% in cash, six points higher than the overall average, while 52% agreed that they would never feel comfortable investing in stocks.*

So in mid to late 2011, young investors had 33% of their capital in cash equivalents. A much, much higher percentage allocation than any standard asset allocation model would recommend for investors in their 20s.

And roughly 50% of young investors "will never feel comfortable investing in stocks." This compares with an average of 29% for all investors polled. A marked variance.

But is this Wise?

No.

A hard one to explain, especially given the equity market returns over the last few years.

Modern portfolio theory is based in large part on the relationship between risk and expected return. Under the Capital Asset Pricing Model, expected return is a function of risk. Yes, there are times when it is not perfect but I think the principles hold.

I shall not get into the theory – the linked Investopedia article does a good job – but it should be intuitive to anyone reading this. When faced with two scenarios, you will require a higher return for the riskier venture.

Consider Nicole and Matt

For example, my niece and nephew come to me needing a $10,000 loan each.

Nicole will spend the money on a car to get to and from her new job. She has borrowed money from me before and always paid off her debt in full and on time. Further, she will use the car as signed collateral on the loan.

Matt, on the other hand, is like most Matts. He just lost his last job as a landscaper (who knew that sod did not go in grass side down?) and plans to use the money to finance a trip to Ibiza. His repayment history has been poor and the only collateral he has is a broken down ski-doo.

Now would you expect that I would charge each the same interest rate? Especially bearing in mind that they are my niece and nephew, so naturally I like neither.

No, I would desire a higher return to take a chance on the deadbeat, Matt. The probability is much higher that I will have difficulty collecting the debt from him versus Nicole.

You would do exactly the same.

In any aspect of life, the greater the risk you must assume, the greater the return you want.

This Holds For Investments

This risk-return relationship has held over time in the capital markets.

Cash pays less interest than investment grade bonds. And investment grade bonds pay less than riskier speculative (i.e., junk) bonds.

And the relationship between low risk cash, higher risk bonds, and highest risk (of the three asset classes) equities also holds over the long run.

If you take a quick look at the linked chart you will easily see that over the long run, higher risk assets (small and large company stocks) outperformed moderate risk assets (government bonds) which in turn outperformed risk-free assets (Treasury bills).

But note that in many short periods (1930s, 1970s, etc.) riskier assets underperformed the risk-free asset. So during shorter terms, risky assets may not always outperform. A crucial point to always bear in mind.

Perhaps an argument can be made as to whether this long-term risk-return tradeoff will continue. Even I have some concerns due primarily to demographic shifts (a topic for another day). But I think the majority of experienced investors do see the risk-return relationship holding into the future.

The Key is Youth

In the short term risky assets may underperform. But over the long run, the tradeoff works.

How does that impact investors?

The key to utilizing the risk-return relationship is the investment time horizon.

The longer the investment time frame, the more likely that the risk-return tradeoff will hold true. Investors with long time horizons can ride out short term volatility and still prosper.

If you are 30 years of age with a 40 year investment horizon, you can invest in riskier assets knowing that the long term trend is positive. But if you are 65 and only have a few years before needing your capital to live on, you cannot afford to be caught up in a shorter term bear market.

My Advice to Young and Middle Age Investors?

The 50% of young adults who "will never feel comfortable investing in stocks" need to reassess that viewpoint. Equities are not to be feared. And for the younger investor, stocks have proven to be the best of friends over time.

For most young and middle age investors, a 33% asset allocation to cash is probably excessive. I suspect a large portion of cash could easily be allocated to equities.

As for the exact asset allocation, creating a comprehensive Investor Profile will help determine the correct mix for each person. Part of this reflects an investor's time horizon, personal risk tolerance, and phase in one's life cycle.

Investors must take a more rational approach to their risk aversion. Take a long term perspective and tune out the short term hysteria and unpleasantness. Young and middle age investors have the time to ride out the periodic ups and downs. Use time to your advantage.

The phase in one's life cycle plays a significant role in the asset allocation of common stock. Make certain you understand where you are in life. Then take an investment approach that takes advantage of your personal situation.

One comment that I may expand on in a subsequent post. When I refer to risky assets, I refer to them in a traditional investment sense. Shorting stocks, playing the futures' markets, writing naked call options, are all high risk investment tactics. But I would never recommend their use by non-expert investors even though I believe high risk assets outperform lower risk assets over time. The potential exposure is great enough that a short term negative movement could cause irreparable harm.

And be aware that even within traditional investments, there may be different risk-return profiles within asset subclasses.

Use some common sense when investing to reduce portfolio risk. Focus on mutual and exchange traded funds (bearing in mind that risk-return can also fluctuate within these groups). Employ proper investment techniques including adequate diversification, long term buy and hold strategies, and dollar cost averaging to create strong portfolios.

Is the Buy and Hold Strategy Dead?

SmartMoney.com recently issued a short video entitled, “Why ‘Buy & Hold’ Strategy No Longer Works”.

I am a proponent of the “buy and hold, but rebalance” approach, but thought it useful to provide a differing view. Not one I agree with, but it is always good to show all sides of a topic and let readers reach their own conclusions.

The video and my commentary are below.

I Still Like Buy and Hold

First, let me reiterate that I like the buy and hold strategy for diversified assets. Primarily mutual and exchange traded funds (ETFs).

Especially important is to maintain a well-diversified asset mix. One that incorporates assets of differing correlations, so that as one asset class suffers another is there to prosper.

Buy and hold can be used for non-diversified investments, such as individual stocks, but it is much trickier. I do not think that investors should plan on owning individual stocks forever (even with periodic reviews and rebalancing). The world changes too quickly to ensure that one company will dominate for your investment time horizon of possibly 40 to 60 years.

With a built-in diversified investment, changes occur organically within the asset. You do not need to monitor and make decisions yourself. As the next Apple comes along, upon reaching certain characteristics (market capitalization, revenue, etc.) it will be added to the appropriate indices. And it will replace a company whose fortunes (as measured by the index criteria) are declining.

There Are Legitimate Buy and Hold Concerns

The video makes a few good points. Some I have previously addressed in *Legitimate Buy and Hold Concerns*.

Tactical Asset Allocation

As for the use of tactical asset allocation as a superior strategy to buy and hold, there is some merit in the argument. I like tactical asset allocation and employ it myself to some extent. More in broad strokes than in jumping in and out like a day trader though.

But there are two problems in tactically shifting allocations as you try to anticipate shifts in markets or market segments and exploit them.

One, it is exceedingly difficult to time market movements. This is mentioned in the video. It is questionable as to whether actively managed portfolios can outperform passive investments. So while it may be well and good to state that tactical asset shifts during volatile markets is a better strategy than sitting tight, the ability to successfully implement it is doubtful.

Two, unless you have the time and technical expertise to assess potential market trends you will need to pay someone to advise you. This may be through an advisory service where you make the final decisions or it may be where you hand over the decision-making to an investment professional (e.g., actively managed investment fund, discretionary investment account, etc.). This costs money and further erodes any portfolio returns.

For these main reasons that is why I believe a buy and hold, but rebalance approach is best for most individual investors.

Mutual Versus Exchange Traded Funds

The video makes a good point on differentiating between mutual funds and ETFs. That you can buy and sell ETFs throughout the trading day, whereas most mutual funds can only be traded at day’s end.

So if there is a major market crash, you may be able to sell your ETF during the day, losing less than if you had to wait until the close of business to determine your selling price.

This may be important if you intend to be an active trader, much less so if you take a buy and hold approach.

I should also note that not all mutual funds allow for purchases or redemptions on a daily basis. While no longer common, there are still funds that may only allow for transactions weekly, monthly, etc. Before investing any capital into a fund, be certain to read the prospectus and know exactly what you are acquiring.

Company Pension Plans

As pointed out in the video, often the investment choices in company pension plans are limited.

When investing, always take a holistic approach to your assets.

Take advantage of what is offered by the company.

But that may not be your only investment route. If there are asset classes you wish to invest in that are not offered in your corporate plan, consider investing in these classes outside your pension scheme.

The goal is to arrive at a target asset allocation that meets your needs. If that can be achieved entirely in your company pension plan, great. But more likely, you will need at least one other investment account to hold other bankable assets.

Do not forget to include your non-bankable assets in your asset allocation. Your home, lake cabin, stamp or coin collection, etc. These are assets (and unique asset classes) and must be included in your asset mix.

Portfolio Protection

Protecting one's portfolio is very important.

If you can successfully time market movements, shifting assets between classes may work well. Or it may not.

I prefer ensuring that investors maintain a well-diversified portfolio that combines assets with different correlations. As one asset class increases in value, another with a negative correlation to the first will decrease. This means that your portfolio will never participate fully in the upside of a bull market in one class. But it also means that you will have some protection against bear markets in specific classes.

Enjoy the video.

Actual Versus Target Asset Allocation

You should compare your portfolio's performance against predetermined target benchmarks.

We have already covered a few useful benchmarks.

Arbitrary return figures such as nil, the risk-free rate, or a required rate of return based on your needs.

Relevant publicly available indices that reflect the composition and risk of your actual portfolio.

If investing in funds, comparing your portfolio returns and expenses against the funds' peers.

There is one other important benchmark that we have not yet covered.

Comparing your actual portfolio against your target asset allocation.

We will look at this today.

Target Asset Allocation

Your target asset allocation should be derived from your Investment Policy Statement (IPS).

It should factor in your personal circumstances, investment objectives, personal constraints, risk tolerance, and so on.

As your situation changes over time, your target allocation will shift as well. But changes should be made only when material events occur in your life (i.e., something major like marriage, children, career change) or when you move through phases of your life cycle. Alterations to one’s target asset allocation should not be an annual activity for most investors.

Actual Versus Target

Some experienced investors may compare the expected returns of their target asset allocation to the actual results. This can be done if you can assign expected returns to each asset class. But it is beyond our area of discussion at this time.

Instead, compare your actual asset allocation against your intended allocation. It will not likely be the same.

The reason is that your portfolio will probably earn some income in the form of dividends or interest. You may also buy or sell investments from existing liquid assets. These will all impact your cash component.

As well, you will incur unrealized gains or losses on your investments. These changes will affect your actual allocation.

For example, you invested $10,000 on January 1. Your target asset allocation was 60% global equities and 40% in mixed bonds. So you acquire 150 shares of Vanguard Total World Stock Index ETF (VT) at $40 per share and 400 units of ING Global Bond W Fund (IGBWX) at $10 per unit. At year end, you review your portfolio and find that the VT shares are worth $50 each and the IGBWX fund is worth $8 per unit.

Although you did not buy or sell any shares or units during the year, your portfolio allocation now sits at 70% equities and 30% bonds. Suddenly, you are out of alignment with your plans.

Good or Bad?

When comparing your actual portfolio performance against an index, peer, or arbitrary value, the higher your performance the better.

But in comparing your portfolio against the target allocation, the less variance the better.

Ideally, you would like your actual portfolio to maintain its target ratio as long as possible. But this is not realistic. And if you have a well-diversified portfolio, it is pretty certain that your allocation will differ.

Why? Because a well-diversified portfolio should see some assets increasing in value and others falling as they act as hedges against each other's movements.

So your objective in this analysis is to monitor your portfolio and make sure that it stays within a certain range of your target asset allocation.

Target Range

Range?

Yes, range.

To the extent practical, you want to maintain a buy and hold investment strategy. But if you want to ensure a fixed ratio of 60% stocks and 40% bonds, then you will need to rebalance constantly.

In our example above, that might mean selling $1080 of VT and purchasing additional units of IGBWX with the proceeds. That works for now. But what about the next review? What if stocks have fallen in price and bonds have increased? You might find that your VT shares are only worth 50% of your total capital. Then you need to sell some bonds and buy some more VT. And the next review, things may change again.

Not a formula for successful investing.

Instead, use ranges for your target allocations. Maybe you desire a 60-40 split between stocks and bonds. But create a comfort zone to prevent frequent adjustments. Perhaps your target can be 55-65% stocks and 35-45% bonds. Or 50-70% stocks and 30-50% bonds.

That will give you some leeway during your reviews, thereby prevent continuous adjustments with the attendant transaction fees and capital gains taxes.

The range you select should reflect your individual tastes. Your investor profile, personal risk tolerance, and ongoing review experience will play a large part in how wide the ranges are.

Asset Allocation: Common Shares

The final core asset class is common shares.

Yes, I know the final class is equities, but I consider preferred shares to be more fixed income in nature.

We can also use percentage allocations for these equities.

Once again, the right allocation is determined by your own comprehensive investor profile. Keys include your current financial situation, phase in the life cycle, and risk tolerance.

Here are a few thoughts from my side.

Common Shares

Common shares traditionally have the highest risk and expected return of the three core asset classes.

Some common shares distribute dividends and may be purchased for an income stream. But most common shares are acquired for capital appreciation potential, rather than income.

As such, common shares are more suitable for investors who can handle higher volatility in their investments. This may include investors with long time horizons, those that do not require immediate liquidity, and those with more aggressive levels of risk tolerance.

Common Shares for Accumulators

Common shares are well suited for Accumulators.

Accumulators generally have the longest time horizon of any investor group, so they can more readily ride out the fluctuations of higher risk assets. At times, liquidity may be an issue for Accumulators owning common shares. But if they properly plan their cash reserves, that should not be a major concern.

With the highest expected returns and the fact that Accumulators can handle the higher risk, it should make sense that Accumulators invest 100% of their wealth (less any cash reserves) in common shares.

Too Much of a Good Thing

It may seem to make sense, but probably not the best strategy in actuality.

That is because of the risk reduction benefits in diversifying one’s investment portfolio across multiple asset classes.

The Magic Number

As an Accumulator, wealth allocated to cash equivalents may be proportionately high. Say 20%. If you allocate another 5-25% in fixed income, that leaves between 55-75% available for common shares.

Probably a good range for most Accumulators.

Of course, your risk tolerance may lead you to increase or decrease the amount you allocate to common shares.

Further, as you consider investing in alternative asset classes, that will also impact your allocation to common shares.

Common Shares for Consolidators

Common shares are also very good investments for Consolidators.

The same rationale applies to Consolidators as to Accumulators. Those with relatively long time horizons should focus on higher risk investments.

The Magic Number

Consolidators have already accrued some wealth. Cash reserves, as a percentage of accumulated capital, will be less than in the Accumulation phase. Say 5% in cash equivalents. I suggested 10-30% in fixed income for the generic Consolidator in a previous post. That would leave 65-85% for common shares.

That seems to me a decent range for a Consolidator with a moderate risk tolerance. If your personal risk level differs, you should adjust the percentage accordingly.

While this is a good starting point, I would offer a couple of potential amendments.

First, as you age within the Consolidation stage of life, you may want to slowly lower your risk tolerance over time. This reflects your ever reducing time horizon and the desire to begin generating a fixed income stream for retirement. One that also improves portfolio stability and liquidity.

Second, as you increase your wealth and investment expertise, you probably will want to consider alternative asset classes. Real estate is common for investors. There are many other classes as well. The extent that you allocate a portion of your capital to alternative assets will also impact the percentage allocated to common shares.

Common Shares for Spenders

During retirement, there will probably be little income from employment or business. Spenders will normally need to live off their savings and pensions. As such, Spenders desire liquid, low risk investments, that provide a constant stream of cash flow. This suggests a shift from higher risk equities into lower risk fixed income assets.

And many Spenders do lower their component of common shares to a minimal amount.

But I do not think this is prudent for most investors.

<u>An Ever Lengthening Time Horizon</u>

Despite the natural inclination to lower your risk tolerance and seek safe investments, you should not completely succumb to this approach. The main reason is today's life expectancy.

Traditionally, people worked until 65 and then retired and lived off pensions. That was not a problem previously. According to U.S. National Center for Health Statistics, National Vital Statistics Reports, in 1950 the U.S. life expectancy was only 68.1 years of age. Three years from retirement to (average) death did not require significant savings.

But by 1970, life expectancy had risen to 70.8 years. By 1990, it was 75.4. For 2010, 78.3 years. And for 2020, life expectancy is projected at 79.5 (81.9 if you are female).

If you retire with same assumptions that they did in 1970, you may fall 9 years short in your ability to live.

That means you may need to work longer than 65, start saving much earlier to accumulate more wealth, and/or increase the level of risk in your retirement portfolio to compensate for a longer life.

<u>The Magic Number</u>

For the generic Spender, by retirement you may have about 10% allocated to cash equivalents and another 30-40% in fixed income. That leaves about 50-60% for common shares and alternative asset classes.

As the generic spender moves through the Spending phase, the percentage allocated to higher risk equities should decrease over time. A gradual reduction to 20-30% in common shares may be appropriate for the average Spender.

How fast you adjust your allocation depends on your financial situation, risk tolerance, and personal circumstances.

Perhaps you retire at 65 with $100,000 in capital and plan to live another 20 years. At a 5% return, an annuity would pay you $657.22 monthly Not great.

But if you had accumulated $500,000 in capital, that same annuity would provide $3286.09 monthly. Much better.

And if you had saved $2,000,000, your annuity would pay $13,144.35.

If you have accumulated closer to $100,000 than $2,000,0000, you may need to take on additional risk comfortably live through retirement.

If you could earn 10%, rather than 5%, your $100,000 annuity would pay $957.05 monthly. And at a 15% return, your annuity would pay $1300.53 monthly. Both are an improvement over $657.22 at 5%.

Personal circumstances also play a role in your allocation decision.

If your family all lives to 100, you may want to plan on a longer life than the average.

If you live in a location with a high cost of living, you may need to generate greater returns to keep up with inflation and higher expenses. For example, retiring in the Cayman Islands is a more expensive prospect than living out your days in Saskatchewan, Canada.

Conclusion

So those are my thoughts on asset allocation considerations for common shares, fixed income, and cash equivalents.

There are some general allocation principles that make sense for most investors.

Invest in higher risk and return assets when you have long time horizons. Shift into more liquid investments that provide a fixed income stream as you age and require safety. Diversify across asset classes to lower portfolio risk.

However, your personal circumstances will play a huge role in the right allocation for you.

Your current financial situation, investment objectives and constraints.

Your investment time horizon, phase of life cycle, and risk tolerance.

These variables are unique for each investor. They do not easily fit into a generic asset allocation calculator. They must be considered both separately as well as in their entirety.

That is why attention to your comprehensive investor profile is crucial.

Asset Allocation: Fixed Income

Fixed income is the second core asset class.

Here we can start to look at percentage allocations when investing.

Again, the investor profile will determine the appropriate amount to invest in fixed income.

Within the profile, the phase of one's life cycle and the investor's risk tolerance are keys.

Fixed Income Recap

Fixed income normally includes bonds, debentures, notes and preferred shares.

Fixed income is generally higher risk and higher return than cash equivalents. But it has a lower level of risk and expected return than common shares.

People who desire a constant stream of income liked fixed income.

What about the suitability of fixed income for those in the different phases of the life cycle?

Fixed Income for Accumulators

Not Really Suitable Investments

The logic goes that Accumulators tend to be young, with extremely long investment horizons. As a result, they can better absorb the fluctuations of higher risk and higher return investments than those in other phases of life. Because of this, Accumulators tend not to emphasize lower risk fixed income in their portfolios.

I agree with this logic.

Unless extremely risk averse, Accumulators should not invest heavily in fixed income assets.

But Do Not Exclude Completely

But that does not mean they should be totally excluded from one's portfolio. Fixed income investments may provide diversification benefits with other asset classes.

For example, consider a few current inter-asset correlations.

From the website Asset Correlations, as at February 4, 2011, the 1 year correlation between U.S. Bonds (i.e., fixed income) and various traditional equities are: U.S. Large Cap Stocks –0.32; U.S. Mid Cap Stocks –0.31; U.S. Small Cap Stocks –0.30; EAFA Stocks -0.26; Emerging Market Stocks -0.26.

If you recall our discussion of correlations, combining two assets with negative correlations is very beneficial in reducing portfolio risk.

For a refresher on diversification and asset correlations, please review here and here.

When we look at alternative asset classes, we shall see that fixed income can also enhance diversification. Consider the latest 1 year correlation between U.S. Bonds and: Commodities −0.24; U.S. Real Estate 0.12; Gold 0.17. Once again, fixed income can aid in portfolio diversification with alternative assets.

And do not forget that within the asset class itself, various subclasses may provide diversification benefits too. For example, the correlation between U.S. and Emerging Market Bonds is only 0.05. So there is value in diversifying within the asset class.

The Magic Number

I believe that Accumulators should include a percentage of investable assets in fixed income. For diversification if nothing else.

But I do not personally believe that most Accumulators should invest more than 50% of their investable assets in fixed income. I likely would not recommend 50% in fixed income even after backing out one's cash equivalent component. That is because the time horizon is so long that investing in riskier assets, with higher long-term expected returns, makes more sense.

For the generic Accumulator, I might recommend somewhere between 5%-25% in fixed income. This assumes someone with a moderate risk tolerance and whose cash component, as a percentage of total wealth, is roughly 20%.

It also assumes that the fixed income itself is diversified. Something that should be done when investing in any asset class.

Where you fall in this range will depend on your risk tolerance and amount invested in cash.

Fixed Income for Consolidators

Consolidators are older, but still have lengthy time horizons in which to invest. Consolidators should have some wealth accumulated and their investments in cash equivalents will reflect this. Perhaps 5-10% of total assets will be in cash.

Not the Best, But Not Bad

Because of the relatively long time frame, fixed income should not dominate the portfolio. Rather, the focus should be on investments with greater capital growth potential.

Same as with Accumulators.

Becomes Better With Age

As the time to retirement shrinks, Consolidators should increase their allocation to fixed income. This will solidify previous accumulated portfolio gains and begin to generate stable income flows for retirement.

But not too much, as we shall see below.

The Magic Number

For the generic Consolidator, 10%-30% allocated to fixed income may be appropriate. The increase from the Accumulation phase simply reflects a reduction in necessary cash equivalents to about 5%. The suggested allocation also takes into account that Consolidators often invest in alternative asset classes.

One’s risk tolerance will determine the appropriate allocation.

If you are extremely risk averse a higher percentage allocated to fixed income may be appropriate. It is your portfolio. You need to be comfortable with your investments. Because it is also your (potential) ulcer.

Finally, the extent that you invest in non-traditional investments (e.g., derivatives, commodities, venture capital, etc.) will impact your ultimate allocations.

The wider you spread your investments, the less that is usually allocated to any one class. How you diversify your portfolio will depend on your investment knowledge, comfort level, risk preferences, asset correlations, and the like.

Fixed Income for Spenders

Spenders are usually individuals at retirement age. Employment or business income has ceased and Spenders need to live on their pensions and savings.

Spenders are generally risk averse. This reflects the reduced time horizon for surviving asset volatility.

Because of this, Spenders traditionally invest primarily in fixed income and cash equivalents.

Now We Are Talking

These asset classes provide the stability, consistency, and liquidity Spenders want.

So many Spenders invest 80-90% of their wealth in cash and fixed income.

However, the trade-off for low risk investments is a low return. And that is a problem.

Too Much of a Good Thing

Today, many people retire between 55 and 65. Yet many retirees now live until at least their 80s. That means Spenders may need to live off their savings for at least 25 years. Maybe more.

That is a long time to survive on investments with low returns.

With longer lives (and investment time frames), Spenders should strongly consider maintaining a portion of assets in investments with potentially higher returns.

I would suggest that investors do not allocate 80% to cash and fixed income. Keep a portion in equities and other asset classes with better expected returns.

The Magic Number

For the generic Spender, at retirement perhaps 30%-40% in fixed income is suitable. That would assume about 10% in cash equivalents at that date.

As one continues to age, additional assets should shift into cash and fixed income instruments.

Personal factors need to be taken into account. Theses include: health situation; family history of death age; wealth accumulated; cost of living; prevailing interest rates.

If you expect to live until 110, you need to plan for that in your investing and drawdowns.

If your accumulated wealth is high, you can take a safe investment path. But if you have not saved enough for retirement, you may want or need to try and generate greater returns with riskier assets.

If interest rates are low, your level of income will also be low. If it is insufficient to cover your mandatory costs, you may also need to try to boost returns with higher risk investments.

So where you are at retirement will play a significant role in your actual asset allocation.

And, as is always the case, your personal risk tolerance will also play a part in the allocation. Both at retirement, as well as how you reallocate during your retirement years.

Most Spenders should have relatively low risk tolerance. This reflects the lack of other income on which to live and the reduced investment time frame.

But some Spenders may be extreme and want almost everything invested in safe investments. They will sacrifice some income in order to sleep well at night. Other investors with higher risk tolerances may ignore the shorter time horizon and still want a significant portion of their assets in less stable investments.

Next, equities.

Asset Allocation: Cash Equivalents

What asset allocation should you consider?

As I have written already, one's asset allocation should be unique to his or her comprehensive investor profile. You will need to come up with your own allocation formula.

But perhaps I can offer some advice in general.

Today we will look at cash equivalents.

Life Cycle Phase

A big part of one's investor profile is dictated by one's phase in the life cycle.

For a refresher, please read Life Cycle View of Wealth Accumulation.

Cash and Cash Equivalents Recap

In general, cash equivalents, including money market instruments, are low risk and low return investments. They are typically highly liquid and stable assets.

But as we have seen, within this asset class there are also high risk investments that may lack liquidity. So be careful.

Cash equivalents are useful for maintaining emergency funds.

Cash is also a good investment for any short-term personal objectives. These may include vehicles, housing, weddings, children, and such.

Cash is also needed to cover short-term obligations in full or as part of periodic payments (e.g., loan repayments with interest).

As short-term objectives and obligations approach, you can shift assets from less liquid and more volatile investments into liquid and stable cash assets.

Finally, maintaining a portion of capital in liquid assets is useful to take advantage of sudden investment opportunities.

Cash for the Accumulator

Accumulators are typically young people starting out in life. Or individuals who have experienced a disruption in the normal cycle. Those who have been unemployed, out of the work force for personal reasons (injury, illness, raising a family, etc.), or new entrepreneurs.

In this phase of life, cash requirements may be high as individuals often accumulate 3-6 months emergency funds, begin to start families, and repay relatively high debt loads. All during a phase where income levels are relatively low.

There likely will not be much excess disposable income with which to invest for retirement. After liquidity allocations, what little one has to begin long-term investing probably should not be placed in cash equivalents.

This is because young investors have a long time horizon until retirement. They can prudently accept higher risk in their investments in order to pursue higher returns. Also, Accumulators will have a relatively high percentage of current wealth allocated to cash anyway. Money that is in emergency funds and available for short-term requirements.

As such, it is hard to estimate what young investors should maintain in cash. Many models suggest 5-25% of total assets in cash for investors with greater than 20 years until retirement. The lower end for aggressive investors, the higher end for conservative.

But perhaps you only have $30,000 in assets. Monthly expenses for rent, food, et al., are $2500 and you want to maintain 3 months of expenses in emergency funds. That equates to 25% in cash and does not even factor in any short-term objectives or payments due. So even if you want to be an aggressive investor, you may need a higher cash allocation until you attain a critical mass in your wealth.

For those who are extremely risk averse, 25% in cash might still be too aggressive for their personalities. They might want to have up to 100% of their assets in cash equivalents. Not what I would recommend for most investors developing a long-term investment strategy, but it might be appropriate for those with absolutely no risk tolerance.

As a quick aside, note that some investors maintain their emergency funds in investments other than cash equivalents. They accept some risk – potentially reduced liquidity and loss of capital – in order to generate higher potential returns.

Cash for the Consolidator

Typically, consolidators are individuals in the middle of their careers, probably in their mid 30s to late 40s or early

50s.

Income is relatively high and expenses are low. Personal wealth has increased and debt significantly reduced. There is excess cash available for serious investing.

Individuals should still maintain cash in an emergency fund. But given the level of savings already generated, it may not need to be 6 months worth. And, as a percentage of one's investment, it will probably be small.

In the example above, the person only had wealth of $30,000. So $7500 in emergency funds equalled 25% of total assets. But if the individual now has $300,000 in assets, a mere 5% allocated to cash for emergencies would be $15,000. Double what was put aside in the accumulation phase. If one maintains the same $7500 in reserves, the percentage allocated to cash falls to 2.5%.

As you can see, the percentage of assets allocated to cash must take into account both your potential hard dollar needs as well as your total wealth.

Consolidators may require additional cash for short term objectives. Buying a vacation property, taking a major vacation, paying for the education of children. Or even just generally upgrading one's lifestyle with a larger home, better vehicle, and new wardrobe.

As this phase of life will see the bulk of one's investing, it is also a good phase to maintain some free cash reserves to take advantage of opportunities that suddenly arise. Without available cash, an investor will either need to miss out on the investment or have to liquidate other assets to invest. In selling other assets, an investor will pay transaction fees. The investor may incur taxes on capital gains or face losses if forced to sell something prematurely.

Cash for the Spender

Spenders are those at or near retirement age.

Income will be low, but so too should be one's fixed expenses. By now, people in the spending phase should have accumulated a relatively large amount of capital.

Because accumulated wealth is high, the percentage allocated to cash equivalents may be low. For example, with $2 million in assets, a reserve of 1% would still be $20,000.

But while mandatory expenses may be low, retirees usually want to enjoy life. With increased leisure activities (e.g., vacations, dining, etc.), discretionary expenses may result in a desire for greater liquidity and ready cash.

This is an areas that individuals often forget about when planning for their retirement needs while in their 30s and 40s. They factor in fixed costs, but do not include the increased discretionary spending that comes when retirees want to enjoy their leisure years. Without doing so, retirees may have enough money to live comfortably, but not enough to travel the world or engage in other more expensive leisure activities.

Also, with little to no income, many individuals in the spending phase will have substantially less risk tolerance. They will want to allocate a higher amount of hard dollars to cash as protection in case of emergency (health problems, stock market crashes, etc.).

The Magic Number

I do not think that it is prudent to allocate a percentage of capital to cash. Using a percentage calculation makes little sense.

Regardless of life cycle phase, allocate fixed amounts based on your needs and desires.

1. Determine what you want to maintain in emergency funds.

Funds that will cover 3-6 months fixed expenses.

2. Add in any money needed for planned short-term expenditures.

For Accumulators, this might be vehicles, wedding, children, debt repayment, etc. For Consolidators, a larger home, cabin at the lake, extra car, etc. For Spenders, vacations, known medical work, etc.

3. You might want to include a reserve for unplanned expenditures as well.

This may be especially prudent for Spenders. With no income other than savings and pensions, having cash available for unexpected costs (e.g., medical) may be wise.

But it may be a consideration for others as well. If personal circumstances dictate (e.g., health issues, young children, lack of medical or dental coverage at work, live in a location with violent weather, etc.) you may want to maintain a reserve for unplanned expenses.

4. Include a cash reserve for any investing opportunities that arise.

I suggest that this be an amount equal to what you may typically invest in any one asset. If you only invest $1000 at a time, that should be adequate. But if you normally invest in lumps of $20,000, your reserve will be higher.

How much you allocate to cash in each area will depend on your specific requirements.

If you work in a volatile industry with frequent layoffs, you may want to keep 6 months expenses in an emergency fund. If you work in a stable job, 3 months may suffice.

If you live in a hurricane belt, you might want to maintain some reserves for potential home damage and disruption of life.

How much you allocate will also be based on your personal risk tolerance.

The risk averse might want to save 6 months expenses regardless of how stable their employment is.

Aggressive individuals may want to keep little, if any, reserves for emergencies. Or the more aggressive may want to maintain their cash reserves in more risky cash assets such as foreign currency or short-term corporate paper.

The potential permutations are endless.

Once you total the above hard costs and factor in your risk tolerance, you will come up with the necessary cash component. Based on your total wealth, that will be the percentage that you need to allocate to cash equivalents.

As your wealth and circumstances change, while your needed hard costs may be the same, the percentage allocated to cash will shift.

Next, a look at fixed asset allocations.