Build a portfolio with the right tools

Choosing the right tools to build your portfolio
There are many different kinds of investments you can put your money into. They all have their risks and rewards. They all have their advantages and disadvantages. This section will help you decide which kinds of investments will best help you achieve your goals.

To help you decide which tools are right for you, review the following links:

- Why cash equivalents in your portfolio?
- GIC's: more options than you think
- Bonds: stability, safety & income
- Mutual funds: the easy way to invest
- Stocks: essential for growth

Why cash equivalents in your portfolio?

First, what do we mean by cash equivalents? Simply, any highly secure financial asset that is liquid, i.e. can be readily converted into cash. This would include: savings or chequing accounts, GICs, Treasury Bills and money market instruments (very secure, short-term, interest-paying investments).

Although holding cash and cash equivalents may not help much in growing your portfolio or in keeping pace with inflation, they should be part of a well-balanced portfolio.

Why hold cash? For one thing, your capital will be secure. And it will be liquid, which means that if an investment opportunity were to arise, you would have funds readily available to be able to take advantage of it.

Another reason is if you know you'll need certain funds within a short time – several months or even a year or two – holding those funds in this way ensures that you'll have it when the need arises.

In addition, whether you're in your prime career years and earning an income, or you're at or near retirement, you should always have emergency cash reserves for unforeseen events.

Choosing a cash strategy that's best for you
So what's the right strategy for your cash holdings? How much should you hold in each of the various forms? It all depends on your financial goals and the relative importance of liquidity and return.

Generally there is an inverse relationship between liquidity and return – the more liquid the investment, the lower the return. Cash in the bank earns the least, long term GICs generally earn the most, with a wide variety of options in between.

Keep in mind that the returns on cash, although they may be low, can be maximized through smart management. You should try to manage your short-term assets just as carefully as your long-term assets. Over the long run, when you have the power of compounding working for you, it can make a big difference to your overall investment returns.

GICs: more options than you think

GICs (Guaranteed Investment Certificates) are secure investments and as the name says, they are guaranteed. Your money is preserved and earns a predictable return that's based on current interest rates and the time period you choose.

Here are some of the various kinds of GICs you can invest in:

Short and long-term. GICs can range from one day to ten years. Generally the longer you invest, the higher your rate of interest.

Market-linked GICs are based on the performance of various stock market indices. Your principal is guaranteed but you won't know your actual return until time of maturity. You have the benefits of diversification and a higher potential return without risking your original investment.

Interest-linked GICs offer a variable rate of return during their term. As interest rates fluctuate, so do the rates on these GICs, allowing you to continue earning more as rates increase.

Specialty GICs are designed to meet specific investing needs. There is a wide variety available, for example, GICs that allow you to contribute through a monthly contribution plan.

Cashable or Redeemable GICs can give you the flexibility of accessing your money before the end of the term, without any penalties. These can also be called flexible GICs.

Non-redeemable GICs may pay a higher rate of return but are not redeemable prior to maturity except in exceptional circumstances.

Laddering: A popular GIC strategy
Laddering, or staggering maturity dates, allows you to smooth out rate fluctuations, increase your potential returns and ensures you always have easy access to your money.

The strategy is to divide your principal and invest it in a combination of short-and long-term GICs with staggered maturity dates. A common choice is to invest in 5 GICs, with terms ranging from one to five-years. When the most current GIC matures, you can decide whether to cash in your principal or to re-invest in a five-year term GIC.

This is a great way to take advantage of the best rates, and have consistent long-term investment growth. Using this approach, it's easy to customize your ladder to meet your specific needs and timing.

Because laddering has become so popular, special GICs have been created which ladder your investment for you. You get the same result but you don't need to manage and track separate GICs yourself.

Bonds: stability, safety & income

Bonds serve three purposes in your portfolio: to stabilize your overall return, to provide an element of safety and to generate steady income.

Like a GIC, a bond is a debt instrument. When you invest in a GIC you're lending your money to a bank, and in return they pay you interest. When you invest in a bond, you're lending your money to a corporation or to a government – the issuer – for which they also pay you interest.

Like a GIC, the amount of the loan – the face value of the bond – is guaranteed by the issuer to be repaid when the bond matures. However, with a GIC, the value is guaranteed by a bank and insured by the CDIC (Canadian Deposit Insurance Corporation).

With a bond the guarantee is only as good as the issuer. If the issuer runs into financial difficulty, they may default when the bond matures. Which is one reason why bonds pay higher interest than GICs. Generally, the rate of interest you'll earn on a bond is related to the credit rating of the company.

The expression "junk bond" refers to a bond issued by a corporation, which does not have a good credit rating. A junk bond generally pays a much higher rate of interest because the possibility of default is so much higher, which is why they must be considered a speculative investment.

Another difference between a GIC and a bond is the maturity period – bonds generally range from 5 years to 30 years. Plus bonds may be sold in the bond market at anytime before they mature. In addition, because of fluctuations in interest rates, the price of the bond in the market may be higher or lower than the face value.

That means you can make money with a bond in two ways: you can earn interest income plus you can sell it for more than you paid, giving you a capital gain.

The price of a bond, as opposed to its face value, is largely determined by the level of current interest rates and the credit rating of the issuer. As rates go up, the price of bonds on the market tend to go down.

The interest rate paid by a bond is determined by the level of current interest rates, the term of the bond (generally the longer the term, the higher the rate) and the issuers credit rating.

Canada Savings Bonds have for many years been one of the most popular investments in Canada. And with good reason. They have several unique features that make them attractive to many investors:
-they can be purchased for as little as $100 (most other bonds are a minimum of $1,000)
-they can be redeemed at face value at any time
-you can choose simple interest – you can receive regular annual payments – or compound interest – interest is reinvested and paid in full on redemption

Another type of bond that has become popular in recent years is the provincial savings bond. They have similar features to Canada Savings Bonds.

Bond funds can be a good way for the average investor to invest in bonds

If you want to invest in bonds, you should hold a diversified mix of bonds. However, since most bonds are priced at $1,000 or more, it takes quite a bit of capital plus time and effort to build a properly diversified portfolio of bonds. A solution is to invest in a bond mutual fund.

For a reasonably small investment, you can participate in a diversified portfolio of professionally managed bonds. The fund manager can purchase a number of different bonds, and in denominations that offer more favourable interest rates.

Short-term bond funds can be ideal for holding money that you're eventually going to invest. Suppose you receive an inheritance or a lump-sum distribution from a retirement plan. Although most investors would likely put those funds in a money market fund, you could put it in a short-term bond fund until you decide what you're going to do with it. And depending on the timing, you'll likely earn more than in a money market fund.

If you'd like to know more about the role bonds should play in your portfolio, click here to find the CPA financial planning professional closest to you.

Mutual funds: the easy way to invest

A mutual fund is a pool of money invested by many investors and managed by professionals.

When you buy a mutual fund, you're letting a professional portfolio manager do your work for you. Instead of you spending hours and hours researching the best stocks or bonds or whatever investments that interest you, you're letting an expert do it.

Professional managers also have the discipline and experience that are so necessary for success. And in exchange for all this – their time and efforts and ongoing expertise – they earn a fee that is part of the expense of managing the fund.

Whatever your goals, you can achieve them with mutual funds

There's a mutual fund that's right for every investor. From the inexperienced individual investor with a few thousand dollars to a gigantic employee pension fund with many millions, there's a fund to suit their purpose.

Mutual funds provide significant advantages to most investors. In fact, for many investors, mutual funds will be the key component in their portfolio.

We know how important diversification and asset allocation are to every investor. A mutual fund offers you both with a fraction of the investment you'd need if you were acting on your own, to say nothing of the time and effort involved.

Mutual funds allow you to participate in many asset classes, geographic areas, industry sectors and investment styles. Whatever kind of portfolio you want – from ultra conservative to ultra-aggressive – it can be created with mutual funds.

Here are just a few of the types of funds available:

Balanced Funds - These funds offer a mixture of safety, income and capital appreciation. They hold fixed income securities for stability and income, and a wide variety of common stocks for diversification, dividend income and growth potential. Balanced funds let you participate in the growth that stocks can provide while earning income through bond holdings. At times they also hold a small amount of cash for liquidity.

Equity Funds - The primary objective of an equity fund is capital growth, although dividends may contribute to the total return. They vary widely by their level of aggressiveness - the more aggressive the investment approach, the higher the risk and the greater potential for capital growth.

Bond Funds - Income and safety of principal are the main objectives. However, you should be aware that their values can depend on interest rate movements and they will be subject to capital gains and losses.

Dividend Funds – Their goal is to earn tax-advantaged income with some possibility of capital appreciation. These funds invest in Canadian preferred shares and high quality common shares that consistently pay dividends. The income from these funds qualifies for the dividend tax credit, providing an important tax advantage to investors.

Mortgage Funds - Goals are income and safety. They're not as risky as bond funds because mortgage terms are usually relatively short (five years or less) so their values will not be as sensitive to interest rate changes.

Specialty Equity Funds - Some investors like to diversify into specific areas that they feel will outperform the overall markets, such as natural resources, real estate, science & technology, precious metals. Specialty funds invest in these markets or industries. And although they are subject to volatility, they may provide excellent opportunities for growth over the long term.

International Funds - More and more investors are realizing that the best investment opportunities often lie outside of Canada. As a result, international funds are gaining in popularity.

With this kind of wide variety available you can enjoy a level of diversification – and risk reduction – that would require hundreds of thousands of dollars to achieve on your own. With mutual funds you can easily do it with just several thousand.

You can make money with mutual funds in two ways:

You can accumulate distributions – the earnings of the mutual fund. Mutual funds earn money through capital gains, dividend payments or interest income. These returns (when they are made

– they are not guaranteed!) are distributed to investors on a regular basis. You can also choose to reinvest the distribution, increasing the number of mutual fund units you hold.

You can sell your units for more than you paid. As the value of the investments in the fund increase in value, fund units increase in value. You can earn a capital gain by selling your units for more than you paid.

A summary of the advantages of mutual funds

-You get easy and convenient access to a broad range of investments in Canada and around the world.

-You achieve instant diversification because funds are made up of many individual investments. For example, one equity fund might hold 100 or more different stocks in its portfolio.

-You can achieve a level of diversification that would be impossible on your own, unless you have substantial dollars to invest.

-You can enjoy the benefits of a professional money manager looking after your investments, even if you don't have a six-figure portfolio.

Mutual funds are highly liquid investments so you can get your money out when you want it.

If you believe that a particular industry sector is going to grow, i.e., oil and gas, precious metals, telecommunications, etc., you can invest in it without having to research and choose any individual stocks.
Mutual funds are a way to enjoy the growth potential of equities while avoiding the generally higher risk of investing in individual equities

Like any investment, mutual funds have pros and cons. However, on the whole, mutual funds are an excellent type of investment for just about all investors.

They can be right for you even if you have limited experience, limited time or limited capital. They're also perfect if you have years of experience, plenty of time and unlimited capital. In other words, whatever kind of investor you are, whatever your goals, you can find a solution through the more than 2,000 mutual funds that are available today in Canada.

You should keep in mind that we've only talked about traditional, actively managed mutual funds. There is another category of mutual funds – such as index funds and exchange traded funds – which are "passively managed" and that you may want to learn more about.

If you'd like to know more about mutual funds you can click here to find the CPA financial planning professional closest to you.

Stocks: essential for growth

Equities are growth investments, and can include things like real estate, art, antiques and gold. However the most popular equity investments that people rely on for growth are stocks. But stocks can also serve purposes other than growth.

In addition to potential capital gains, stocks also have the potential to pay dividends. With GICs and bonds, you are a lender and your reward is interest. With an equity you are an owner, and if your company makes money, your reward is a dividend.

Because of the preferential tax treatment for some Canadian source dividends, dividends can play an important role in your portfolio. But as important as dividends may be, it is the potential for growth and capital gains that make stocks a vital part of your portfolio.

What the experts say about stocks
Financial experts have many opinions on many things, but there is one fact on which they will all agree – you need to have stocks in your portfolio to provide the growth you need to stay ahead of inflation and have a secure future over the long-term.

They also agree on the best way to invest in stocks – with a long-term view in mind. Yes, there are “day traders” and “swing traders” and many other “traders” whose success depends on timing the market. How do they do? For the most part, the ones who benefit most from “trading” are the brokers who earn commissions on each trade.

Trading stocks successfully over short run periods is difficult to say the least and there are far more losers than winners. Equities go up and equities go down. That is predictable. To know when they will go up or down is not.

But history has taught us one valuable lesson.

Over the long run, equities do go up and have proven to be the most profitable investment by far. But the key phrase here, the vital strategy for success is “over the long run”.

You saw an earlier example of the disastrous results of missing the “best” days in the market. Here’s another statistic that shows how important is to stay invested rather than be a trader:

From 1975 to 2000 the average annual rate of return on the Dow Jones Industrial Average was 12.3% per year. However, if you missed the best 35 days during this period, the return drops to 6.92%. Imagine. All you have to do is miss 35 days out of 25 years and you miss almost half of the gains.

When you hold stocks for the long run you get all of those key days. If you’re a short-term trader, unless you have a crystal ball working for you, you’re going to miss most of those key days. The simple secret to success is to stay invested.

What kind of stocks should you stay invested in?
That depends on your needs, your goals, your resources, your time horizon and your tolerance for risk. But whatever kind of stocks you want to invest in, you can find them.

If your goal is to preserve your capital and receive an income, there are ultra-safe blue-chip preferred stocks that have paid dividends regularly for years. (Always keep in mind that even though a stock may be ultra-safe, it is still a stock and its value is subject to performance and market forces.)

If your goal is to get rich quick, there are endless speculative opportunities to double and triple your money overnight. But if that's your goal, you'll have about the same chance of success at the racetrack or gaming table, where you'll probably have more fun.

And of course, in between the blue chips and the speculatives, there are thousands and thousands of stocks, covering the full range of risk and return.
With thousands of stocks to invest in, there are two basic investment styles – value oriented and growth oriented. Some investors strictly look for value stocks, others strictly for growth stocks. But most experienced investors practice both styles to some extent.

In today's market, value stocks are more in favour
A value stock is one whose price is lower than what its potential indicates it should be. The value investor looks at the relationship between the current price of a stock and its intrinsic value.

To determine a stock's intrinsic value, you evaluate things like current earnings, long-term earning potential, price-to-book ratio, and dividend paying ability. If this evaluation is higher than its current price, the stock could be a good long-term investment opportunity. A common guideline is to compare a company's P/E or Price/Earnings ratio to other companies in the same sector.

These value distortions or mispriced stocks can happen for a variety of reasons, but emotional reactions of investors is probably one of the most important. Here's how it happens.

Suppose that a certain company has excellent long-term prospects. But some negative event occurs that poses a short-term difficulty for this company.

Many investors, letting their emotions get the best of them, will overreact to the short-term problem and sell their shares. Share prices fall and create the kind of opportunity a value investor with a long-term horizon looks for.

A note of caution. Investing in stocks just because they are cheap is not value investing. Some share values are low because they deserve to be. The trick of course is knowing when the fall in price is called for or when it is an overreaction.

Which is why successful value oriented investors are not only research oriented but have the discipline to ride out stormy periods.

Growth stocks have more potential but . . .
Growth stocks, as the name implies, are stocks whose earnings are either on the rise or are expected to rise. During the late 90's, just about everyone was a growth investor. Every dip in prices was a buying opportunity. And then the great bull market began to falter. And investors who were buying on dips saw their investments keep going down and down. And you know the rest of that story.

As a result of that dramatic drop, many investors have shunned growth stocks. But this is like throwing the baby out with the bath water. There are still many growth opportunities that deserve examination.

The key for most investors is balance. Value and growth investments are both effective strategies through most stages of the economic cycle, and both should be represented in your portfolio. The extent that each should play is up to you.

Also keep in mind that mutual funds are an excellent way for an investor to participate in the high growth potential of equities with less risk and much less capital, time and effort.

How do you decide when a stock is attractive to purchase?
There are two general ways of determining a stock's potential as an investment. You can look at the “fundamentals” or you can look at “technical analysis” and of course you can look at both.

Fundamental analysis looks at factors such as earnings, cash flow, debt, strength in its industry, outlook for the industry, general economic factors, interest rates, and so on. If these factors are good, then even if there are short-term setbacks, over the long-run, the stock should do well.

Technical analysis looks at factors like volume of trading, cyclical behaviour, trends, moving averages and many others.
Some investors use both approaches. They use fundamentals to determine the long-term potential of a company and technical analysis to decide when to buy. For example, you may believe that a certain company has great potential over the long-term and will be worth much more in years to come.

However, it could be that the current market for this company’s product is temporarily weak and that as a result, the stock price could fall. Technical analysis could be helpful in determining how far the price might fall and could provide help in indicating a good time to buy.