Minimizing Risk and Maximizing your return

Although you can't avoid risk, you can certainly reduce it. In fact, there are proven investment strategies that will allow you to not only reduce risk, but will also let you increase your returns.

Start your browsing by clicking on one of the following topics:

-Diversification: Foundation of all strategy
-Asset allocation determines performance
-Which strategy is best for you?
-When should you rebalance your portfolio?
-Success is measured over time

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Diversification: Foundation of all all strategy

We know that no single investment, regardless of how secure, will allow you to avoid all risk. If you hold only cash, GICs or bonds, you face the inflation and interest rate risks described in the section, Whatever you do with money you face risk.

The only way to avoid those two risks is by adding more risk by investing in equities. Although stocks do carry higher risk, only stocks have the growth potential you need to beat inflation and have a secure financial future.

By holding cash, GICs, bonds and stocks in your portfolio, you're employing a strategy called diversification, possibly the most important and powerful investment strategy you can use. It lets you accomplish two seemingly opposite goals at the same time: Reduce your risk and increase your returns.

In the early 90's two economists won a Nobel Prize for developing the Modern Portfolio Theory. They discovered when you add together two investments whose returns react differently to the same event, it's possible to reduce risk and improve performance at the same time.

Different market sectors and different investments can react differently to the same events. For example, an increase in interest rates can cause some investments to go up and others to go down.
A diversified portfolio improves performance and reduces the risk by adding the high return from equities to the solid base of cash and fixed income investments.
In one sample 10-year period, a diversified portfolio earned 95% of the average return of an equities-only portfolio with less than 40% of the risk. The risk in the diversified portfolio is reduced because during times when equities were down, the fixed income securities continued to provide earnings.

Diversification can be achieved on many levels
Some of the leading wealth management firms practice investment strategies that diversify portfolios on 3 levels: By assets, by investment style and by management style.

Diversification of assets – Assets can be diversified on many levels. Most important, by asset class, holding a mix of stocks, bonds and cash. Possibly then by geographic sector taking advantage of global opportunities and the fact that if one economy is weak, another is strong. And then by economic sector, to include a variety of industries, because when one industry is slowing down, another is picking up. Each of these diversifications will serve to increase returns and reduce risk.

Diversification of styles - Each asset class is then diversified into multiple investment styles - such as growth, value, and income and by market capitalization including a mix of small-cap, mid-cap and large-cap companies.

Diversification of managers - Portfolio returns can be enhanced by using multiple managers with complementary investment styles who react in their own ways to varying market conditions.

It would be impossible for most individual investors to achieve such levels of diversification on their own. The amount of capital required would be immense. But you can enjoy the

advantages of this kind of multi-level diversified portfolio through certain mutual funds and investment programs.

If you would like to know more about how multi-level diversified investments can help your portfolio, click here to find the CPA financial planning professional closest to you.

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Asset allocation determines performance

Except for the most conservative portfolios which do not hold equities, every portfolio should be diversified to hold all three assets classes:

You need cash for security and liquidity so that you can take advantage of opportunities as they arise.
You need bonds and GICs to help you preserve your capital and provide a steady income.
And you need stocks for growth to help you beat inflation and counter the impact of taxes.

The question is, what should your asset mix be? Exactly how should you allocate your capital among those assets? What percentage should you hold of stocks, of bonds and of cash?

This is what asset allocation is all about. And in case you're wondering if it's important, studies have shown that over 80% of long-term portfolio performance comes from having the right asset mix.

Although you may find it hard to believe, this means that picking the right stock or mutual fund is not as important as making the right asset allocation decision.

And it means spending some time to determine your appropriate asset mix is an invaluable exercise before you begin to select individual mutual funds or stocks.

Your portfolio should contain some non-Canadian investments
Out of the many assets allocation decisions you'll make, here's an easy one – you should plan to incorporate global investments into your portfolio. This will give you one more way to boost potential returns and decrease risk.

Did you know that Canada represents less than 3% of the world's investments? That means if you don't have some international holdings in your portfolio, you're missing out on 97% of all investment opportunities and some of the best performing companies in the world.

Here are some figures based on annualized returns from the TSE (now the TSX), S&P 500 and MSCI for the period 1981 to 2001 comparing the performance of a globally diversified portfolio vs a domestic portfolio.

Domestic portfolio
Canadian equities – 100%
US equities - 0%
International equities – 0%
Annual return – 10.7
Standard deviation – 15.2

Globally diversified portfolio
Canadian equities – 70%
US equities – 15%
International equities – 15%
Annual return – 11.2
Standard deviation – 11.4

As you can see, not only did the globally diversified portfolio outperform the domestic portfolio, but it experienced a significantly lower level of risk.
The message is clear. If you don't include some foreign stocks in your portfolio, you'll not only be missing out on growth, but you'll incur a higher level of risk than necessary.

Which strategy is best for you?

Most portfolios should be structured with 5 financial objectives in mind:
-Growth
-Income
-Inflation protection
-Peace of mind and preservation of capital
-Minimize taxes

You have to weigh and balance the importance of each and keep them in mind as you structure your portfolio. There is no such thing as an optimal balance that's right for everyone. The balance between them is personal and depends on the relative importance of these factors for you.

Your thinking should begin with these three questions
1. What are your goals? Why are you investing? To accumulate money for a specific purpose? A house? A cottage? A fabulous vacation or trip? For retirement? Which is more important to you at this point – growth or security? Are you investing to create income now or in the future? What kind of performance do you expect from your investments?

2. What is your time horizon? When do you want to realize the fruits of your investment? How long will it be before you will need to draw on your invested capital or access your investment earnings? This is critical because both the risk and the reward of investments can vary according to the time horizon. Generally, the more time you have, the more aggressive your investments can be. The less time, the more you need to avoid risk.

3. What is your risk tolerance? There is a risk-reward continuum running from cash to bonds to stocks. You have to weigh the return you want against the risk you're willing to tolerate. If you want to earn double-digit returns each year with no risk, you simply can't do it.

We've looked at the emotional part of risk, but risk has other dimensions. You also have to consider how easy it is for you to replace your capital. If you're not earning any income, replacing lost capital will be difficult, which means a more conservative approach. Other considerations are your present financial situation, your estate plan and your level of taxation.

One other important factor is your age. As a general rule, the younger you are, the more aggressive you can afford to be with your investment portfolio. The older you are the more conservative you should be because you have less time to recover from any possible setbacks in the value of your portfolio.

Simply put, deciding on your assets allocation strategy is difficult. Or if you'd like to receive personal assistance, click here to find the CPA financial planning professional closest to you.

When you should rebalance your portfolio

Every now and then you should reexamine your asset allocation strategy in light of current and expected market conditions. By rebalancing your portfolio's holding of stocks, bonds and cash, you can lessen the risk in downturns and improve the growth in upturns.

When should you rebalance? One rule of thumb is to consider rebalancing if your portfolio has shifted more than 5% from your recommended asset mix.

Here's another scenario that would call for a rebalance. Let's say you're a moderate growth investor and you're building your portfolio during a growth phase in the economy. To capitalize on expanding corporate profits, you'd want to have a relatively high percentage of stocks, perhaps 60%, with 30% in bonds and 10% in cash.

When the economy enters a contracting phase, interest rates may rise, and corporate profits may begin to shrink. You might want to move away from stocks, and more to bonds and cash, for example to a mix of 20% stocks, 45% bonds and 35% cash.

Many investors struggle with the question of what percentage equities should comprise in their portfolio. There are really no set formulas – it depends on your goals and investor profile. However, as a general rule, the older you are the less equities you should have.

Success is measured over time

How do you define success? If success for you is to see your investments grow by 30% and 40% a year and more, then diversification and patience is not the way. To achieve those kinds of high returns requires speculation, exposure to high risk and most important, a great deal of luck.

But if your idea of success is to achieve a reasonable return on your investment with an acceptable level of risk, then diversification and a long-term outlook are the two keys.

"It's time in the market, not market timing, that counts"
Your greatest ally in investing is time. In a sense, the main difference between investing and speculation is the time horizon. If you look at stock performance (measured by the S&P index) over just about any 10 year period throughout the past century, you'll see stocks did better than any other financial asset.

Being in the market on a continuous basis really pays. Usually a large percentage of the growth of any investment in any year takes place on several key days. If you miss any of those days, it can cost you dearly. These figures prove it:
10 years on S&P and TSX
staying invested – earned 8.8%
missed 10 best trading days – earned 4.7%
missed 20 best days – earned 1.4%
missed 50 best days – lost 5.6%

As these numbers show, achieving your investment goals requires a steadfast focus on the long term. Making dramatic changes to your portfolio as a response to short-term market events can be costly.

One of the worst and unfortunately most common mistakes made by investors is losing patience or panicking when the market drops. Unless you have a good reason, like taking a tax loss, selling an investment in response to a market decline simply guarantees you a loss that had only existed on paper.

Thinking in the short term can cause you to miss out on the gains when the market bounces back. And if you look at the history of the market, after major declines, the market has always bounced back.

There's no doubt, stocks can be volatile. However, the potential for loss, although a major factor in the short run, decreases significantly the longer you hold them.

Which leads us to three simple rules for investment success:
1. Diversify with all asset classes
2. Be patient and stick to your long-term plan
3. When in doubt, reread rule #2