

## Asset Allocation

### Balancing Lifestyle with Lifecycle Asset Allocation

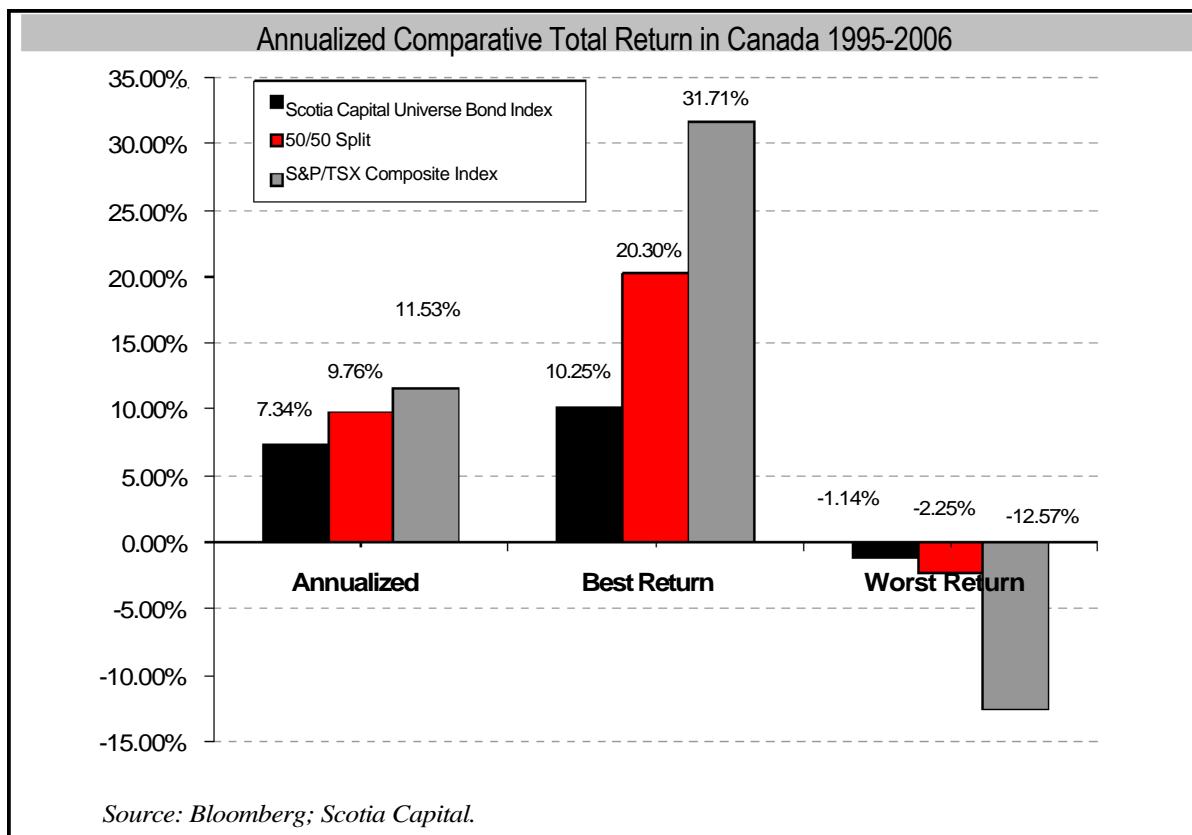
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As highlighted in our feature article from Barry LaValley, the way Canadians are thinking about retirement is changing. Just as we are no longer seeing retirement as a move to a 30-year weekend, nor should our financial objective be constrained to a single goal: build a massive nest egg to become completely dependent upon as soon as the lights in the office go out and the sunlight of retirement begins. Financial goals should be much more dynamic, and built to compliment your lifestyle goals during the many years of retirement. Your lifestyle may actually change many times during this stage in life. Perhaps there will be consulting work, providing additional streams of income or perhaps there will be big-ticket expenditures, that although weren't originally in the plan, have been pushed to the forefront due to a sudden health scare or change of life realization. The length of our retirement years has also been increasing over past generations. The retirement years can make up the single longest stage in one's life, with the potential to last 30 years or more. This increased length of time inherently changes what you need your portfolio to do for you and for how long you need it to do so. When planning for your retirement, you need to take into consideration many factors including your age, your financial status, future plans and needs.

ScotiaMcLeod believes that a key component in planning for retirement is to take the time to reflect and think about the life you want to lead, before deciding how to position your financial portfolio. However this advice is not just for retirement, but should be followed at the many other stages of your life where there is significant change. These major stages will usually have an effect on your risk/return profile and therefore they will change how your portfolio should be designed. An example may be having your first child or buying your first home. Another would be the same child, or children becoming old enough to no longer require your financial support. At each of these stages, it is likely your financial needs will change, as will your ability or desire to take on risk.

Therefore, once you decide the lifestyle you want to lead, you should also be thinking about how your financial plan fits with either your stage of life or your risk/return profile. In this article we provide guidelines that focus on asset allocation techniques to help match up your financial plan to your desired lifestyle.

Asset allocation is the decision to invest in different types of financial assets such as equity, fixed income, or real estate, to differentiate the way your portfolio will look and act. We stress the importance of asset allocation, as the proportion of your money allocated to each of these asset classes will have a substantial impact on your portfolio returns. In fact, asset allocation is one of the most important determining factors of not only your portfolio's level of returns, but also the volatility of these returns. Why is this? The reason is the concept of diversification. By not placing all of your financial eggs in one asset basket, you spread out the return factors, and also reduce the potential for loss in your portfolio. For example, on the following page is a chart that plots returns since 1995 of three separate portfolios using different asset allocation strategies. The first is 100% Fixed Income (Scotia Capital Universe Bond Index), the second a 50% Fixed Income, 50% Equity mix and the third, 100% equity (S&P/TSX Composite). As can be seen, the 100% equity portfolio has outperformed the 100% Fixed Income portfolio on an annualized basis. However, the 100% equity portfolio hasn't done so without the addition of risk, and therefore increased frequency of losses which is illustrated by the "best return" and "worst return" chart. However, the blended portfolio has generated significant returns comparable to the 100% equity portfolio, but at a fraction of the volatility.



Although the importance of holding different types of assets is clear, how do we decide what percentage of assets to buy? There are generally three schools of thought on asset allocation:

- Life Cycle/Time Horizon Model
- Client Risk Profile Model
- Market Driven (strategic long term and tactical short term).

In general, each of the asset allocation models is based on the assumption that over time, Equity investment (stocks) will outperform the return on Fixed Income investments, but will also have higher volatility and risk of loss, as seen in the chart above.

### Life Cycle/Time Horizon Approach

The majority of an investor’s needs and abilities can be based on assumptions about certain periods in an investor’s life, and then generating financial allocations to match those needs. We can separate an investor’s life into four specific stages– Accumulation, Consolidation, Spending and Gifting. Below are the relevant details of each grouping.

Accumulation	Consolidation
<p>This stage represents an investor’s early to middle working years. Needs are represented by short term goals and long term growth.</p> <ul style="list-style-type: none"> <li>■ Approximate age: 25-35</li> <li>■ Ability to take risk: high</li> <li>■ Time horizon: extremely long</li> <li>■ Life factors/Portfolio needs:                             <ul style="list-style-type: none"> <li>■ Growing earnings capacity</li> <li>■ Paying off education loans</li> <li>■ Potentially saving for purchase of a home</li> </ul> </li> </ul> <p><b>Portfolio composition:</b> High % weighing to equities (100 minus your age is industry rule of thumb), small amount should be in bonds, and small amount in cash for opportunities/emergencies.</p>	<p>This stage begins around the midpoint of an investor’s working life. While growth is still important, protection of assets that have been accumulated must be considered.</p> <ul style="list-style-type: none"> <li>■ Approximate age: 36-55</li> <li>■ Ability to take risk: moderate to high</li> <li>■ Time horizon: long</li> <li>■ Life factors/Portfolio needs:                             <ul style="list-style-type: none"> <li>■ Portfolio is of reasonable size</li> <li>■ Earnings may exceed current needs</li> <li>■ Education for children is a possibility</li> </ul> </li> </ul> <p><b>Portfolio composition:</b> Majority remains in equity, as some risk can be taken over the long time horizon remaining. Slightly larger allocation to bonds to protect assets. Cash weighting remains for opportunities/emergencies.</p>
Spending	Gifting
<p>This stage usually begins with the traditional retirement from one’s major source of income. Protection of assets is key, and a higher level of income is usually required from the portfolio.</p> <ul style="list-style-type: none"> <li>■ Approximate age: 56-70</li> <li>■ Ability to take risk: low</li> <li>■ Time horizon: moderate</li> <li>■ Life factors/Portfolio needs:                             <ul style="list-style-type: none"> <li>■ Dependants usually gone/ low or no mortgage</li> <li>■ Income may exceed lifestyle needs</li> <li>■ Protection of assets is key</li> </ul> </li> </ul> <p><b>Portfolio composition:</b> Shift to principal protection – increase bond weighting. Inflation is a larger concern however, equity weighting can increase return to offset. Cash weighting remains for opportunities/emergencies.</p>	<p>Similar to, and can overlap with, the Spending stage. Thoughts of estate planning should be completed by this time. Needs are low, and preservation of wealth, while minimizing tax should be of concern.</p> <ul style="list-style-type: none"> <li>■ Approximate age: 71-85</li> <li>■ Ability to take risk: very low</li> <li>■ Time Horizon: short to moderate</li> <li>■ Life factors/Portfolio needs:                             <ul style="list-style-type: none"> <li>■ Portfolio may be sole source of income</li> <li>■ Protection of wealth main concern</li> <li>■ Tax minimization is key concern</li> </ul> </li> </ul> <p><b>Portfolio composition:</b> Principal protection is high priority. Majority of portfolio usually shifted to bonds. Inflation and tax considerations are a concern when attempting to preserve purchasing power of withdrawals. Cash weighting increases for possible emergencies for liquidity.</p>

## Client Risk Profile Model

The life cycle model is a broad guideline to help give investors structure and ideas of investment mix at any point in their life cycle. However, just as investors don't fit into the age old "retirement" mold anymore, nor should we believe that investors always fit into a specific Life Cycle mold that dictates their investment decisions. Therefore the most important asset allocation model is one based upon an investor's specific risk/return profile, irrespective of their life cycle. For instance, there may be an elderly client that will assume large amounts of risk due to the size of their portfolio or their knowledge of the markets. Conversely, there are some investors with 30-40 years of potential working years remaining with a very low willingness to take risk and invest only in low volatility securities.

This model is based upon a client risk assessment and should be conducted with your Investment Advisor. In doing so, both of you will have a better understanding of your current and future financial goals and constraints. From this discussion, a risk profile can be developed to help decide what assets are best for your portfolio. This risk profile can also overlay and compliment the Life Cycle asset approximations. ScotiaMcLeod currently employs our proprietary "Best Mix" asset allocation tool. Best Mix can provide guidance on what combination of the various asset classes is most efficient for achieving an individual's goals. This knowledge can then support the creation of an Asset Allocation model within an Investment Policy Statement and the remaining steps required to construct a portfolio and implement plans for review and rebalancing.

Summarized in the table on the following page are ScotiaMcLeod's **Best Mix** asset allocation model categories, blended with the Life Cycle stage that most commonly is represented by each risk/return level.



Scotia Capital Asset Mix – Spring 2007

Life Cycle Equivalent Typical Risk Assessment	Asset Mix (BestMix) Asset Percentage	Sample Portfolio
<p><b>Accumulation Maximum Growth</b></p> <p>Investment Objective: To generate maximum long-term capital growth</p> <p>Description of Asset Mix: Heavily weighted in equities</p> <p>Expected Risk: Very high volatility, will likely have negative returns within a 4 year horizon</p>	<p>Cash 0%</p> <p>Fixed Income 0-25%</p> <p>Equity 15-100%</p> <p>Real Estate 5-10%</p>	<p>Equity, 82%</p> <p>Real Estate, 10%</p> <p>Fixed Income, 8%</p>
<p><b>Accumulation/Consolidation Moderate Growth</b></p> <p>Investment Objective: To generate primarily capital growth, with capital preservation being secondary</p> <p>Description of Asset Mix: Heavily weighted in equities compared to fixed income securities</p> <p>Expected Risk: High volatility, will likely have negative returns within a 4 year horizon</p>	<p>Cash 0-15%</p> <p>Fixed Income 0-40%</p> <p>Equity 10-90%</p> <p>Real Estate 5-10%</p>	<p>Equity, 64%</p> <p>Fixed Income, 26%</p> <p>Real Estate, 10%</p>
<p><b>Accumulation/Consolidation Growth and Income (Balanced)</b></p> <p>Investment Objective: To generate both capital growth and moderate income. Some income is required from portfolio, but a portion may be reinvested.</p> <p>Description of Asset Mix: More heavily weighted in equities compared to fixed income.</p> <p>Expected Risk: Medium volatility, will likely have some negative returns within a 5 year horizon</p>	<p>Cash 0-15%</p> <p>Fixed Income 5-40%</p> <p>Equity 10-65%</p> <p>Real Estate 5-10%</p>	<p>Equity, 50%</p> <p>Fixed Income, 29%</p> <p>Cash, 11%</p> <p>Real Estate, 10%</p>
<p><b>Spending Income</b></p> <p>Investment Objective: To generate current income and preserve capital</p> <p>Description of Asset Mix: More heavily weighted in cash and fixed income securities than equities</p> <p>Expected Risk: Low to medium volatility, will likely have negative returns within a 6 year horizon</p>	<p>Cash 0-15%</p> <p>Fixed Income 5-60%</p> <p>Equity 5-55%</p> <p>Real Estate 0-10%</p>	<p>Equity, 38%</p> <p>Fixed Income, 40%</p> <p>Cash, 15%</p> <p>Real Estate, 7%</p>
<p><b>Gifting Capital Preservation</b></p> <p>Investment Objective: To preserve capital and generate some current income</p> <p>Description of Asset Mix: Weighted heavily in cash and Fixed Income, with limited equities</p> <p>Expected Risk: Low volatility, will likely have positive returns each year</p>	<p>Cash 0-15%</p> <p>Fixed Income 0-95%</p> <p>Equity 0-35%</p> <p>Real Estate 0-10%</p>	<p>Equity, 24%</p> <p>Fixed Income, 60%</p> <p>Cash, 15%</p> <p>Real Estate, 1%</p>

As illustrated, the Client Risk Profile Model has five major strategies for clients given their respective risk/return profiles, and recommends target percentage asset allocation ranges. This information should be a natural progression from creating a client Investment Policy Statement that outlines investment objectives, risk tolerance, and investment constraints.

However, how do you determine the appropriate allocation within these ranges at any given point in time? The third aspect of asset allocation is much more active, called *Tactical Asset Allocation*. Tactical Asset Allocation is market driven; in which portfolio managers recommend shifting products or percentages, either between or within asset classes, in an attempt to take advantage of perceived market opportunities. Tactical Asset Allocation strategies are generally recommended for clients with a strong understanding of the markets, and those with higher risk tolerance. The strategy not only involves changing the level of assets between Equity and Fixed Income, but also the level of geographical representation or level of risk within those asset allocations. Examples of Tactical strategies would include overweighting U.S. Equity and underweighting Canadian if the relative value in the U.S appeared greater. Another would be to allocate a greater portion of a portfolio to cash in times of uncertainty, before reinvesting when further opportunity is available.

Scotia Capital Portfolio Strategist Vincent Delisle provides a recommended asset allocation strategy for institutional investors that can be used as a guideline. These tactical asset allocation strategies can be easily integrated into both the Life Cycle, and/or Client Risk Profile strategy, by using his overweight/underweight recommendations for each asset class to influence your decision to change the relative weight of your portfolio in the ranges outlined.

Scotia Capital Asset Mix – Spring 2007			
	Weights		Recommended
	Min	Max	
<b>Equities</b>			<b>62% (overall)</b>
TSX (Canadian)	10%	30%	<b>18%</b>
S&P 500 (U.S.)	10%	30%	<b>23%</b>
MSCI EAFE (Euro)	10%	30%	<b>21%</b>
<b>Bonds</b>	<b>20%</b>	<b>70%</b>	<b>31% (overall)</b>
<b>Cash</b>	<b>0</b>	<b>20%</b>	<b>7% (overall)</b>

*Source: Scotia Capital.*

For instance, let's assume an investor is in their mid thirties, with an average risk tolerance. Their risk assessment will most likely lead them to follow a Moderate or Maximum growth strategy. This would result in a recommended 10-100% weighting for the equity portion of the portfolio, a 0-40% weighting towards fixed income, and a 0-15% weighting towards cash. Currently, Vincent Delisle is recommending a slightly overweight 62% allocation weighting towards equity, a slightly underweight 31%

allocation towards fixed income, and a slightly underweight 7% allocation to cash.

Therefore, the investor could be above the middle of their equity weight, say 75%; and slightly below average weightings towards fixed income and cash – say 18% and 7%, respectively. In addition, the investor could also take into account Delisle's recommendations for relative equity market exposure – underweight Canada, and overweight international stocks, as highlighted above.

### Where to go from here

ScotiaMcLeod prides itself in offering tailored investment advice, such as the above asset allocation strategies. As we are thinking differently about retirement, we need dynamic financial portfolios that compliment the way we want to live and the goals we want to achieve while also providing structure for future foreseen or unforeseen events.