

Income and the “new realities of retirement”

The following provides a context to comments that appeared in the June 10 National Post article, “Boomers to Play it Safe, but not too safe”.

BMO launched two new funds in June noting the precept of the new realities of retirement. In fact, the realities of retirement have always been the same, as have the realities of investment.

Investors should consider the “new realities” of retirement as more to do with asset managers becoming fully aware of the business opportunities the retiring baby boomers present and are now *beating their old drum to a different tune*.

The question that individual investors need to ask, is do these new products deal with the realities of retirement and the realities of investment combined?

- The realities of retirement are that individuals will not just need a higher level of income from their portfolio, but *they will in varying degrees need to consume capital*.
- The realities of the individual are that *no one set of financial needs are the same*. They do not just consume an average monthly income requirement but they will often have larger one off capital expenditures.
- The reality of constructing a portfolio to meet financial needs is *that certainty of income and capital to meet these expenditures is very important to individuals depending on their assets for their financial security*.

Creating greater certainty of income and capital is the biggest challenge to any portfolio manager, especially since all assets and all returns are exposed to risk, to lesser or greater extent.

Proper portfolio structure and planning is key to providing certainty of income and capital, irrespective of significant stock market and economic risks.

This means making sure that the planned income and capital expenditure can be met safely from interest and dividends and where capital is being depleted that the maturity structure of the low risk portfolio and, the liquidity profile of the equity portfolio complement the consumption profile of the individual.

- This means a low risk portfolio where the allocation to cash, to domestic government fixed interest, to corporate bonds, to high yield, to preference shares to preferred shares, to index linked, to zero coupon bonds, to global bonds and currency is specific to the size and timing of the individual’s financial needs and is capable of managing the risks that will hit the portfolio.
- It means an equity portfolio where the allocation, the dividend yield and the liquidity and risk profile of the securities has a relationship with the need to deplete capital over. Consuming capital at the short end of the portfolio will demand transfers from the equity portfolio over time. This also means a low risk allocation which can not only meet financial demands without

“Approaching the new realities of retirement from the conventional lump sum funding perspective is no longer viable,” Excerpt from BMO press release

“Certainty of income and capital can only be met through proper portfolio construction, planning and management.”

financial penalty but an allocation that does not depend on annual transfers from higher risk equities.

- **It also means being able to model risk to the ability of assets to meet financial needs.** For example, the only risk that is likely to hit a government of Canada 5 year bond that is held to maturity is inflation. But the risks that could hit an income trust or an income trust portfolio include a fall in capital values due to recession, a market correction, a rise in interest rates, an inability to pay dividends or a weakening or the collapse of the company. If you adjust the yield and the capital for these risks (presuming you have a diversified portfolio) you may find that the yield you can safely rely on is much closer to that of the bond, or worse, significantly less.

In other words, what you see is not necessarily what you get. ***It is not just the size of the yield or the dividend that counts, but the quality of the yield and the underlying capital asset.*** The lower the quality of the asset the less you can rely on the yield and the further out the asset needs to be in the portfolio in terms of your dependence on its capital and the lower the percentage of the yield you can take for granted.

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This is very important since ***most of the products that we see on the market place only advertise the current yield, not the risks to the yield and, if you need to access capital, not the risks to the capital.*** If the risks have not been taken into consideration within the planning, and the risks actually hit your portfolio, your financial security will be affected.

So, in order for a portfolio to guarantee income and capital with any degree of certainty, your advisor's planning will need to have the portfolio with the risks it need it to withstand; this means hitting the portfolio with inflation risk, interest rate risk, currency risk, credit risk and stock market risk and the duration of these risks.

“Can your portfolio cope? If not, how certain is your income?“

In truth, the realities of retirement are much more than just looking for higher yield.

Indeed, placing too much focus on interest and dividend yield could force too high an allocation to lower risk assets and insufficient exposure to longer term higher risk assets; this risks over emphasising current consumption as opposed to future consumption. Or worse, the search for too high a yield could lead you down the path to much higher risk investments that could place both your current and your future security at risk.

Key problem

The reality of investment in the retirement context is that there is a very fine line between current consumption and future consumption, and the allocation and management of assets to make it work.

Are the products we see in today's market place the solution?

There is a place in any portfolio for any asset class at the right price and at the right cost; but the place and the cost are key and, knowing where the place is and the price you are willing to buy is another.

What about the “One Size fits all income” fund?

There are a number of problems with these types of funds.

1. The first is that they do not provide any information about the certainty of the income derived and the capital invested. This would not be a problem if mutual fund companies were only responsible for the management of assets and not the asset allocation, in which case they would not selling such funds but vehicles that allocated to each specific component.

It is a problem where a client is receiving advice as part of a traditional transaction led client relationship. That is the client is being sold the product as opposed to being provided advice over risks, portfolio composition, planning and management. The current distribution framework for financial products is not capable of managing the risks that such products pose.

2. Secondly, diversification is an important element of portfolio construction, but much of the benefits of diversification are lost when all components are held within one unitised structure; especially the case where an individual relies on their assets for income and capital over time.

If you need access to capital as a retired investor will, you will need to sell under valued assets as well as over valued, bonds as well as equities, short dated bonds as well as long dated bonds; in fact you will be forced to do much that proper portfolio management is designed to rule against.

3. Thirdly, as far as the realities of retirement is concerned these funds apply to no-one in particular and are incapable of solving the key portfolio problem as it affects those in retirement. That is, how to optimise the allocation of assets relative to the consumption of income and capital over time?

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4. Many of the asset classes that an investor needs to provide secure and certain income at the short end of the portfolio can be managed and implemented at a much lower cost than many of these funds. Indeed, it is because of the costs of many managed low risk products that one could conclude the only funds that appear attractive are those with higher risks and consequently higher yields.

“Costs lower the return and increase the risks.”

Costs lower the return and increase the risks to which investors are exposed. **Remember**, that though the yield may be reduced by management expenses the risks are not.

Product costs are more often aligned to the demands and inefficiencies of the distribution system than the needs of the client or the actual demands of the portfolio construction, planning and management process. Note that an ETF passive bond portfolio only costs 0.25%.

Conclusion

The average investor lies between a rock and a hard place when it comes to products, their suitability and their costs. And, judging by the sounds emanating from the industry regarding the sales opportunity of our time, the risks remain that of individual investors accumulating products and funds that are inefficient and inappropriate to their needs over their lifetime time.

In truth, by offering managed products that neither personalise nor manage the risks that are key to

“The need for higher yield is only the door to the problem.”

effective management of assets to meet financial needs, today’s mutual fund and product managers are operating outside their effective boundary of expertise and risk taking responsibility for decisions they cannot manage.

As far as the consumer is concerned they would be better off if these managers concentrated on developing cost effective managed components that could be easily accommodated within a personalised and appropriate portfolio structure. But this would require an industry structured to deliver total wealth management solutions and a mutual fund and product industry forced to compete on both quality and cost.

Back to the drawing board!

The new realities, if there are indeed new realities, should be that managed “one size fits all products” are not the solution to the realities of retirement which require personalised, low cost solutions that provide certainty of income and capital through structure and modelling.