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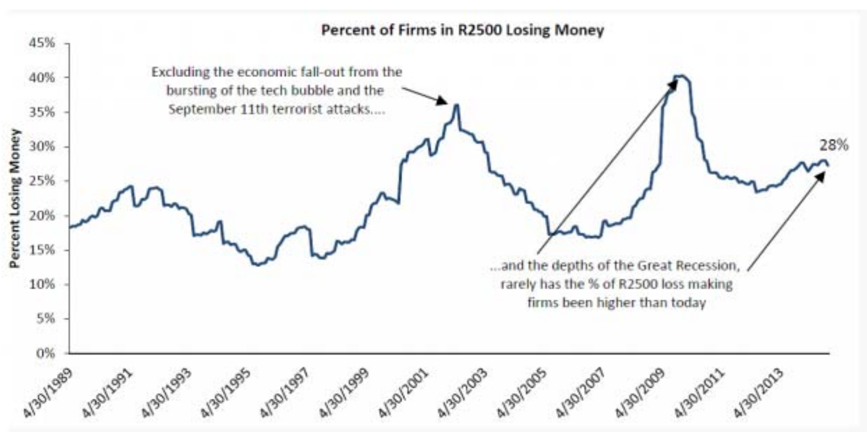
Diversification That Increases Your Risk

Yes, you read that right. Diversification can increase your risk. This is very much contrary to the thinking that is commonly taken as simple, gospel value; "the more investments I buy, the better I'm going to be diversified which means my portfolio will be safer".

The way diversification is often done is by buying what we call "the index" and just holding on for the ride. This is basically buying a portfolio where the underlying companies you are invested in aren't changing. This is usually done through an index investment of some kind. Others may do this by instead choosing a list of companies that they are familiar with and buying all of them. Some take either of these approaches for simplicity, for cost effectiveness (it's the cheapest way to do it) or it feels the most comfortable.

There are several things very wrong with building a portfolio this way. The main reason it was done in the first place, safety through diversification, is actually doing the exact opposite. Diversifying as such most likely is increasing your risk. It will probably reduce the long term growth of your portfolio as well.

The chart below shows how many companies in the US today are losing money. As of January it was 28% (although these are numbers related to companies with head offices in the US, I think it could be a fair representation of what is happening globally). If you are simply buying a wide range of com-



Source: Passive Vehicles & the Profit Penalty. Kailash Concepts, January 2015.

panies (the index) and not having an investment manager doing the work and very selectively hand picking the best investments for your portfolio you are often making investments that are putting your money at risk and more worrisome is that you may not even know it.

What makes this even more unknowable is that the number of companies losing money has been occurring during what is called a "bull" or rising market. With more and more people investing the longer the bull market runs, means more and more people are buying risky companies. Taking the "buying more is safer" complacent approach is doing the opposite and in the long term, performs lower than what is required to give you the retirement income you need.

INDEX-LINKED GICS SOUND GOOD BUT….

Index-Linked Guaranteed Investment Certificates (GICs) promise to guarantee your investment and give you some upside as well. The guarantee is provided by the bank and the CDIC. The returns you will get are tied to the direction of the stock market but you get none of the risk. Sounds good doesn't it?

The impression given is that you can profit with no risk. That is essentially how they are marketed by the banks that underwrite them. Banks and insurance companies however aren't in the business of giving you something for nothing. They put in place very clever formulas that actually reduce the probability of paying you out a return that even comes close to the index. One way they do this is base the return you get on the average level of the index over the course of a year, not the year end value.

Now the tax part. Like any GIC, any returns you get are all interest. If you were actually invested in an appreciating asset, you would have a capital gain which is taxed at 1/2 the rate interest is taxed at.

There is a distinct marketing angle to these GIC hybrids. You see them highly promoted after a market down cycle, when many people are scared. Ironically, this is often the worst time to deposit money in these savings vehicles. But, unfortunately that is often how financial products are promoted, on marketing fluff rather than giving sound advice.

HOW MUCH INCOME CAN YOUR RETIREMENT PORTFOLIO SAFELY PAYOUT?

An RRSP is supposed to build a nest egg that will create a monthly income for your entire retired life. With that though, there is striking a balance of getting as much income as possible today without running out of money later in life.

In 1994 there was an article in the Journal of Financial Planning where a number of different income simulations were done based on historical investment performance data. It was concluded that a person retiring at age 65 who invested 60% of their retirement assets in equities (stocks) with the remainder in bonds could withdraw 4.2% of the portfolio in the first year as retirement income. With adjustments in following years for inflation, a retirement income could last 30 years. Since that article was written, there have been reams of data analyzing what is called "the 4% withdrawal rate rule" and it's validity.

Nobel Laureate William Sharpe has said that what is wrong with the 4% withdrawal rate is it applies to someone who requires a fixed amount of income when the portfolio's returns are so widely variable. In other words, if your portfolio is down by, let's say 20%, you won't be taking 4%, you will be withdrawing 5% of your portfolio to keep giving you the income you need. In other words, you are selling part of your portfolio when it is detrimental to do so. If you can adjust your income needs in relation to how your portfolio is performing, you can, over several years, actually take out a number that is higher than 4% on average.

Along with that income flexibility, if you can emotionally live with a portfolio that has a much higher proportion of equities and thus more ups and downs, you can actually enjoy more income than 4% (on average) coming from your portfolio and still have it last for as long as you do. Having said all of this though, withdrawal rates set for your own very special needs and wants should only be determined with a Financial Planner who can review them annually with you and make adjustments to your portfolio when necessary.

CHOOSING LIFE INSURANCE FOR A YOUNG FAMILY

I recently read a quote about a survey that reported 62% of Canadians would prefer to shovel snow, go to the dentist or wait in an airport security line rather than thinking or talking about insurance coverage. So, unlike an airport security line (unless you have a Nexus card), this topic will be relatively short.

A young family who needs life insurance has 1 of 2 options. Buy a "term" policy or buy a "permanent" one. Although there are many financial professionals only licensed to provide insurance can give you all sort of reasons why a permanent policy is the one to buy, I strongly suggest otherwise.

First, cost is lower initially for term insurance. You can get the most amount of coverage for the lowest cost and the premiums are usually fixed for 10 or 20 years. This is very important to a young family that is usually dealing with strained cash flow. Permanent insurance on the other hand is insurance where the premium is the same for the life of the policy. However, you are paying more now to offset the lower cost later. Frankly, you may not need life insurance when you are an empty nester. Most people don't.

What you do want to get is a term policy that is guaranteed renewable. With this, at the end of the term, your policie's premiums will go up by a pre-determined amount, which yes, is usually a substantial increase from what you were paying previously. You will however have insurance should you be sick and are uninsurable. If not, you can simply apply for another term policy and be set for another 10 or 20 years. If you want to have the ability to buy a permanent policy, simply get a term policy that is "convertible".

Why Spouses Should File Income Tax Returns Together

I've occasionally seen where spouses file their income tax returns separately. A reason for doing that may be that 1 spouse may be a "do it yourselfer" while the other would simply rather drop it in the lap of someone else and pay to have it done. Another reason may be that they both handle their finances separately or one spouse wants to keep their own finances completely secret from the other.

There are a few issues in taking the "filing separate" approach. It may result in the family unit not using all the available tax credits and deductions. More common than that though is duplicating the claiming of these credits which may cause CRA to re-assess both tax returns.

Along with that, there is the benefit of being able to move child care expenses, child fitness or arts credits, personal medical expenses or charitable donations to the other spouse's tax return. This can produce larger tax savings than if each simply claimed them on their own tax returns.

Grey Romance Caveats

With that title you may think who are you to put the damper on a budding 50's or older relationship? Well, my role is a Financial Planner so if you want warm and fuzzy, this piece isn't going to be it (although, what finance topic is?). Although, it's not that I can't do warm and fuzzy…

More people seem to be getting into relationships later in life, either as their first, after a divorce or early passing of a spouse. Because people later in life generally have more assets and more responsibilities than those younger, there are some things that must be done before sooner rather than later. If not, you could be looking at some very bad results down the road.

It should be agreed upon what each person's rights and obligations are in the relationship. This is usually done through a marriage contract or co-habitation agreement. Although philosophically I'm not 100% on board with these, it is financial planning advice that is materially valid in reducing downside risk.

You would layout your assets and liabilities as well as income. This would form the basis of what happens in the event of separation or divorce. You would specify how assets would be separated and if there would be support paid to the spouse that has less income than the other or no income at all. Some provinces have 50/50 split of some assets and spousal support payable upon a breakdown of a marriage like relationship.

If this is a second relationship, and there are blended families involved, then this is an excellent reason to draw something up to financially protect your family, especifically with the possibility that one of you will outlive the other. Does everything end up with the adult children, of your spouse should they outlive you? It could very well, unless you put an agreement in place. (Note: This can't always be done through a Will alone)

Protect Your Most Valuable Asset…. You

What would happen to you or your family, if you couldn't earn an income? Would the house of cards, made up of mortgage payments and lifestyle expenses be blown down flat? For most working families, that answer has the strongest and most catastrophic "Yes". What would happen to your family if 1 of your incomes was lost completely.? Could you still live in the same house? If not, could or would you be willing to downsize to something much smaller? With the mortgage you currently have, could you buy housing of any kind at all?

If you aren't paying for disability insurance through your employer or if you are a self employed person it's time to take the loss of earning income risk off the table by putting some disability (income loss) insurance in place… now. If you don't think it can happen to you, I can tell you about a few people I know who thought the same thing…. and it did.

Tech Gems— Microsoft Surface

Along with my office computer, which I definitely use the most (by far), I also used to have a laptop, a tablet and a smartphone. That was until I tried and bought a Surface well over a year ago (sounds like an infomercial lead in). Because you have the full computer functionality, performance and data storage of a laptop yet the size and tactile use of a tablet, my tablet and laptop are long gone. Part of the reason is, with the bigger smartphone screens available, when I'm not using my Surface, the phone is the tablet. Life has stepped a bit closer to simplicity.

Hhhhhmmm……

European equities posted their best quarterly performance since the third quarter of 2009 and their best first quarter advance since 1998. CI Investments, April 2015 (most people have preferred to be invested in companies domiciled in the USA because Europe is seen to be a scary place to invest and have done so at their detriment)

A bad year for “high yield bonds” was in the recession year of 1990 when they fell in price by 7%. Then, in 1991, a good year, they rose by 41%. The Investment Reporter, March 2015

Owning a ski area operation (a business) will outperform real estate over a 20 year period many times over. Ski Canada Magazine, Winter 2015

I believe the best prospects for growth in the Canadian real estate market are behind us. Catherine Ann Marshall, Vice-Chair of the CFA Society Toronto's alternative-investments committee, March 2015

Mozilla, the company behind the Firefox web browser severed it’s relationship with Google by signing a deal with Yahoo. With that, Google’s market share has dropped below 75% for the first time since 2008. Business Insider, March 2015

Household debt-to-disposable-income ratio in Canada is 159.1%, one of the highest of any country in the entire world. Invesco Fundamentals, Jan. 2015

Total household debt in Canada increased by 7.7% in 2014. Globe & Mail, March 2015

China along with many other countries face an "aging crisis". The USA doesn’t have this problem because of a workforce that will increasingly buy homes, furniture, cars etc., growing the economy. Mackenzie Express, March 2015

Switzerland has no minimum wage law which contributes to one of the lowest unemployment rates in the world. It reached a 5 year high of 3.9% in February. Countries with the most generous minimum wage laws generally have much higher rates of unemployment. Thomas Sowell, Senior Fellow at the Hoover Institution at Stanford University, March 2015

In partnership with Arizona State University, Starbucks offers all eligible employees full tuition coverage for a 4 year bachelor's degree though ASU's online degree program which costs on average, $60,000. USA Today, April 2015

5 people born in the 1800s are still with us - and they're all women. Three of these supercentenarians live in the United States. A husband and wife aged 108 and 105 respectively, celebrated 82 years of marriage. USA Today, April 2015

Top 4 cancers diagnosed in BC listed from 1 to 4 are; Prostate, Breast, Lung and Colorectal cancer. Canadian Cancer Statistics 2014

In 1943 the Canadian government proposed health insurance which included dental. They put it off because it was said that “Personal hygiene and balanced diets are under the control of the individual” (thus no dental coverage). The dental profession strongly shaped policy so as to exclude dental care within Medicare. Network for Canadian Oral Health Research

Millions of cellphone calls aren't sharing the caller's location (“location” is turned off) with 911 call centers that send out police, fire and ambulance crews during emergencies. In some cases, callers have died while waiting to be found. USA Today, Feb. 2015

We are by nature flawed and inconstant creatures. We can’t even keep from snacking before meals. We are not built for discipline. We are built for novelty and excitement, not for attention to detail. The 4 Disciplines of Execution (book)

On Twitter it seems that if you follow people those people tend to follow you. I notice most people have thousands of followers but it seems only because they follow thousands. Seems a little silly to me or am I missing something?