ADAPTING TO THE INVESTMENT SHIFT

Onus is on advisors to educate clients moving to retirement income

The oldest Canadian baby boomers turn 60 this year. By 2020, much of the influential cohort born between 1946 and 1964 will be within retirement age. This sea change is having profound impact on investor behaviour and the need for advisors to help their clients derive income – and ongoing security – from their nest eggs.

"People are growing older, and they'll need the money that they've been putting away for so long," says Guy Lalonde, an investment advisor with National Bank Financial in Montreal. "They'll be using their savings. What we see is a demographic investment shift, from wealth accumulation to wealth utilization. At the same time, and it is probably related, the huge bull market we've had in bonds over the past 20 years is pretty much at an end, so clients are of course looking for solutions."

For baby boom investors, the fallout from the recent income trust controversy vividly demonstrated the potential dangers of the ensuing shift. In a painful echo of the dot-com bust, there are once again countless anecdotes about retirees losing large portions of barely adequate nest eggs.

"The problem," says Mr. Lalonde, "is that investors can develop very bad reflexes. One is focusing on the distribution a product such as high-yield bonds or income trusts will have, instead of the total return of the asset itself."

Especially for investors who are depending on the conservation of their capital, he says, it is extremely dangerous to overweight a portfolio in high-yielding securities. "Investors need a diversified, conservative portfolio – and to focus on the total return of the portfolio. If the portfolio is conservative, and stable enough, clients can withdraw money on a yearly or monthly basis and still preserve their capital."

That change in focus requires an investment in time and education on the part of the advisor. Mr. Lalonde says his team spends a minimum of 90 minutes to two hours at the beginning of the relationship to educate potential clients. "People talk about returns a lot, but they very seldom talk about risk. We talk about the variability, or volatility, of the portfolio. We take the time to explain that a portfolio needs a certain multiple asset-class structure, and that income can come from the total portfolio and cash balance management rather than distributions, in order to reframe the client's references."

The process that begins at that initial meeting is ongoing throughout the relationship. "We provide very simple reference points that we can refer to down the line, but it takes consistent contact. We meet at least once annually to sit down and go over the concepts again, and to examine how the investments have actually behaved over the past year so our clients get a feel for that.

"When you talk about investment behaviour, the discussion includes returns, but it also includes volatility, and independence from major benchmarks and/or one particular asset class. As we accompany our clients through the lifespan of the portfolio, they begin to understand what is going on, and the dynamics behind it."

The benefit of that investment in time and knowledge-building was evident following the announcement about the tax changes to income trusts earlier this fall.

"Money in financial markets doesn't evaporate," says Mr. Lalonde, "it mainly migrates to other asset classes. And that is exactly what happened that day and during the following weeks. Money migrated from income trusts to dividend-paying stocks, bonds and different asset classes. If you have an adequate portfolio structure, you're holding up a vessel for the money to migrate to, so the overall volatility of the portfolio is very low and there is little loss."

It is as important to help clients manage their emotions as it is to help them manage their investments. "Again, it is very important to avoid the bad reflexes, the excessive responses – going from Nortel to a T-Bill. Excessive responses always happen when you have a bad portfolio structure. If investors become too stressed with their portfolios, they start making errors."

In addition to diversification, the most important elements of portfolio construction are costs and tax efficiency, and Exchange Traded Funds (ETFs) offer advantages on all three counts. "You could create the same portfolio structure with mutual funds," says Mr. Lalonde, "but it is much more cost effective with ETFs. It is about bringing value to the client."

The high MERs (Management Expense Ratios) that accompany managed mutual funds are a brake on performance, but he is also disturbed by the lack of transparency. "The MER doesn't include all expenses. Transaction costs aren't included, so if you have a mutual fund with an MER of 2.6 per cent and the turnover is high, you could be looking at 3 per cent."

Due to much lower portfolio turnover than actively managed funds, most ETFs do not have year end distributions, which is of benefit in all non-registered accounts and is particularly attractive to those investors who buy in late in the year – and may otherwise end up paying tax on capital gains they didn't participate in.

There is also no more efficient way, he says, to participate in the bond market, as bond mutual funds MERs are so expensive relative to the returns. A typical client portfolio includes the iShares broad bond fund, the iShares short-term bond fund, and a small percentage of the Real Return (inflation-indexed) bond fund. The bond side represents about 60 per cent of the more conservative portfolio; also included are an income trust ETF and a REIT ETF, together representing about 10 per cent of the portfolio, and dividend stock ETFs.

"I think people are so vulnerable to the quick or easy solution. That is what happened with trusts. The idea of total return is extremely important, as is planning ahead of time, advising the client that this is what is going to happen down the line, this is what we are going to do in a couple of years. Transition from growth to a more conservative portfolio should occur in an orderly, gradual, non-emotional manner." ■

THE BALANCING ACT

EQUITIES AND PENSIONS WORK TOGETHER

Charles Goddard, senior vice president and branch manager with Dundee Securities in Ottawa, works with a unique segment of the baby boom population. "Many of our clients have pensions," he says, "so the appetite for income from other sources isn't there."

Because a client's entire financial situation is approached with a global view, the pension is seen as the income component of the portfolio. "What is needed is equity to balance that off, and that is not likely to change over time. Most pensions have some degree of inflation indexing, so the only time the non-registered portfolio would be drawn upon would be in times of above-average inflation."

Within the core of those equities portfolios, he says, ETFs play a very important role, providing inexpensive exposure to a desired asset class.

CANADA'S CHANGING POPULATION

The following facts from Statistics Canada illustrate the dramatic rise in the number of Canadians entering retirement. Such statistics underscore the increasing need for advisors to guide Canada's aging boomer population from growth oriented investment strategies to portfolios that provide for stable retirement income.

- During the 10 years between 1991 and 2001, the population aged 45 to 64 in Canada increased 35.8 per cent to almost 7.3 million due to the aging of baby boomers (people born between 1946 and 1965).

- By 2001, people aged 45 to 64 alone accounted for about 25 per cent of Canada's population; that cohort represented 20 per cent of our population in 1991. By 2011, the 45 to 64 age group will make up almost one-third of our total population.

- While the median age within the core working group (20 to 64) was 41.3 years in 2001, up 3.2 years from 1991, it is expected to reach 43.7 by 2011.

- In 1991, for every 100 people aged 55 to 64, there were 160 15- to 24-year-olds. By 2011, if current trends continue, we may have one person in the aged 44 to 64 range for each person in the 15 to 24 age range.