THE PRUDENT CANADIAN'S

# Guide to Reducing Risk in your Portfolio

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Investment Planning Counsel™

FINANCIAL SOLUTIONS FOR LIFE

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Most investors would like to invest their capital so that they obtain an above-average rate of return and experience minimum risk. Since we sacrifice a great deal to accumulate wealth, we do not want to put it at risk unless the return is worth it.

If you are serious about putting your capital to work through a well thought out investment strategy, here's some advice from arguably the most successful investor of all time, Warren Buffet, who tells us:

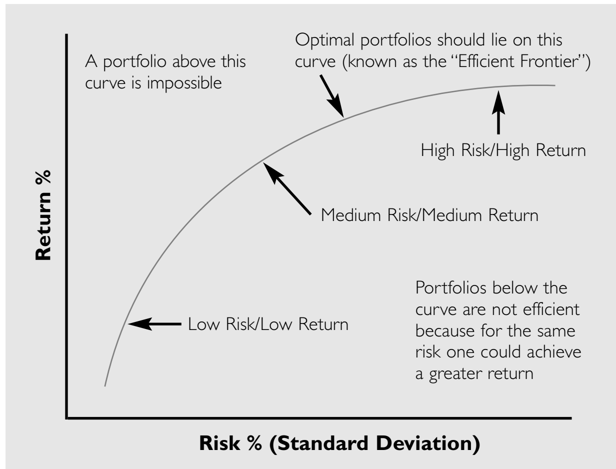
*"To invest successfully over a lifetime does not require stratospheric IQ, unusual business insight, or inside information. What's needed is a sound intellectual framework for decisions and the ability to keep emotions from corroding that framework"*

The following are some of the time tested strategies that veteran investors have used successfully to build a sound intellectual framework with the goal of minimizing risk while achieving a reasonable rate of return. They should help you achieve your portfolio objectives while keeping your emotions from corroding that framework:

## Be consistent with your investing approach

The first lesson of investing is to adopt a consistent strategy that you adhere to no matter what. The Efficient Frontier, based on an investing theory of risk-efficient portfolios associated with Nobel laureates Harry Markowitz and Bill Sharpe, is one such investment strategy. Under this approach, the goal of investing is to minimize your risk for the amount of return you wish to achieve through the diversification of your portfolio by asset class, geographic allocation and style of investment management.

The Efficient Frontier is illustrated in the following graph:



## 2 Mixing bonds and stocks moderates portfolio risk.

High-grade bonds and stocks are fundamentally different assets. Bad years for bonds are often good years for stocks. Poor years for stocks can be good years for bonds. It is important to note, however, that 1987 and 1994 were below-average years for both asset classes, serving as a reminder that the two can have poor years at the same time.

**Consider the following example:**

| Investment Portfolio | Best One Year Gain | Worst One Year Loss |
|---|---|---|
| 100% Stocks | 37.4% | -22.1% |
| 75% Stocks/25% Bonds | 36.1% | -12.8% |
| 50% Stocks/50% Bonds | 34.6% | -3.6% |
| 25% Stocks/75% Bonds | 33.2% | -5.5% |
| 100% Bonds | 31.7% | -8.9% |

***Past performance is no guarantee of future results.*** *There can be no guarantee that diversification will result in market gains or prevent against a loss in a down market. Stock returns based on the Standard & Poor's 500 Index and bond returns based on the long-term government bonds from 12/31/82-12/31/02. Results assume reinvestment of all dividends and income, and are not indicative of future returns of any actual investment. It is not possible to make investments directly into an index. Source: August 15, 2003. Ibbotson Associates, Inc.*

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As you can see from the above example, the 50% stocks/50% bonds portfolio had only a slightly lower best one-year gain than 100% stocks but had the least percentage loss for worst one-year loss. This tells us that the best way to reduce risk in your portfolio over the long run is to have diversification among asset classes and not over concentrate in any one area.

## 3 An all-bonds portfolio is not the lowest-risk portfolio.

A common myth about investing is that if you want to reduce risk, you should increase the weighting of bonds and fixed income type of investments in your portfolio. However, studies have shown that even risk-averse investors should own some stocks. From 1987 to 2002, a study showed that a 15 percent stock and 85 percent bond portfolio had a lower standard deviation (risk measurement) than a 100 percent bond portfolio, which is 8.8 percent versus 9.1 percent. This is due to the fact that when interest rates rise, bond prices drop and create losses.

### 4 Returns rise disproportionately quickly as stocks are added to the portfolio.

In the same study, for the years 1987 to 2002, the 25 percent stock portfolio earned about 40 percent of the additional return on the all-stocks portfolio compared to the all-bonds portfolio. The 50 percent stock portfolio earned about 75 percent of the additional return. As you can see from this study, if you want to get better long term gains on your portfolio it is wise to add some high quality stock holdings or even equity based mutual funds for better diversification.

### 5 An often-overlooked risk for the long-term investor is keeping a too-conservative portfolio.

By focusing too closely on the volatility of individual assets instead of on the entire portfolio, investors often maintain an undersized stock exposure for their long-term horizon.

*"Investing isn't just about making money. It's a way of reaching our personal goals…"*

Peter Lynch

For many investors, the risk-return trade-off favours an even higher exposure to stocks. This risk is one that we tend to see after a bad market or a sudden drop in the market.

Instead of following a set investment strategy, some investors become fearful of the stock market and over weight into more conservative holdings such as cash and fixed income. However, they often fail to re-deploy this capital back into stocks at the appropriate time and, as a result, their portfolios under perform even though they are taking the same risk on their portfolio.

### 6 Rebalancing gives a stable risk exposure.

The objective of rebalancing is to return the portfolio's risk to its original level. Specifically, if you are modeling your portfolio in an Efficient Frontier format, you need to automate a mechanism to take your portfolio's allocation (asset, style and geographic) back to the original. Why? If stock returns are unpredictable (i.e., future returns will be like random draws from historical returns) and you have a long investment horizon, then your optimal stocks/bonds mix should not depend upon recent years' returns. After good times (for example, 1995 to 1999) and bad times (2000 to 2002), your target asset mix should be essentially the same.

Unfortunately, this appears to be the opposite of what investors actually accomplish. Most increased their target stock exposures through the 1990s and decreased it

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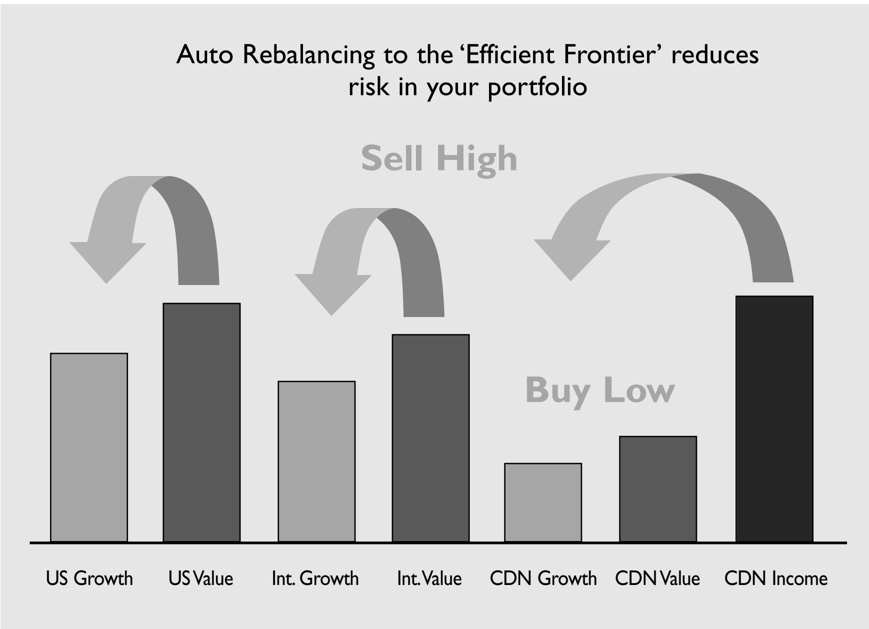
“*An investor’s worst enemy is not the market but one’s self*”

Benjamin Graham

through the bear market. The fixed-weight strategy prevents investors from a tendency to increase the target stock weight after good times and to decrease it after bad times.

## 7 A balanced portfolio avoids market timing.

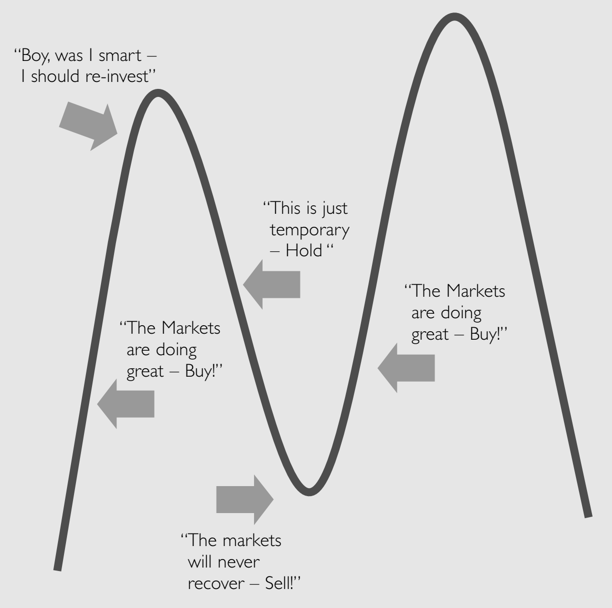
You should never keep all of your assets in the worst performing asset class. This is important because losses are more costly than gains in two senses: First, for most of us, the sting from a 10 percent loss exceeds the euphoria from a 10 percent gain; second, if an asset class loses 33.3 percent of its value, it takes a 50 percent gain just to break even.




Another investing myth states that market timing works. However, study after study shows that no matter how much research and how much data is available, the average investor (and even most sophisticated investors) does not have the capacity to accurately time the market. Most armchair investors use the power of hindsight to back up the myth. After all, if we had this ability, why was so much capital allocated to technology stocks in the late 90’s?

The solution to market timing is good diversification of assets, styles and geographical regions. This strategy will tend to under perform in good times, but should keep your portfolio safe in bad times.

**The roller coaster of market timing and emotional investing**




**8 Due to rebalancing, if an asset class becomes overvalued, you will be selling it as it rises; if an asset class becomes under-valued, you will be buying it as it falls.**

> *"An investment operation is one which upon thorough analysis promises safety of principle and an adequate return. Operations not meeting these requirements are speculative."*
>
> Benjamin Graham

In contrast, someone who invests, for instance, 50 percent in stocks and 50 percent in bonds, but never rebalances, is guaranteed to have the highest percent of the portfolio in the overvalued asset class at its market peak, and the lowest percent in the undervalued asset class at its market trough. For example, someone who started in 1987 with a 50 percent stock/50 percent bond portfolio but never rebalanced would have had a 73 percent stock exposure at the peak of the stock market in March 2000.

**9 Rebalancing provides discipline that helps investors overcome inertia.**

Without this discipline, many investors do nothing because they are not sure what action to take. From our

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*"For the investor who knows what he doing, volatility creates opportunity"*

John Train

experience, this control is very important. We can rarely predict that stocks will beat bonds or vice versa. Without rebalancing, the uncertainty might prevent the average investor from making any changes at all. Emotion is by far the biggest enemy of long term returns.

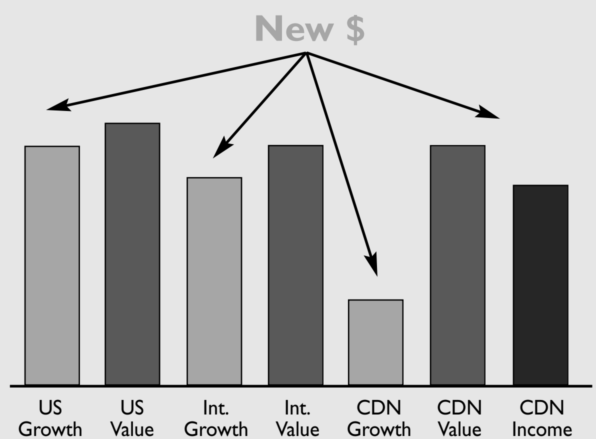
## **10** A fixed-weight strategy takes little time and can save time when doing taxes.

Portfolios that not only automatically rebalance the asset classes but also do the rebalancing based on a new money contribution and not a buy/sell discipline will keep you controlled and avoid undue taxation. This is not an exciting strategy and usually not one that too many advisors would recommend. Why not? Many advisors and investors feel that if they are not always buying or selling a security, then they are not doing their job. They feel that any action is better than no action. This is the fallacy of long-term investing. Investors who have a lasting dream such as retirement, a child's education or just financial security know that the most difficult part of investing is patience. If you have a solid intellectual framework for making decisions and can keep emotions from corroding that framework, you will avoid unnecessary risk and with enough time commitment, manage to live your dreams.

*"In this world, nothing is certain but death and taxes"*

Benjamin Franklin

**A rebalancing strategy with new money saves undue taxation on non-registered money**



## How can we help?

Your Investment Planning Counsel advisor can help you understand the risks of investing. Investment Planning Counsel and their portfolio management service, Counsel Wealth Management have launched the Portfolio Management System. This program offers industry-leading portfolio solutions, directed towards building wealth for investors at each level of affluence and risk.

The Portfolio Management System reinforces our ability to meet your needs with a complete range of managed asset programs, supported by the talent of world-class managers and a rigorous due diligence process that enhances our focus on risk management. These managers have been carefully selected from across Canada and around the world, based on their ability to meet the high standards of their organization, investment process, investment philosophy, and performance.

The Portfolio Management System provides investors with a dedicated due diligence team of third party investment professionals. It evaluates and monitors portfolio managers, to ensure an appropriate mix of managers for proper diversification. Our due diligence process includes on-site reviews and ongoing assessments of investment processes, trading, compliance, performance, research capabilities and client service.

With the assistance of an IPC advisor as your financial planning specialist, you will be able to reduce risk and take advantage of a complete portfolio management system.

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