# Portfolio Performance – What is your MAGIC number?

Yesterday I was speaking to a gentleman that I have recently met about financial planning (I will call him Bob). He is on the cusp of retirement and needed a few things clarified before he hits the employment "toodleloo" button.

He has done well for himself financially over the years and he will likely have a fabulous retirement. There is one major flaw that I pointed out to him that could quite seriously alter his future financial dreams. The REQUIRED performance of his investment portfolio versus REALITY is disconnected. Part of financial planning is making calculated projections about the growth potential of investments. This number is one of the most important variables in the equation to keep on top of. After all, a person's investment portfolio is the likely to be the main source of retirement income.

You see, Bob's portfolio has grown over the years because he was a diligent saver and was constantly adding money. However, he admitted that he has never kept track of the underlying performance of his portfolio. Now that he is planning on retiring, there will no longer be savings to add to "the rescue", and performance of the portfolio going forward needs to align with his needs – without excessive risk taking.

Financial planning is an advisory business of guiding people in the right direction – and giving them the "next steps". But it's also chock full of math. Projecting the value of money for the future is part of it. In order to do that, it's important - and I mean VERY important to know and keep track of ongoing investment performance.

Most people have goals. They want to spend a certain amount of money, they don't want to run out of money, or maybe they want to leave a legacy. So many factors come into play to make all these goals come to fruition. Sometimes it's difficult for some to grasp the true meaning of the concept of TIME VALUE OF MONEY. It can magnify itself or it can do the opposite and erode future value depending on the surrounding "what if" factors at stake. These "what if" factors include performance, inflation, taxation, legal changes, liquidity, among others. Everything needs to play a part – but performance is ***the biggie*** and should not be ignored.

It doesn't mean you need to strive to beat everything in sight in terms of performance such as beating the market, or your lucky neighbor. Nor does it mean you have to watch performance like a hawk on a daily or monthly basis. What it means, is to achieve the performance number **over time** that you REQUIRE that allows you to meet all your goals while taking the least amount of risk to get there.

The best way to determine this REQUIRED number, is by going through the financial planning process as your first step.

The following are some simple examples of what can happen when this REQUIRED number is in line or out of line with what is needed.

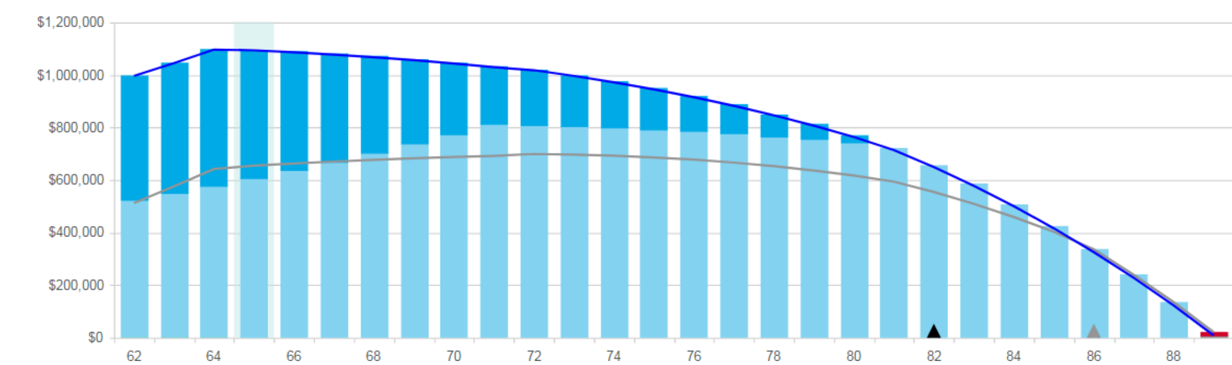
Enjoy,

Susan

**Example 1**

This is Bob's chart of his financial future. Everything is working for him so far. He knows that sometimes markets don't move in a straight line up or down – but keeping track annually is vital to ensure that any deviations that are grossly out of line become known sooner. Tracking makes it easier to understand long term impacts of deviations, and what can be done fix them.

Financial Assets

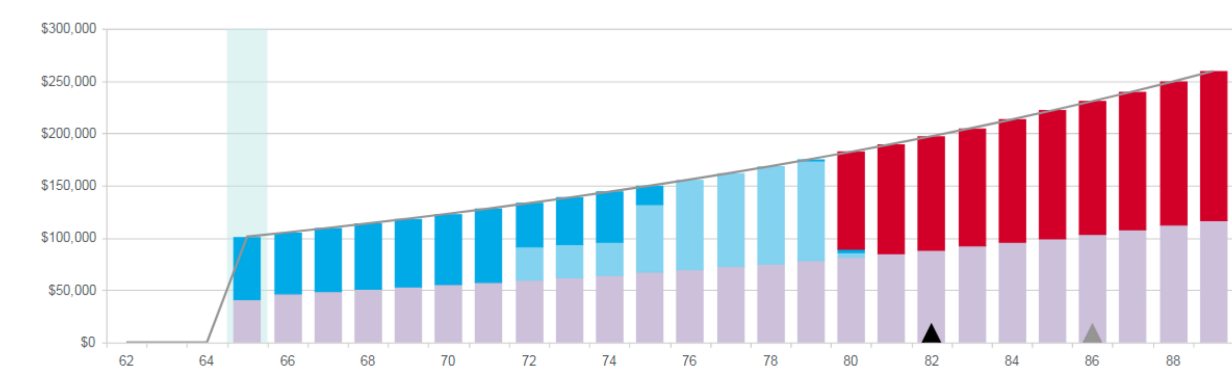



Bob will have just enough money to last until he is 89. He is fine with this, as he wants to spend it all. He REQUIRES an annualized return on his investments of 5% in order to make this happen.

Now assume Bob doesn't keep track of his REQUIRED performance, and doesn't update his math projections, things could take an unknowing turn for the worse and he won't even know it until it's too late.

In this chart, I reduced the rate of return slightly, and I also increased the inflation potential slightly. He now runs out of money right when he will likely need it the most at age 80 (the RED bars mean no money left)

Cash Flow



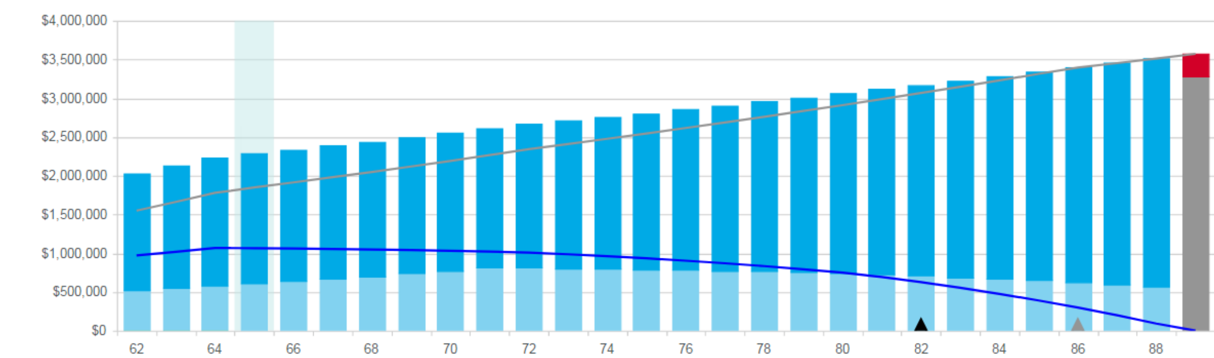
Running out of money is a potential reality for some people. For other's it could mean that the legacy they want to leave behind will fall apart.

**Example #2**

Sally (not her real name) wants to leave a sizable inheritance for her family and money to her favorite charity once she leaves this world. This will entail deep thought about estate planning as well as putting certain legal aspects into place – which is time consuming and sometimes costly.

This is what her chart looks like based on her 6% REQUIRED returns on her investments:

Financial Assets



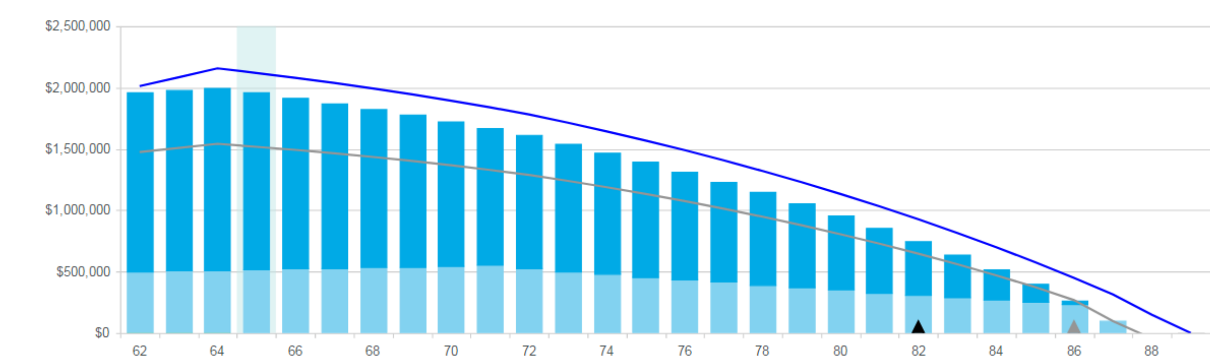

Estate Value: $3,280,000

According to the math projections, she has an estate of over $3 million to make plans for.

However, if the performance does not match up over time– all could be for naught.

In this chart, all I did was reduce the performance and her estate is no longer there. Poof!

Financial Assets




Estate Value: $0

## Position your Portfolio to Meet the REQUIRED Number

I find it interesting that many people don't keep proper track of portfolio performance, but I also run into quite a few people that really don't know what performance they actually REQUIRE in order to make everything alright financially for the future.  The only way to really know what YOUR Magic number is, is to have a financial plan done.  But that leaves another question…..HOW does one position their portfolio to meet that REQUIRED number? There is no perfect predictable answer – but using a very good dose of common sense and foresight is the best way.

In order to do figure it out, we need to make assumptions of what the possibilities are. Right now we know that short term cash equivalents will not pay much more than 1% per year. There is a possibility this could go higher in the future, but certainly assuming anything higher right now is too aggressive of a prediction. Fixed income (GIC's and Government bonds) investing provides for predictability in a portfolio – but it does not provide much of a return above 2%. In order to attain a higher return from fixed income, one must invest in corporate type of fixed income that provides a higher a rate of return. Right now, if investing in certain quality corporate bonds, we can assume a rate of return of about 6% (ask me about this). Buying shares (equity) also plays an important role to attain longer term returns. Using a conservative return prediction of 8% for equities, we now can at least get the asset allocation that has the potential to meet Bob's 5% overall rate of return.

### Return / Tax Efficiency Calculator

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Rate of Return & Tax Efficiency through Asset Allocation

| Assumptions | Value | | Return | | Tax Efficiency |
|---|---|---|---|---|---|
| Investment: | $500,000 | Cash: | 1.00% | Interest: | 0.00% |
| | | Fixed Income: | 6.00% | Dividend:* | 25.00% |
| | | Equity: | 8.00% | Capital Gain | 50.00% |

| Allocation | Type | Interest | Dividend | Capital Gain | Deferred CG |
|---|---|---|---|---|---|
| Cash: | 15.00% | 100.00% | | | |
| Fixed Income: | 45.00% | 100.00% | 0.00% | | |
| Equity: | 40.00% | | 3.00% | 20.00% | 77.00% |

| | |
|---|---|
| **Weighted Portfolio Return:** | **6.03%** |
| **Return on Investment:** | **$30,130.00** |

This asset allocation shows it's probable to achieve 6% return. Bob needs 5%. But, we must assume fees of about 1%

This is a very nicely balanced and moderately conservative asset allocation. Both of the people I mentioned in this article do not need to hit all the investment "home runs". This is important for them to know that they don't need to take on a lot of risk to meet their goals. But keeping track is necessary so that proper asset allocation adjustments can be made over time when necessary.

Reasons to understand and keep track of investment portfolio performance numbers:

1) Once you have your REQUIRED rate of return number – it's easier to know how to structure an investment portfolio best suited to meet the requirements.

2) There is no reason to take on excessive investment risk if you don't really REQUIRE it. The downside of taking too much risk is the potential to incur large losses.

3) If your actual performance starts to deviate away from the REQUIRED number, it's important to recalculate the math projections to see the long term impact. The sooner deviations are noticed, they can be addressed to lessen any negative impact.

4) Always look at performance AFTER fees. Some investments have fees higher than 2% which will erode your finances in the future – or entail you to take higher investment risks to compensate.

5) When getting involved in regular financial planning, it is not necessary to factor taxes in the performance numbers. My financial planning software already "bakes it into the cake" and takes it into account.

6) Keeping track of performance keeps you, or your advisor, or portfolio manager informed and accountable for understanding your needs and your parameters for risk.

**Important Information regarding this article:**

The asset allocation and return requirement projections in this article should not be construed as personal financial advice to be acted upon without consultation. Not all corporate fixed income products are predictable or safe. Some pay less than the 6% projected and some are very risky and pay much more than the 6% indicated. Investing in the high yield corporate bond market is an excellent way to achieve steady returns – but like anything else in the investment world – there are sometimes a few hazards to avoid. Please don't hesitate to ask me for further details regarding this asset class as much more information is available.

This article on financial planning was to bring into focus the necessity to monitor portfolio performance over time as well as to highlight the importance of finding out what your actual requirements are. Financial planning encompasses much more details and envelops all the important matters into one.