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Kim Inglis, BCom, CIM

Desperate times call for calculated measures

Looking around, I see investors taking on excessive risk, jumping into the markets fully exposed but without a strategy. Desperate to recover losses, they've moved heavily into equities, hoping to hit home runs and rebuild retirement nest eggs.

According to Statistics Canada, Canadian households lost an astonishing $252 billion in the fourth quarter of 2008, or 4.4%. Americans faired even worse, falling 9% in the same period. This is likely one reason so many investors, nearing or already in retirement, are behaving in a riskier fashion.

However, contrary to the old saying, desperate times do not call for desperate measures. For investors these times call for rational analysis and planning. Investing too heavily in equities without maintaining a properly balanced portfolio is a sure-fire way to further shrink an already reduced nest egg.

I recently spoke with an investor who, along with many others, had found himself swept up in the mania of the bull market. Attracted by increasingly higher returns, he had shifted away from his cash and fixed income holdings and into the risky territory of 100% overweight equities. His advisor cautioned him against the move, but his mind was made up.

It was costly. When the markets crashed, he lost 40% of his portfolio. Compounding the error, he sold at the bottom and crystallized his losses. Unfortunately, he didn't reflect on his mistakes and almost immediately jumped back into the markets without re-balancing his portfolio. Having reverted to old habits he is once again fully exposed in equities.

As a result, his level of risk is very high. Although the markets have rallied significantly since March, the possibility of a near-term pullback appears likely. Should investors decide to take profits, or if negative economic news pulls down the index, his portfolio will be hit again. Corrections typically include volatility and therefore careful planning is critical.
The planning begins with reviewing asset allocation and re-balancing. Investors must assess the level of risk present in their portfolios and determine whether it is suitable for their particular situation. They need to go back to the basics of financial planning and create a healthy balance between cash, fixed income, and equities.

Jack Bogle, founder of the Vanguard Group, has a rule of thumb when trying to determine a conservative asset allocation. He recommends holding the same amount of cash and fixed income as your age in years. That is, a 70 year-old's portfolio should have 70% in cash and fixed income. The basic premise is that younger investors can handle more risk because their earning power is greater and they have a longer time horizon. Conversely, older investors are no longer in their peak earning years and therefore preservation of capital becomes much more of an issue.

However the rule of thumb is just a guideline, and not a comprehensive or detailed approach, so adjustments ought to be made according to individual risk tolerance and preferences. Within each asset class, tactical changes should take advantage of short-term trends and opportunities. For instance, investors might change the maturities in their fixed income portfolio based on the positioning of the yield curve or, depending on the environment, either increasing or decreasing their exposure to higher yield corporate bonds.

Instead of irrationally reacting to market events, investors must soberly assess their holdings, stay focused on the horizon and remain true to their long-term goals. Taking uncalculated risks in a volatile market is not smart investing.

Kim Inglis, BCom, CIM is an Investment Advisor. The views in this column are solely those of the author. www.kiminglis.ca

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