



BUILDING A PORTFOLIO AFTER THE SALE OF A BUSINESS

A good quote by Nathan Mayer Rothschild states that...

"It requires a great deal of boldness and a great deal of caution to make a great fortune: and when you have got it, it requires ten times as much wit to keep it."

Nearly 75% of our clients (or approximately 90% of our assets under management) are business owners who have experienced a liquidity event. The few years immediately prior to the liquidity event is often referred to as the "red zone". This expression comes from a sports analogy in football when an attacking team is within their opponent's 20 yard line (in other words, about to attempt a touchdown!). The red zone is typically one of the most intense emotional periods for a business owner; they are about to realize the value of their life's work, and make the transition from business management to retirement. Some common causes for the heightened anxiety in this transition phase are the fear of change, loss of control, lack of certainty, and wondering if they have enough money to support their lifestyle requirements in retirement. Once the transition is made, the next few years that follow can be equally nerve-racking as the owner makes the transition from active to passive income.

Many business owners do not have a traditional pension, so their investment portfolio will be responsible to fund the majority of their lifestyle requirements in retirement. In essence, their investment portfolio is their personal pension plan. The need to draw regular income from the portfolio has a big impact on determining the optimal asset allocation. During times of market weakness, withdrawals exacerbate the downward momentum by reducing the capital base even further making it increasingly difficult for the portfolio to recover. One method we use to manage this is to work with a financial planner to complete an estate planning review and prepare a cash flow analysis. This process is key in establishing a long-term plan for clients to ensure their objectives are met over time. Through this process, a desired spending rate is typically determined. When income is being drawn from a portfolio, we typically consider the draw rate (calculated as spending divided by total portfolio value) plus taxes and fees as the minimum return requirement. The ideal return would also cover some growth for inflation or liquidity needs. Where possible we prefer to structure the portfolio to provide sufficient income (dividends and interest) to offset the draw rate. This provides a safer strategy to achieve the target return as there is limited reliance on price appreciation of the

investments to fund living expenses. This is a particularly useful strategy during years of weak equity markets, such as 2008 and 2011.

What we have found in working with clients during the transition period from saving to spending is that there are methods to portfolio construction that can help manage anxiety while assisting them in achieving their investment goals and ultimately providing financial peace of mind. ***We believe that controlling investment volatility should be of the utmost importance.***

The best way to manage the volatility of a portfolio is through asset allocation. In its simplest form, asset allocation is the trade-off between Fixed Income (more conservative) and Equities (more risky).

"Selecting the right mix of asset classes is the first step to long-term investment success. Studies have indicated that more than 90% of long-term fluctuations in portfolio returns hinges on asset mix. Other factors, including choice of individual securities and attempts to time the market, account for less than 10%."

Source: Brinson, Singer, Beebower Study Financial Analysts Journal, May/June 1991.

Fixed income and equities are affected by different factors. As a result, they tend to move in opposite directions. When the economy is doing well, stocks will perform strongly, and since interest rates usually rise in times of strong economic growth, bond prices often will fall at the same time as stock prices go up. The opposite is true as well. Another factor is that historical returns on equities are higher than that of fixed income, so generally speaking, the more equities you hold, the greater the return potential over time. Lastly, fixed income is historically less volatile than equities. As a result of these differences, there are diversification benefits available from combining both asset classes.

A quote from the CFA Magazine Nov/Dec 2008 when describing the seminal investment book, "Security Analysis", comments that:

"[Many] suffer from the misconception that trying to make serious money requires that one take serious risks. In fact, the converse is true. Avoiding serious loss is a precondition for sustaining a high compound rate of growth."

The question is, “what is the correct asset allocation?”. To determine this we consider the objectives and unique circumstances of each client. Things such as income needs, risk tolerance, time horizon, etc. will factor into our final recommendations. Capital preservation is usually the first stated objective as clients do not want to risk their life’s work.

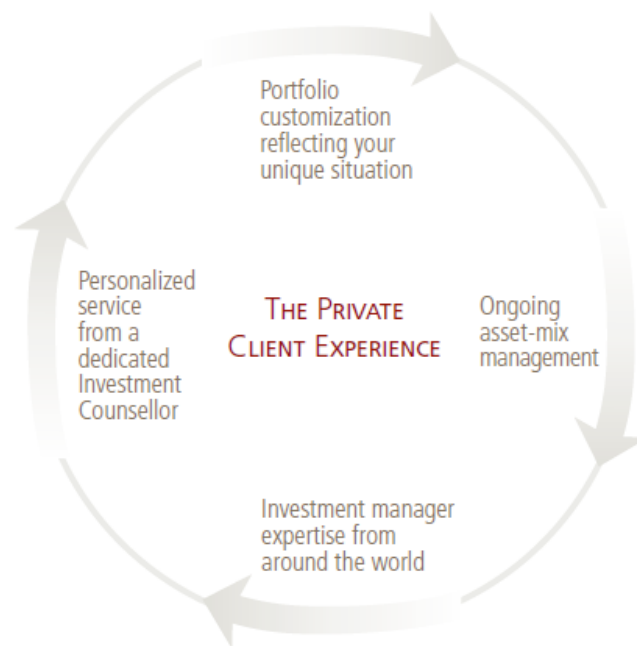
We often start our asset allocation discussion with clients by introducing a portfolio with 65-75% in fixed income and 25-35% in equities. We call this the “starting point”. Historically, this asset mix is very efficient over time (meaning maximum return relative to risk). The key to this portfolio is having approximately three times as much fixed income as equities. This ratio provides upside potential from the equities, while having sufficient fixed income to cushion the volatility during poor market conditions. It is interesting to note that based on historical returns, this asset mix has exhibited less volatility than bonds alone over five-year rolling periods (Source: 2009 Ibbotson S&P Classic Yearbook, “Chapter 2: The Long Run Perspective”). As a result of this efficiency, we often consider this to be the starting point for clients transitioning into retirement. From there, we can increase the equity exposure to attempt to generate a higher return, but in doing so, the portfolio volatility will also increase.

The next level of asset allocation analysis that we do for clients is determining the correct investment style to use. Examples of equity investment styles include Growth, Value, Growth At a Reasonable Price (GARP), and Income. Due to the importance of yield, we often include a significant element of income-generating securities in our portfolios. Given the low interest rate environment we currently find ourselves in, generating dividends on the equity component of a portfolio is becoming increasingly important. In addition, dividend stocks are much less volatile than the broad market, thus having the added benefit of reducing portfolio volatility (Source: CIBC Wealth Management Economics and Strategy, May 2005).

Similarly, various approaches and styles are considered for the fixed income component of a portfolio. This is a challenging time to be a fixed income investor as interest rates are at or near historical lows. In addition, there is a risk that interest rates could start to rise as economic conditions stabilize. If this were to happen, bond prices would adjust downwards. There are several strategies or combinations of strategies that could work well to mitigate this risk. A more passive “laddered” strategy systematically takes advantage of rising yields by staggering bond maturities equally over a desired holding period. For example a 10-year laddered strategy would have 10% of the bonds coming due each year, with the principal being re-invested in new 10-year bonds. Furthermore, a good active bond manager can use interest anticipation strategies to guard against rising rates. The use of corporate bonds can raise yields and potentially provide better protection against rising rates that are caused by improving economic conditions. In this scenario, risk premiums on corporate bond yields as compared to Government bond yields would tend to compress causing corporate bonds to relatively outperform.

The last step in the investment management process is to ensure that there is regular communication with clients after the initial plan has been implemented. This will ensure that clients are comfortable with their investment results and any necessary changes can be made. Below is a graphical representation of our approach to client servicing. The key here is that it is an accountable, ongoing process.

THE DISCRETIONARY INVESTMENT MANAGEMENT PROCESS AT CIBC PRIVATE INVESTMENT COUNSEL



IN SUMMARY

- Plan
- Get experienced and professional advice
- Start conservatively – control volatility
- Match yield to draw rate to the extent possible
- Ongoing communication with your advisors

Brent L. Nichols, CFA, CFP
 Vice-President, Investment Counsellor
 CIBC Private Investment Counsel
 (604) 658-3153

Danielle Slavin, CFA
 Associate Investment Counsellor
 CIBC Private Investment Counsel
 (604) 658-3154

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