

## Is it risky... to try to avoid risk?

### PORTFOLIO RISK

Volatility is the most commonly used measure of risk in portfolio management. It is measured statistically by the standard deviation – a measure of dispersion of data points versus the average.

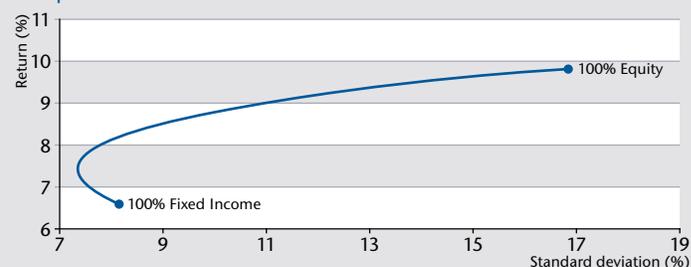
Simply put, when having the choice between two investments with the same expected long term returns, it is generally preferable to choose the one that is the most consistent (i.e. has the lower standard deviation).

Risk management has evolved in the investment industry in recent decades. It is now common practice to assess the risk tolerance of investors in order to determine the asset allocation of their portfolio.

Historically, over long periods, stocks have had both superior returns and greater volatility than bonds. The following graph shows the relationship between risk and return (annual data) for portfolios composed of various

proportions of Canadian stocks (S&P TSX) and Canadian bonds (DEX Universe).

RETURN AND STANDARD DEVIATION OF PORTFOLIOS composed of Canadian stocks and bonds between 1950 and 2013



For this period of over 60 years, we note that the minimum risk portfolio includes stocks – in the order of 20% – and the addition of stocks beyond this level increases both performance and risk.

### OTHER ASPECTS TO CONSIDER

Emotional investors who decide to make a major change away from stocks following a market correction reflect the main risk associated with risk tolerance. By selling stocks following a market decline the investor is not able to fully participate in a subsequent market rally. This hurts long term performance and can jeopardize the success of a financial plan. The elements below are other factors to consider when establishing an investment policy:

#### TIME HORIZON

The younger you are, the more time you have to grow your capital before having to start making withdrawals. Thus, you can put more emphasis on maximizing long-term returns and volatility should be a lesser concern.

#### LIQUIDITY NEEDS

Quantifying projected withdrawals and savings along with making conservative portfolio return assumptions helps assess if there is a good alignment between the risk you are willing to take and the risk you have to take to achieve your financial goals.

#### TAXATION

Various types of returns have different tax rates. Investment strategies should take into account each investor's own tax circumstances.

#### UNIQUE CIRCUMSTANCES

We must understand a portfolio's broad context. For example, an investor's asset allocation has to take into account other assets that generate substantial income such as a defined benefit pension plan, an annuity or rental properties. The same idea applies if an imminent special project needs to be funded from the portfolio.

Hence, to determine an investor's asset allocation, there is a lot more to consider than just risk tolerance...

## OTHER RISKS TO CONSIDER

As previously mentioned, reducing volatility usually implies having to sacrifice performance. The risks associated with poorer performance include: settling for a lower lifestyle upon retirement, leaving a smaller estate to your heirs, or worse, surviving your portfolio. We refer to the latter as longevity risk.

We believe that longevity risk is exacerbated by two factors: the growth of life expectancy and unrealistic return expectations on fixed income assets.

### LIFE EXPECTANCY

Life expectancy at birth has increased by more than 20 years in the last century. The table below shows that life expectancy at retirement has also increased significantly and that this trend is expected to continue.

#### THE EVOLUTION OF LIFE EXPECTANCY AT AGE 65\*

YEAR	MEN	WOMEN
1951	78	80
1981	80	84
2012	84	87
2025	86	88
2075	89	91

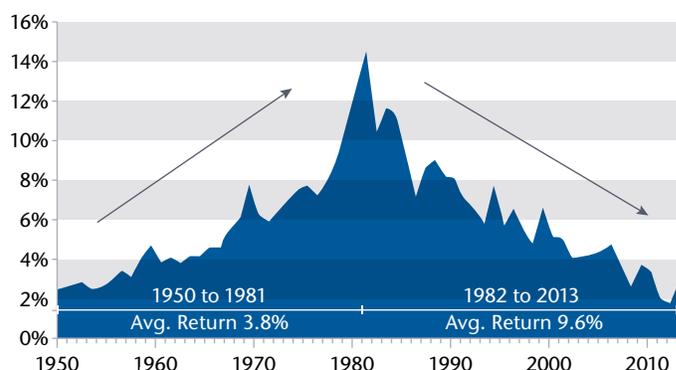
Among the consequences of living longer, we note: an increase in the number of years in retirement, more time for inflation to reduce purchasing power and retirement plans that could end up falling short.

Statistical expectancy stands for average. So if life expectancy at age 65 for a woman is 87 years, we can expect 50% of women to live to at least 87 years old. Consequently, in the case of an individual retirement portfolio, one must plan for the portfolio to last much longer than what life expectancy dictates.

### FIXED INCOME RETURNS

The graph below shows the evolution of 10-year U.S. Treasury Bond yields since 1950. From 1950 to 2013, Canadian bonds (Dex universe index) achieved an annual compound return of 6.7% (vs. 9.8% for the S&P TSX).

#### INTEREST RATES ON 10 YEAR TREASURY BONDS



However, we notice that this return was the result of two very distinct periods. From 1950, when rates were very low to when they peaked in 1981, the average return on Canadian bonds was a meagre 3.8% per year – a return below inflation. The second period, from 1982 to today, was a period of delight for bonds holders as their returns averaged 9.6%, surpassing Canadian equities (9.2%).

In the current low rate environment, we believe the next decade of fixed income returns will be modest. To extrapolate the returns achieved since the early 80s would be unwise.

\* Source: Canadian Longevity Database, Office of the Chief Actuary of Canada

## IN SUMMARY

Holding fixed income securities is desirable for most investors as they contribute to increase the consistency of a portfolio's returns. However, although a higher weighting in fixed income may seem more cautious, this is not always the case. Also, it is important to ensure that short-term prudence does not lead to insufficient long-term performance.

### Portfolio managers

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