

## Unique Portfolios for Unique Investors

In order to deliver truly effective investment solutions to our clients, we must first recognize that individuals are unique. Each client has different circumstances and different needs and therefore, requires a customized portfolio. In our family of over 110 relationships, we have yet to find two portfolios that are alike. Certainly, we employ a consistent investment style throughout all portfolios (see article “Portfolio Construction and Investment Style”), but there are many reasons why each is structured and managed differently. Our main considerations are:

**1) Purpose of the Money** - The first question which needs to be addressed is “What is the money for?” Is it to be a source of supplementary income, a retirement nest egg, a fund for future generations, an upcoming real estate purchase or perhaps for a future charitable donation? Different purposes dictate different portfolio compositions and strategies.

**2) Time Horizon** - Once the portfolio’s purpose has been identified, the next step is to determine how long the funds will be invested before they are used. This is one of the most important factors in setting an investment plan and sometimes it is not an easy question to answer. Future events like a medical emergency, a job loss, an inheritance or a marriage might influence when the money is needed. Since life has a funny way of not always proceeding as planned, establishing “probabilities” is usually helpful. Even in the face of uncertainty some estimates must be made which attempt to quantify the likelihood of future events. For example, one conclusion might be, “there is an 80% chance I will not require these funds for the next 20 years.”

Why is this question of time so important in constructing portfolios? Because the more volatile asset classes (equities and real estate) will outperform less volatile asset classes (fixed income securities) **over time**. But if the time horizon isn’t long enough, this extra potential return is not a relevant consideration, since the risk of short-term volatility is the overriding factor. The following chart shows how, with the passage of time, stocks have outperformed bonds and cash over different holding periods:

Holding Period	Time Period	Stocks Outperform Bonds (%)	Stocks Outperform T-Bills (%)
1 Year	1802-2002	61.0	61.5
2 Years	1802-2002	65.3	65.3
5 Years	1802-2002	70.9	74.0
10 Years	1802-2002	80.1	80.1
20 Years	1802-2002	91.7	94.5
30 Years	1802-2002	99.4	97.1

Source: Stocks for the Long Run, Jeremy J. Siegel 2002

Putting other considerations aside for a moment, it becomes clear that portfolios that will be invested for a long time benefit from having a higher proportion of equities since any short-term volatility does not disrupt the long-term plan. In addition to an expectation for higher returns, equities enjoy additional tax advantages not evident in the above chart, (see article “Asset Location”).

**3) Risk Capacity** - We define this as the amount the portfolio can decline before it begins to compromise lifestyle requirements. In general, portfolios with large financial cushions can afford more short-term volatility and therefore, unless other considerations dictate against it, may hold more aggressive stock weightings. The key point to recognize is that volatile price movement is a short-term phenomenon overlaid on a long-term upward sloping price curve. Over time the upward curve more than compensates for the short-term “ups and downs”.

**4) Risk Tolerance** - This may be thought of as one’s ability to sleep at night during periods of volatile/negative price changes in the portfolio. Some people feel much more comfortable with this than others and there is no right or wrong feeling. The critical issue is that the portfolio be structured to suit the client’s personality. Risk-averse personalities are suited to a more conservative portfolio structure. Others are comfortable taking on additional short-term volatility in the quest for higher long-term returns.

These last three points - time horizon, risk capacity and risk tolerance - are considered together in our determination of the appropriate asset mix structure. Whichever one is the most conservative element drives the decision. For example, even if a client has a very long time horizon and a substantial capacity for risk, if their risk tolerance is low, we will build a conservative portfolio.

**5) Taxes** - Taxation introduces a complex dimension to private portfolio management that tax-exempt management (such as institutional pension funds) does not face. We have observed that many of our professional peers do not manage the tax element very effectively because of the complexities (and the costs) involved. To demonstrate some of the issues, consider the following:

- Different types of accounts have different tax rates. Personal accounts are taxed at personal tax rates, tax-deferred accounts such as RSPs, RIFs, RESPs are not taxed until funds are withdrawn, corporate accounts are taxed at corporate rates and finally personal trusts have their own tax nuances based in part on the origin of the funds. Even among personal accounts, a family portfolio may include accounts with a high-income earner, a low-income earner and children without any income.
- Different asset classes have unique tax rates and realization periods. This affects both the amount and timing of tax liability.
- Tax rates vary over the years because of changes in personal circumstances (e.g. retirement, maternity leave) and also because of new tax legislation.
- Large unrealized capital gains create other challenges. We frequently receive assets with a very low tax cost from new clients. Some managers sell everything to get a new account “on the program”. We think that approach is usually inappropriate and very damaging to the client. Our process is to assess each holding on its merits within the context of the whole picture and develop a plan to restructure over time. This flexibility minimizes the client’s tax liability while also achieving the investment objectives.

All of these considerations must be incorporated into the plan and managed with the goal of paying the least amount of tax at the latest time possible. Fortunately we now have sophisticated software that greatly improves our ability to incorporate many probabilities and projections into this sophisticated analysis and thereby achieve optimal tax management.

**6) Income Requirements** - Current and future income needs greatly influence the structure of the portfolio. Since income is effectively a portfolio outlay, we view it as the portion of the portfolio being drawn down at regular intervals. As such, the higher a client's income needs, the more conservatively the portfolio should be managed. We also assess income needs on an inflation-adjusted basis to ensure long-term objectives will be met.

**7) Unusual Financial Requirements** - In addition to regular income needs, individuals may have episodic cash requirements for unusual events. A couple may be planning a world cruise or a parent may be helping fund a child's house purchase. These expectations need to be identified and incorporated into the management of the portfolio. In some cases they can be thought of as a small portfolio within the larger one, requiring different investment objectives and strategies.

**8) Regulatory Restrictions** - Additional constraints on the investment management process may arise from capital taxes on certain assets within corporate accounts or restrictions due to employment. These also need to be identified and incorporated into the investment process to maximize results and eliminate the possibility of unnecessary penalties.

**9) Preferences and Aversions** - Many people have their own preferences and aversions towards certain kinds of investments. As long as our clients understand that such a stance may involve more portfolio risk or lower expected returns, we try to accommodate their wishes.

**10) Unusual Circumstances** - There are usually other special factors that need to be incorporated into the investment plan in order to achieve the best results with the lowest level of risk. Clients may have additional assets elsewhere like pension plans or employee stock option plans. Some may wish to retire outside of Canada. By their unique nature, items in this category must be evaluated individually as to their impact on the appropriate structure of the portfolio under our management.

The above list illustrates how, as an investment portfolio grows, the issues surrounding it become more complicated. Once it reaches a few hundred thousand dollars in assets a portfolio should be managed on a segregated, not a "pooled", basis (e.g. mutual funds or wrap programs). Such "cookie-cutter" approaches are simply unable to accommodate the issues. A truly effective solution must include:

- A comprehensive plan incorporating asset management and financial planning
- Experienced personnel developing customized solutions for each situation
- Segregated portfolios for each client.

Bottom line: customized portfolio management works best for individual investors.

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