



Practical Advice for Coping with Turbulent Market Conditions

Many investors with a portfolio today likely experienced the 'great' bear market of 2001/2002 and not only survived to tell about it but went on to experience the subsequent bull market that was one of the strongest and longest lasting in decades. While reveling in the good times of that five-year bull market many forgot what it can be like to have their nest egg invested during more turbulent periods, including times like these, with extreme volatility and economic uncertainty. Once again, investors are looking to investment professionals for help and support, but seemingly, the only advice available is that which we heard continually during the last bear market, which is simply to 'hang in there' and think long term.

While this continues to be good advice, it doesn't make coping with a bear market any easier. It is the intention of this report to provide practical advice on how to cope with prolonged periods of volatile and difficult market conditions. It should help provide an understanding of the current market turbulence, provide insight into how it may be affecting your financial security plan, and examine some ideas to ensure you are getting the most from your financial advisor, investment providers and investment managers.

What's happened in the Markets?

Understanding the forces behind today's difficult market is helpful in coping with such periods of uncertainty. The catalyst was the fallout from the 'sub-prime' mortgage crisis in the United States. Mortgages had been issued to high risk borrowers at low interest rates, and those mortgage obligations were then bundled and sold as complex financial instruments known as asset-backed securities. When interest rates increased many homeowners in this sub-prime category began defaulting on their mortgages, abandoning homes and leaving lenders with significant losses. As a result, lenders are pulling back from offering credit, fewer people are buying homes, and banks that were on the hook are experiencing significant losses. This has caused people to become worried about the financial health of the country and consumer spending to decline, putting even further pressure on the economy. On top of all that we have more expensive fuel costs and increasing food costs. This all results in a slow down in the economy and puts pressure on the profitability of companies, which puts pressure on the capital markets.

With the failure of several large US financial institutions, and several others requiring 'bailout packages' it has left the financial sector in some trouble as banks have been unwilling to lend to each other and to businesses for fear of default on the loans. It is expected that recent government measures taken around the world, including in the US, to help provide liquidity and guarantee short terms loans will be helpful but will likely

not be enough to lift the US out of a recession. These factors all contribute to downward pressure on the stock markets.

How does it affect Me?

While it's helpful to understand the cause of the current market volatility, it's even more important to understand that this type of activity is rather normal and happens as part of normal market cycles. This is why so much emphasis is placed on taking a long-term view with investing. We experienced similar bear markets and similar volatility in the early 1990s, the late 1990s (Russian default crisis and Asian Contagion) and the early 2000s (technology collapse and terror attacks on US soil). The bear market of 2001/2002 was the third worst market in Canadian history, only behind the Great Depression and pre-World War II eras. However, coming out of this, the bull market that ran from 2003 – 2008 was one of the strongest in decades.¹

This leads us to another important point, which is that the major rallies in the S&P/TSX that have followed the major declines over the past 52 years, on average, have proven to be twice as powerful, both in terms of rate of return and duration² – a fact that favours the long-term investor and rewards those that stay the course during difficult market conditions.

Gaining an understanding of the cause of the market volatility and understanding that this is somewhat normal activity ultimately leads to the question of “how does this affect me and my financial security plan?”

The bottom-line answer is that changing market conditions, including a bear market, *should* have very little or no long term affect on your financial security plan. A financial security plan, which should show you how you need to save and outline your standard of living during your retirement years, should be able to account for variable returns year over year, in addition to using conservative assumptions. With this type of plan in place, you should then have an investment portfolio that is suited to your ‘risk requirement.’

Too often, financial security plans or savings illustrations will assume an average rate of return and assume that it is earned every year. The reality is that with market-based investments you will have varying returns year over year that, when combined over the life of the plan, have an *average* compound annual growth rate. For example, if you illustrate a compound annual growth rate of 6 percent, while this may be a realistic average return rate, it means that in one year you may experience a 1percent return, the next year 15 percent, the next year -5 percent, and so on, combining for an *average* compound annual growth rate of 6 percent. A detailed financial security plan should be able to account for this type of annual fluctuation in return rates through what is known as a “Monte Carlo” scenario, which runs your plan using varying, random return rates year over year. This is a test to help ensure that your plan should hold up, even during the tough years. Therefore, if your plan has been tested and held up using a Monte Carlo

¹ Source: GWL Investment Management Inc.

² Source: GWL Investment Management Inc., Investment Manager Commentary, July 22, 2008

scenario, then this current market downturn should be viewed as nothing more than a nuisance.

Another key factor in the financial security planning process, as it relates to difficult markets, is to use conservative assumptions, particularly when it comes to rates of return. If you achieve an average compound annual growth rate of 6 percent over the life of your plan, which called for a 5 percent return requirement, this is significantly better than achieving a 14 percent rate of return when your plan called for a 15 percent return requirement.

If you have a financial security plan that uses conservative assumptions that is able to account for varying return rates, you then need to ensure that your investment portfolio is designed such that it 'drives' the plan. You should be invested in accordance with your investor profile, which takes into consideration many of the key factors in your plan, such as your age, your income requirements and your time horizon. It should also consider not only your risk tolerance but also your 'risk requirement.'

While risk tolerance measures refer to how much risk and portfolio volatility you are willing to accept, your risk requirement refers to how much risk you *need to accept* in order to achieve an expected rate of return that will satisfy the requirements of your plan. If you only need to earn a compound annual growth rate of 5 percent in order to meet your plan objectives then you don't need a portfolio aggressive enough to target an expected 10 percent, even if you are *tolerant* of that level of risk. If you want to be more aggressive and target 10 percent that's great, but be aware that you are taking on more risk and accepting more portfolio volatility in order to achieve it. This can lead to trouble during bear markets since often times the consequence of a major loss in your portfolio far outweighs any benefits of a major gain in your portfolio. A major gain near retirement might mean you can quit work slightly early or have a marginally higher standard of living but a major loss near retirement might mean delaying retirement or having a lower standard of living. If the consequence of the major loss outweighs the benefit of a major gain, it is advisable not to take more risk than you need to in order to meet your objectives, even if you are tolerant of greater risk.

Balancing your risk tolerance with your risk requirement is a difficult process and can only be effectively done if you have a proper financial security plan in place. If you do have a proper plan in place and your portfolio is well designed to drive your plan, then bear markets, even if deep and prolonged, should have no impact on your plan. However, if that's the case, does it mean you should sit back, do nothing and simply wait for recovery? Not necessarily.

Getting the most from your Advisor and Investment Providers

Although anytime is a good time, tough markets present a good opportunity to assess the value you are receiving from your financial advisor and from your investment providers and investment managers. While 'value' is different for everyone, some issues to consider might include the depth of your financial security plan, the fee structure of your investment account, the level of service you receive for your fees, exclusive options

available as an affluent investor, and strength and accountability of the investment manager.

When reflecting on your relationship with your financial advisor your first consideration may be whether or not you even have a financial security plan. If you do, is it written down and updated over time, or was it presented once and then left in the drawer? Consider also whether or not your plan includes risk protection and estate planning. A written financial security plan is integral to helping ensure that your investment portfolio is developed according to your specific needs, balancing both your risk tolerance and your risk requirement.

You should also consider client service. Most advisors regularly send out newsletters and have review meetings with you when times are good, but what about when times are tough? Does your advisor sit down with you to review your plan, review your performance and effectively explain performance? A high level of service won't change tough market conditions but should help you get through them with your plan in tact and let you know that you are on the right track.

While assessing your advisor relationship, you may also wish to consider looking at your investment provider and your holdings to ensure you are getting the most from them. For example, are you holding loaded mutual funds, paying full 'retail' management fees when you could be in funds reserved only for higher-value accounts that have lower fees? Is your non-registered money optimized for tax efficiency, thereby adding to your bottom line, or are you hit with T3 and T5 slips each year and paying more tax than you need to? Investors with \$250,000 or more in combined assets have the ability to hold lower-fee options of most mutual funds that are also optimized for taxation in a corporate class structure. This can all add to your net return and gives you the ability to add real value, particularly in tough times.

Consider also your investment or mutual fund manager. Talk to him/her or your advisor about whether or not he/she is 'hugging' the index and taking a beating with the market or if he/she is at all defensive and shoring up some of your exposure to volatility. Do you have a balance of different investment styles in order to offset some of the volatility? Also important to consider is whether or not your investment managers are positioning their funds to take advantage of the market recovery or whether they will simply move on average with the index. During strong rally markets it's tough to do wrong as an investment manager with a competent level of skill and training. However, it's during the down markets that real value is added. While mutual fund managers may not be able to completely avoid losses in a fund if markets are down, they should be able to hold more defensive positions and not be hit as hard as the broad market. As the 'Sage of Omaha', Warren Buffet, says, "the first rule is not to lose. The second rule is not to forget the first rule."

It's also reasonable to expect that during depressed markets investment managers will take the opportunity to buy companies expected to provide strong returns over time but that have simply been beaten up by the broad market, thereby picking them up at discount

prices. Is your investment or mutual fund manager making these moves or do his/her top-10 holdings essentially reflect the index, which is a measure of the market average?

These, and other questions, should always be considered but are often not thought of when times are good. When times are tough it's a good opportunity to ensure that you are getting the most from your advisors and providers, since somewhere, somehow, you are paying them for their service, whether it's in the form of mutual fund loads and management expense ratios, transaction costs, advisor management service fees or account service fees. Are you receiving value for your fee?

In an ideal world, we would not have to endure down markets or even flat markets. However, the reality is that with market-based investments we are going to encounter tough times, and we need to cope with them as best we can, knowing an overwhelming amount of evidence historically shows we will prevail in the long run. Hopefully, the information in this report will help you cope with the markets by providing an understanding of the cause behind the current volatility, showing you how tough markets should not have any long term impact on your financial security plans, and offering some ideas on how to ensure you are getting the most from your financial advisor and investment providers and the advantage of investment managers.

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