How can Stella, 57, build a balanced and diversified portfolio?

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Stella, 57, is a do-it-yourself investor.

After years of managing her own consulting business and raising four children, Stella wants to learn how to better manage her investment portfolio. She is age 57 and recently retired from work. Although she is married, Stella and her husband keep their finances separate. Two of Stella's children live at home and help out with the grocery bill.

Stella is a do-it-yourself investor, following the popular practice of investing mainly in dividend-paying Canadian corporations to take advantage of the dividend tax credit. While this strategy has allowed Stella to live off her dividends, it has left her $860,000 portfolio heavily weighted in Canadian financials, utilities and telecom stocks.

Recently, Stella signed up for an investment course that focuses on goals-based financial planning using a balanced and diversified portfolio. "My investment portfolio consists mostly of Canadian dividend stocks, but I would like to have better asset allocation," Stella writes in an e-mail. Her goal is to maintain her current lifestyle. She also asks how to determine whether she has sufficient money to last until she is at least 85, and when she should start collecting government benefits.

We asked Daniel Evans, a certified financial planner and investment coach at Money Coaches Canada in Vancouver, to look at Stella's situation.

WHAT THE EXPERT SAYS

Stella has developed a portfolio with the sole purpose of getting the dividend tax credit and receiving tax-free income, Mr. Evans says. "For what she is saving in tax, there could be offsetting and even greater costs associated with risk and lack of diversification."

Stella's dividend income is $43,200, reflecting an average rate of return since inception less than five years ago of 6.8 per cent, the planner says. But her year-to-date return, including dividends, is minus 15.1 per cent.

"In years like this one, it would be nice to have the cash from the dividends to put toward the purchase of more shares rather than having to rely on the dividends for current income," he says. "It's important to reduce that dependence and include other income sources."

First, Stella should set aside enough money in a high-interest savings account to cover three years of cash needs, Mr. Evans says. "This will reduce her portfolio's overall volatility, allowing her to sleep a little easier knowing that she can cover her expenses and either reinvest or reallocate the dividends that she receives," the planner says. "In addition, she will not be susceptible to changes in dividend payout rates, which are out of her control."

Stella's existing portfolio is far too concentrated, with 85 per cent in three Canadian sectors: financials, telecoms and utilities. "Yet Canada only represents 3 per cent of the world's capital markets," Mr. Evans notes. "Stella is missing out on the 97 per cent of the world's investment opportunities that are outside Canada."

For a target asset mix, the planner recommends 15 per cent cash (her reserve fund), 15 per cent fixed income, 35 per cent Canadian equities and 35 per cent global equities, the latter split evenly between U.S. and international equities.

A portfolio with the recommended asset mix can be expected to earn an average annual rate of return, including dividends, of 4 per cent on her non-registered assets, including cash reserves, and 5 per cent on her tax-free savings account, invested in growth stocks, for an average of 4.1 per cent. This will cover her spending needs and with far less risk, Mr. Evans says.

With these guidelines, Stella can build a fixed-income portfolio, then move gradually into global equities and expand her exposure to a broader range of sectors, Mr. Evans says. To get proper diversification, she may want to use broadly based and easily traded exchange-traded funds, index funds or even low-cost mutual funds rather than the individual stocks she is holding now. She might also want to consider robo-advisers – online portfolio managers that offer automatic rebalancing.

For the fixed-income component, “she could focus on inflation-protected bonds with short to medium-term durations,” Mr. Evans says. Inflation-protected or real return bonds have increasing payments indexed to inflation, although they do not perform well during deflationary periods.

Mr. Evans recommends Stella use her TFSA to invest in Canadian growth companies or related ETFs rather than fixed-income securities or term deposits. That way, the potential gains can grow tax-free. “The tax-savings opportunity is far greater than the money she would save by sheltering interest-bearing securities,” the planner says.

U.S. and other foreign dividends do not qualify for the dividend tax credit, but the tax credit should not be the focus on which to build an investment portfolio, he says. Rather, Stella should focus on her spending goal.

Once Stella achieves the recommended asset allocation, monitoring will be key, Mr. Evans says. “You use your predetermined asset allocation as your portfolio’s benchmark.” For example, Stella would add 5 per cent in Canadian equities if the portfolio allocation slips from 35 per cent to 30 per cent.

Looking ahead, “there is little risk Stella will run out of money as long as she achieves an average portfolio return (including dividends) of 3.5 per cent and her spending doesn’t increase,” Mr. Evans says. “Based on our projections, she could continue to spend $41,100 a year, adjusted for inflation, to age 95 and still have some money left over.”

Any surplus can go to her TFSA. Otherwise, she can draw from her non-registered capital each year to contribute to her TFSA.

Finally, the planner looks at Stella’s government benefits. As a business owner, Stella has not paid into the Canada Pension Plan for many years, so she qualifies for only 48 per cent of the maximum CPP benefit at age 65.

Taking CPP early reduces the benefit amount by 0.6 per cent a month or 7.2 per cent a year. “It will be difficult to beat a 7.2-per-cent return on average in the markets.” So, using an apples-to-apples comparison, it would make sense for Stella to wait until 65 to take CPP.

Yet a case can be made for Stella taking her CPP benefit early, Mr. Evans says. If she compares the alternatives in dollar terms, it would cost her only about $2,500 a year rather than the $5,000 she would forgo if she qualified for full benefits, the planner says. “It’s an easier decision to give up $2,500” to have the income sooner, he says. As well, having the CPP benefit would allow her to lower her cash reserves by an amount equal to the benefit, leaving more of her capital invested.

Because Stella spent time travelling abroad, she qualifies for 95 per cent of full OAS benefits. “Delaying OAS until age 67 would give her the additional two years of residency needed to qualify for full benefits.”

CLIENT SITUATION

The person: Stella, age 57

The problem: How to build a balanced and diversified portfolio. Figuring out how long her savings will last.

The plan: Set aside three to four years of cash needs in a high-interest savings account. Build a fixed-income component using some real return bonds. Gradually shift into U.S. and international securities across a broad range of sectors using ETFs or index funds to achieve the desired diversification. Use TFSA for growth stocks.

The payoff: A portfolio to last a lifetime with less risk than she is taking now.

Monthly dividend income: $3,600

Assets: TFSA $61,000; non-registered stock portfolio $860,000, share of residence $560,000. Total: $1.48-million

Monthly outlays (her share): Condo fees $450; home insurance $85; property tax $210; utilities $100; transportation $230; groceries $1,335; clothing $210; personal care $40; dining, entertainment $135; pets $25; health care $50; phones, TV, internet $200; gifts $20; vacation, travel $335. Total: $3,425

Liabilities: None

Some details may be changed to protect the privacy of the persons profiled.