Asset Allocation – A Strategic Approach

One of the best kept secrets in investing is that asset allocation plays a much bigger role in overall portfolio performance than individual investment selection. It's the relative weight of the asset classes in your portfolio – the percentage of equities, fixed-income securities and cash – that can make the real difference to portfolio performance and not the individual stock picks, assuming the investor is adequately diversified within each of the asset classes. There are different asset allocation models that can be followed depending on the investor's financial goals, their investment time frame and their risk tolerance.

Strategic asset allocation establishes asset class percentages based on their differing past or anticipated rates of returns. When combined they can be expected to generate a targeted average annual fixed return for the whole portfolio. Asset classes need periodic re-balancing to maintain their constant-weighting. That's what triggers most trading activity in the account.

Tactical asset allocation is a more active and dynamic model, giving the investor more room to move within a percentage range for each asset class. This allows some flexibility to capitalize on changing market conditions and seize investment opportunities when they arise.

Determining the type of allocation model varies with each investor. However, the investment objective is the same: to maximize a portfolio's returns and minimize its investment risks. And, the portfolio still needs to be managed and organized to achieve its investment potential. Here are a few management considerations to keep in mind.

Account Diversification

Canadian investors have three distinctly different types of investment accounts to work with: their non-registered trading accounts, their registered RSP or RIF account and, now in its second year, their Tax Free Savings Account (TFSA). Asset allocation becomes more effective and efficient if investors coordinate their investment activities using all three types of accounts to take advantage of their different tax efficiencies and trading flexibilities.

Taxation Consideration

Make sure the right asset class goes into the right kind of account. Registered accounts have upfront tax advantages for many investors, but the account's assets will eventually be taxed as income when the funds are withdrawn from the account and, for successful investors, that will likely be at a high marginal tax rate. It usually makes more sense to have interest-earning securities in registered accounts and investments with capital gains potential or paying dividends held in a non-registered trading account where the capital gains taxes are lower and the dividend tax credit applies. A TFSA has no immediate tax advantages, but all capital gains, dividend and interest income earned by the account's investments can be withdrawn tax free. For that reason investors should use their TFSA as an account for their growth and high yielding assets and not just use it as a cash "savings" account.

Liquidity Needs

Quick and easy access to your investments may be an important consideration. Plan any withdrawals from the portfolio well in advance. A rushed sale of an asset might trigger an investment loss, selling penalty or have unforeseen tax implications. In addition, some fixed-income investments might be thinly traded and take time to sell. If liquidity is an issue and access to cash is an important consideration, then keep in mind that transaction fees are lowest on your cash-equivalent securities and they should be kept in a non-registered trading account. Withdrawals from a registered RSP account are subject to withholding taxes. In time, the TFSA account will become the most likely source of cash for many investors in need of funds to make a major purchase or finance an education. There are no tax penalties for withdrawals from the TFSA and any withdrawn amount is added to the investor's contribution room in the following year.

Inflation Protection

Keep in mind the portfolio must outpace the inflation rate and be able to keep up with future interest rate hikes. Risk averse and near-retirement investors want the security and predictability of cash-equivalent and fixed-income investments. But safety comes at a price: a low rate of return and quite possibly a money losing investment if the inflation rate rises and interest rates go up. Higher yields mean greater investment risk, but there is no other investment option if the portfolio is to outpace inflation. This means, for most investors, their asset allocation model has to include growth assets that provide some inflation protection for the portfolio.

There is clearly more to asset allocation than just assigning percentages and picking stocks. It's a method of organizing your investments and adds a disciplined approach to your portfolio management. Your Raymond James Financial Advisor can guide you through the asset allocation process and help you build an asset allocation model designed to meet your personal and financial goals.

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