



# Asset Allocation

What is the most important strategy you can use to enhance your portfolio?  
Andrew Baechler explains the finer points of asset allocation.

---

While a number of options are available to ensure proper oral health, most dentists agree that brushing and flossing should be every patient's core focus. When it comes to investing, numerous strategies can be used to manage a portfolio, but most investment advisors agree that the most important one is the proper strategic use of asset allocation.

Asset allocation is the process of allocating percentages of wealth among identified asset classes, the most common of which are cash, fixed income (bonds, preferred shares, etc) and equity. Sub-asset classes can also be created, for example, Canadian equity, U.S. equity and International equity. Numerous studies<sup>1</sup> have concluded that asset allocation is the single most important factor in determining a portfolio's overall performance and volatility and accounts for 70 to 90 percent of the variability of returns in investors' portfolios. The asset allocation that works best for you will depend largely on your personal time horizon and your ability to tolerate risk.

## Time Horizon

A time horizon is the expected number of months, years or decades you will be investing to achieve a particular financial goal. An investor with a longer time horizon may feel more comfortable taking on riskier investments because he or she is prepared to wait out slow economic cycles and the inevitable ups and downs of the markets. By contrast, an investor saving up for a teenager's university education in an RESP would likely take on less risk because he or she has a shorter time horizon.

## Risk Tolerance

Risk tolerance is the ability and willingness to lose some or all of your original investment in exchange for greater potential returns. The reward for taking on risk is the potential for a greater investment return. If you have a financial goal with a long time horizon, you are likely to make more money by carefully investing in riskier asset categories, such as stocks or bonds, rather than restricting your investments to less risky assets, such as cash equivalents.

The goal of successful asset allocation is to maximize returns in light of the level of risk you're willing to assume. For example, you may elect to invest a portion of your portfolio in small-cap stocks. Historically, small-cap stocks have generated higher returns than large-cap stocks, but generally carry a higher level of risk. On the other hand, if all your money is put into low-risk/reward assets, thus protecting your capital base, the expected returns will be more modest.

For example, let's suppose that it's the beginning of 1987 and two 40-year-old dentists, Dr. Smith and Dr. White\*, are saving for their retirement. Each has \$250,000 to invest, with a 20-year time horizon. Dr. Smith has a lower risk tolerance and elects to invest his money equally between a Canadian bond and Canadian 30-day T-Bill portfolio, which would've ultimately yielded 7.37 percent. Based on historical data<sup>2</sup>, his portfolio value at the end of the investment term would've been \$1,075,576. Dr. White has a higher tolerance for risk and elects to invest 30 percent of his portfolio in

the same Canadian bonds as Dr. Smith and the remaining 70 percent of his portfolio in equities (split evenly between Canadian, U.S., European and Japanese equities). At the end of the 20-year period Dr. White's portfolio reads as follows:


From 1987 – 2006

- Japanese. equity yields 2.03%, so \$43,750 = \$65,365
- Canadian bonds yield 8.92%, so \$75,000 = \$414,572
- Canadian equity yields 10.03%, so \$43,750 = \$295,681
- European equity yields 10.75%, \$43,750 = \$337,390
- U.S. equity yields 10.86%, so \$43,750 = \$343,810

Using the strategy above, Dr. White's final portfolio value would've been \$1,456,821 vs. Dr. Smith's value of \$1,075,576. Even though Dr. White's Japanese investments fared quite poorly, his final portfolio value is far greater. While this example may prompt you to add more higher risk/higher return asset classes to your portfolio, consider the graph below:

As you can see in the graph, Dr. White's portfolio doesn't fully eclipse the value of Dr. Smith's portfolio until Year 9 and the two portfolio values almost converge again in Year 17. This reinforces the need to consider the investment horizon and how it relates to your risk tolerance. While this is a simplified example, which doesn't take into account rebalancing, additional investments, etc, it

does highlight how asset allocation in a portfolio can allow the strongly performing asset classes to offset the weak performers and can thus significantly improve the overall return. It also highlights the need to properly diversify a portfolio, as the U.S and European equity allocations generate the bulk of Dr. Smith's returns.

When next reviewing your portfolio, be sure to consider whether or not you actually have a proper asset allocation strategy — it can be very reassuring during periods of increased market volatility. 

*Andrew Baechler, CFA, is an Investment Advisor with PWL Capital Inc. in Ottawa. Andrew can be reached at 613-237-5544 ext 309, or [abaechler@pwlcapital.com](mailto:abaechler@pwlcapital.com).*

1. "Determinants of Portfolio Performance 2," Brinson, Singer and Beebower, *Financial Analysts Journal*, May 1991.  
"The True Impact of Asset Allocation on Returns," Roger G. Ibbotson, *Financial Analysts Journal*, January/February 2000.
2. Returns for each quoted asset class are from the period of 1987 to 2006. Returns used were sourced from Ibbotson and Associates and are represented by: Canadian 30 Day treasury bills, Scotia Capital Universe Bond Index, S&P/TSX Composite Index, S&P 500 Index, MSCI Europe Index and the MSCI Japan Index. All returns are in Canadian dollars.

**Graph 1:** Portfolio Comparison

