

THE Guardian

...building better retirement incomes since 1974

Summer 2010

EXPECTED RETURNS: NAVIGATING BETWEEN CAUTION AND HOPE.

In the last edition of the Guardian we reviewed various studies intended to provide the investor with guidance about how much capital is needed to retire and how much to save to get there. In this edition we want to talk about another variable-expected rate of return.

In dealing with clients on a daily basis, many seem to have a reasonable handle on variables such as when they will retire, how much they feel they will spend/need in retirement and how much they will save leading up to retirement. What individuals have much greater difficulty in estimating, is what rate of return can be expected. With world stock markets struggling to cope with global debt and concerns of a potential double dip recession, investor uncertainty on this point is understandably magnified.

When it comes to return assumptions, there are costs to being both too optimistic and overly conservative. Obviously, overly rosy assumptions can lead to disappointment as people fall short of their goals. But there is a price for being too conservative as well – since overly pessimistic assumptions could lead investors to make poor decisions about investing. For example, the investor who has a negative view of equity markets both short term and long term, may invest all their capital in bonds and GIC's. While this may be perfectly appropriate for an investor whose objective is purely income, it would be equally inappropriate for the investor requiring growth.

Investors have been told for years that stock markets will provide higher long term returns than fixed income investments such as bonds and GIC's, but for that premium, they must be willing to accept volatility over a shorter term. With some exceptions of course, investors had grown to accept this. Where the equation starts to disintegrate, revolves around what different investors consider long term.

The typical investor would likely agree that 10 years is a long term investment time frame and as noted in the table below, they would be deeply disappointed at the end of 2009.

10 year average return to December 31, 2009	
S&P/TSX (CDN Index)	3.30%
S&P 500 (US index)	-4.40%
Short Term CDN Gov't Bonds ¹	3.5%
Long Term CDN Gov't Bonds ²	4.9%

If we were to rely solely on the above, the investor would avoid stock markets and invest purely in fixed income investments. However, history teaches us two important lessons:

- i) The last 10 years can be described as a very ugly exception.
- ii) Extending time frame increases certainty of return. Given the long time frame associated with saving for retirement, it makes sense to look out at least 15 to 20 years. While that may seem an unduly long time frame to some, one must keep in mind that for a 65 year old couple, there is a 50% chance that one will live to age 90.

Keeping these two points in mind, the investor should also focus on after-inflation, or real returns, not gross (pre-inflation) returns. In the low inflation environment we have been in for the past several years, this point has become increasingly lost on investors. Stating the obvious, an investment yield of 8% with an inflation rate of 5% for a real return of 3%, is less attractive than an investment yield of 6% with a corresponding inflation rate of 2%.

Taking this all into account, what can a stock market investor reasonably expect?

Comprehensive data on US stock markets exists back to 1926. In the 85 years since then, **after-inflation** returns have averaged 6.6%. However, the difficulty with an average number is that often you will be below it. Given the high cost of underperforming, one needs to look beyond the average return to the distribution of those returns. That will assist in telling you how badly you might fall short based on historical precedent.

1. Less than 3 years
2. Greater than 10 years

Looking at the returns of the broad based US market (S&P 500), since 1926, there have been 65 20-year periods. In the table below we list the **after-inflation** returns during the 65 periods from highest to lowest and look at how often those returns happened.

Annual return after inflation in 65 20-year periods – 1926 to 2009:	
Return	% of the time this happened
13.3%	1%
12.7%	5%
11.9%	10%
10.8%	20%
9.3%	33%
8.5%	50%
5.0%	67%
3.3%	80%
2.2%	90%
1.8%	95%
0.8%	100%

In deciding on the expected return for the stock component of the portfolio, an investor could pick the after-inflation return that's halfway down the list, providing a return of 8.5%, but risks erring on the optimistic side. For those who want to be more conservative, an investor should choose one of the lower numbers – the 5% that was achieved two-thirds of the time or the 3.3% that was exceeded 80% of the time. Or you could be really cautious and pick the 1.8% that was delivered 95% of the time, or in 62 out of 65 20-year periods.

Selecting the right return assumption for your investments will vary with an investor's attitude toward risk. Further, respective stock market portfolios will differ, with more aggressive portfolios having a greater return variance than a more conservative portfolio. By focusing on after-inflation returns, taking a long-term view and digging deep into the historical experience, one can end up with a realistic number that strikes the right balance between undue optimism and extreme pessimism.

**REGISTERED RETIREMENT INCOME FUND (RRIF)
STATUTORY MINIMUM MONTHLY INCOMES BASED ON \$100,000
COMMENCING ONE MONTH FROM ISSUE**

Best Current Rate: 3.65%

Age	1st Year	TOTAL PAYMENTS	A R.R.I.F. can also be structured to pay a level income for a shorter period. Based on current interest rates, \$100,000 will produce the following monthly income. For 5 years:\$1824.00 For 10 years:\$987.00 For 15 years:\$713.00
		TO AGE 100	
55	\$239.00	\$214,564.00	
60	278.00	191,882.00	
65	334.00	172,572.00	
71	616.00	152,492.00	

**MONTHLY ANNUITY INCOMES COMMENCING
ONE MONTH FROM ISSUE BASED ON \$100,000**

Age	LIFE (Payments cease at death)		LIFE 10 Year Guarantee		JOINT LIFE 10 Year Guarantee
	MALE	FEMALE	MALE	FEMALE	MALE & FEMALE
	55	\$561.58	\$525.02	\$551.87	\$520.25
60	610.48	571.87	592.77	562.94	505.59
65	686.63	624.37	648.07	607.25	542.97
71	814.29	711.42	729.35	668.52	613.25

The material contained herein is intended to provide the clients of Solguard Financial Ltd. with advice and guidance of a general nature, and is believed to be accurate at the time of writing. However, due to rapid changes in interest rates, market conditions, tax rulings and other investment factors, readers should seek further advice specific to their situation, before proceeding with investment action.



Peak Securities Inc. is a member of the Canadian Investor Protection Fund.

SOLGUARD FINANCIAL LTD.

...building better retirement incomes since 1974

Vancouver: 805 - 675 West Hastings Street
Vancouver, BC V6B 1N2 Telephone: (604) 688-9577
Website: www.solguard.com Toll Free in BC 1-800-663-0644
Email: info@solguard.com

North Shore: 200 - 100 Park Royal South
West Vancouver, BC *By Appointment Only*

Victoria: 520 - 645 Fort Street
Victoria, BC V8W 1G2 Telephone: (250) 385-3636
Toll Free in BC 1-877-500-3636