Asset Allocation: Meet Drs. Frank & Edna Vet

Submitted by John Ambrose, CFA

Many people retiring today face low interest rates and increasing life expectancies. Meet a fictitious couple (both veterinarians) as they consider how to build their investment portfolio.

To help illustrate how asset allocation works, we'd like to introduce you to our successful, married veterinarian clients, Drs. Frank and Edna Vet. At age 60, they are considering retirement, and want to devote more time to their golf games. They wish to stay close to their families and, most importantly, they want freedom from making daily investment decisions. The Vets have asked us to review their investment portfolio and develop a new asset mix to provide income for their retirement. To help them in their decisions, we need first to look at the current state of North American equity markets.

The disturbing 'stock market bubble' of 2000 has passed. Now we see a generally healthy economy despite higher oil prices. Steady growth in GDP (Gross Domestic Product), low unemployment, low interest rates and a strong housing demand indicate investor comfort. Investors are buying stocks for their capital gain potential rather than for dividend yield. They are also waiting for more evidence that growth will continue at low interest rates. When they are convinced, higher stock prices may follow.

Should the Vet consider a cautious approach or invest for the growth envisioned by some? Let's review their situation. They are in good health with a $1.5 million portfolio, a home worth $500,000 and no liabilities. Currently the couple invests in cash and short-term bonds for "safety." Their combined after-tax earnings of $160,000 exceeds their expenses of $100,000 per year, allowing for savings of $60,000. The couple wants to maintain the value of their estate.

After retirement, their portfolio of cash totalling $1.5 million will generate an annual return of 3 percent, which represents $45,000 before taxes or about $30,000 after taxes. This means that their after-tax income will fall short of their pre-retirement expenses by about $70,000. Therefore, they should consider a change in asset allocation to allow for more growth and capital gains, and a reduction in their living expenses. This will help to preserve their estate value.

They also own their veterinary practice and need advice on valuing it and finding a buyer.

Stocks Allow Growth, Bonds Dampen Volatility

If the Vets maintain their living expenses and their all-cash investment portfolio, their net worth will fall, since their spending will exceed income. A prudent mix of equities can allow higher total returns. We modeled their portfolio to simulate returns and risks with different asset mixes, as shown in the table. Higher returns can allow either growth in net worth or a higher allowable living expense, or a blend of the two. Naturally, this strategy is not risk-free.

Risk means the possibility of price changes and is a natural, but uncomfortable, part of investing for long-term growth. Adding bonds to the portfolio can help dampen this volatility, and may be more suitable in their non-taxable registered account.

With 60 percent equities, the expected after-tax return from their portfolio rises to $75,000, as shown in the table. With the same living expenses of $100,000, the Vets' portfolio will still decline by $25,000 annually. Furthermore, this strategy involves increased market volatility, or risk of $190,000 per year. Increased volatility accompanies potentially higher returns from more capital gains with less interest and dividends.

Frank and Edna will either have to reduce their cost of living or they may opt to find part-time or locum work to augment their income to close the gap between their expected investment income of $75,000 and their pre-retirement living expenses. Perhaps they can do both.

Decisions for the Vet Family

Should Frank and Edna change their asset mix? Investing in cash with no longer-term bonds or equities seems overly cautious if markets are strong. The Vet family has a life expectancy and therefore an investment horizon of 20 years or more. We expect that the 60% mix of equities will provide more total return with tolerable risk controlled by the 40% mix of cash and bonds. However, if equity markets weaken, their "overly-cautious" strategy with a risk of $22,500 may suddenly seem prudent.

As the table shows, Frank and Edna Vet must hold more equity for more return. This means more risk. All clients must address this trade-off and be comfortable with it. Portfolios that blend bonds and selected equities will provide the right balance of return and risk for a client's needs. Equities with longer-term sustainable growth can provide consistent returns.

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More Equity, More Return, More Risk — For the Vets' $1.5 Million Portfolio

Asset Mix %			Optimal	Long-term After-tax Return			Maximum
Cash	Bonds	Equity	Pre-tax Return	Interest + Dividends	Gains	Total	Variability = Risk %
100%	0%	0%	3.0%	$30,000	$0	$30,000	$22,500
0%	100%	0%	4.8%	$40,000	$5,000	$45,000	$120,000
0%	70%	30%	6.6%	$35,000	$30,000	$65,000	$165,000
0%	40%	60%	7.5%	$25,000	$50,000	$75,000	$190,000