ILLUSTRATION BY CORNELIA LI

TOO MUCH OF A GOOD THING

Affluent Alberta couple should build up inflation protection and cull investments to get retirement plans on track

In spite of the Alberta economy's downward spiral, Charles and Bettina Crohsman* seem financially secure. Both have careers apart for the ailing energy industry, their incomes more than cover expenses and they have substantial financial assets. Yet, they have a good reason to worry. Their investment portfolio is messy and it's too heavily weighed in bonds and cash to outpace future inflation, which could hurt when they enter retirement.

A senior manager for a consumer products company, Charles ,57, brings home $9,200 a month. Bettina, also 57 and an administrator for a manufacturing company, adds her take-home income of $3,500 a month on top of a net $3,300 pension she already receives. The couple' s monthly income allows ample funds for saving. But Charles would like to retire in eight years, while Bettina wants to quit now, despite the loss of some future pension benefits.

"Our goal is simple: ensure that we have adequate funds for retirement," Charles says. "We would like to travel and we plan to down size our home, which we now share with our 19- year-old son, when he finishes university and moves on."

Derek Moran, head of Smarter Financial Planning Ltd. in Kelowna, B.C., notes the couple have been diligent savers and conservative spenders, setting up the base for a comfortable retirement. "If they downsize their house around age 70, as they plan, they could liberate even more money to generate income," he says. But there are some things they should do in the meantime.

Charles earns 60% of the couple' s income and is in a high tax bracket. If Bettina retires, her income will drop to the $48,000 pension she already receives. Between now and Charles' retirement, the couple can use a lending plan to bring down their combined tax bill. Charles can lower his tax bill if he lends money—and their portfolio has $93,400 of cash squirreled away—to Bettina and she pays him interest at the prescribed rate, currently 1% per year, which is deductible to her and taxable to Charles.

The advantage of this plan is clear from the numbers. On, say, $50,000 of income, a dollar of Canadian-source dividends costs her 9.63% in tax. Charles would pay 20.33% on that same dollar of income on top of his $174,000 salary. Tax savings will depend on how the money Bettina bor-

INVESTING**TIP**

Markets wobble, yet there are certain ties (well, almost) for stocks of companies with solid market positions and histories of raising their dividends. The price of a stock with a 4-5% dividend—banks and telcos, for example—backed by a company that raises the dividend by 5-10% every year will tend to follow the rising dividend upward. It' s not guaranteed to work, but even if the stock sags for many years, the dividend will eventually makeup the loss.

rows is invested, but Moran notes they could be substantial over the eight-year period until Charles retires.

Charles and Bettina already have $1.66 million in assets including a $550,000 house. If they continue to save $7,000 a month, as they do now, and grow their financial assets at 3.5% per year over inflation, their nest egg will be more than $1.9 million in seven years. That would give them $109,000 to spend per year until they are 90, assuming their money grows at 3% over inflation until then.

But if Bettina were to quit now, their savings capacity would drop to $4,000. Assuming 3% growth after inflation, their investments would grow to more than $1.65 million in 2016 dollars by the time they are 65. That could produce an annual income of $92,300 with return of capital to age 90. We'll go with the latter assumption since Bettina wants to quit as soon as possible.

When Charles retires at 65 and his tax bracket drops, he can split his wife's $48,000 pre-tax pension from previous employment. He should have full Canada Pension Plan annual benefits of $13,110 at 2016 rates, while Bettina would get an estimated $11,483. Both will get full Old Age Security of $6,846 per person per year, using the 2016 rate. Their investment cash flow of $92,300 would bring their total income up to $178,585. Split evenly, their individual incomes would be $89,293. They would be exposed to the OAS claw back, which began at around $74,000 in 2015. Anything over that amount would be taxed at 15%, costing each about $2,300 and reducing their income to about $174,000. Each would pay income tax at an average rate of 23%, making after-tax income about $11,165 a month.

Most of the couple's income in retirement will come from defined-benefit job pensions and government pensions. Given their margin of income over core expenses, Charles and Bettina could sustain a substantial income decline without having to change their way of life in retirement. But they have a serious problem: their portfolio is so light in common stock that it will be unable to keep up with inflation. Their present allocation is 76% fixed income, 9% cash and just 15% equity.

Chartered financial analyst Nigel Roberts, who heads Bluenose Investment Management Inc. in Lake Country, B.C., says the couple' s portfolio structure is quite lopsided in favour of fixed income. "If they are going to pace inflation, they have to restructure to 60% equity and 40% fixed income." Moreover, he adds, there are more than 80 assets in their portfolio, such as $3,852 in Boston Pizza Royalty Income Trust units, and managing so many small positions is difficult.

Roberts says their first move should be to put all their assets in one institution rather than spread among three as it is now. That would make management easier, since there would be only one set of accounts. The second move is to raise the common share equity of the portfolio to 60% with 40% remaining in fixed income, a blend that would be expected to produce a 6.5% gross return. If inflation runs at 2.5% and they pay investment management costs of 1% to their investment dealer or independent advisor, their portfolio would have a 3% net real rate of return. They would pace inflation and have rising dividend income, Roberts notes.

But there is still more to be done. The majority of positions in the portfolio are quite small. Many of the bonds and notes are illiquid short-term instruments that mature within a few years. It would be costly to sell them, as investment dealers no longer make active markets in the small corporate issues. They have to find buyers and then take big cuts for the bother. As a result, patience will be a virtue, Roberts says. Charles and Bettina should aim for a couple of dozen equity positions, each with an approximate size of $24,000.

They can also make their portfolio more tax efficient. About 78% of the portfolio is in tax-sheltered accounts so a shuffling of their assets is in order.

Trading accounts should hold Canadian common shares and non-dividend-paying foreign company shares. U.S. dividend-paying shares should be in the couple's RRSP, since there is no withholding tax on foreign dividends held in retirement accounts. Interest-paying investments such as bonds and GICs should be in registered accounts or tax-free savings accounts, Roberts adds.

The new portfolio can be built up over time as cash is released from matured bonds and mutual funds, which are sold when their deferred sales charge penalty periods end.

PORTFOLIO ADVISOR

Charles and Bettina Crohsman have to simplify their investment portfolio and boost the equity portion to ensure their retirement. Chartered financial analyst Nigel Roberts recommends that the couple hold the following stocks and bonds:

- Four banks: perhaps Toronto-Dominion Bank, Bank of Nova Scotia, Royal Bank of Canada and Wells Fargo & Co.
- Two telcos: say, Telus Corp. and BCE Inc.
- Four pipelines: Enbridge Inc., Trans Canada Corp. Pembina Pipeline Corp. and Atco Ltd.
- Three energy companies: perhaps Cenovus Energy Inc., Chevron Corp. and Suncor Energy Co.
- An income trust: for example, H&R REIT
- Three consumer products companies: such as Dollarama Corp., Boyd Group Income Fund and Alimentation Couche-Tard Inc.
- Five foreign consumer staples companies: like Unilever, Coca-Cola Co., Walt Disney Corp., Starbucks Corp. and Johnson & Johnson.
- A railroad: say, Union Pacific Corp.
- Precious metals: perhaps Agnico Eagle Mines Ltd. and Goldcorp Inc.

For the fixed-income side:

- 30% of the portfolio can be in provincial bonds, which tend to pay about a third more than Government of Canada bonds. Bonds can be laddered from one to five and one to ten years. The advantage of actual bonds over a bond exchange-traded fund is that the former mature at a known and certain price while ETFs can carry gains or losses forever.
- 5% should be in preferred shares.
- And 5% goes into corporate bonds with maturities of no more than four years. Bonds should be in registered accounts, as interest is fully taxable.

This portfolio allocation will give the couple inflation protection and the likelihood of rising income. As the bonds mature and high-cost mutual funds are sold, the Crohsmans can maintain a substantial cash position for buying opportunities. Bond income would be modest, but bonds are a form of portfolio insurance, gaining in price when common shares plummet.