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A clean slate

Andrew Allentuck | Tuesday, April 10, 2012

ILLUSTRATION BY JACKIE BESTEMAN

On one of Italy's lovely, warm Mediterranean islands, corporate executive Albert Reiseman (not his real name), 63, has spent three decades managing several companies' plants in Europe and the Middle east. Now he's contemplating coming back to Canada. He's worked in several countries, some with uncertain political futures, and longs for the relative calm of his home country. With his wife, Luisa, 55, he will have more than $2.1 million in financial and property assets, including a condo in Ottawa and farmland in eastern Ontario, at his disposal.

Albert and Luisa have two grown children, one of whom works in Canada. Their destination? Perhaps Vancouver, where one child works, or Ottawa, where they already have a pied-à-terre. "I left Canada in 1980. now I want to come home to retire, to be in a country with a good health-care system and some political stability," Albert says.

Albert has been a corporate nomad, living well in what have often been cushy hotel suites, picking up languages (he speaks three fluently in addition to English) and building up the political skills of a diplomat and the bean-counting talents of an accountant. But he craves what others have: friends who are not just passing acquaintances, roots in his own country and a future in which he does not have to look at his recent inbox to be sure of where he is.

But Albert doesn't really know Canada anymore. At present, he lives in an apartment that costs him 1,500 euros (C$1,970) per month. His other expenses are modest. His financial assets are almost entirely in cash, because, as he admits, he has been more of a saver than an investor. Coming back to Canada, he will be making a fresh start with a tidy fortune, no debts and a deep desire to put down roots.

Albert and Luisa have a double-edged dilemma as they plan for the next three or four decades. Their retirement income will depend on how he invests his financial assets, because he will no longer have a salary to support their way of life, nor significant cash flow from CPP and OAS. On the other hand, the income they need will depend on the life they establish in a country they remember more than know.

What the Experts Say

Moving back home may be emotionally satisfying, but Albert will have to nimbly manage his resources to make it work, says Derek Moran, head of Smarter financial Planning Ltd. in Kelowna, B.C. On returning to Canada, Albert must establish that his assets are owned on a 50/50 basis with Luisa. This will minimize income-splitting complexities in future, and it is important to take advice from an accountant about this switch.

Albert must then deal with his Ottawa condo. It has a market value of $360,000 and produces rental income of $1,920 per month, or $23,040 per year, before expenses. Taxes and condo fees are $11,535 and property management fees take up a further 8% of income, or $1,843 per year plus one month's rent, if a new tenant signs a lease. Those costs total $13,381 per year, reducing net income to $9,659 per year.

Put another way, that's a 2.7% return on present equity — not a lot for the risk of damage, vacancy and the headaches of owning a distant property. If Albert and Luisa choose to live in the condo, they would no longer pay the management fees. If they choose to live elsewhere, they should sell the condo to a new owner who will respect the present tenancy agreement. We will assume the condo sells for its estimated price of $360,000.

Albert's tidy $2.1-million fortune looks good on paper, but the Reisemans are much more dependent on their financial assets than most folks who live in Canada. He has spent so little time here that he will have only 13 of the 40 years of residence required to get full Old Age Security (OAS), currently $6,480 per year. That works out to $2,106 per year. Luisa will have spent 18 years in Canada and can expect $2,916 annually in OAS benefits. Albert's Canada Pension Plan benefits will be just a quarter of the maximum $11,840 payable or $2,900 per year. Luisa didn't work enough in Canada to earn CPP benefits. Their public pensions will thus total $7,922 per year.

Assuming that Albert and Luisa need a total pre-tax retirement income of $100,000 per year, they will need to find another $92,078. If they keep the Ottawa condo and their rural acreage worth $80,000, their assets available for investment will be almost $1.7 million. In other words, the Reisemans need to generate a 5.45% return on their financial assets to reach $100,000 in annual income, Moran says.

If they choose to buy a home in Vancouver's pricey market and sell the Ottawa condo, they could spend $800,000 for a new nest. They could use the net proceeds of about $342,000 from selling the Ottawa condo, which would leave them with total assets of just over $1.2 million to invest. In this case, they would need a return on assets of nearly 7.5% before tax to reach $100,000 per year.

There's a world of risk between the two scenarios. Achieving a 5.4% return can be done by blending dividend-paying large-cap stocks and strong fixed income, while a 7.5% return would likely mean relying on trading stocks for capital gains and buying high-yield junk bonds with potential default problems. A portfolio designed to achieve such a 7.5% return would be fraught with danger. It is not suitable for retirement and need not be considered further.

Achieving a more reasonable 5.4% return requires blending stocks, in several asset classes to spread risk, and fixed-income assets such as bonds, mortgages and preferred shares that tend to rise in value when common stocks fall, thus stabilizing overall portfolio value, says **Nigel Roberts, head of Bluenose Investment Management Inc.** in Lake Country, B.C. The move to a balanced portfolio, 55% stocks and 45% fixed income assets, is essential, Roberts adds.

"Interest rates on quality fixed-income investments have been declining for the past two decades, so Albert's investments in mainly U.S. dollar deposits will not provide a sufficient return to fund their retirement," he explains.

The 55% stock component should go into Canadian companies that have a long-term record of paying dividends, with those dividends increasing over time (see sidebar, pg. 39). Keeping money in Canadian assets is prudent, Roberts says, because Albert and Luisa will be living and spending in Canada. These stocks' dividends should have a long-term rate of return of 8%, of which about 4.1%, or about $38,500, would be dividend distributions that are expected to grow over time. The 45% fixed-income portfolio would have an overall cash flow of 4.5%, or about $34,730 per year.

Total annual cash flow from stocks and bonds would be $72,230. Albert and Luisa would therefore need to harvest about $19,848 per year of capital gains, or 2% of their portfolio's value.

The Reisemans must bear in mind that this strategy — based on investing in high-quality, dividend-paying common stocks or exchange-traded funds that hold the desired sectors, and very sound fixed-income bonds, preferred shares and mortgage pools — constrain but do not eliminate the risks that go along with investing in capital markets. The couple could hire a portfolio manager for perhaps 1% of assets under management. That could lower returns, but would help the couple, new to investing in stocks and bonds, manage risk while maintaining an active trading program, Roberts says. By starting with a manager, and watching the results and studying capital markets, Albert and Luisa could eventually take over managing their portfolio.

"The couple has not had to rely on their portfolio for investment income until Albert's recent retirement," Roberts says. "They were able to use low-risk, fixed-income investments. But interest rates around the world have declined and their present investment strategy will not provide a sufficient return to fund their retirement."

Balancing act: Building a portfolio for retirement income

The 55% equity portion of Albert's new portfolio should be divvied up as follows, suggests investment manager Nigel Roberts:

- 8.25% in three of the Big Six Canadian banks > 8.25% in four real estate investment trusts
- 8.25% in three utilities > 8.25% in three pipeline companies > 5.5% in two telecommunications companies
- 5.5% in three energy companies > 5.5% in three mineral companies > 5.5% in a couple of consumer discretionary income companies and a couple of consumer staples companies
- The 45% fixed-income portion should be allocated as follows: > 20% to provincial bonds with an expected 3% rate of return
- 15% to preferred shares spread among 10 or more investment-grade issues from various companies with a minimum expected return of 4.5%
- 10% among at least two mortgage investment corporations with expected returns of 7.5%