ETF INSIGHTS

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Portfolio construction and asset allocation considerations

Michael Prittie, Special to Financial Post |
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When constructing a portfolio, the retail investor needs to take into consideration many different factors and priorities. Time horizon and tax considerations are two key aspects. After all, you should likely not be considering equity investments if you require your capital back in a very short period of time or are highly risk adverse. And the higher your net income the more tax you will pay on investment income and the more diligent you should be towards what is held in your portfolio.

Consider the thought of three silos when allocating your investment capital. One silo holding short-term cash equivalents and short duration fixed income securities suitable for redemption in case of emergency or needed within three to five years. A low cost ETF such as a laddered 1-5 year government or corporate bond will provide higher yields than cash with little variability and reasonable diversification. Several versions abound – including strip bond laddered products that can offer better tax efficiency.

A second silo can hold mid-term securities – those with a five to ten year time horizon. REITs, Mortgage Investment Corporations (MICs), mid-term bond structures, preferred share ETFs and high dividend paying income stocks like BCE are examples.

In your last silo, consider common stock ownership in high quality businesses, either individually or through a proven ETF provider or mutual fund. Corporate Class versions of mutual fund shares still exist for additional tax planning purposes. These securities can help protect you against the ravages of inflation that can eat away at your purchasing power of money over the long term. They can also offer tax deferral in non-registered accounts since profits from

capital growth generally only become taxable when sold at some future date, and capital gains are taxed at lower tax rates. You can include foreign investments here to gain exposure to economic growth from the other 97% of opportunities that are represented outside of Canada.

When populating asset classes with individual securities many portfolio managers, and mutual funds for that matter, incorporate ETFs to obtain low cost diversified exposure in areas of need. Whether it is a specific geographical exposure or asset class, ETFs can be an excellent choice. As discussed in my last column, for retail investors ETF choice has never been more diverse, offering the opportunity to mix and match passive and active strategies to achieve lower costs and better diversification.

Adopting a mix of strategies to suit your investment objectives (i.e. income versus growth), risk profile (i.e. low to high) and time horizon (i.e. short to long term) will help you better achieve your goals. Most firms have asset allocation and risk profile questionnaires. Professional advisors utilize these tools along with a thorough client discovery discussion to construct a portfolio that best meets individual investor needs.

Another element touched on above is taxation. Like inflation, taxation will erode returns and wealth and, while inflation is a silent detractor, tax is present each and every year on April 30th. Consider tilting your fixed income needs more towards your registered plans (RRSP/TFSA) where it will compound tax free. That allows you to consider holding more equity – both income oriented Canadian dividend paying stocks which have preferential tax treatment and securities designed for long-term capital growth and tax deferral.

By prudently allocating capital to different asset classes you can manage both risk and tax. Mix in some high quality Private Equity (if you are accredited or work with a registered Portfolio Manager) and you have the foundation for a well designed and implemented portfolio. Then it is a matter of rebalancing the asset mix from time to time to stay on course with your risk and objectives. As time passes and your objectives change in response to material changes in personal or financial situation (i.e. marriage, retirement, loss of spouse etc.) the asset mix will evolve to suit the new realities.

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