While reviewing the most recently released economic statistics, Ryder, a CFP professional, began to think about the clients he should contact to discuss how their goals may be impacted. His first thought went to Larry, a 58-year-old who owns and operates a small manufacturing business in Alberta. The business is impacted by the cost of oil. It is affected from a transportation perspective and because its major contracts are from oil-dependent businesses in China, India and the United States. The business has grown in size and value substantially over the last 30 years. Larry’s financial plan includes selling the business at age 65. Despite declining in value over the last quarter, Larry’s portfolio is up $15,456 for the year, and $133,998 over his initial account deposit. He is on track to meeting his retirement goal.

Ryder made a number of observations while reviewing recent market commentaries. The Canadian economy had benefited from six years of positive growth in Gross Domestic Product (GDP), albeit with slower growth each quarter. Until recently, consumer spending and personal savings rates had been at their highest and lowest levels respectively. That said, annual inflation was holding steady at one percent, the lower end of the Bank of Canada’s target range, due in part to falling commodity prices such as oil. The annual unemployment rate had grown to 6.8 percent, slightly above normal, but last month’s results showed an addition of 66,000 jobs to the Canadian economy. Stock markets in North America had seen expansive growth for four of the previous six years, with higher-than-average volatility more recently. Over the last three months, the Toronto Stock Exchange (TSX), New York Stock Exchange (NYSE) and Nasdaq saw their year-to-date growth wiped out. International markets were also experiencing extreme volatility with limited growth. Larger countries, including India and China, continued to experience positive stock market returns; however double-digit growth in GDP has been replaced by lower, single-digit returns. The Bank of Canada recently dropped the overnight rate. The U.S. Federal Reserve was expected to increase the Federal Reserve Rate at their next scheduled meeting, which would result in a higher overnight rate than Canada’s. The European Central Bank planned to maintain its current monetary policy.

In addition to receiving income from the Canada Pension Plan (CPP), Old Age Security (OAS) and an individual pension plan (IPP), Larry expects to fund the majority of his retirement with proceeds from the sale of his business. To prevent his overreliance on the business, he opened an investment account some years ago with an asset allocation split between 60 percent equities and 40 percent fixed income. During their last meeting, Ryder advised Larry to maintain his asset allocation, given that he has eight years until retirement. Since then, the portfolio has grown to 67 percent in equities, of which 15 percent is held in actively managed mutual funds focused on small cap industries in the U.S., Canada, Australia, Germany and Switzerland; 46 percent is invested in passively managed, exchange-traded funds that track major stock market indices available in North America; the remaining six percent is invested in an international equity fund. Individual, shorter term fixed-income securities account for 21 percent of the portfolio and there is $20,000 in cash. Larry is on track to meet his retirement goals.

Five years ago, Larry also opened a self-directed brokerage account to trade a few stocks with his “fun money”. He holds common shares in the following companies: a bank that has not missed a dividend payment in more than 100 years, an airline that flies within North America, a national grocery store chain with very little debt, a luxury chain of hotels and a railway transportation company. Larry is concerned about the impact that recent economic circumstances might have on his business and portfolio going forward.
Knowledge Expectations – Economic Cycle

The CFP professional should be able to:

• Explain to Larry that his business and investment portfolios have benefited from positive growth in the economy over the last six years, and that he is in a good position to meet his retirement goals.

• Explain that the falling commodity prices, sluggish GDP growth rates and slowed stock market growth signal that the economy may be heading into a period of contraction. Higher-than-normal unemployment and a reduction in the overnight rate by the Bank of Canada provide further clout to this expectation.

• Explain that, while Larry’s investment account has suffered a setback over the last three months, his portfolio is up $15,456 for the year and $133,998 since his initial deposit to the account.

• Explain that the Bank of Canada can take measures, such as adjusting the overnight rate, to influence the behaviour of financial institutions, businesses and individuals. The overnight rate is an interest rate at which major financial institutions can borrow from, or lend to, one another. This interest rate affects other interest rates in the economy, including borrowing rates for businesses and individuals. By reducing the rate further, the Bank of Canada is taking measures to stimulate the economy for renewed growth. A similar opportunity is available to the Federal Reserve in the U.S. The Federal Reserve's decision to increase its overnight rate might signal that the strengthening of the economy has begun south of the border, which may have positive repercussions for Canada.

• Explain that significant volatility in the investment markets can be a signal of uncertainty that can continue for an indeterminate length of time. For this reason, it would seem prudent for Larry to maintain his asset allocation of 60 percent in equities and 40 percent in fixed income, so long as his retirement goals, risk tolerance and personal circumstances do not change. This would require a rebalance of Larry’s portfolio, which has become overweight in equities.

• Explain that, as part of the rebalancing process, Larry may consider reducing his exposure to small cap equities in favour of large cap equities. They tend to be less volatile and, as a result, can hold more of their value during periods of market downturn. Actively managed mutual funds tend to be costlier than index funds. Even so, explain that a higher proportion of actively managed funds may be beneficial for the opportunity they provide to hold cash, which may be desirable in periods of uncertainty.

• Explain that Larry may consider investing the $20,000 in cash. This would enable him to buy in at lower prices (“on sale”) vs. deciding to wait until the market recovers and investment values increase. Alternatively, he may consider a dollar-cost averaging strategy to invest the $20,000 over time.

• Explain that the net effect of the recent market downturn on Larry’s business is unclear; some of the changes are likely to benefit the company, while others may not. Falling commodity prices, specifically oil, should help reduce transportation costs. The business may also benefit from increasing orders to U.S. customers who take advantage of the depreciating Canadian dollar. Conversely, if customers feel uncertain about future economic conditions, they may choose to postpone their orders.
CASE STUDY – IMPACT OF EXTERNAL MARKET ON CLIENT GOALS

• Explain that the economic climate may have varying impacts on the investments held within Larry’s self-directed brokerage account. The financial sector, including banks that maintain steady dividend payments, tend to be able to withstand economic downturns. Similarly, grocery stores, such as the one in which Larry holds shares, tend to fare relatively well in market downturns given their business focus on consumer staples. In general, railway stocks would likely see a reduction in their share price as cheaper oil prices lead some firms to switch to trucking deliveries. However, Canadian companies are dependent on the railway for the transportation of large quantities and specific goods for which trucking is not feasible; for this reason, railways tend to weather economic downturns well.

• Explain that his airline and hotel stocks are likely to suffer the most if the economy continues to contract. While the airline may benefit from falling oil prices, it may see a reduced number of travellers as people choose to forego vacations or travel closer to home. The luxury hotel industry may suffer similar effects.

• Explain that Larry may consider limiting further stock investments within his self-directed account. Doing so would help him avoid an overexposure to equities which would create a risk beyond his comfort limit.