During their annual review meeting, Gretchen expressed concern to Shannon, an FPSC Level 1 Certified in Financial Planning, about the performance of her portfolio. Gretchen was anxious about the negativity that the media were reporting, and wondered how in one year things had deteriorated so much. She remembered that prior to her portfolio dropping in value, the stock market, interest rates and inflation had all been steadily rising. Her mutual fund portfolio is now giving back one third of the growth it has earned over the last four years. Since inception, the return on her portfolio has dropped from an annual average of 12 percent to 4.6 percent. Gretchen was also concerned about interest rates, and where they might be at the time of her upcoming mortgage renewal next year.

While the Standard & Poor’s 500 stock index (S&P 500) has rebounded slightly, inching up one percent during the first quarter of this year, the U.S. market fell 15 percent in the past year from its four-year high. Analysts have revised down their growth forecast of the gross domestic product (GDP) for this year, from two percent to one percent, after GDP missed expectations over the last three quarters. Unemployment is on the rise and retailers are reporting that their earnings will be severely affected this year on lower-than-expected sales during the Christmas shopping season. The Government of Canada’s upcoming budget is expected to include a spending increase on transit in major cities across the country, and a reduction in personal income tax rates. The Bank of Canada is expected to reduce interest rates during the bank’s next regularly scheduled meeting.

To meet her goal of retiring in 15 years, Gretchen requires an average annual rate of return of four percent. According to her account statement, the equity component of her portfolio is now 58 percent, which is significantly lower than the recommended 75 percent.

Despite uncertainty and confusion brought on by the news media, Gretchen knows that Shannon is well versed in financial and investment planning. Moreover, she always manages to cut through the noise, and bring clarity to media reports.

Knowledge Expectations – Economic Impact on a Financial Plan

The FPSC Level 1 Certified in Financial Planning and CFP Professional should be able to:

- Explain to Gretchen that it is natural to be concerned when investment values drop, but that the drop in the value of her portfolio is a normal part of investing. These types of market downturns are not unusual, and associated with inevitable periods of contraction in the economy. Other results that Gretchen has been hearing in the media are also to be expected–declining GDP growth, rising unemployment and reduced earnings forecasts for companies.

- Explain that, with 15 years until retirement, Gretchen has the time to wait out the downturn until the market recovers. Although historical results are not necessarily indicative of future results, history has shown that each period of recovery after a downturn has taken the market to higher values. Similar results are expected after this downturn.
• Explain that Gretchen’s financial plan was developed using a set of assumptions, including projected growth rates in equities, and fixed-income investments that take into account normal fluctuations in market cycles. The assumptions were based on years with above-average growth rates and years with below-average growth rates, like this past one.

• Explain that Gretchen is financially on track to retire in 15 years. Reassure her that her average annual rate of return of 4.6 percent is in keeping with the rate required to meet her retirement goal, although her portfolio experienced a relatively significant decline this past year.

• Explain that a review of economic indicators may be used to help predict future economic trends.

• Explain that GDP measures the value of all goods and services produced within a country over a given period. It is used to assess the financial condition of countries worldwide. When the economy is doing well, GDP growth rates tend to be stable or increasing. Conversely, when the economy is not performing as well, the growth rate of GDP tends to drop. Reiterate that the slowdown in GDP growth over the last three quarters means that the economy was probably in a period of contraction. Also, given that the GDP forecasts have been revised down, the period of contraction may continue.

• Explain that the growing unemployment rate may also be indicative of a contracting economy.

• Explain that about one year ago, interest and inflation rates were on the upswing. In general, stock markets were at a four-year high. Remind Gretchen that her mutual fund portfolio had benefited from that growth. This will help her put into perspective that she has achieved growth overall, although the value of her portfolio dropped this year by a third.

• Explain that a reduction in corporate profits, caused by a reduction in consumer demand for goods and services, tends to follow periods of economic expansion. With lower profits, businesses tend to respond by reducing labour, one of their largest expenses, which leads to greater unemployment. This has a tendency to affect retail sales and stock prices in a negative way. Gretchen’s mutual fund portfolio suffered from the drop in stock prices because the majority of her portfolio is invested in stocks.

• Explain that these kinds of setbacks tend to be temporary, which is why it is important to remain invested, especially since Gretchen’s goals and investment objectives have not changed.

• Explain that, in time, the economy should recover. Also, the Bank of Canada and the Government of Canada have tools at their disposal that they can use to speed up this process.

• Explain that, if the Bank of Canada follows through by decreasing the overnight interest rate, other interest rates in the economy will likely follow. Lower interest rates tend to spur individuals to buy more goods, including houses and cars, as their costs of borrowing are then reduced. Gretchen may benefit from this when she renews her mortgage. Lower interest rates may also encourage businesses to invest in longer term projects that require borrowed funds to finance them. Both of these actions will require an increase of workers in various industries, which will result in decreased unemployment overall. With more people able to consume more goods and services using their new-found or increased incomes, corporate profits should increase, leading to higher stock prices.
• Explain that the Government of Canada’s budget proposal to spend on transportation across the country should also help the economy recover more quickly. By spending on transportation, new jobs related to the construction and operation of transportation services will be needed. More people entering the labour force should generate greater demand for goods and services, and increase corporate profits, again supporting stronger financial markets and higher stock prices.

• Explain that the Government of Canada’s budget proposal to reduce personal income taxes should also stimulate the economy. Reducing taxes is expected to provide taxpayers with greater disposable income that they can use to purchase more goods and services. Similar to an increase in government spending, the tax reduction should help increase corporate profits and translate into higher stock prices.

• Explain that there is a lag in time between the Bank of Canada and the Government of Canada’s announcement of their intentions to stimulate the economy, and the effects of the plans set in motion. Spending by businesses and individuals takes time to plan and make an impact on economic and market recovery.

• Explain that there may be signs of recovery in the most recent quarter. Specifically, a one percent increase in the S&P 500 since the beginning of the year may signal that the economy is moving toward an expansion phase. Other indicators would be required to give greater credence to this outlook. However, it is still too early to conclude a reversal, given the small amount of growth recorded over a short period of time. Gretchen may, therefore, experience further drops in her portfolio’s value before the economy and investment values begin to improve.

• Explain that economic shifts tend to have varying impacts on equities and fixed-income investments. As a result, the proportion of Gretchen’s portfolio holdings in equities and fixed income will tend to shift over time. With only 58 percent currently in equities, Gretchen should consider rebalancing her portfolio back to her optimal asset allocation of 75 percent in equities and 25 percent in fixed income. This may seem counterintuitive, given that equities have fallen in value and may continue to do so. However, rebalancing at a time when equities are relatively inexpensive may increase the growth opportunities that Gretchen can benefit from. This approach is also consistent with her risk tolerance, investment objectives and time horizon.