RAYMOND JAMES FINANCIAL PLANNING LTD.

# PLANNING AHEAD

FINANCIAL PERSPECTIVES AND COMMENTARY

SUMMER 2012

## INSIDE

» The Financial Planning Pyramid

» Will Your Personal Financial Security Plan Prepare You for the Worst?

» Pay Off the Mortgage or Invest?

» In Retirement, When the Market Drops Can Matter More Than How Much

» Don't Let Uncertainty Derail Your Retirement Income

FINANCIAL PLANNING

# A Visual Aid for Successful Financial Planning: The Financial Planning Pyramid.

Understanding the Financial Planning Pyramid is an essential part of understanding the financial planning process. This widely accepted and simple tool is a visual aid to help you understand the necessary steps to create a written financial plan that is built on a solid foundation.

Your plan can be as detailed and complicated or as simple as you want it to be. It generally starts off fairly simple and develops overtime into a more complex plan that addresses your short- and long-term financial goals, your insurance coverage and your Investment Policy.

The financial planning pyramid is used from the bottom to the top illustrating which financial matters you should address first. As you move up the pyramid (by reducing debt and acquiring assets), your income protection needs are replaced by your need to accumulate more wealth, keeping in mind that as you rise higher in the pyramid both risk and potential profits increase.

### A SOLID FOUNDATION

Whether you're building a house or building wealth, a rock-solid foundation is a must. Otherwise, one small unexpected change can cause the whole pyramid to collapse.

We all like to think that we'll live long, healthy and prosperous lives. But to base our financial plans on that assumption would be foolish. When it comes to financial planning, you need to prepare for the unexpected.

The first bricks you want to lay in your financial foundation ensure that no matter what twists and turns life sends your way - losing a job, becoming sick or disabled, or dying too soon - you'll have a financial safety net in place to protect you and your family.

This means establishing an Emergency Fund (3-6 months of salary), purchasing Insurance (Life, Health, Disability, Critical illness Insurance, etc), and drafting a Will as well as Powers Of Attorney (health and property).

You will also want to focus on paying off all your debt by getting a better handle on your cash flow. Developing a written budget by allocating every dollar goes a long way in breaking the debt cycle and freeing up your largest wealth-building tool – your income!

Now you have the foundation needed from which you can build your wealth.

(continued on page 2)

### WEALTH ACCUMULATION

The first stage in the journey to financial freedom is to start saving and accumulating wealth through investment for eventualities such as your retirement. This could be in the form of adequately funding RRSPs and TFSAs, homeownership, or a combination of all three.

While you can start building non-registered investment portfolios, it does not make a lot of financial sense to have a taxable investment portfolio if your tax deferred (RRSP) and tax free (TFSA) accounts have contribution room.

If you have reached a level where your debt is eliminated, you have enough retirement funds and enough wealth accumulated in your investments you may wish to expand your investment horizons. This could range from buying investments like junior gold companies to investing in private partnerships. But remember, these investments should not come at the risk of your overall financial plan.

### SUMMARY

Visualizing your priorities is a good way to understand the importance of financial planning. If you work your way up the pyramid in the specific order and one level at a time you will have a solid financial plan and be able to weather short periods of financial hardship without jeopardizing long-term goals.

### Speak with your Advisor

As you progress, you'll repeatedly face the need to seek professional help regarding the insurance you have, the retirement plans you choose, the investment vehicles you use and the estate plans you make.

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RISK MANAGEMENT

## Will Your Personal Financial Security Plan Prepare You for the Worst?

Your most important asset is not your home, your car, your jewelry or other possessions. It's your ability to earn an income. Think about it: All of your plans for the future—from buying a home, to putting your kids through college, to building a retirement nest egg—are based on the assumption you'll continue to earn a paycheck until you retire. But what would happen if those paychecks stopped? That's where disability insurance may come in. It provides an income to you and your family if you are unable to work because of illness or injury.

Though disability is behind a significant number of home foreclosures and personal bankruptcies, insuring against it has not been a high priority for most workers because many assume they're already covered through employment insurance, provincially-mandated Workers' Compensation or employer-provided group plans. However, there are numerous holes in this safety net of coverage.

Know that about 55% of those who initially apply for disability benefits through Social Security (CPP) are initially denied, and those who are approved get an average benefit of just $843 monthly (Jan 2012)—hardly enough to replace the average worker's income. Workers' Compensation covers only work-related disabilities, but according to the Canada Safety Council, 90% of disabling accidents aren't work-related. And what about coverage through work? It's a great employee benefit, but it's not available to many workers. According to the Council of Canadians with Disabilities and Stats Canada, more than 50% of the labour force has no disability insurance coverage as a workplace benefit. Among the self-employed, just 38% have insurance coverage for disability.

So what's a worker to do? Explore your options and learn more about disability insurance. If your employer offers disability coverage, take the time to find out if the coverage would be sufficient to meet your income replacement needs in the event of a disabling illness or accident. If it's insufficient, you can purchase coverage on your own.

Take this opportunity to make sure you'd be okay financially in the event that a disability keeps you out of work for an extended period of time.

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PLANNING TIP

## Pay Off the Mortgage or Invest? A Decision for Your Future.

How do you choose between prepaying your mortgage and investing your extra cash (or tax refund)? It's not always a straightforward question of finance, although you should certainly run the numbers. If you have a 30-year, $300,000 mortgage at 5.00% with 20 years left, paying an extra $400 a month on principal could save you approximately $48,000 and cut the time to payoff by nearly six years.

But what if you invested that money, instead? In 14 years, at an annual return of 7%, you could accumulate well over $100,000. Of course, any investment involves risk, and if your goal is to outstrip your calculated mortgage savings, you may find yourself choosing an investment with substantial risk.

What is clear is that if you choose to pay off the mortgage, you can determine your savings because the numbers are known. Investment results are not certainties. For someone uncomfortable with debt, prepaying the mortgage may be the obvious choice. But an investor with the financial discipline to invest the extra cash may choose otherwise. Don't forget to factor in each option's effect on your taxes.

Can't decide? Consider the middle ground. Put half toward prepaying your mortgage, half into investments. Even small adjustments can help.

INVESTMENT PLANNING

# In Retirement, When the Market Drops Can Matter More Than How Much.

After the economic collapse of 2008, a new generation of investor became acutely aware of the ups and – more specifically – the downs of the market. For those of us close to, or living in, retirement, market risks not only represent the potential loss of funds, but also the loss of a planned lifestyle.

When accumulating funds over decades, returns can be up and down. But for the most part they average out – regardless of the order or sequence in which they appear – providing an average rate of return. But it's not until we start to withdraw funds in the form of retirement income that the ups and downs really start to matter.

Especially during the early years of retirement, a consecutive sequence of poor market returns can negatively impact the sustainability of retirement assets and withdrawals. This is what retirement planning experts refer to as sequence of returns risk.

To fully understand the importance of sequence of returns versus historic averages for retirees, let's look at the following illustrations.

In Figure 1, we show a 20-year period of returns (1989–2008) for the S&P 500 that produced an average return of 8.43%. When the sequence is reversed, the average annual return is still 8.43%. For the investor, this is an acceptable average rate of return – no matter the order of sequence.

However, for retirees taking systematic withdrawals, the order in which they realize their returns is crucial to the long-term sustainability of a retirement portfolio, as shown in Figure 2.

In Figure 2, we'll use the 1989–2008 and 2008–1989 sequences with a retiree who has $1 million in retirement savings invested 100% in equities – for illustrative purposes – represented by the S&P 500 index. He plans to spend $50,000 (5% initial withdrawal rate) in the first year and is indexed to inflation (3% average).

After 20 years in retirement, the 1989–2008 sequence has supported retirement spending and enabled the account value to grow to more than $3 million. But the result for the 2008–1989 sequence is another story. The negative 37% performance in the first year, followed by significant negative returns in years seven, eight and nine reduced the account value dramatically to approximately $235,000.

To help ease the effects of the sequence of returns here are four simple strategies that can be used in retirement income planning.

### Portfolio diversity

Stay invested in cash, fixed income and stocks. If the retiree had used a 60/40 balanced portfolio instead of just equity investments, the results for the 2008–1989 sequence would have been better. In a diversified portfolio, poorly performing investments don't have to be sold to fund spending, helping the long-term sustainability of the retirement portfolio.

### Use a cash flow reserve ladder

This can provide allocations to cash and short-term, highly liquid investments.

It may also alleviate pressure to sell, especially in years like 2008, when both fixed income and equities were undervalued in the market.

### Develop a growing income stream

Use high and growing dividend paying stocks for the equity portion of the portfolio. This can provide a growing income stream that may reduce the dependency on capital appreciation to achieve the retirement plan.

### Insure the risk

When you add a Guaranteed Minimum Withdrawal Benefit (GMWB) to a variable annuity contract you can remain invested in equities while potentially protecting the future income of your retirement portfolio. The next article in this newsletter, titled "Don't let uncertainty derail your retirement income" will discuss this solution in more detail.

### Work with your financial advisor

He or she can help develop and manage your retirement income plan and provide guidance when markets become turbulent.

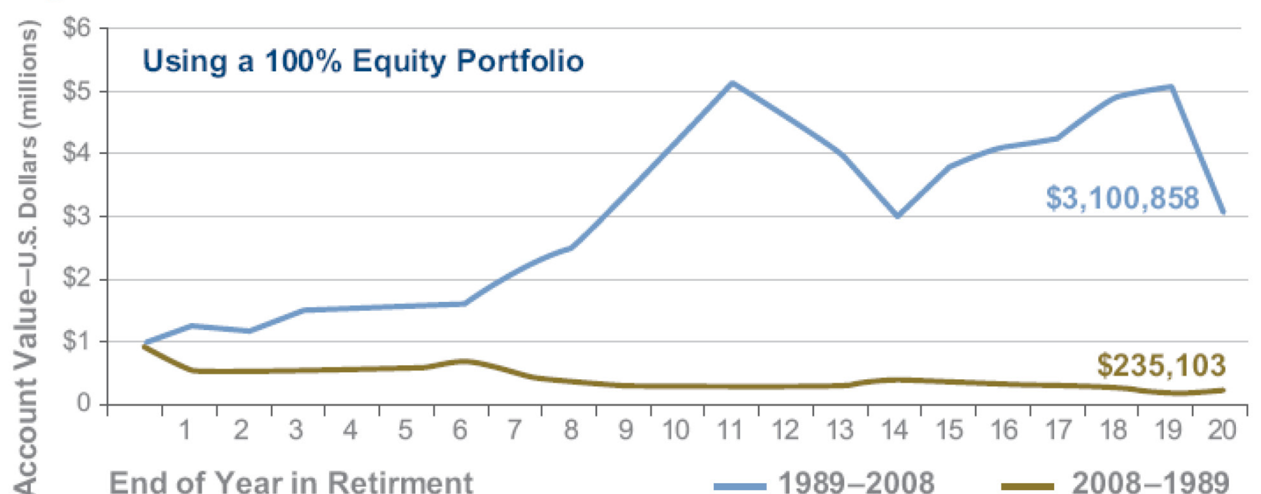
Dividends are not guaranteed and will fluctuate. The returns mentioned do not include fees and charges that would reduce an investor's return

**Figure 1.**
S&P 500 Index Sequence of Returns

| YEAR | 1989-2008 SEQUENCE | 1989-2008 SEQUENCE |
|---|---|---|
| 1 | 31.69 | -37.00 |
| 2 | -3.11 | 5.49 |
| 3 | 30.47 | 15.84 |
| 4 | 7.62 | 4.91 |
| 5 | 10.08 | 10.88 |
| 6 | 1.32 | 28.68 |
| 7 | 37.58 | -22.10 |
| 8 | 22.96 | -11.88 |
| 9 | 33.36 | -9.11 |
| 10 | 28.68 | 21.04 |
| 11 | 21.04 | 28.68 |
| 12 | -9.11 | 33.36 |
| 13 | -11.88 | 22.96 |
| 14 | -22.10 | 37.58 |
| 15 | 28.68 | 1.32 |
| 16 | 10.88 | 10.08 |
| 17 | 4.91 | 7.62 |
| 18 | 15.84 | 30.47 |
| 19 | 5.49 | -3.11 |
| 20 | -37.00 | 31.69 |
| Average Annual Return | 8.43% | 8.43% |

*Past performance does not guarantee future results.*
**Source:** SP 500

**Figure 2.**




Hypothetical investment for both sequences consist of 100% equities, represented by the S&P 500 index. *Past performance does not guarantee future results.* **Source:** Thornburg Investment Management

The S&P 500 is an unmanaged index of 500 widely held stocks. An investment cannot be made directly in the index. Diversification does not guarantee a profit nor protect against loss.

# Don't Let Uncertainty Derail Your Retirement Income.

Market uncertainty rises every time the stock market takes off on a volatile ride. Investors wonder if we're facing a downturn, or bear market. Some are worried, afraid that if they don't sell now they'll lose more money; yet if they do sell, they might miss a rebound. The only sure thing about volatile markets is that they are uncertain.

Fortunately, there is a way to remain invested in equities while potentially protecting the future income of an existing retirement portfolio. By simply shifting certain assets into a variable annuity with a living benefit, such as a Guaranteed Minimum Withdrawal Benefit (GMWB), you can assure yourself retirement income from a known minimum investment – and the amount may be at least twice the amount of your investment.

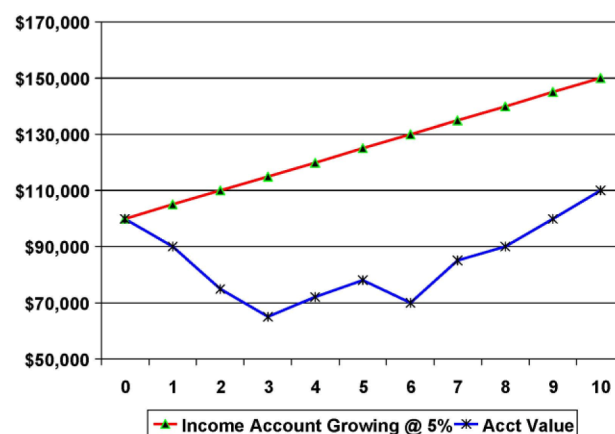
When you add a GMWB to a variable annuity, the provider tracks a separate "income account" alongside your regular account. The income account is guaranteed to grow at a rate of 5% per annum (no withdrawals allowed), and it can be tapped to provide a lifetime income equal to 5% of its value at the time the income begins. Generally, you have to be at least 65 to receive lifetime income.*

The graph in Figure 1 shows how this concept can work in an extremely poor market. Although the account value demonstrates virtually no growth over the decade shown, its income account grew at 5% per year. In any year, you have the option of receiving 5% of the income account balance for life.

However, only the account value is available for lump-sum withdrawal, and withdrawals above the 5% allowed by the GMWB will negatively impact the benefit.

Of course, such a low return over almost 10 years is very unlikely. But suppose this concept was put to the test during a period similar to 1997- 2008, based on the performance of the S&P 500 – there were strong gains initially, then a three-year bear market followed by four strong years. You may have seen little progress overall during this 10-year period. But look at the graph below to see how the "income account" works with the regular account to capture gains during the up years while still growing in the down years.

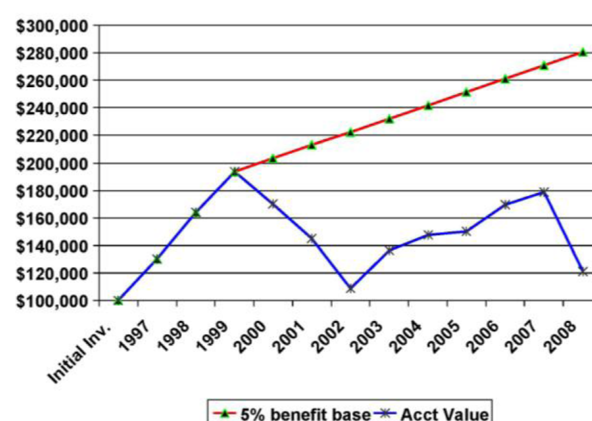
Figure 1.




This chart is for illustrative purposes only and is not intended to imply or represent a specific return on any particular investment. It also does not reflect fees, charges or taxes associated with any particular investment, which would reduce the total return.

From 1997 to 1999, the regular account grows faster than 5% per year. Therefore, the insurance company increases the "income account" to match the regular account. Each time the "income account" increases (the industry calls it a "step up"), the insurance company adds the 5% on the basis of this higher amount, so any market gains are captured. When the market goes south, as it did from 2000 to 2002, the "income account" continues to grow at 5%. Although the market recovered nicely from 2003 through 2006, you can see the regular account is still well below the income account. At this point you can either choose to receive the annuity account value, begin to receive 5% income or allow both accounts to continue to grow.

Figure 2.




Most living benefits require the client to invest in asset allocation models, or limit the percentage of the investment that can be invested in the most aggressive sub-accounts. The living benefit will carry an incremental cost of 80 to 120 basis points, thereby further reducing your annual returns.

This chart is for illustrative purposes only and is not intended to imply or represent a specific return on any particular investment. It also does not reflect fees, charges or taxes associated with any particular investment, which would reduce the total return.

As you can appreciate, these annuities carry a certain amount of complexity. But if you are interested in using one to help provide an income stream in retirement, don't hesitate to call your financial advisor.

Investors should carefully consider the investment objectives, risks, charges and expenses of variable annuities before investing. The Information Folder & Contract contains this and other important information. Information Folders for both the variable annuity contract and the underlying funds are available from my office and should be read carefully before investing.

Variable Annuities are long-term investment alternatives designed for retirement purposes and are subject to market fluctuation, investment risk and possible loss of principal. Withdrawals may be subject to Deferred Sales Charges and income taxes (where applicable).

All guarantees are based on the claims-paying ability of the issuing company. Guarantees do not apply to the investment performance or safety of the underlying sub-accounts in the variable annuity. Past performance is no guarantee of future results. The selection of additional protection features, options or riders will result in higher variable annuity charges.

* The lifetime withdrawal amount (LWA) is the guaranteed income you are able to withdraw each year depending on your age at the time you elect to start withdrawing income, your chosen payout option (Single Life or Joint Life), the applicable product purchased.

RAYMOND JAMES®
FINANCIAL PLANNING LTD.
2200 – 925 West Georgia Street, Vancouver, BC V6C 3L2
Tel: 604.659.8494 • 1.800.661.4220 • Fax: 604.659.8291
www.raymondjames.ca

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