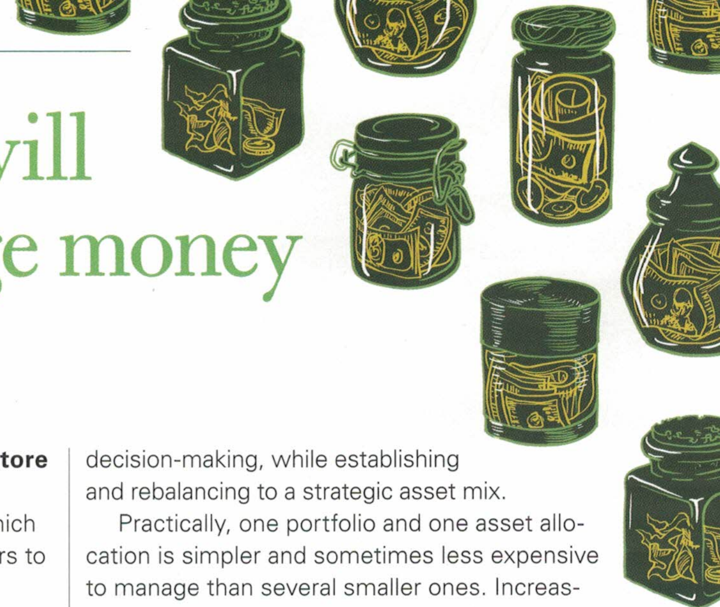

Proposed regulations will impact how you manage money

Understanding "jam jar" investment management

A family legend tells of my uncle, at age seven, being sent to the store with a coin in his left hand to buy a loaf of bread and a coin in his right hand for a quart of milk. He returned with neither, having forgotten which coin was for which item. Will proposed regulations require investment advisors to consider his dilemma?

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Significantly expanded guidance for know-your-client (KYC) and know-your-product (KYP) provisions proposed for National Instrument 31-103 and its companion policy target suitability and disclosure of conflicts of interest. Let's examine the potential suitability impact on portfolio construction.

Good news, bad news

The proposals suggest good news: that legislation is moving toward portfolio-level suitability, and away from trade-based suitability. Current KYC and KYP rules, wittingly or unwittingly, have led some compliance departments to insist that clients with a "conservative" risk profile have all their accounts uniformly reflect that mix—20% equity, 80% bonds, for example—and that only investment products with a "conservative" risk rating be used.

Investment professionals know the imprudence of this idea that forgoes and ignores the advantages of diversification (see Advisor.ca/diversify, from May 2014), so the proposed changes are a positive development.

The bad news is that most firms and their advisors aren't prepared to comply with this development, which integrates portfolio construction with product characteristics and may require the application of liability-driven investing (LDI). For example, a product risk rating of "moderate" may not be good enough to qualify for portfolio inclusion for someone with moderate risk tolerance if it doesn't also contribute to reaching a goal. That's good news for investors, but lots more work for advisors and compliance departments.

The jam jar method puts money into separate jars to ensure that anticipated expenses are always considered

Cookie jar versus jam jar methods

Derived from the established trust model for wealthy families, the "cookie jar," or omnibus, investment account includes all client goals invested in a single portfolio (often including both taxable and tax-deferred accounts, like an RRSP). The investment objective is to maximize returns, risk-adjusted or otherwise. The investing time horizon is long and sometimes perpetual, in the case of intergenerational trusts.

The investment industry and regulations governing it were built around this "cookie jar" model and use modern portfolio theory (MPT)—mean-variance optimization and efficient frontiers—to drive asset allocation and investment decision-making, while establishing and rebalancing to a strategic asset mix.

Practically, one portfolio and one asset allocation is simpler and sometimes less expensive to manage than several smaller ones. Increasingly, however, it is not appropriate for mass affluent investors, who must plan, save and invest to meet their goals.

More appropriate for most people would be the "jam jar" method, like the one my uncle was supposed to use but with better labelling. It puts money into separate jars—for rent, utilities, vacation and education, for example—assuring that these anticipated expenses are always considered and the status of each goal is always clear. If there is not enough money, near-term goals "borrow" from longer-term goals like retirement. Each goal is plainly visible, objectives are kept in focus and spending can be adjusted accordingly.

Investors without adequate capital to meet their various financial goals with their different time horizons need liability-driven investing (LDI) to address these contingent-liability problems because MPT can't handle them. LDI is a method only a few advisors know how to implement. The jam jar approach simplifies tracking different goals with different time horizons.

If the proposals go through, establishing investment needs, considering financial objectives and incorporating a client risk profile could involve knowing what product characteristics support each goal. Here are three factors that can help triangulate the appropriate characteristics.

1. **Price variability (standard deviation):** High variability, traditionally too risky for short-term goals, may have to be harnessed to improve the probability of achieving objectives.
2. **Risk of absolute loss (VaR):** Suffering an absolute loss early in retirement, for example, can penalize the investor's entire future because there is less opportunity to make back capital through contributions. This sequence-of-return risk is an important consideration for advisors whose many baby boomer clients are retiring.
3. **Duration:** Communicating with clients the likelihood of achieving each stated objective within the targeted time horizon is like observing how well funded each jar is.

Solving for these factors in a single client algorithm may be the future of the industry. Meanwhile, advisors who learn how to use LDI and the products that will address this goals-based approach will have an advantage. They'll also be able to use the jam jar approach to client communications that is more intuitive and effective. **AE**