

# Russell Update

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## Overly Conservative Portfolios Do Not Guarantee Investment Success

Many investors are understandably anxious about the threat of a U.S. recession, continuing repercussions from the sub-prime crisis, the Lehman Brothers' bankruptcy and the possibility that a slowdown in global growth will spell the end of bull markets.

With such volatility in the markets, some investors might be tempted to invest too conservatively and shift their portfolios toward guaranteed products such as Guaranteed Investment Certificates (GIC).

Naturally, you want to keep your portfolio safe. But "safe" isn't the same as "risk-free." In fact, if you're holding mainly cash or GICs that pay a guaranteed return, there's a good chance that your portfolio won't provide the returns needed to stay ahead of inflation in the long run. In addition, investing too conservatively might not be the right move in a market where interest rates are low and possibly heading lower.

### Risk and Reward of Guaranteed Investments

For conservative portfolios, GICs offer investors a guaranteed rate of return over a fixed period of time. But the downside is that they offer an interest rate (usually between 1% and 5%) that may turn out to be lower than other types of investment such as stocks, bonds or balanced funds.

Guaranteed investments are often a part of retirement plans because they provide a low-risk fixed rate of return. Unlike other investments, the principal is at risk only if the issuing institution defaults.

Some investors select these instruments based on short term market events, locking in investments that may shrink their retirement buying power in the long run. Before panicking and running to the "safe haven" of guaranteed investments, it's important to dissect the math behind these products to see what the benefits and risks are to the buyer.

### Rewards of a Guaranteed Instrument

- Lowest return is 0% - guaranteed return of principal is comforting in volatile markets
- Highest or actual return is known – usually a published rate on the note, be it GIC or GIC Plus
- Often a short investment horizon –typically 90 days to 5 years
- Near term simplicity and certainty

### Risks of a Guaranteed Investment

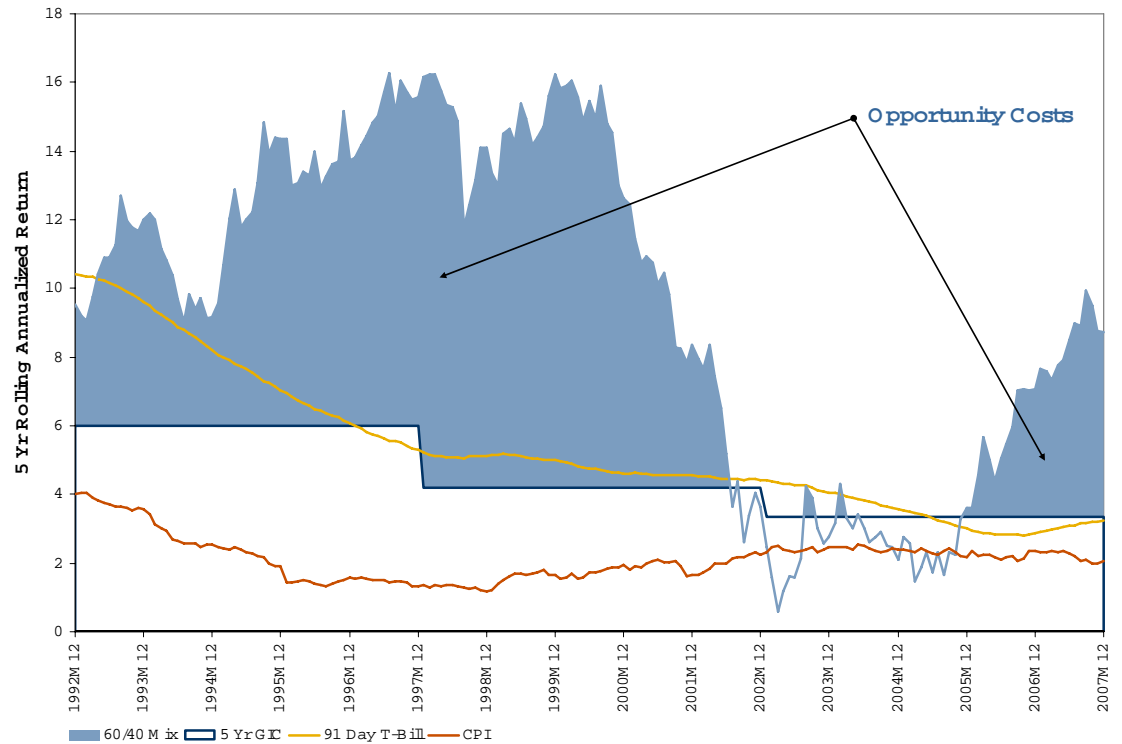
- Opportunity costs – how much might the investor have earned, had they stuck with their investment program?
- Declining real spending power due to inflation and higher taxation (interest returns are taxed at higher levels than dividends and capital gains in non-registered portfolios)
- Credit risk of the issuer—while guaranteed by the CDIC, this is only valid up to \$100,000 per issue and only for a term of up to five years.
- Illiquid investment – often locked in for the term of contract, or significant penalties to redeem early

### What Does a GIC Really Cost?

Let's assume you purchased a 5-year GIC in January 1970 at the Bank of Canada's published rate of 7.75% yield. Also assume that the 5-year note is rolled every five years to the new rate. The rate of return is shown below as the dark blue line in Figure 1. This seems quite favourable in today's uncertain market environment. But how does this particular GIC example compare to a balanced portfolio (60% equities/ 40% fixed income) over the long run?

All shaded blue areas above the dark blue line (yield of the 5-year GIC) represent missed return opportunities for an investor who bought the hypothetical guaranteed investment back in 1970 and kept rolling it forward. In fact, 91 day Treasury bills offer similar stability as the GIC, with comparable returns, less credit risk and much higher liquidity, as shown by the yellow line below.

Figure 1: The Opportunity Cost of Owning GIC vs. Balanced Fund



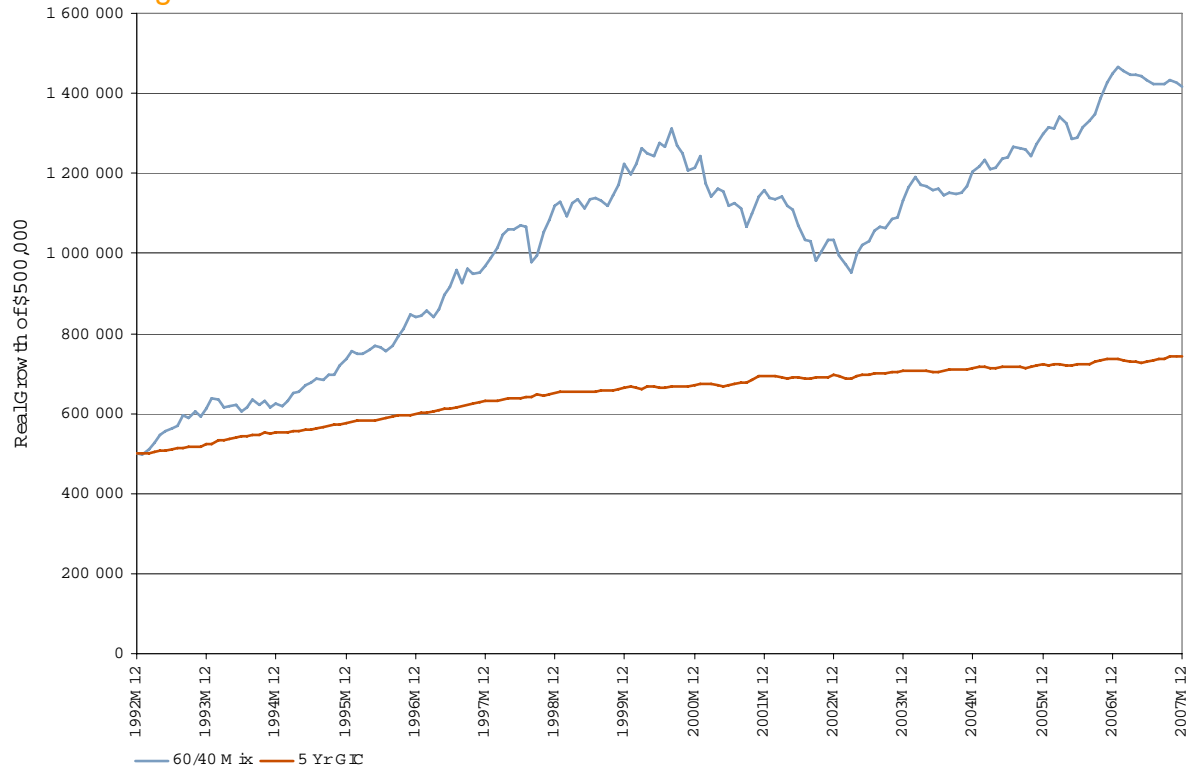
Source: Russell Investments Canada

The average balanced fund return over all five year periods since 1970 is 11.6%. This means that the hypothetical opportunity cost of a guaranteed instrument, had you purchased one in 1970, and continuously held it since then, would be approximately -3.4% versus a balanced approach. Figure 1 also examines all rolling 5 year returns for a balanced portfolio and calculated the number of periods it returned 5% (the current GIC rate) or higher since 1970 — 88% of the time a balanced portfolio outperformed a 5% current yield on a GIC.

### The Risk of Being Too Conservative

When relying too heavily on GICs in your portfolio you may be overly cautious. When you think about inflation at 2.5% over the last few years, a 2.5% real return does boost retirement monies, so long as inflation stays low. Figure 2 displays the cumulative real return for a market rate GIC since 1970. The real return of a balanced fund is also shown over the same period.

Figure 2: Inflation Reduces Effectiveness of GICs



Source: Russell Investments Canada

The GIC might have provided short term comfort, but over the long term, it moved the investor away from capital growth goals by providing only slightly positive real returns over the long term.

### Credit, Liquidity & Reinvestment

A Treasury bill or a balanced fund is highly liquid. In the case of T-bills, the credit quality is of the highest liquidity with little or no default risk. In addition, the balanced fund owns stocks and bonds in a variety of companies across the globe, diversifying specific risks, whereas a GIC or GIC Plus is a single issuer security — creating an undiversified portfolio. The GIC is generally insured by the Canada Deposit Insurance Corporation for up to \$100,000 principal and for up to a five year term. Higher balances or longer issues run issuer specific credit risk. These instruments rarely provide intra-period liquidity without significant penalties.

In addition, as with most fixed income instruments, investors need to be aware of the prevailing interest rate environment. During periods where rates are trending lower, an investor holding a maturing GIC with substantial cash coming due will be faced with reinvestment rates which may be lower than the preceding term. This would be a clear disadvantage as these funds would be locked up for a new multi-year period at rates which would not necessarily be supportive of longer term goals.

## Conclusion

Times such as these require patience and perspective. Keeping your ultimate investment goal in mind may protect you from making short term decision that could endanger your long term goals. Abandoning your investment plan and over-emphasizing guaranteed products during periods of short-term volatility can often:

- Minimize opportunities to take advantage of episodic and long term market gains, versus a balanced fund
- Reduce the real spending power of retirement savings
- Limit investor liquidity
- Increase credit risk, versus a diversified balanced portfolio
- Face the possibility of re-investment risk in a declining interest rate environment

In contrast, a diversified balanced fund can offer investors greater return potential and a conservative allocation that suits your personal risk tolerance. For instance, the Russell Sovereign Investment Program, the Sovereign Diversified Monthly Income Portfolio, and LifePoints Portfolios can all be tailored for conservative investors who want to maintain exposure to the equity market without unwanted risk to their investment. Please contact your financial professional for more information.

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Kelley Fairbank provides expert insight on financial strategy issues, working with both institutional and individual clients. Her extensive background as a manager research analyst, investment strategist, and senior consultant for some of the largest asset pools in the world is used to provide exclusive research and knowledge for clients.

Recent research articles written by Kelley include:

- “Short Term Pains Can Lead to Long Term Gains” – January 2008
- “2007 Review Offers Clues to 2008 Previews” – January 2008
- “Increasing Return Potential with Core Plus Fixed Income” – December 2007

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