Risk-adjusted return is key to investing

Dollars & Sense

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Guest Contributor

Today's column is about an imaginary Oakville couple in their 50s who want to start planning for retirement. Now that the children are off to university it is time to focus on their golden years.

They interview three investment advisers who outline their investment strategy. The investment return projections range from low, medium to high; five, seven and nine per cent per year.

Which adviser should they choose? If this was you, who would you pick?

We will assume all factors are equal, you like them all, you are confident in their abilities and you could see yourself working with any one of them.

The temptation is to choose the adviser who presented the highest projected investment return of nine per cent. It may seem logical but from an investing perspective it may be the wrong choice.

The theory and practice of investing is not to maximize investment returns but to minimize investment risk. Once risk is minimized, then within that context you want to maximize the return but only with that same level of risk.

Why take risk that you do not need? The industry term for this is a risk-adjusted return. The key is the subtle blending of the desired return within the risk level with which you are comfortable. Try to get the best return with the least amount of risk.

Investment portfolios should be designed to achieve a specific target return. This requires some planning and a little number crunching.

The planning is a collection of all the important variables such as how much money you have, how many years until retirement and how much can you save every year while you continue to work.

Looking forward, you will estimate your spending needs in retirement and then determine from where that money will come. Funds will flow from government benefits such as the Canada Pension Plan and Old Age Security. Perhaps you are fortunate to have a pension from your employer. The balance will come from savings.

Working backwards you determine how much money you will need at your retirement age to provide the necessary annual cash flow.

A part of that process is determining the target investment return you need to achieve the desired amount of money. With sufficient assets and less spending you can ac-

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