Managing Risk in Financial Planning

Looking at an insurance portfolio as a financial planning tool.

Financial Planning without accounting for risk management is like planning an outdoor wedding without a plan B for rain: you've only missed one variable, but the whole plan could fail miserably nonetheless.

When we think about risk management, we generally think about our investment portfolios and what we can do to reduce the risk of loss via diversification, downside protection or asset allocation. That's certainly one piece of it, but the other piece that's not discussed nearly enough is an insurance portfolio that's used to manage the financial risk posed to a family's future as a result of premature death, disability, critical illness or the need for long-term care.

Here's a basic description of each of the four categories of coverage:

1. **Life Insurance:** The person whose life is insured is known as the *life insured* (go figure); the person, or company, that pays the deposit is the *policy owner*; and the person, or company, who receives the death benefit is the *beneficiary*. A regular deposit is paid to an insurance company, who agrees to pay the beneficiary (or beneficiaries) a tax-free death benefit when the life insured passes away. Factors that affect the size of the deposit include: age, gender, overall health and smoking status. In general, the younger you are and the healthier you are, the lower the deposit. Given that on average females outlive men, all other things being equal women will pay less than men.
2. **Disability Insurance:** There are different ways of structuring a disability contract, but generally the owner, beneficiary and insured are all the same person. The insured pays a deposit; and in return an insurance company agrees to pay a monthly income, (or benefit which is generally tax free) in case of a disability that prevents the person from being able to work and earn an income. Factors that affect the deposit are the same as those with life insurance, but also include occupation (construction workers will pay more than accountants), how long the benefit payments are scheduled to last (known as the benefit period), and how long the insured must be disabled for before the benefits begin (known as the waiting period).
3. **Critical Illness (CI) Insurance:** As with disability insurance, the life insured, beneficiary and owner are generally the same person. The insured pays a deposit, and if they become critically sick and survive a period of time (known as the survival period which is generally 30 days), the insurance company will pay out a tax-free lump sum benefit to the beneficiary. Although there can be more than 25 illnesses covered, over 60% of all claims are a result of cancer, which I don't think would be a surprise to anyone. Similar factors affect the deposits of a CI insurance policy: age, gender, general health, family history.
4. **Long Term Care insurance (LTC):** Perhaps the least discussed of the 4 coverage options. The insured pays a deposit to the insurance company, and in return, the insured receives a monthly benefit if they are unable to take care of themselves (defined by not being able to complete 2 of the 6 daily living activities). Coverage can be implemented for in-home care or for care at an assisted living facility. LTC is best implemented when the insured is healthy and capable – that's when deposits are affordable.

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Unfortunately, we all know how devasting a critical illness, premature death, disability or having to place a loved one in the hands of others for proper care can be on a family. We never expect this to happen to us or the people we care for, but it's important to remember that as hard as it can be emotionally, having a financial plan to deal with the unexpected will help mitigate the overall damages.

Implementing an insurance portfolio is tricky in that if we covered ourselves against every possible risk, we wouldn't be able to save meaningfully for retirement, never mind put a roof over our heads. However, if we ignore insurance all together, we run the risk of ruining our financial lives, along with our personal lives. To analyze which coverage we should implement, we need to look at both the probability of having to make a claim and how severe the consequences could be to us and our families if a claim needs to be made. Educating ourselves on the available insurance options is the first step and once that's complete we'll be in a good position to decide if we want to add the coverage to our insurance portfolio.

Once we've decided on what to implement, the application process begins. An insurance advisor (us at Hillside Wealth), would complete an application with the insured, which then gets submitted to the insurance company. The insurance company then asks the insured for more information which could include, amongst other things, their medical history, lifestyle, driving record and more than likely they'll also require blood and urine samples. If the findings of the underwriting team are considered standard, the insurance company will offer the contract at the quoted rate. If the underwriting process reveals issues of concern, the contract may be issued with certain conditions that are excluded or may rate the contract with a higher deposit than originally quoted. Once the underwriting process is complete, the applicant can decide if they want to accept the contract and implement the coverage. If the applicant decides they don't like the terms of the contract being offered, they can simply walk away at no cost.

Each of the four categories of insurance has different levels of coverage, and each level has different options (known as riders). For example, there are two main umbrellas of coverage for life insurance: Term or Permanent Coverage. Under the term umbrella you can have Term 10 or Term 20, and under the permanent umbrella you can have Universal Life, Whole Life or Term to 100. Within each permanent option there are multiple options available to choose from. There's simply too much information to cover each in complete detail here – it would fill a book (and as important as insurance is, the book wouldn't be all that exciting).

We believe that insurance plays a vital role in the financial planning process. For the next few letters, we'll review the 4 categories in more detail, so that you can have a meaningful understanding of how each category applies to your situation and whether it should be implemented into your financial plan. After all, how are the newly weds and their guests supposed to enjoy what's supposed to be their best day ever if it's pouring rain and there's no shelter?

Portfolio Update

Read more about February's positive portfolio performance.

February saw another steady advance for our model portfolios. All three outperformed their respective benchmarks both on monthly and year-to-date timeframes. We are pleasantly surprised by these results for reasons that may not be obvious and discussed below.

The reason we are surprised is due to the fact we presently hold much less equity than our benchmarks. This can be seen in the table below:

Model Portfolio	Current Equity Weight	Benchmark Equity Weight	Difference
HILLSIDE INCOME & GROWTH*	30%	45%	-33%
HILLSIDE MODERATE GROWTH*	44%	65%	-32%
HILLSIDE GROWTH*	79%	100%	-21%

Source: HillsideWealth

How is it possible for our strategy to outperform when we are 20-35% less exposed to an asset class that has moved materially higher (up ~13-17% from the lows) in a short period of time? This flies in the face of conventional wisdom. The simple answer lies in the central thesis of our process: If we can identify companies that possess above average financial metrics and own them in concentration we should be able to put ourselves in a position to outperform.

We have been fortunate (although we would argue it's by design) that our basket of stocks has outperformed a 'passive basket' comprised of many stocks. Let's imagine a scenario where a well selected basket of stocks outperforms the passive approach by double (2x). The math tells us we need only 50% of the exposure of the well selected basket to match the performance of the passive basket. In short, one of the unintended consequences of our central thesis is that there will be times during economic uncertainty (such as now) where we will have less equity weight than a benchmark/index, but it may still be possible for us to keep pace and/or outperform. This is a pleasant surprise and one that should stand us well during the present situation and future periods of economic/market uncertainty.

Lastly, we'd like to touch on an individual position we own in many of our client portfolios. We own a sizeable (10%) weight in a debenture issued by Constellation Software (CSU.db). This is a unique position that we became aware of because we held shares in CSU. Each CSU shareholder was given the right to buy the debenture at a discount. We liked the company and the terms of the debenture so much that we started buying more rights on the open market. The terms were such that the debenture would pay 6.5% interest plus the trailing consumer price index (CPI). For example, the CPI in 2018 was 2.3% so the rate we receive this year is 8.8%. This means the debenture has a built-in inflation protection mechanism which adds to the uniqueness of this issue. When the debenture was issued in late 2014, CSU had $378m of free cash flow (FCF) and $24m of interest (int) commitments. The ratio of FCF/int was 15.75 – put differently they had $15.75 coming in for every $1.00 of interest expense. In 2018, the FCF has grown to $836m while the interest expense was $28m (due to higher inflation/rate noted above). Their ability to service the debt has nearly doubled with the current coverage ratio at 29.86.

We can see how the debenture has traded over the past 4+ years:

Source: www.tmxmoney.com

The point we'd like to make is that it moves around a bit having traded between $105 and $128. All the while it has kept paying interest in the 7-9% range. There is a feature to the debenture, however, that gives us pause for concern: CSU can call the debenture with 5 years notice and the debenture will be retired at $100. This means if they called it tomorrow, we would get our 7-9% interest but would lose 5% a year (given current price of ~$125) and our return would drop to the ~3% range. Clearly, not as attractive as the current 7% yield. We have been in touch with the CFO of the company and they have indicated they have no immediate plans to call the debenture as they value having this type of funding avenue available to them. If they call the debenture and hurt existing holders, it seems to reason this source of capital would be gone. In short, we like CSU and CSU.db. They have both added considerable outperformance to our portfolios; however, it is good to be reminded of the features, benefits and downfalls of positions we own.

February Performance Results

An overview of our three portfolios to date.

Performance to February 28th 2019	YTD	1 Mo	6 Mo	1 Yr	3 Yr**	Inception**	Added Value vs. Benchmark**
HILLSIDE MODERATE GROWTH*	**4.65%**	**2.07%**	**-2.47%**	**3.32%**	**8.4%**	**9.8%**	**+7.86%**
MG Benchmark[1]	*4.29%*	*1.29%*	*-1.08%*	*1.93%*	*7.5%*	*1.94%*	
HILLSIDE GROWTH*	**9.03%**	**2.72%**	**-8.43%**	**-1.19%**	**9.04%**	**8.9%**	**+3.38%**
HG Benchmark[2]	*7.43%*	*2.22%*	*-0.47%*	*5.6%*	*11.97%*	*5.52%*	
HILLSIDE INCOME & GROWTH*	**2.81%**	**1.48%**	**-1.91%**	**2.83%**	**6.25%**	**7.01%**	**+5.54%**
IG Benchmark[3]	*3.87%*	*1.18%*	*-1.02%*	*1.48%*	*4.69%*	*1.47%*	

Past performance is not an indication of future returns.
** Performance is presented gross of fees.*
***Inception: Sept 2, 2014. Results beyond 1 year are annualized.*
[1] MG Benchmark: 30% TSX | 35% Universe Bond | 20% S&P Pref | 15% TSX Small Cap
[2] HG Benchmark: 50% TSX | 25% S&P500 | 25% TSX Small Cap
[3] IG Benchmark: 25% TSX | 55% Universe Bond | 20% S&P Pref
Source: SIACharts.com

The performance presented in this portfolio report is hypothetical and does not represent a specific client account. Details regarding actual returns of an investment account are available from the client's advisor.

Performance is calculated using month-end market values of the model portfolio. Since we use a model portfolio to calculate performance there are no client-initiated cash flows (deposits/withdrawals) to account for. Performance is calculated by dividing the change in the model portfolio's market value by the model portfolio's market value at the beginning of the performance period. Also, all income generated by the portfolio's holdings are held within the model portfolio in cash and is accounted for in the portfolio's month-end market value - this results in a total return measure of the model's performance.

Returns for periods less than 1 year are shown as periodic returns while returns for periods greater than 1 year are annualized. Returns do not include fees and actual returns experienced by an investor may differ from those shown. Past performance is not a guarantee of future results.