

Fina 411: Portfolio Management

Case #1 “A Good Life”

Horatio, 45, graduated with a degree in political science with a major in Chinese literature from Western University in London, Ontario. His anglophone father and francophone mother created a rich, cosmopolitan, and multi-lingual household. Personable, tactful, adventurous, and curious, he travelled extensively as a student. The continent that fascinated him the most was Asia and in particular ancient China. At university, this attraction led him to major in Chinese studies. Hard work, and the gift of a musical ear permitted him to learn to read, write the basics, and speak Chinese (Mandarin dialect) with moderate fluency. Those that knew him certainly were not surprised when he choose a career in the diplomatic service with the Canadian Government.

His current salary is \$150,000 per year which may sound low for this prestigious position. But one should not forget that the position is secure for life and comes with many benefits. For example, \$40,000 of this income is considered an expense allowance and is tax- free. He is also provided an automobile, which is replaced with the latest model every two years and supplied with a driver if requested. Furthermore, he is provided with comfortable dwellings in upscale neighborhoods. All housing expenses such as heating, electricity, repairs, property taxes, and insurance are paid by the Canadian Embassy wherever he is posted. Essentially he is living rent-free. Finally, he can look forward to a very generous defined benefit pension plan and is eligible for retirement at age 55. At that time he will receive an annual pension equal to 70% of his average salary earned in his last five years of active employment with the Canadian diplomatic service. Until that time, promotions to various degrees of ambassadorships are still possible

His spouse, Helene, 41, graduated from Concordia University in Cinema some years back and had been quite successful despite interludes to raise their young family. Her three children, daughter Doe 19, son Ray 14, and the youngest daughter Mia, 11, are her joy and top priority and consequently works only as a freelance on a part-time basis. Her last mandate was as a script and casting consultant. She has a flair for characterizations and enjoys her work. On average she earns some \$70,000 per year. Although a fickle source of income, her recent success led a new client to inquire if she would be interested to work as a full-time employee and possibly doubling her earnings. Thus far she has resisted in favour of motherhood. However, as Mia approaches high school age, and the children becoming more independent, she is considering the offer.

At a recent diplomatic dinner party, they met up with an old classmate, Wally Street, CFA, a finance major graduate of JMSB. His favourite course was Fina 411, Portfolio Management which motivated him to pursue a CFA charter upon graduation and ultimately a career as a portfolio manager with Blue Sky Investment Management Inc. Wally suggested to Horatio and Helene that this was a critical but still an opportune time to think of their retirement and financial futures although earlier planning would have been better

An appointment was made at Wally’s office the following week. Horatio and Helene stated that they were in good health. Since diplomats are eligible for retirement at age 55, Horatio and Helene share the goal of retiring in ten years while still in excellent physical condition to pursue travel. “Travels” does not mean poolside in Miami but rather trekking in Nepal or the teak jungles of Northern Thailand. Adventurous in life, they are, on the contrary, very conservative in the world of investments.

Wally learns that both have not participated in RRSP's (registered retirement savings plans), TFSA's (Tax-free savings accounts) or RESP's (registered education savings plan) and last year they paid an average tax rate of 35%.

They also expressed the desire to buy a house by year end 2023 as house prices have declined. The current accommodations are adequate but tight for their growing children. They have focused on an area where houses are older but exude charm and selling for approximately \$2,500,000. They plan to purchase the house with a 25% down payment, financing the balance with a fixed rate mortgage at the semi-annual compounded rate of 4.95%, five year term amortized over 25 years. Annual costs of owning the house (property taxes, utilities, insurance, repairs, etc.) are estimated to be \$34,000 per year. These home costs would no longer be covered by the diplomatic housing allowance. But then on the other hand, they would benefit from the inevitable appreciation in house prices.

Helene's mother, a widow, 80, is not independently wealthy but is comfortable. One thing for certain, she adores her grandchildren. She is willing to advance her life-savings of \$500,000 as a gift to help purchase a new house. Why such generosity? She is a very practical woman: better to give when they need it most and can enjoy the money instead of leaving it as an inheritance! Besides, their new house would be closer to her home and she would see her grandchildren more often. She is very active for her age. An hour a day on her piano, despite her arthritis, daily walks with her dog, Bond-bond, and her twice weekly community service activities keeps her fit. Her only concern was if there were any tax consequences of the sizeable gift or would she be better off to bequeath it as an inheritance. Helene told her Mom that Wally would look into it. Any money not needed for the house will be invested back in Helene's name.

Horatio and Helene currently have a portfolio of \$1,200,000 at market values invested 60% in Canada bonds at an interest rate of 2.25% and the balance in Apple stock. Horatio has the large holding in Apple through luck rather than investment skill. Impressed with his first computer, the Apple "Macintosh", he invested in Apple stock early at \$6 per share (post-split valuation).

When it comes to investments, both Horatio and Helene are considered risk-adverse. Aside from Apple stock, Horatio had lost money heavily in the stock market having invested in stocks on the Shanghai stock exchange and a dally with cannabis stocks and cryptocurrency. No wonder he is now risk-adverse. As for Helene, she was never interested in "business" or the financial markets. All told, they are adamant about not investing in emerging markets, technology and oil stocks, nor commodities. Derivatives, trading on margin, short-selling, hedge funds and complicated instruments like collateralized debt obligations are also strictly frowned upon.

Having lived through the 1980's when inflation reached over 10%, they are very concerned about protecting their asset base and maintaining their 2022 standard of living. He believes that the current higher inflation rates are here to stay. Horatio reasoned that the huge US deficit and covid subsidies would lead to higher inflation.

Doe is an exceptional student, competent, and ambitious, she is currently applying for medical school for the 2023 Fall semester. Although locally, McGill University's medical faculty is world-renown, her first choice would be Johns Hopkins University in Baltimore, the top medical school in the United States. Her strong GPA, MCAT, exceptional extracurricular activities, and stellar reference letters from teachers almost assured her of gaining acceptance to both of these institutions. Staying in Montreal would basically be free since tuition in Quebec is about \$6,000, the lowest in Canada and she can continue to live at home. The tuition at Johns Hopkins University, on the other hand, is \$70,000 USD for out of state students and would require living costs of another \$40,000 USD. A MD program is typically five years.

Ray is the athlete of the three children. Outstanding in several sports, tennis is his favourite. Although only 14, he has already been selected by Tennis Canada to be on Team Canada and groomed for international competition, perhaps to reach the level of Bianca Andreescu, Canada's first grand slam champion, men or women, at the 2019 US Open. His potential as top world 100 player is readily apparent. He is tall, quick, and left-handed with a devastating kick serve. The coaching and the numerous tournaments throughout the world are largely covered financially by Tennis Canada and by corporate sponsorships, such as Nike. Nevertheless, approximately \$20,000 per year is spend by the family to travel and watch Ray compete in some of the tournaments.

Horatio and Helene are “tree huggers”, committed environmentalists. They recycle, compost and practice sustainability. They drink tap water. They believe that they should do their part for the earth and would like to make a \$250,000 donation to Greenpeace or a similar charity sometime in the future.

And of course, they want to leave a meaningful inheritance to their three children. Experiencing the current financial challenges of buying a home, they realize that home ownership for the next generation without parental help might only be a dream. The simple fact is that income has not kept up with the increase in house prices. Is it not the harsh reality that despite both having enviable careers and income, they still appreciate the help from Helene's Mom?

Required:

You are a summer intern and assistant to Wally Street, CFA. Prepare for his meeting with Horatio and Helene, in detail an:

1. IPS (Investment Policy Statement) for Horatio and Helene.
2. Asset allocation
3. Sector recommendations; specific securities permitted but not required)
4. As in reality, you will have to make appropriate (but realistic) assumptions. This is fully acceptable. Furthermore, you are encouraged to do any relevant outside research
5. Enjoy the challenge of this assignment. There is no “right” or “wrong” answer. You will be graded on how well you support (i.e. the quality of arguments) your IPS and Asset Allocation
6. This case is a team effort.
7. Professor Wong's tip: start by preparing a family cash flow
8. Enjoy