Life Cycle Planning

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Life cycle theory is a popular tool for making financial planning and asset allocation decisions

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By identifying the usual activities that an individual faces progressing through life, the typical portfolio structure and constraints can be developed. For example, an older client will likely have a lower tolerance for risk than a younger client, but these generalities should be avoided and detailed discussions with the client will help to determine the client's own objectives and considerations. An individual's own unique circumstances are paramount, and life cycle should only be used as a guideline.

Life cycle planning often puts individuals into four or more broad age categories. While different names are used to describe each stage, they generally fall into one of the following categories:

- early earning period;

- later earning period;

- peak earning period; and

-retirement.

During the first stage, individuals generally have low earnings and high expenses. Many professionals today pursue education until their late 20's or early 30's, at which time they begin their careers and earning. Those who pursue less education are usually entering their profession at a relatively low level of earnings. At this time, portfolios tend to be small and more heavily invested for long-term growth. Individuals also tend to have high expenditures during this stage as they establish a first home, purchase a vehicle, pay off student loans, and possibly travel.

The second stage, or later earning period, includes an increase in earnings and is characterized by high expenses as children are raised. The trend toward starting families later means that many individuals will have large expenses later in life, which may reduce the ability to save during this period.

The third stage encompasses the peak earning years prior to retirement. In addition, for many families the expensive child raising years are past, and saving, investing, and debt elimination can be given focus. At this time, a slight reduction in risk and investment time horizon is often prudent, although most experts recommend a significant growth component to the investment portfolio. However, many individuals may have aging parents or university age children to support, so this stage may be marked by both high earnings and high expenses.

At retirement, focus usually shifts to preservation of capital and maintenance of lifestyle. Expenses are expected to be lower during retirement, but discretionary funds for travel and hobbies is often a goal. The importance of a pension plan and RRSP planning become evident during the retirement stage. Since the

time horizon is shorter, lower risk assets are desirable. Recently, some planners have pointed out that for many retired investors, the time horizon may still be 20 or 30 years, highlighting the importance of some growth component in the portfolio. Careful financial planning is still necessary for the retirement stage investor. It is in this stage that many retired individuals may decide to gift their assets. Those who have built family businesses or substantial assets may find it more reassuring to gift assets during their lifetime when the process can be controlled, rather than leaving them as part of an estate.

This traditional view of life cycle theory has recently encountered criticism, as the nature of individual life cycles has changed dramatically. First, professionals may spend more than a decade in post-secondary education, dramatically delaying the start of their earning years. These individuals may reach their peak earning years more quickly, but their earnings will have been delayed because of the additional education. The increasing cost of education means large student loans, which inhibit cash flow and reduce the time to amass a suitable asset base.

Second, rapid technological advancements have created a shift to life-long learning. For many, there is no longer a measurable end to education. Rather, education is now pursued throughout a career, rather than prior to beginning a career. Some experts believe that an individual’s current career is one of up to seven lifetime careers. This reinforces the role of lifelong learning and fewer peak earning years. At best, there may be several periods of low earning and peak earning throughout a lifetime as the result of career changes.

Third, the theory makes assumptions about typical life cycle expenses, particularly a home and the cost of raising children. However, many individuals today are delaying the purchase of a home. A growing number of households are non-traditional households, and not all of these will purchase a home or raise a family. There is also evidence that many younger professionals are forsaking the traditional purchase of a home to build a small business or work outside Canada to reduce their taxation burden.