

How asset allocation can enhance your wealth

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Risk can severely impact your investment results, leaving you with substantially less money than you anticipated having when you made your investment. You cannot escape risk, as nearly every investment confronts you with uncertainty about what it will be worth in the future. In fact, even if you took all your money and hid it under your mattress, assured of earning no interest but preserving the number of dollars in your possession, you would still risk losing a good deal of its value if inflation increased the cost of living dramatically. Since you cannot escape risk, it is a good idea to eliminate as much of it as possible given your investment objectives.

Asset allocation is a highly effective way to reduce investment risk. It entails systematically diversifying your wealth among different types of investments, such as

stocks, bonds, and money market securities. In terms of an investor's wealth, the benefits from asset allocation can be substantial, as history demonstrates.

THE IMPACT OF RISK

In spite of losses in the past few years, from 1970 through 2001, Canadian investors watched stock markets in Canada, the U.S., and other industrialized countries produce compound annual returns in excess of ten percent (see Figure 1).

Performance of Six Asset Classes (1970 - 2001)	
Asset Class	Compound Annual Return
U.S. Small Company Stocks ¹	15.0%
U.S. Large Company Stocks ²	13.2%
International Stocks ³	12.4%
Canadian Long-term Bonds ⁴	10.8%
Canadian Stocks ⁵	10.1%
Canadian Money Market Securities ⁶	8.3%

Figure 1.
All returns are in Canadian Dollars. See End Notes for market indexes used.



These returns give the impression that stocks are superior investments for investors who are patient and have long-term objectives. But is it reasonable to draw such a conclusion without understanding the potential risk stocks pose? Is it possible that a mix of stocks, bonds, and money market securities could produce more favourable results? Furthermore, what constitutes a long period? We can begin to answer these questions by examining the results from the past three decades a little more closely.

Let's begin with the last question. Most investors would agree that ten years represents a fairly long period, so we will examine how well Canadian and U.S. Large Company Stocks performed over various ten-year periods from 1970 through 2001. Before proceeding, however, we should establish a target.

Canadian Stocks grew at an average rate of 10.1% per year during the period. If an investor earned 10.1% per year on a \$10,000 investment held for ten-years, the investment would grow to \$26,174. We shall use this value as our target and compare it to outcomes from hypothetical investments in the Canadian and U.S. stock markets over ten-year periods.

There are 265 overlapping ten-year intervals from 1970 through 2001 when we divide the period into months. The first ten-year interval extends from January 1970 through December 1979, the second extends from February 1970 through January 1980, and the last extends from January 1992 through December 2001. If

someone invested \$10,000 during any one of these periods and received the returns earned by the Canadian or U.S. stock markets (see data sources for market indexes used to represent these stock markets), what value would his or her investment have attained? How would that value compare to our target of \$26,174? Which period produced the best results? Which period produced the worst results?

When receiving the returns on the Canadian Stock Market, the best period would have been from September 1977 through August 1987, when our hypothetical investor would have grown his or her \$10,000 investment to \$59,405, substantially in excess of our \$26,174 target. The worst period would have been from December 1980 through November 1990, when our hypothetical investor would have been left with only \$18,964, well short of the target. What's most interesting is that the two periods overlap substantially, as they both cover the same 69 months from December 1981 through August 1987. Figure 2 shows the two outcomes relative to our target.

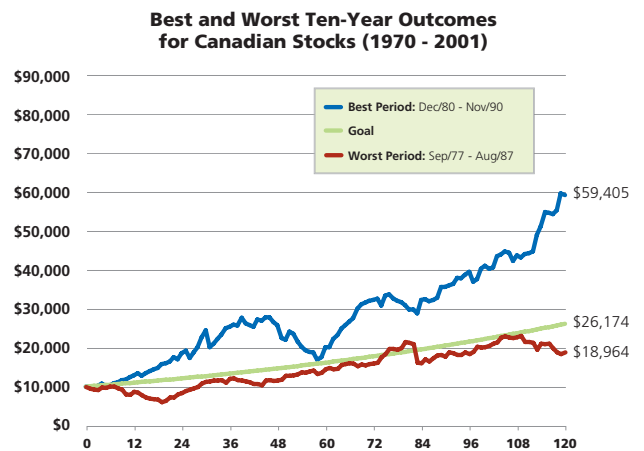


Figure 2





Clearly, there is a wide range of possible outcomes that confront an investor when investing in stocks – that is risk. Risk inhibits our ability to plan for the future, as we confront the real possibility of falling short of our target regardless of the term of our investment.

The chart may give you the sense that the outcomes for stocks are skewed toward the best result, i.e. even though we may fall short of our target, it looks as though most outcomes probably beat our target. You should be careful, however, because if we examine every ten year interval from 1970 through 2001, then you might be surprised at how often stocks produced results that fell short of our target. The table below (see Figure 3) shows the outcomes of hypothetical \$10,000 investments earning the returns of the Canadian Stock Market for every ten-year interval from 1970 through 2001. The red cells indicate ten-year periods when outcomes fell short of the target, and blue cells indicate ten-year periods when the outcomes beat our target.

There are probably far more red cells than you expected. Remember our target was set based upon the average rate of return earned by the Canadian Stock Market over the period 1970 through 2001, so there were many ten-year periods within this 32-year period when Canadian Stocks produced below average returns. Many of the ten-year periods that fell short of our target occurred in the later part of the 32-year period.

In comparison, we would expect the U.S. Stock Market to have produced better results for Canadian investors over the period because the compound annual return on U.S. Large Company Stocks was 13.2% in Canadian Dollars.

Examining every ten-year interval from 1970 through 2001, as we did with Canadian Stocks, shows that a wider range of outcomes would have resulted by investing \$10,000 and earning the returns on U.S. Large Company Stocks in Canadian Dollars. (see Figure 4)

Figure 3

Outcomes for \$10,000 Hypothetical Investments in Canadian Stocks (Ten-Year Periods 1970 – 2001)

Outcome for first ten-year period: January 1970 through December 1979

Ten-Years Ending	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
1979												\$26,950
1980	\$31,292	\$33,013	\$27,094	\$30,879	\$36,170	\$38,613	\$39,328	\$38,735	\$37,748	\$38,444	\$39,587	\$36,369
1981	\$34,615	\$33,975	\$34,987	\$34,989	\$36,816	\$36,048	\$34,878	\$33,945	\$30,476	\$31,873	\$33,976	\$30,222
1982	\$25,362	\$22,952	\$22,490	\$21,688	\$21,065	\$19,216	\$19,384	\$21,193	\$21,419	\$24,618	\$24,036	\$25,040
1983	\$25,500	\$26,737	\$27,383	\$30,983	\$33,602	\$33,564	\$31,983	\$32,694	\$31,520	\$27,991	\$34,026	\$33,833
1984	\$31,957	\$30,488	\$31,033	\$33,293	\$34,205	\$34,817	\$32,975	\$40,962	\$45,304	\$40,621	\$43,840	\$44,583
1985	\$41,419	\$40,294	\$41,262	\$40,751	\$41,451	\$40,093	\$41,079	\$42,232	\$41,900	\$44,517	\$45,152	\$47,060
1986	\$42,135	\$40,957	\$44,564	\$44,026	\$44,607	\$44,918	\$42,799	\$44,231	\$44,352	\$46,844	\$50,502	\$46,183
1987	\$50,859	\$52,338	\$55,118	\$56,217	\$56,406	\$54,293	\$58,323	\$59,405	\$58,089	\$46,281	\$43,486	\$44,170
1988	\$45,355	\$47,102	\$45,955	\$45,507	\$42,397	\$44,881	\$41,527	\$39,207	\$37,544	\$41,005	\$38,022	\$37,823
1989	\$39,000	\$37,650	\$35,616	\$35,662	\$35,600	\$33,855	\$37,123	\$34,389	\$32,725	\$36,083	\$33,661	\$31,710
1990	\$26,474	\$24,347	\$29,308	\$25,854	\$26,265	\$24,844	\$23,398	\$21,792	\$20,201	\$19,892	\$18,964	\$20,761
1991	\$21,267	\$22,975	\$21,670	\$21,778	\$21,672	\$21,268	\$22,738	\$23,387	\$26,020	\$27,582	\$24,722	\$25,911
1992	\$29,010	\$30,857	\$30,835	\$31,089	\$31,798	\$35,344	\$34,725	\$29,996	\$29,226	\$26,689	\$25,287	\$24,199
1993	\$22,997	\$23,287	\$23,558	\$22,809	\$22,615	\$22,846	\$22,553	\$23,451	\$22,456	\$25,331	\$23,021	\$23,674
1994	\$25,773	\$25,512	\$25,335	\$25,580	\$26,996	\$25,171	\$27,080	\$25,249	\$25,182	\$25,214	\$23,874	\$24,211
1995	\$21,339	\$21,898	\$22,713	\$22,320	\$22,316	\$22,884	\$22,752	\$21,925	\$23,538	\$22,783	\$22,289	\$22,171
1996	\$23,832	\$23,554	\$22,210	\$22,741	\$22,861	\$22,213	\$22,801	\$23,050	\$24,073	\$24,964	\$26,744	\$26,118
1997	\$24,644	\$23,771	\$21,107	\$21,687	\$23,347	\$23,176	\$22,961	\$22,269	\$24,240	\$30,431	\$29,314	\$28,362
1998	\$29,301	\$29,562	\$30,402	\$30,573	\$31,053	\$28,405	\$27,213	\$22,246	\$22,563	\$24,110	\$25,343	\$25,128
1999	\$24,413	\$23,159	\$24,102	\$25,258	\$24,033	\$24,216	\$23,148	\$22,530	\$22,823	\$23,918	\$24,605	\$27,269
2000	\$29,422	\$31,776	\$33,276	\$35,768	\$32,940	\$36,579	\$37,097	\$42,566	\$41,481	\$39,435	\$35,204	\$34,377
2001	\$35,654	\$29,145	\$27,128	\$28,503	\$28,543	\$27,611	\$26,846	\$25,955	\$25,059	\$24,304	\$26,679	\$27,040

Best and Worst Outcomes

Outcome for last ten-year period: January 1991 through December 2001

■ Ten-year outcome fell short of \$26,174 target
■ Ten-year outcome exceeded \$26,174 target

Looking at all of the ten-year outcomes, we find that in the majority of the periods, U.S. Large Company Stocks exceeded our target (see Figure 5).

The returns on U.S. Large Company Stocks from 1985 through 1999 caused many Canadian investors to abandon Canadian stocks completely and focus on investing in the U.S. But if you compare the two tables, you will notice that in many of the periods when U.S. Large Company Stocks fell short of our target, Canadian Stocks were exceeding our target by fairly wide margins. Compare the results for the ten-year periods ending from January 1980 through December 1981.

Maybe the past couple of years have dimmed people's views about investing in stocks all together, as most of the extraordinary gains in U.S. Large Company Stocks have evaporated. Are there better alternatives? Could diversification have improved our results?

THE POWER OF DIVERSIFICATION

Instead of investing solely in Canadian or U.S. Large Company Stocks, we can examine the outcomes that would have resulted by diversifying among the six asset classes introduced in the table of historical returns (see Figure 1).

Consider the hypothetical asset allocation shown in the chart (see Figure 6). The portfolio is reasonably diversified with 50% of its assets in stocks (distributed between Canadian, U.S., and International stocks) and 50% of its assets in bonds (split between long-term bonds and money market securities). This is not a recommended asset allocation; its sole purpose is to investigate whether a diversified portfolio could have produced more favourable results than were obtained with investments in single asset classes (Canadian and U.S. stocks).

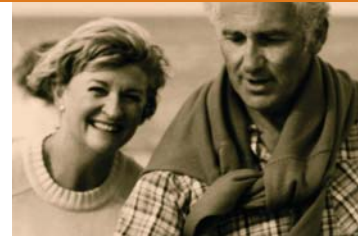
Figure 5

Outcomes for \$10,000 Hypothetical Investments in U.S. Large Company Stocks (Ten-Year Periods 1970 – 2001)

Ten-Years Ending	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
1979												\$18,012
1980	\$20,610	\$19,419	\$18,151	\$20,798	\$22,521	\$25,191	\$25,313	\$24,653	\$24,793	\$25,524	\$27,397	\$25,395
1981	\$23,264	\$23,472	\$22,989	\$21,806	\$22,815	\$22,292	\$24,055	\$21,418	\$20,538	\$22,557	\$22,990	\$20,763
1982	\$20,113	\$19,063	\$18,805	\$19,319	\$19,008	\$19,630	\$18,603	\$19,915	\$20,087	\$21,793	\$21,652	\$21,396
1983	\$22,588	\$24,005	\$24,737	\$27,431	\$27,675	\$28,620	\$26,612	\$27,769	\$27,049	\$26,890	\$30,731	\$30,343
1984	\$31,134	\$30,766	\$32,462	\$34,804	\$34,182	\$35,836	\$38,108	\$45,294	\$52,265	\$44,714	\$46,514	\$48,356
1985	\$46,338	\$46,210	\$44,678	\$41,914	\$42,406	\$40,428	\$42,777	\$43,663	\$44,291	\$43,829	\$46,436	\$49,390
1986	\$46,133	\$50,930	\$51,233	\$50,471	\$53,803	\$53,329	\$50,434	\$53,939	\$48,382	\$52,233	\$49,978	\$47,307
1987	\$53,838	\$55,213	\$55,638	\$56,818	\$57,906	\$57,161	\$59,924	\$62,651	\$60,914	\$49,194	\$43,292	\$46,334
1988	\$49,994	\$51,864	\$47,202	\$43,686	\$44,006	\$45,965	\$43,058	\$40,760	\$40,914	\$46,825	\$43,404	\$43,114
1989	\$43,645	\$44,577	\$44,314	\$46,932	\$49,687	\$46,893	\$49,893	\$48,077	\$48,116	\$49,095	\$47,627	\$47,606
1990	\$43,091	\$43,981	\$47,263	\$44,185	\$47,400	\$45,694	\$42,137	\$38,209	\$35,102	\$34,657	\$32,456	\$34,197
1991	\$37,724	\$38,994	\$39,415	\$39,941	\$40,779	\$39,091	\$39,956	\$44,156	\$45,393	\$43,480	\$41,322	\$48,103
1992	\$48,244	\$50,443	\$50,119	\$50,117	\$51,107	\$49,202	\$53,180	\$47,368	\$49,710	\$45,195	\$46,213	\$45,872
1993	\$44,079	\$43,067	\$42,845	\$39,373	\$40,755	\$39,883	\$41,055	\$43,018	\$42,779	\$43,569	\$42,550	\$42,738
1994	\$44,115	\$44,873	\$42,544	\$42,338	\$44,994	\$42,021	\$44,152	\$41,316	\$38,953	\$40,055	\$39,479	\$39,810
1995	\$38,132	\$36,900	\$38,465	\$38,422	\$37,774	\$38,530	\$40,054	\$39,552	\$42,465	\$40,673	\$39,609	\$38,215
1996	\$38,812	\$36,530	\$35,131	\$36,794	\$35,838	\$35,024	\$35,708	\$33,687	\$38,921	\$37,059	\$39,542	\$40,523
1997	\$38,631	\$38,136	\$36,809	\$38,921	\$40,446	\$40,511	\$42,056	\$38,617	\$41,774	\$51,685	\$60,063	\$57,866
1998	\$58,060	\$59,345	\$65,859	\$66,861	\$66,059	\$67,800	\$69,782	\$62,275	\$63,232	\$66,529	\$73,297	\$76,437
1999	\$74,171	\$72,623	\$74,271	\$71,258	\$66,281	\$70,481	\$64,772	\$62,773	\$60,144	\$65,960	\$67,277	\$69,671
2000	\$69,717	\$69,551	\$74,466	\$73,724	\$65,177	\$68,273	\$68,518	\$78,529	\$79,645	\$79,586	\$69,723	\$66,999
2001	\$66,358	\$58,510	\$54,521	\$57,526	\$56,179	\$56,620	\$53,732	\$50,018	\$47,970	\$48,816	\$53,419	\$47,969

Ten-year outcome fell short of \$26,174 target
 Ten-year outcome exceeded \$26,174 target

Best and Worst Outcomes



Following the same analysis we performed on Canadian and U.S. Stocks, we examined all of the ten-year outcomes that would have resulted by earning the returns on this asset allocation from 1970 through 2001. The portfolio is rebalanced monthly, meaning that its allocation to the asset classes remained constant throughout the ten-year periods studied.

The results show that the range of outcomes narrowed relative to the performance of Canadian and U.S. Stocks (see Figure 7). Most importantly, for the worst ten-year period (April 1970 through March 1980), the result of \$22,614 is substantially better than those we saw for the worst periods with Canadian and U.S. Stocks – an improvement in total wealth by about 19% over the worst period for Canadian Stocks and 25% for U.S. Stocks.

Even more striking is the number of ten-year periods that exceeded the target of \$26,174 – all but 20 of the 265 outcomes exceeded the target, as shown in the outcome table (see Figure 8). For those periods where the outcome fell short of the target, the amount of the shortfall was generally very small.

THINKING AHEAD

You should keep in mind that when investing, you face a great deal of uncertainty about how various investments will perform. For example, we can easily add an additional column to the table of returns presented at the beginning of this article – let's call it "Compound Annual Return 2002 – 2033." (see Figure 9)

Do you have any confidence in your ability to predict these returns? Given recent market performance, it is

Figure 4

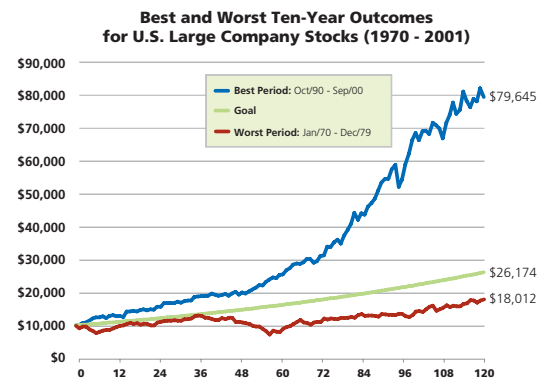


Figure 6

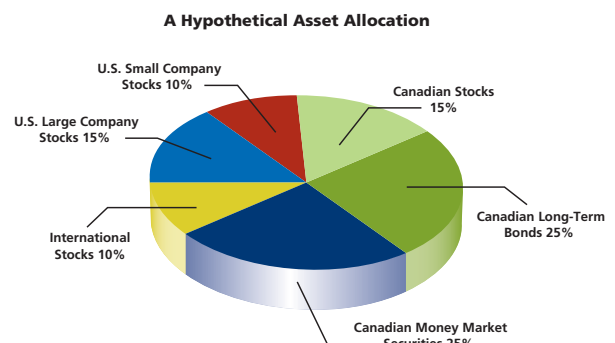


Figure 7

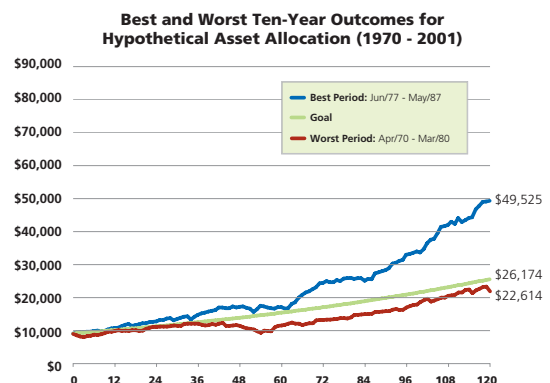


Figure 8

Outcomes for \$10,000 Hypothetical Investments in Asset Allocation (Ten-Year Periods 1970 – 2001)

Ten-Years Ending	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
1979												\$23,415
1980	\$24,579	\$24,186	\$22,614	\$25,035	\$26,863	\$28,338	\$27,905	\$27,787	\$27,503	\$28,033	\$28,773	\$27,851
1981	\$26,354	\$26,255	\$26,381	\$25,694	\$26,404	\$26,226	\$25,801	\$25,040	\$23,826	\$25,371	\$26,636	\$25,093
1982	\$23,801	\$23,126	\$22,980	\$23,399	\$23,293	\$22,912	\$22,817	\$24,102	\$24,862	\$26,567	\$26,482	\$27,145
1983	\$27,465	\$28,482	\$29,074	\$31,266	\$32,070	\$32,509	\$31,303	\$31,875	\$31,616	\$30,897	\$33,894	\$34,145
1984	\$33,926	\$33,304	\$34,069	\$35,399	\$35,406	\$36,487	\$37,090	\$41,397	\$43,591	\$41,471	\$42,316	\$43,511
1985	\$41,386	\$40,106	\$40,440	\$40,113	\$40,874	\$40,332	\$41,476	\$42,307	\$43,069	\$43,399	\$44,708	\$45,899
1986	\$43,438	\$44,984	\$47,046	\$46,990	\$47,393	\$47,961	\$47,004	\$48,380	\$46,869	\$47,965	\$47,506	\$45,642
1987	\$48,073	\$48,566	\$49,479	\$49,460	\$49,525	\$48,452	\$49,081	\$49,461	\$48,214	\$44,107	\$42,031	\$43,059
1988	\$44,653	\$45,564	\$43,970	\$43,002	\$42,265	\$42,886	\$41,057	\$39,497	\$39,392	\$42,397	\$41,155	\$40,991
1989	\$41,226	\$41,322	\$40,621	\$41,224	\$41,907	\$40,938	\$42,548	\$41,391	\$41,193	\$43,037	\$41,853	\$41,557
1990	\$39,417	\$39,080	\$40,980	\$37,910	\$38,957	\$37,876	\$37,291	\$35,226	\$33,169	\$33,356	\$32,739	\$33,569
1991	\$34,988	\$36,667	\$36,097	\$36,769	\$36,810	\$35,726	\$37,766	\$38,732	\$41,258	\$40,192	\$37,445	\$39,906
1992	\$41,240	\$41,858	\$41,199	\$40,288	\$41,281	\$42,138	\$42,869	\$40,195	\$39,494	\$37,111	\$36,476	\$35,582
1993	\$35,250	\$34,791	\$34,872	\$33,744	\$34,229	\$34,030	\$34,851	\$36,333	\$35,302	\$36,542	\$35,163	\$35,823
1994	\$36,914	\$36,934	\$35,610	\$35,700	\$36,628	\$35,178	\$35,966	\$34,719	\$33,947	\$33,655	\$32,977	\$33,040
1995	\$31,311	\$31,874	\$32,069	\$32,017	\$31,383	\$31,578	\$31,713	\$31,381	\$32,306	\$31,279	\$30,908	\$30,482
1996	\$30,925	\$29,492	\$28,309	\$28,671	\$28,892	\$28,129	\$28,117	\$27,569	\$29,062	\$29,369	\$30,171	\$29,857
1997	\$28,519	\$28,257	\$27,069	\$27,584	\$28,594	\$29,020	\$29,914	\$28,953	\$30,608	\$33,183	\$34,103	\$33,366
1998	\$33,399	\$33,354	\$34,341	\$34,637	\$34,633	\$34,238	\$34,162	\$31,751	\$31,890	\$32,374	\$33,803	\$34,130
1999	\$33,471	\$32,459	\$33,038	\$32,788	\$31,727	\$32,192	\$30,982	\$30,644	\$30,403	\$31,008	\$31,580	\$32,475
2000	\$32,934	\$34,656	\$35,879	\$35,975	\$33,569	\$34,855	\$34,738	\$37,454	\$38,296	\$37,355	\$35,357	\$34,959
2001	\$34,570	\$31,848	\$30,741	\$31,256	\$30,972	\$31,236	\$30,463	\$29,919	\$28,419	\$28,674	\$29,781	\$28,793

Ten-year outcome fell short of \$26,174 target
 Ten-year outcome exceeded \$26,174 target

Best and Worst Outcomes

virtually guaranteed that they will be different and that the rankings will likely change. Even if you could predict long-term rates of return, that ability would not help you decide how to allocate your investments for the next ten years – will your result be blue or red? How far short of your target could you fall?

Those are not easy questions to answer, but if you have a diversified portfolio that is aligned with your investment objectives, you will be taking less risk with your investments – protecting yourself from falling short of your target. If during the next ten-years, returns on stocks turn-out to be extraordinarily good, and your diversified portfolio does not beat your target by as much as you may have with stocks alone, then you

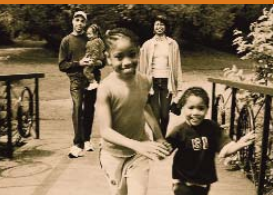
should think back to when you made your decision to diversify and ask the following question: Would I have rather accepted the risk of falling substantially below my target?

FINDING THE APPROPRIATE ASSET ALLOCATION

Your financial advisor should be able to assist you in finding a fund that practices asset allocation according to very specific strategy, or she/he may be able to help you select from a variety of funds to create you own asset allocation. In either case, here are some things you may want to ask yourself as you review your investments:

Performance of Six Asset Classes (1970 - 2001 and 2002 - 2033)		
Asset Class	Compound Annual Return	
	(1970 - 2001)	(2002 - 2033)
U.S. Small Company Stocks ¹	15.0%	?
U.S. Large Company Stocks ²	13.2%	?
International Stocks ³	12.4%	?
Canadian Long-term Bonds ⁴	10.8%	?
Canadian Stocks ⁵	10.1%	?
Canadian Money Market Securities ⁶	8.3%	?

Figure 9
All returns are in Canadian Dollars. See End Notes for market indexes used.



1. Do I need to accept a lot of risk to obtain reasonable growth? Can my advisor find ways to diversify my investments, even if I am only invested in stocks?
2. If my investments are in a taxable account, does my asset allocation strategy seek the highest after-tax returns for the level of risk that I am seeking?
3. If my investments are in a tax-deferred account, does my asset allocation strategy seek to invest in the widest array of investments possible for the level of risk that I am seeking, and does it deal effectively with foreign content constraints?
4. How was the asset allocation strategy developed? Has it been tested and modeled under many different scenarios?
5. Are the investments underlying the asset allocation strategy from more than one fund company or advisory firm? Are the money managers specialists in the areas they invest?

FINAL THOUGHTS

Asset allocation strategies seek to reduce risk, i.e. reduce the uncertainty we have about what the future will bring for our investments. When properly designed and managed, an asset allocation strategy can offer some protection from severe market contractions, helping you from falling short of your target, which we would all like to avoid in the long run.

End Notes

- 1 U.S. Small Company Stocks – CRSP 6-8 Market Cap Based Portfolio (Returns in Canadian Dollars). CRSP, Center for Research in Security Prices. Graduate School of Business, The University of Chicago 2002. Used with Permission. All rights reserved. www.crsp.uchicago.edu.
- 2 U.S. Large Company Stocks – CRSP 1-2 Market Cap Based Portfolio (Returns in Canadian Dollars). CRSP, Center for Research in Security Prices. Graduate School of Business, The University of Chicago 2002. Used with Permission. All rights reserved. www.crsp.uchicago.edu.
- 3 International Stocks – MSCI EAFE Index (Returns in Canadian Dollars). Morgan Stanley Capital International.
- 4 Canadian Long Term Bonds – Scotia Capital Long Term Bond Index. Scotia Capital Debt Market Indices.
- 5 Canadian Stocks – TSE 300 Composite (1970 – 2001) recently converted to the S&P/TSX Composite Index. TSX, Copyright 2002 The Toronto Stock Exchange Inc. All Rights Reserved.
- 6 Canadian Money Market Securities – Scotia Capital 91-Day Treasury Bill Index. Scotia Capital Debt Market Indices.

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