Asset Allocation Rethought

Jamie Golombek
Managing Director, Tax & Estate Planning, CIBC Financial Planning and Advice

This article originally appeared in
The National Post on January 18th, 2012. Updated March 2018.

As you sort through the maze of options for your RRSP contribution, keep in mind that managing your portfolio involves two important decisions: Asset allocation and asset location.

If you're like most investors, you spend the bulk of your portfolio maintenance time on asset allocation. That is, deciding, how your investment portfolio should be diversified among various asset classes such as stocks and bonds.

A potentially equally important decision often overlooked, however, is the asset location decision. In other words, once you've chosen a particular asset allocation, based on your risk tolerance, should a particular asset be held in your taxable non-registered account or your sheltered registered account?

For many Canadians who save for their retirement exclusively through registered plans such as the RRSP or tax-free savings account (TFSA), the question of asset location is moot.

The issue of asset location, therefore, is only relevant for investors who have maximized their RRSP and TFSA contributions and must hold any additional savings in a taxable non-registered account. In our continuing rock-bottom, low-interest rate environment, the question of asset location between taxable and non-taxable accounts has taken on a new importance.

The traditional rule of thumb holds that fixed income assets such as bonds, GICs or money market mutual funds should always be held in RRSPs. This is because they generate interest income, which is the most highly taxed form of investment income and is fully taxable at the investor's marginal tax rate.

The corollary, therefore, is that equities are best suited to non-registered accounts since they have their own inherent, unique tax advantages. Firstly, capital gains on the sale of equities can generally be deferred until the asset is sold. Secondly, when equities are sold for a profit, the resultant capital gain is only 50% taxable. Finally, if you hold dividend paying Canadian equities, then the dividends received are taxed favourably due to the dividend tax credit that, in most provinces, means tax rates similar to those levied on capital gains.

But in this current low interest rate environment, does it still make sense to keep all our fixed income investments inside our RRSPs and TFSAs and our equities outside?

If you have the ability to choose what goes into your RRSP or TFSA, with the result that any excess beyond your available room is held in your non-registered account, if your fixed-income investment is only expected to yield a per cent or two, it may make better sense to reserve your scarce RRSP and TFSA room for equities, which may have a greater return potential than fixed income.

Jamie.Golombek@cibc.com

Jamie Golombek, CPA, CA, CFP, CLU, TEP is the Managing Director, Tax & Estate Planning with CIBC Financial Planning and Advice in Toronto.

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