STEADYHAND

How Is Your Portfolio Doing?

A Framework for Assessing Investment Performance

January 2012

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Steadyhand Investment Funds is an independent no-load mutual fund company that offers a straightforward lineup of low-fee funds directly to investors. The firm has an experienced management team and clear investment philosophy rooted in the belief that concentrated, non-benchmark oriented portfolios are the key to index-beating returns. Steadyhand's only business is managing money for individual investors and it offers practical advice on building and monitoring portfolios.

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We want to thank the clients and industry professionals who generously gave their time in providing feedback on this report.

This update was published on January 18, 2012, by Steadyhand Investment Management Ltd.
This report was originally published on January 20, 2011, by Steadyhand Investment Funds Inc.

Introduction

Do you know how your portfolio is doing?

If you open your quarterly statement and have more money than the previous quarter, do you feel good? And vice versa, if the market value has dropped, do you grumble?

A few years ago, we met with a prospective client who thought her advisor had done well for her in the previous five years, but was letting her down in the current year – her portfolio was down 3%. After assessing the situation, we discovered that her portfolio was actually holding up well in the current year relative to a weak market. In previous years, however, it had performed poorly – the return didn't nearly reflect the strength of the markets. This example speaks to how muddy the area of performance measurement is and how little effort investors make in answering the question, How am I doing?

There are reasons for this neglect. Assessing performance takes time and is tough to do. There are many factors to consider, the necessary data is difficult to obtain and the conclusions don't always match up with how you feel. In addition, the wealth management industry doesn't help matters. Its lack of effort in providing useful information borders on negligence.

This is Important!

Conducting a proper assessment is extremely important. Monitoring your portfolio is a key element of being a successful investor.

A thorough review is important because the "Am I up or down this quarter?" approach doesn't work. The time frame is inappropriate - short-term results are as close to random as you can get - and there is no context to it. As the story above reveals, a portfolio may be down and yet have performed well and vice versa.

It's also important because if you haven't analyzed your past decisions, it's more likely your future ones will be sub-optimal.

When

We suggest undertaking a thorough performance review once a year. It's better than doing partial assessments multiple times a year.

In our experience, investors monitor their portfolios too closely. Reviewing returns daily, weekly or even monthly is too frequent. Investing is a long-term endeavour and strategies take time to play out. Looking at the numbers often may induce action when none is required.

A Practical Approach

This paper provides a usable, common-sense framework for investors to assess their investment performance. We've tried to capture 90% of what's important. In other words, practical over perfect.

We acknowledge that there are more rigorous analyses that can be done. For instance, there are more detailed attribution and ratio analyses that compare returns, volatility and added-value, but again, these extra variables add to the complexity of the task. It would be ideal to make comparisons after factoring in taxes and inflation, although it would make the process considerably more difficult.

What our approach will do is:

- Require that you look at your portfolio as a whole.
- Necessitate that you have all the facts before making judgements.
- Reinforce the importance of having an investment plan.
- Lead to a better understanding of how your portfolio works.
- Allow you to intelligently speak to your advisor or portfolio manager about performance.
- Help address your biggest potential weakness – impatience.

And hopefully, make you a better investor.

Numbers

To determine how you're doing, you first need the facts.

It's important to look at all your investments at one time. There are two reasons for this, one practical and one analytical. The practical one is that it's more efficient, especially if you have a number of providers. There is considerable repetition across quarterly reports, which makes for unnecessary reading. For instance, after you've read one commentary and know what's going on in the bond and stock markets, you can skim or skip the other market reviews.

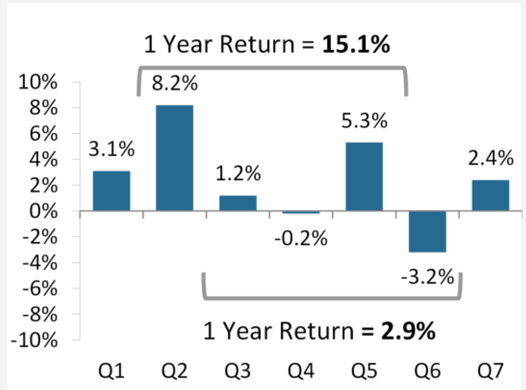
The second reason is more important. It relates to the fact that *it's the overall results you're interested in*. Yes, the returns of your total portfolio. If you review your investments on a piecemeal basis, it's too easy to get focused on one particular holding, trend or personality – obsessing over a gold stock or poorly performing mutual fund – that has minimal impact on the overall return. You want to keep an eye on the trees, but not lose sight of the forest.

So gather all the data in one place before you sit down to do your work. ***And make sure the data is for the same time period. Comparing numbers from periods ending on different dates renders the analysis useless. A one month or quarter difference can have a significant impact on the conclusions*** (see box **A**).

A

End-date sensitivity

Investment returns are very sensitive to the start and end-dates of the measurement period. The inclusion of an additional quarter, good or bad, influences how the returns look over all time periods.



As you can see, the one-year return for the period ending Q5 (+15%) is quite different than the one-year number reported three months later (+3%).

Detective Work

Investment returns are not always clearly displayed on an account statement, so you may need to do a little digging. Fortunately, most investment dealers now have calculators as part of their on-line account offering. If you have an advisor, you can ask him to send you a performance report on your account(s).

In cases where it's not possible to get your returns, there are two things you can do. First, consider changing the firm you work with. Assessing performance is too important to be ignored. But in the meantime, there are sources of information online where you can go to find out how your individual investments are doing:

- Globefund – Useful source for fund data and returns.
- Morningstar – Similar to Globefund, a useful source for fund data and returns. The Premium Membership provides good portfolio performance tracking tools.
- Fund company websites – Performance data on all their funds.
- Showmethereturn.com – Calculator designed to compute annualized rates of return.

Annualized Rate of Return

Show me the money! You want to know what you have now compared to what you put in, so you can see how many dollars you've earned. But that number doesn't properly take into account how much you've invested and for how long. ***Annualized rates of return, the percentage return earned per year on your invested capital, is a better measure. It factors in the size of your account and length of time it's been invested. It includes all forms of***

income including interest, dividends and capital appreciation.

For example, the return on a stock is made up of dividends received and the price appreciation (or depreciation) over the time period. If it traded at $10 on January 1st, paid a $0.50 dividend at the end of the year and closed the year at $11, the return would be 15%.

(($11.00 – 10.00 + 0.50) / 10)) x 100 = 15%

Similar to individual securities, the annualized rates of return for mutual funds and other pooled products include distributions made during the period as well as the gain (loss) related to changes in the unit price.

Calculating a rate of return is simple when there have been no cash flows during the period (purchases or sales). When there are flows, as well as dividends or other distributions, it's more difficult. In this case, you may need to call on your dealer for help or find a performance calculator.

It's important to note that all returns should be net of fees. You can't spend pre-fee earnings.

Time Frame

Short-term predictions of stock prices, or asset class returns, are nothing more than speculation. You might as well roll the dice or throw a dart, as the outcomes are entirely random. There are too many factors at play to suggest otherwise.

But predictions about asset class returns become more reliable over longer time periods. Will bonds earn 3% this year? It's hard to say. But given current yields of 2-4%, it's relatively certain that returns over the next 10 years will be in that neighbourhood. Will stocks beat bonds this year? We have no idea. But over a longer time frame, we can say *Yes* with some confidence.

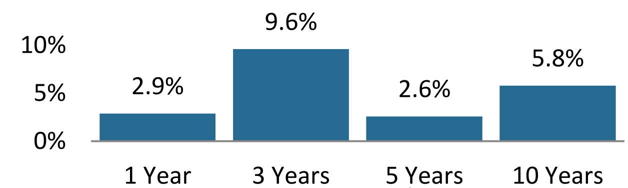
It's the same when assessing investment returns. The most recent quarter, or other short period, is of limited value in indicating how you're doing. (Note: That's not to say that short-term swings aren't useful data points. A significant change to your portfolio's value may mean there are opportunities to do some buying at lower prices, raise cash for future needs when prices are up, or just do some routine re-balancing).

So when you're assessing the results of an investment plan, the correct time frame is one where the elements of luck and randomness have been filtered out of the data, and the numbers are a truer indication of skill. It's a time period described by two words – long term.

What does long term mean? There is no precise definition. Investing is an endeavour that spans many years and is done to offset liabilities that are in the distant future (i.e. providing a paycheque in retirement). ***Long term means at least five years, and ideally even longer*.**

The best solution to the time frame question, in our opinion, is to analyze your investment returns in two ways. First, ***look at the annualized rates of return for the overall portfolio, and individual components, over periods of 3, 5 and 10 years. The longer-term numbers are the best indicator of how you're doing*.**

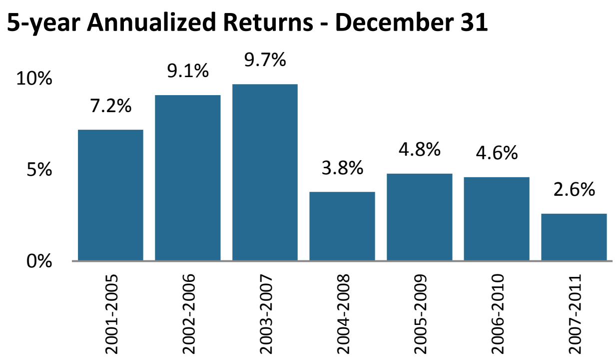
Annualized Returns - December 31, 2011



2007	2008	2009	2010	2011
2.9%	-16.1%	16.4%	9.8%	2.9%

Annualized returns are indicative of how you're doing, but they're heavily influenced by the specific start and end dates. For instance, if the portfolio has performed well, or poorly, in recent months, the longer-term returns may be impacted significantly. There is nothing wrong with this – it reflects the experience you've had – but as we noted earlier, it makes your analysis highly sensitive to the most recent period.

The second way of analyzing performance gets around end-date sensitivity by looking at returns at different times. *Using returns for 3, 4 or 5-year periods with different end dates gives you a better sense of how consistently the portfolio has performed over time* – i.e. 5-year returns at December 31st 2002, 2003, 2004 and so on up to the most recent year-end (See chart on next page).



We recommend using five-years, but there's nothing to say the periods can't be another length – Canadian pension funds and their consultants typically use four-years as a point of comparison. The important thing is that the time frame be long enough to eliminate short-term noise and yet still be meaningful to you – i.e. you're willing to be patient for up to five years while the investment strategy plays out.

Reporting

It should be obvious by now just how important it is to buy investment products that clearly show returns, and work with advisors and fund managers who provide information that allows you to properly assess how you're doing. As the investment world gets more complex with product choice and market information, performance reporting is no longer a 'nice to have', but an essential requirement. ***Proper reporting of investment returns should be a key criterion in selecting, and retaining, an investment firm.***

Summary

1. *Look at all your investments at the same time.*
2. *Use the same end-date for comparison.*
3. *Assess returns over longer periods of time – 5 years or more.*
4. *Use annualized rates of return (net of fees) to measure how you're doing.*
5. *Avoid the impact of end-date sensitivity by also using rolling 3, 4 or 5-year periods.*
6. *Make performance reporting an important criterion for picking an investment firm.*

Context

The market environment

Capital markets are very dynamic. They can move significantly in short periods of time, with some securities going up in price and others dropping. Therefore, you need to know what the investing environment was like for your type of portfolio, so you can carry out an 'apples-to-apples' comparison.

One of the biggest mistakes investors make is comparing their portfolio, or a portion of it, to something they've seen in the newspaper or heard in the locker room. It's a mistake because the objectives of their conservative balanced portfolio, as an example, could be totally different than the 'play money' a golf partner has with his broker. Too often, investors let a story about oranges influence how they view their apples.

All of that to say, ***you need to gather information about the overall market and put it in a form that best reflects the composition of your own portfolio.***

Market Data

All quarterly reports will have information on what the capital markets have done over the previous quarter. This gives you an understanding of what's been driving the markets, but it isn't a big factor in your analysis. It's more important to get your hands on asset class returns for longer periods (see the table below). The report(s) you receive will likely have annualized returns for each category. If not, there are many good sources of this information on the internet (see the list on page 3).

Default Portfolio

To be successful, you need to have a plan. It's an overused axiom, but it's true. A key part of your plan is the strategic asset mix (SAM), which is the mix of investments that has the best chance of achieving your goals. It's an educated guess, designed to find the right balance between return, volatility and income.

For example, a young investor with a long investment horizon should be oriented towards stocks, which are more volatile in the short term, but provide higher returns over the long term. Her mix might be 20% bonds, 40% Canadian stocks and 40% foreign stocks. An investor with a shorter time frame should have a larger portion of his mix in more stable bonds (i.e. 50% bonds, 25% Canadian stocks and 25% foreign stocks).

Without a SAM, you can't do any meaningful performance comparisons. It's the starting point for calculating the returns of a default portfolio, or what's commonly referred to as a benchmark.

Capital Market Returns

		Annualized – Dec. 31, 2011				*Rolling 5-Year Annualized – Dec. 31*						
Asset Class	**Index**	**1 Y**	**3 Y**	**5 Y**	**10 Y**	**01-05**	**02-06**	**03-07**	**04-08**	**05-09**	**06-10**	**07-10**
Cash	DEX 91 Day T-Bill	1.0%	0.7%	2.0%	2.4%	3.0%	2.9%	3.2%	3.3%	3.0%	2.6%	2.0%
Bonds	DEX Universe Bond	9.7%	7.3%	6.4%	6.5%	7.4%	6.6%	5.6%	5.5%	5.2%	5.3%	6.4%
Canadian stocks	S&P/TSX Composite	-8.7%	13.2%	1.3%	7.0%	6.6%	13.1%	18.3%	4.2%	7.7%	6.5%	1.3%
U.S. stocks	S&P 500 ($Cdn)	4.3%	7.0%	-2.8%	-1.6%	-4.4%	-0.3%	2.8%	-3.1%	-2.2%	-0.9%	-2.8%
International stocks	MSCI EAFE ($Cdn)	-10.3%	1.0%	-7.2%	0.1%	-0.5%	8.0%	10.8%	0.7%	0.8%	-0.7%	-7.2%

Your default portfolio reflects the investment environment that's relevant to you. It can be constructed by multiplying the returns of the asset classes in the SAM by their proportions. For example:

Calculating a Default Portfolio Return

SAM	%		5 Yr Return		
Bonds	30.0%	x	6.4%	=	1.9%
Cdn stocks	35.0%	x	1.3%	=	0.5%
U.S. stocks	17.5%	x	-2.8%	=	-0.5%
Intl. stocks	17.5%	x	-7.2%	=	-1.3%
Default portfolio return					**0.6%**
Estimated annual fee					-0.5%
Default portfolio return (fee adjusted)					**0.1%**

Note: The table above assumes the SAM has not been changed or re-balanced over the period. Ideally, the default portfolio should be calculated at a regular interval (quarterly or annually) and cumulated to create a longer-term index. This allows for changes to the SAM and serves to automatically re-balance the mix. In the table **below**, we provide a Default Portfolio Calculator that is re-balanced annually.

To make the default portfolio representative of the real world, you may consider factoring fees and commissions into the calculation, as we have done above. By subtracting 0.5% from the annual return, it will more accurately reflect the cost of managing an index-like portfolio, which is what your default portfolio is.

Default Portfolio Calculator - Dec. 31, 2011

Asset Mix *Annualized Rate of Return (Pre-fee)*

Bonds / Equities	1 Y	3 Y	5 Y	10 Y
80% / 20%	6.5%	8.0%	5.3%	6.3%
70% / 30%	4.9%	8.3%	4.6%	3.2%
60% / 40%	3.3%	8.6%	4.0%	6.0%
50% / 50%	1.7%	8.9%	3.3%	5.8%
40% / 60%	0.1%	9.2%	2.6%	5.5%
30% / 70%	-1.6%	9.4%	1.8%	5.2%
20% / 80%	-3.2%	9.7%	1.0%	4.9%

Calculator notes:

- Equities: 60% Canada (S&P/TSX Composite Index); 40% Foreign (MSCI World Index)
- Bonds: Dex Universe Bond Index
- Re-balancing: for periods over 1-year, the portfolios are re-balanced annually – e.g. the 80% bonds / 20% equities mix is reset to 80 /20 at the beginning of each year.
- Returns do not include fees

It's important to note that the makeup of your SAM, and the resulting default portfolio, shouldn't change much from year to year, even though the mix of your actual portfolio will bounce around with the markets. The SAM will evolve over time due to the inevitability of aging, but major shifts should only be done as a result of changes to your life circumstances, not in reaction to recent market moves.

Summary

1. *Understand the context in which your portfolio is operating so you can make an apples-to-apples comparison.*

2. *To best represent the market environment, calculate the returns for a default portfolio based on your strategic asset mix.*

3. *Only change your objectives and default portfolio when there's been a significant change to your circumstances.*

Analysis

How am I doing?

OK, so you have the facts and understand something about the investing environment. Now it's time to do some analysis. How has the portfolio done compared to your objectives and the default portfolio? What are the reasons for the good or bad performance? And who is responsible?

Objectives

As part of a financial plan, you should have return objectives for your portfolio. They can take many forms, and you may use more than one. Examples of some long-term return objectives are:

- Inflation plus 3%
- GICs plus 2%
- Fixed return target – i.e. 6%

Your objectives won't jump around nearly as much as your portfolio, so it's important that you only compare them to long-term measures of performance (5 years and longer).

B

What is an appropriate risk-free rate?

To generate higher long-term returns, you have to take risk. Bonds, stocks, real estate or other long-term assets bring with them price volatility and the possibility of capital loss. If you're going to invest, it's useful to know how your return compares to a risk-free return.

When a risk-free return is talked about, it's usually short-term treasury bills issued by the Federal Government that are referenced. T-bills have virtually no risk of default and no sensitivity to changes in interest rates.

It could be argued, however, that a long-term government bond (20 years plus) would be a more appropriate measure of the risk-free rate for investors with a long time horizon. And taking it a step further, inflation-adjusted or real return bonds (RRBs) would be an even better measure given that they take inflation into account.

Realistically, for most investors, 5-year GICs are a good measure of risk-free investing. GICs are readily available and backed by deposit insurance (up to $100,000 per institution).

The Default Portfolio

The market context will have the most impact on how you've fared versus your objectives. But you also want to know how you've performed in relation to your default portfolio.

To answer this question, you need to do analysis at four levels – asset mix, security selection, risk and cost.

Asset Mix

If you pursue strategies where the portfolio diverges significantly from your SAM, either intentionally or inadvertently, then asset mix will have a meaningful impact on how you've done. Carrying extra cash, more foreign stocks, or loading up on corporate bonds are all

Return Comparisons

	Annualized – Dec. 31, 2011				*Rolling 5-Year Annualized – Dec. 31*						
	1 Y	**3 Y**	**5 Y**	**10 Y**	**01-05**	**02-06**	**03-07**	**04-08**	**05-09**	**06-10**	**07-11**
Actual Portfolio *(After-fee)*	2.6%	5.1%	3.2%	6.2%	7.3%	9.2%	9.8%	4.4%	5.5%	5.3%	3.2%
Long-term Objectives											
5-year GICs + 2%	-	-	4.5%	4.8%	5.4%	5.2%	5.1%	5.1%	4.9%	4.7%	4.5%
Return Target	-	-	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
Default Portfolio *(Pre-fee)*	1.2%	4.4%	2.6%	5.1%	5.1%	8.6%	10.6%	4.0%	5.5%	5.1%	2.6%

examples of asset mix strategies. You need to determine how your short to mid-term positioning worked out:

- How did specific moves impact the results? Was the portfolio shifted into higher return assets, or vice versa?
- Were the moves intentional or accidental?
- If intentional, what was the thesis?
- Who determined the strategy?
- Was currency a significant factor?

In assessing the impact of the portfolio's asset mix, we recommend that you keep the analysis general. You want to understand in broad terms how your strategy played out, not get caught up in the decimal points.

Security Selection

Now it's time to move down a level and look at your specific holdings.

If you own individual bonds and stocks, you want to know how they've done in the context of the market. You're likely aware of how the stars and dogs have performed, but you might not know how well you've done overall. How would your returns stack up against a professionally managed portfolio?

To calculate the return of your bond and stock holdings, you'll need help, either from an on-line tool or the system your advisor uses.

With mutual funds and other pooled products, return data is more readily available. There is a natural tendency, however, to measure performance based on how the funds have done during the time you've owned them. In some cases, this may be a short period. You need to resist this temptation because the analysis in no way aligns with the reasons for buying the funds in the first place. ***You based your purchase on long-term returns and a number of other factors. Your assessment should be based on those same factors***. Are the same people managing the fund and are they pursuing the same philosophy? How has each holding done – has it added value to the overall portfolio by beating its benchmark?

A mutual fund should be compared to the appropriate market index – e.g. a Canadian equity fund versus the S&P/TSX Composite Index. For funds that are diversified across different asset types, fund companies often provide benchmark returns that reflect the corresponding asset mix. Clearly, what you're looking for is returns that are in excess of the benchmark over the long-term.

From the table below, you can see that the Bond Fund has not performed well over any period. It should be sold. Although the International Fund's long-term returns are poor, and it did not beat the pre-fee EAFE Index over ten

Fund Returns*

	Annualized – Dec. 31, 2011				*Rolling 5-Year Annualized – Dec. 31*						
	1 Y	**3 Y**	**5 Y**	**10 Y**	**01-05**	**02-06**	**03-07**	**04-08**	**05-09**	**06-10**	**07-11**
Bond Fund	8.3%	6.6%	4.7%	5.1%	7.2%	6.5%	5.5%	4.8%	4.8%	3.6%	4.8%
DEX Univ. Bond Index	9.7%	7.3%	6.4%	6.5%	7.4%	6.6%	5.6%	5.5%	5.2%	5.3%	6.4%
Added value	-1.4%	-0.7%	-1.7%	-1.4%	-0.2%	-0.1%	-0.1%	-0.7%	-0.4%	-1.7%	-1.7%
Intl. Equity Fund	-9.5%	1.3%	-6.7%	-1.0%	0.4%	8.7%	9.6%	2.1%	3.5%	-0.6%	-6.7%
MSCI EAFE Index	-10.3%	1.0%	-7.2%	0.1%	-0.5%	8.0%	10.8%	0.7%	0.8%	-0.7%	-7.2%
Added value	0.8%	0.3%	0.5%	-1.1%	0.9%	0.7%	-1.2%	1.4%	2.7%	0.1%	0.5%
Balanced Fund	-0.7%	7.1%	1.8%	4.9%	10.1%	11.3%	12.3%	6.7%	7.4%	5.9%	1.8%
Benchmark**	-1.3%	10.8%	3.3%	6.8%	7.3%	10.8%	13.3%	5.4%	7.5%	6.8%	3.3%
Added value	0.7%	-3.7%	-1.5%	-1.9%	2.8%	0.5%	-1.0%	1.3%	-0.1%	-0.9%	-1.5%

**Fund returns are after-fees, benchmark returns are pre-fee.*

***40% DEX Universe Bond Index, 60% S&P/TSX Composite Index* years, the rolling 5-year returns show that it has been building a solid record of exceeding the index. The Balanced Fund's long-term record has been deteriorating due to weaker returns in recent years. The returns on their own are not cause enough to sell the fund, but they certainly point to the need for further research.

How far a fund diverges from its benchmark depends on the time frame, how volatile the asset class is and how actively the manager is trying to beat the benchmark.

- *Time frame*: In the near team, you should expect funds to perform quite differently from their benchmarks. Over longer periods of time, the gap will narrow. In this regard, it is useful to look at fund and benchmark returns over rolling 5-year periods to filter out some of the short-term variability.
- *Asset class*: In stable, lower return asset categories (i.e. fixed income), the gap should be small for all time periods. For equity funds, expect significant differences.
- *Fund manager*: The divergence will depend on how your manager positions the fund. Those who are pursuing returns well in excess of their benchmark will be significantly out of line during short time periods. As the saying goes, "if you want to beat the index, you have to look different than it". Funds that are designed to closely track the benchmark, however, will diverge less. At the extreme, there are exchange-traded funds (ETFs) that are designed to match an index. The gap between these index funds and their benchmarks should be narrow and explained mostly by the fee.

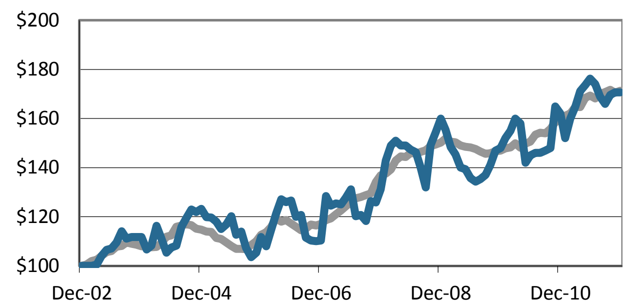
Risk

Not all 6% returns are the same. The path you take to get there can be very different – steady growth, volatile ups and downs or everything in between.

In theory, you shouldn't care how bumpy the path is, but in reality, it does impact how you manage your portfolio. Volatility causes stress, requires more patience and fortitude, and is more likely to lead to inappropriate or ill-timed decisions.

A thorough discussion of risk and volatility is beyond the scope of this report. Suffice to say that you should be cognizant of how each investment achieves its return. They should complement your other investments and fit with your psychological makeup. There's a place for volatile investments in a diversified portfolio if you have the stomach for them.

Different Roads to 6%



Lost Return

Lost return refers to the cost of investing: administrative charges; management fees; trailer and trading commissions; advisory fees; and performance bonuses. As the term implies, there's no upside here. These costs only detract from portfolio returns. The question is, how big an impact did fees and other costs have?

As part of your annual assessment, you should review your costs. In doing so, don't be afraid to ask questions, because in general, the wealth management industry doesn't make it easy to find the information you need.

Some or all of the costs below may represent lost return for your portfolio.

Stocks	- Trading commissions
Bonds	- Trading spread based on a percentage of capital invested
Mutual Funds	- Management expense ratio (MER) - Sales charges at time of purchase or redemption
Administration	- Annual account fees - RRSP, RRIF and TFSA fees
Advice	- Paid via commissions/MERs or charged separately

It’s also important that you make sure you’re not being double charged. For example, if you have a fee-based account with your advisor (i.e. you pay a percentage of your total assets in return for on-going advice, free trades and other services), then you shouldn’t be paying any additional commissions or trailer fees on the funds or structured products you hold. And you should be receiving the full yield on bonds you buy.

Double charging is less frequent today, but we still come across situations where clients are paying an asset-based fee and product commissions.

Summary

1. *Compare your portfolio’s long-term returns to your investment objectives.*

2. *Determine how you have done compared to your default portfolio by doing an analysis at four levels – asset mix, security selection, risk and cost.*

3. *Focus your attention on longer-term returns. Short-term returns provide little in terms of useful information.*

4. *Review your total cost of investing on an annual basis.*

C

Relative versus absolute returns

Should you compare your returns to a benchmark (default portfolio) or a secure investment like a GIC? This dichotomy is often referred to as relative returns (in excess of the benchmark) versus absolute returns (above the risk-free rate).

In a perfect world, investors want market-like returns (relative) when everything is going up and more stable returns (absolute) when markets are weak. In managing your portfolio, however, you need to make a choice. You can’t use one benchmark for one environment and another for a different environment. And certainly, it would be unfair to hold an advisor or portfolio manager to an ever-changing standard.

In the long run (more than 5 years), an investor can achieve success on both levels, but in the nearer term, it shouldn’t be expected.

Success

Factors impacting future returns

When you're looking at how you're doing, it's OK to celebrate good results for a moment, or cry over spilt milk, but then it's time to move on. At the end of the day, you don't generate attractive returns by looking in the rear-view mirror. ***A key part of your performance review is assessing how the past is likely to impact the future.***

Into the Future

If a stock, mutual fund or entire asset class has done well, or poorly, what does it say about the potential for future returns? It's counterintuitive, but good returns over the last 1-3 years often presage lower future returns, just as periods of poor results can set up a good run in the other direction.

Do laggards in the portfolio represent un-sprouted seeds? The definitive answer is, "Sometimes". It's important to understand why a holding is lagging and how long it has persisted. If the underperformer looks a lot like the kind of asset you like to buy – for instance, undervalued, out-of-favour stocks – then they're seeds. It may be time to plant more.

Similarly, it's important to understand why something has done well. There is a natural tendency to deal with the dogs and leave the stars alone **(D)**.

D

Performance cycles

Just as markets go through cycles, so do investment managers. They have periods when everything is working and they're 'stars'. And inevitably, the opposite occurs, which puts a 'dog' collar around their neck. There are a number of reasons why these cycles occur.

Style – Like the fashion industry, investment approaches go in and out of favour. For instance, the type of stocks a growth manager favours may be popular for a few years (i.e. technology in the late 90's or precious metals in recent years) and then go out of favour.

Fatigue - What was good last year will not necessarily be good next year. Stocks may rise due to improving fundamentals (e.g. earnings growth), but also because they went from being unduly cheap to fully priced, or even over-priced. Even though an advisor or fund manager tries to adjust to changing valuations, it's tough to do enough to completely avoid portfolio fatigue.

Luck - In the short to medium term, lady luck plays a significant role. When a manager has a good 2 or 3 years, it's not just skill.

Bonds are an example of what we're talking about. They have generated excellent returns over the last 30 years and have been especially popular lately. But by understanding why bonds have done so well, you are in a better position to assess how they'll do in the future.

Since the early 1980's, interest rates have steadily dropped, going from the high teens to low single digits. With every step down, bond prices went up and investment returns were enhanced. The investor not only collected the regular interest payments, but also saw the capital value of the bonds increase.

Can bonds achieve the same kind of returns over the next decade or more? The answer is *No*. The on-going income level is now a modest 1-3% and there is much less room for interest rate declines, and thus additional price appreciation. Indeed, if interest rates rise, the current yield will be offset by price depreciation.

As the saying goes, past performance is not an indicator of future performance, but it can tip you off to where the opportunities are.

Beyond Past Performance – The Other Three P's

To assess the potential for future returns, it's necessary to revisit the reasons why you made an investment in the first place. Beyond performance, you need to assess the people, philosophy and process of your money manager(s).

People – It's important that the professionals you trusted with your money are still there. If your advisor has left, does his replacement fit the bill? If you bought a mutual fund because of the manager, is she still running it?

Philosophy and Process – This is the softer side of the analysis. You hired your advisor or fund manager because of their approach. Has the philosophy and process changed from when you picked them? Do the funds still have the same objectives? Are your 'active' managers being truly active, or just mirroring the index?

Security and manager selection is beyond the scope of this report, but whatever the process you used for buying a security, it's important that you measure results on the same basis. ***Buying for long-term reasons and selling for short-term ones will produce unsatisfactory returns. Indeed, short-term trading in professionally-managed funds doesn't make sense. You've hired the manager to make the trades and adjustments for you.***

With regard to underperforming funds, however, there will be opportunities to enhance your returns. When your analysis suggests that your mistake was in the timing of the purchase, and not the capability of the fund manager, then additional purchases may be advisable.

Summary

1. *Analyze the past to help position the portfolio for the future.*

2. *Use the same criteria you used to purchase an investment to evaluate it's potential for future returns (people, philosophy, process and long-term performance).*

3. *Assess the winners as vigorously as the losers.*

4. *Regular re-balancing is a good risk management tool - you're buying assets that have underperformed and lightening up on the best performers. And importantly, it's less subject to emotion.*

Action

Now what?

"Wall Street makes its money on activity. You make your money on inactivity." - Warren Buffett

When you come to the end of a performance assessment, there will likely be some adjustments to make. But as Mr. Buffett suggests, your bias should be towards inaction. If you are working from a strategic asset mix (SAM), have selected your investments for the right reasons, and are managing your costs, there may be very little to do.

The question is, how much under/over performance should you tolerate and for how long? Do the things uncovered in the analysis require you to take action?

Again, there are no easy answers to these questions. How much underperformance depends to a large extent on how aggressive your strategy is. If you're seeking returns well in excess of your default portfolio, there will be short to medium-length periods (1-3 years) when you're well behind your targets (and vice versa of course).

As for the duration, it's important to recognize that the biggest mistake investors make being impatient. They don't give strategies enough time to play out and as a result, trade too much and make too many changes.

The best way to address these unanswerable questions is to differentiate between situations that clearly require action and ones that deserve more time.

Immediate Action Required

- *Consistently poor performance* - If a fund has not met its objective over longer periods and the rolling 5-year returns give you no reason for hope, then it's time to sell.
- *Re-balancing* – Not all of your holdings will perform the same, so it's likely that some re-balancing will be necessary to get back to where you want your asset mix to be.
- *Change of key personnel* – When a person you've entrusted your assets with leaves or is removed from his post, you need to reassess your position. In a well-constructed portfolio with 5-8 funds, there is no room for a manager who doesn't fit. Too often investors buy a fund because of a manager, but don't sell it when they leave.
- *Changes to investment philosophy* – Similarly, a change of investment approach or objective (e.g. a growth fund is converted to a dividend fund) may require that you go back to square one and reassess your holding.
- *Performance inconsistent with the mandate* – Investment returns are unpredictable, but over time you have an expectation for how an asset should perform. If a fund produces returns quite different from what you expect – e.g. more volatile or conversely too much like the market indices – then it's time to look for an appropriate exit point.
- *Inactive 'active' manager* – You pay a premium fee to have your money actively managed. If the manager is doing little more than replicating the index, then it's time to move on.
- *Excessive fees.*

Patience Needed

- *Short-term pain* – Recent performance alone is not a reason to make changes to your portfolio.
- *Experience and long-term track record* – It makes sense to give an advisor or manager more time if they've proven their skill over a long period. Even the best long-term records have bad years imbedded in them. Patience in this case assumes, of course, that the managers are doing the same things they were when the record and reputation were established.
- *Specific strategies* – When underperformance results from a definitive strategy that hasn't worked out yet, and it's one that still makes sense, then it pays to be patient.
- *Aggressive managers* – If your advisor or fund manager is striving to generate returns well in excess of the market, then you have to expect that returns will deviate meaningfully from the benchmark. In fact, it will be the rule, not the exception. If a fund can go up 40% in a year, then by definition, it has the potential to decline significantly as well.

- *Extreme trends* – There will be periods in a market cycle when a particular type of security is dominating (e.g. tech in the late 90's; precious metals in 2010). While you likely hold some of whatever is hot, the combination of a diversified asset mix and regular re-balancing will likely prevent you from holding enough to keep up with the overall market. The trend may go on for a year or two, but in these circumstances, patience is usually rewarded when the high flyers come back to earth.
- *Inappropriate securities* – There will also be times when these trends are driven by securities that are inappropriate for your portfolio. For instance, when highly speculative stocks are the place to be, you may intentionally own little or nothing in this category.
- *Income securities* – Conservative portfolios, that have been built to provide steady income, will bounce around with changes in interest rates and the stock market. If you still have confidence in their ability to pay regular dividends or distributions, then you need to focus on the income generation as opposed to their price fluctuations. This is particularly true of higher yielding securities like corporate or emerging market bonds, preferred shares, REITs, dividend-paying stocks and structured products.
- *Asset classes* – If it's an overall asset class that's lagging (e.g. U.S. stocks), as opposed to a manager, fund or individual security, you truly need to take a long-term view. We'd go so far as say you need infinite patience when the asset type is a component of your SAM. It's impossible to know when one part of the portfolio will lead or lag (that's why you're diversified) and trends can go to extremes and extend over frustratingly long periods. For example, U.S. stocks decisively beat Canadian stocks during the decade of the 1990's and just when investors had given up on the home market, the tables turned.

You may be disappointed there aren't always definitive conclusions that come out of your analysis. The reality is, assessing investment performance is more art than science. At times, nothing will be black and white, just grey. But the process will ensure that you don't miss the obvious and will highlight areas that require your attention.

Looking in Both Directions

This paper clearly has a bias towards ferreting out poorly performing assets, which is natural. But you must remember that returns are symmetrical. Markets trend higher over time, but the ups and downs are surprisingly even along the way. Extraordinarily good results are often followed by less satisfactory periods. Unfortunately, our behaviors are asymmetric – we focus on the problems and only react to poor performance.

If you've done an objective, dispassionate assessment of how you're doing, some of your changes should relate to situations where the asset(s) is performing well. Factors that require immediate action can come on both sides of the ledger (e.g. personnel changes or excessive valuation).

Summary

1. *One of the biggest mistakes investors make is being impatient. Recent performance alone is not a reason to make changes to your portfolio.*

2. *There will be discoveries in the performance review that require immediate attention. They include: consistently poor performance; the portfolio being out of balance with your strategic asset mix; personnel or philosophy changes at your managers; and excessive fees.*

3. *In other situations, patience will be the operative word - underperformance from an experienced manager; strategies that need more time to play out; and distortions due to extreme trends in the market.*

4. *A thorough performance review is symmetrical. You should assess the holdings that are doing well, just as you do the underperformers. You may need to make adjustments on both sides of the ledger.*

Takeaways

This is important. Monitoring your portfolio is an essential part of being a successful investor. It's not enough to say, "My portfolio is up, I'm OK" or, "I'm down, time for a change".

Once a year is enough. We recommend doing a thorough performance review of your overall portfolio once a year.

Long term, long term, long term. Short-term results (less than 3 years) are essentially random and not a good gauge of skill or strategy. Annualized returns (after fees) over 3, 5 and 10-year periods are a good gauge of how you're doing. It's also advisable to look at 5-year periods using different end dates.

It's the market. The bond and stock markets have the most significant impact on your results. By calculating returns for a default portfolio based on your strategic asset mix, you'll get a better understanding of the environment your portfolio is operating in and how you should be doing.

Measure your portfolio using the same factors you used to build it. This means assessing people, philosophy, process and long-term performance – criteria that are indicative of skill and potential for future returns. It makes little sense to buy a security based on long-term factors, and then assess it, and perhaps sell it, based on short-term results.

All parts of your portfolio won't do well at the same time. That's what diversification is all about. If your strategies are all in sync, then you're not properly diversified.

Satisfactory long-term returns will include extended periods when your portfolio is declining. For equity-oriented portfolios, the declines may extend over a number of quarters and amount to a significant loss. Fortunately, the opposite will be true as well.

An investment that goes up 40% has the potential to decline significantly too. In reviewing your portfolio, you need to resist the natural tendency to focus only on the poor performing assets. It's not complete to do an 'asymmetrical' analysis of a 'symmetrical' world.

Guaranteed lost return. A key part of any performance review is an accounting of the costs associated with managing your portfolio. Fees and commissions are an unavoidable cause of lost return, so they need to be managed carefully.

Look to the future. After a thorough review of past performance, it's time to take a look ahead. Your assessment gives you a better understanding of how your portfolio works and what's important going forward.

Patience required. There may be a need to make adjustments after the review, but your bias should be towards inactivity. Investors' biggest downfall is their propensity to make changes based on short-term factors and emotion.

Appendix: Capital Markets Returns

Annual Returns – Dec. 31, 2011

Index	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
DEX 91 Day T-Bill	4.7%	2.5%	2.9%	2.3%	2.6%	4.0%	4.4%	3.3%	0.6%	0.5%	1.0%
5-year Average GIC	4.1%	4.0%	3.2%	3.0%	2.7%	3.2%	3.0%	3.0%	2.0%	2.0%	1.9
DEX Universe Bond	8.1%	8.7%	6.7%	7.1%	6.5%	4.1%	3.7%	6.4%	5.4%	6.7%	9.7%
S&P/TSX Composite	-12.6%	-12.4%	26.7%	14.5%	24.1%	17.3%	9.8%	-33.0%	35.1%	17.6%	-8.7%
S&P 500 ($Cdn)	-6.4%	-22.7%	5.3%	2.8%	2.3%	15.3%	-10.0%	-21.7%	7.4%	9.5%	4.3%
MSCI EAFE ($Cdn)	-16.6%	-16.6%	13.4%	11.5%	10.7%	25.9%	-5.1%	-29.6%	11.9%	2.5%	-10.3%
MSCI World ($Cdn)	-11.4%	-20.2%	9.4%	7.3%	6.6%	20.6%	-7.1%	-26.1%	11.8%	6.8%	-2.9%

Compound Annualized Returns – Dec. 31, 2011

Index	1 Year	3 Years	5 Years	10 Years
DEX 91 Day T-Bill	1.0%	0.7%	2.0%	2.4%
5-year Average GIC	1.9%	2.0%	2.5%	2.8%
DEX Universe Bond	9.7%	7.3%	6.4%	6.5%
S&P/TSX Composite	-8.7%	13.2%	1.3%	7.0%
S&P 500 ($Cdn)	4.3%	7.0%	-2.9%	-1.6%
MSCI EAFE ($Cdn)	-10.3%	1.0%	-7.2%	0.1%
MSCI World ($Cdn)	-2.9%	5.0%	-5.1%	-1.1%

Index	Asset Class
DEX 91 Day T-Bill	Cash
5-year GIC	Guaranteed Notes
DEX Universe	Canadian Bonds
S&P/TSX Composite	Canadian Stocks
S&P 500	U.S. Stocks
MSCI EAFE	Overseas Stocks
MSCI World	Global Stocks

Rolling 5-year Annualized Compound Returns – Dec. 31

Index	2001-05	2002-06	2003-07	2004-08	2005-09	2006-10	2007-11
DEX 91 Day T-Bill	3.0%	2.9%	3.2%	3.3%	3.0%	2.6%	2.0%
5-year Average GIC	3.4%	3.2%	3.1%	3.1%	2.9%	2.7%	2.5%
DEX Universe Bond	7.4%	6.6%	5.6%	5.5%	5.2%	5.3%	6.4%
S&P/TSX Composite	6.6%	13.1%	18.3%	4.2%	7.7%	6.5%	1.3%
S&P 500 ($Cdn)	-4.4%	-0.3%	2.8%	-3.1%	-2.2%	-0.9%	-2.9%
MSCI EAFE ($Cdn)	-0.5%	8.0%	10.8%	0.7%	0.8%	-0.7%	-7.2%
MSCI World ($Cdn)	-2.4%	3.8%	7.0%	-1.1%	1.0%	-0.2%	-5.1%