STEADYHAND
INVESTMENT FUNDS

Collected Wisdoms of Tom Bradley

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I'll be Happy With 10% a Year

Excerpt from Tom Bradley's blog on November 8, 2007

I don't know what the market is going to do in the coming months.

I do know we will have weak markets at some point (and I suspect they could be quite messy given the extremes we are now experiencing in the currency, commodity and credit markets).

I also know that investors will not be ready when the downturn comes.

Chris and I are spending lots of time these days talking to clients and prospective clients. What is clear to me is that investors are getting used to positive returns quarter after quarter. Consequently, my hunch is that they will not be psychologically ready when the tide turns. A few down quarters will be quite a jolt.

With the good returns of the recent past, investors have also raised their expectations for future returns. The number I hear most often is 10%. "I'll be happy with 10% a year...my retirement plan works if I can just get 10% in the future."

If we pause for a minute, it is interesting to think about what a portfolio needs to look like to generate 10% annually over the next five years. If we assume that current interest rates of 4.5% are a good proxy for future bond returns, then a 10% target points the investor towards an equity portfolio...100% equities.

For an investor with a long time horizon, an all-equity portfolio makes total sense. In many cases, however, the 10% expectation also comes with the words "and I can't afford to have my portfolio go down...this money is too important to me." In reality, for investors who can't risk having a negative return, expectations should be in the 5-7% range.

I'm writing this blog as a 'kick in the butt' for myself more than a thought provoking piece for our readers. We want to bring new investors to Steadyhand, but we've got to be more direct in discussing return expectations with people...both the magnitude and pattern. Aiming for returns that are well in excess of bond yields will require an equity portfolio and all that comes along with it - big years, bad years, short-term volatility.

Two

We Know They're Mistakes, So Why Keep Making Them?

The Globe and Mail, Report on Business
Published September 29, 2007

"Wisdom comes from sitting on your ass."

According to Warren Buffett's sidekick, Charlie Munger, it's the best road to effective thinking.

For the last six weeks I've been laid up while recuperating from surgery (a friend noted that I'd picked a great time in the market to be "seriously sedated"), so I've been able to put Charlie's thesis to the test. I've spent considerable time sitting on my ass, or should I say, doing some deep, reflective thinking.

As I read and think and read and think, there is one question that has been rattling around in my head. Why is it that investors, both amateur and professional, keep making the same mistakes year after year and cycle after cycle?

The mistakes I'm referring to are not the small, micro decisions (for example, Telus v. Bell, Chou v. Brandes), but the big, incontrovertible stuff.

We chase past performance. Everyone does it to some degree, even the most savvy of investors. We take comfort in recent success. Money managers that are at the top of the charts for one-to-three-year performance look smarter than their competition. We want to invest with the best, so we gravitate towards these managers. Rarely do we take our research a step further to assess whether their record is sustainable or their approach makes sense for the years ahead.

We think it is possible to reliably forecast what the future will bring. This perpetual mistake manifests itself in two ways.

First of all, we think there are people or firms out there who have it all figured out. We believe the Jeff Rubins and Eric Sprotts of the world know what interest rates, commodity prices or the stock market are going to do next.

And second, we delude ourselves into thinking that we are good at forecasting the future.

In reality, the record is poor for both the experts and at-home investors. Given the complexity of the world around us, nobody can reliably predict where the capital markets will be a year or two from now. And we are all prone to basing our predictions too heavily on what is happening today.

We expect high returns without taking any risk. The industry's marketing machine is largely responsible for this mistake. We are constantly barraged with advertisements telling us we can achieve attractive returns with little or no risk. Even if we know deep down that higher returns can only come from taking risk and experiencing more volatility, we get worn down to thinking there is a better way.

From my experience, the biggest mistakes are made when pursuing supposed "high return/low risk" investments.

We are ill-prepared for the down drafts. We don't know when the next Black Monday, Asian crisis or credit crunch will come, but we know for sure that it will. It will occur some time between tomorrow and five years from now. Unfortunately, when it does arrive we'll be like a deer in the headlights, acting fearful (hesitant) when we should be greedy (aggressive).

This mistake is unfortunate because investors who are still building their portfolio (as opposed to drawing on it) should be jumping out of their shoes with excitement when markets are down and people are running for the hills. Stocks, bonds and mutual funds are on sale. What could be better than buying a really good fund, that has an experienced, long-standing manager, when its unit value is down? It's a beautiful thing.

We overdiversify our portfolios. We identify a fund manager or a few individual stocks that we really like, and then we proceed to dilute their impact by adding a bunch of other securities that we don't feel nearly as strongly about. Fund managers do this when they hold too many stocks and their portfolios start to reflect the index they're competing against. Individuals do it by stuffing too many investment products in their account. In identifying this as a mistake, I'm not suggesting that diversification isn't a valuable investment tool, but we go well beyond what is required to achieve the benefit.

And the final one I'll mention is a biggie. We evaluate long-term investments based on their short-term results. We buy for the right reasons, but aren't patient enough to let the scenario play out. This happens with stocks and mutual funds. In both cases, management might be making all the right moves, but the strategy is taking time to gain traction. By the time the payday comes, however, we have sold the stock or redeemed the fund.

Why do investors keep making the same mistakes over and over again? I don't know yet. I haven't been sitting on my ass long enough.

Three

Bigger Isn't Better, So Give Some Love to the Little Guys

The Globe and Mail, Report on Business
Published September 15, 2007

If you've been a regular reader of this column, you know that I sometimes write about things that are driving my wife crazy. When Lori gets on a rant about something and wants me to write about it, there's only one way to make it go away. Write about it.

Her current rant is aimed at this very section of The Globe and Mail. Every Saturday in the statistics section of Report on Business, the performance of the 180 largest mutual funds is prominently reported. Given her considerable investment of time and money in starting a new mutual fund company, she is frustrated to see the business media's rote support of the industry's big boys. "It's hard enough to start up a new fund firm, without the media reinforcing the status quo." Words like "oligopoly" and "hegemony" punctuate her diatribes.

Of course, Lori's rants and this column are more than a little self-serving, but that doesn't negate the point. There are lots of people that feel the mutual fund industry has not served investors well. Fees are generally too high, funds are too index oriented, managers are changing horses constantly and fund firms focus on what's easiest to sell (past performance) rather than what clients need. On the flip side, there is plenty of evidence, including studies by academics and independent consultants, indicating that in general, small funds perform better than large funds.

In light of this fact, investors would be well served to know more about funds offered by firms like ABC Funds, Chou Associates Management, GBC Asset Management, Leith Wheeler Investment Counsel, Mawer Investment Management and my firm, Steadyhand Investment Funds. It's fair to say that few if any of these firms will show up in the top 180 any time soon, while the banks and megafund companies will always have multiple listings.

There are some compelling reasons for investors to look at smaller asset managers.

First and foremost, small managers have the freedom to go anywhere in their pursuit of value. Because they're small, they don't have liquidity constraints that the big funds have. If they want, they can make a small or medium-sized company a significant holding in the fund. An example of this is the Leith Wheeler Canadian Equity Fund, which has a 4-per-cent position in Toromont Industries Ltd., a Canadian industrial company. If a manager of a huge fund liked the Toromont story and wanted to put the stock in its funds, it would have to be a much smaller position (i.e. 1 per cent or less). As a result, the impact of Toromont on the megafund's performance would be minimal.

In most cases, when you buy a fund managed by a smaller firm, your money is being managed by the founder or founders. The firm's most talented money makers are focused on investing and are the ones making the buy, hold and sell decisions. If you buy a Chou fund, for example, you can be assured that Francis Chou is pulling the trigger. Now, I admit to having a bias here. I firmly believe it is people that make money for investors, not global research teams, risk management systems and/or a rigid decision-making processes.

Related to the founder's involvement, the investor can also be assured that there is a close alignment between their interests and the interests of the fund manager. Invariably in small firms, the managers have a vast majority of their net worth invested in the fund.

This close alignment makes smaller-sized mutual funds very appropriate for individual investors. With a large stake in the fund, the managers don't want to lose money any more than other unitholders do, so they are less likely to be complacent about risk or add a security to the fund that they don't want to own themselves. In the end, that translates into better performance in down markets and higher long-term returns.

It's also important to note that the fees charged by the small fund firms tend to be considerably lower than the megafunds, although this is not always the case.

In singing the praises of the smaller asset managers, I am not suggesting that large firms can't have some of these traits and aren't able to provide excellent returns. It can be done and some have the record to prove it. But William Bernstein, the financial theorist and author of The Intelligent Asset Allocator, captured the challenges facing large investment firms when he offered this rather blunt assessment in a recent publication: "Money managers at large investment companies, banks and insurance companies, [who are] too focused on next quarter's bottom line and next year's bonus, gradually disengage from the slow methodical development of their skills. Add a soupcon of fear of failing unconventionally, stir in a large dollop of groupthink, cook slowly for several years, and competence eventually simmers off."

I don't expect that my editors are going to start featuring the 180 smallest mutual funds in the Saturday Report on Business, but if nothing else, this column has accomplished one thing - it's cooled Lori off for a while.

Four

Private Equity II - Jeremy Grantham's Buyer's Guide

Excerpt from Tom Bradley's blog on July 31, 2007

I've admitted before that I am a Jeremy Grantham junky. He's not ahead of Steve Nash or Lucinda Williams, but he's in the running. He's often accused of being perpetually bearish, as am I, but both of us are able to crank it up when opportunities arise. Certainly, his firm, GMO, has had spectacular returns over the years.

As part of his July letter, Grantham offers a buyer's guide, or perhaps it's more of a reality check, for those looking to invest with a private equity firm. The piece is not aimed at the typical client of Steadyhand, but there are useful lessons that can be applied in a broader context and be useful for all buyers of investment management services.

So as a follow-up to my July 21st Globe & Mail column (Will Going Public Kill Private Equity?) here are a few things that I took away from Grantham's commentary.

- He surmises that with the flood of people getting into the game, the exceptional private equity firms now make up at best 10% of the business. Ten years ago, it was 20-25%.

- Unfortunately, the average practitioners (and worse) have the same fee schedule as the elite 10%.

- If an investor hires a private equity manager, he/she is being forced to pay a steep fee on all elements of the fund's return, each of which has a different amount of added value. For example, the 2 and 20% fee is applied to (1) the manager's added value (great - send it in); (2) the normal market return during the term of the fund (which is available through an ETF at a fee of 0.25%); and (3) the leverage applied to the portfolio (for which you are taking the risk). *TB: If we disaggregate the components of a balanced mutual fund, a mutual fund wrap (which are hugely popular right now) or principal-protected note, the same situation exists. Investors are paying a high fee on the whole product, despite the fact that only a small portion of it deserves that level of fee.*

- The premium prices private equity firms are now paying to acquire assets offsets any added value the manager can provide from improving operating efficiency, focusing the company on its strengths and/or fixing the capital structure.

- Grantham notes that it is now assumed that increasing a company's leverage increases its value. Disappeared is the 'age old paradigm' (my words) whereby the value of leverage is offset by increased risk. To quote Grantham - "[This] is a new idea in this cycle - [whereby] leverage is a free good not burdened by increased risk."

- As opposed to a perfect storm, Grantham suggests that private equity has had the "perfect calm" as a result of easy credit, low risk premiums, rising profit margins and high price-earnings multiples. In the perfect calm, all funds do well (not just the best ones) and a lot of the industry's sins are covered up. *TB: I would add that this applies to all kinds of asset classes including hedge funds and good ole mutual funds.*

- He thinks that few managers are assuming in their models that (1) profit margins will drop below the current record levels or (2) price-earning multiples might decline. *TB: Profit growth and healthy valuations are taken for granted. But if both these factors reverse direction, look out.*

Private equity provides the most illuminating canvas for Grantham's comments, but when it comes to management dilution, fees, corporate profits and the perfect calm, they apply to all types of equity investing.

Five

Small Investors Can Also Benefit From the Buffett Doctrine

The Globe and Mail, Report on Business
Published July 7, 2007

Avner Mandelman's column in this space last Saturday featured the investment philosophy of Warren Buffett. If you've been reading this column or my blog, it's obvious that I also follow Mr. Buffett (at 76 years of age, he still has it).

Whether you're in the investment business or not, his healthy dose of common sense and "tell it like is" makes for good reading.

The investment management industry is full of worshippers of Mr. Buffett and there is always a contingent of Bay Streeters that go to Omaha for the annual pilgrimage. I've only done it once, but I found it to be a mind-blower. I'd never have thought I could sit in an arena with 16,000 other people and listen to two senior citizens answer questions for five hours (Charlie Munger, Mr. Buffett's sidekick, is 83). I found it captivating. Go figure.

What I find just as mind blowing is the fact that so few investment professionals actually apply any of the common sense of Mr. Buffett and Mr. Munger. I don't mean to imply that everyone should pick stocks on the same basis, but the dynamic duo live by some principles that apply to all types of investing.

To understand why more investment professionals don't follow these principles, put yourself in their shoes for a day.

Imagine it's the Monday morning after your sojourn to the Berkshire Hathaway annual meeting. You have taken copious notes and have come home with some ideas on how you might change your fund. By the time you arrive at the office, however, you've read two or three newspapers and your head is full of current news. As soon as you settle in at your desk, the phone starts ringing with the story of the day. At 9, you meet with the rest of the investment team to talk strategy. Many of them haven't read the Berkshire Hathaway annual report and think the world has passed Mr. Buffett and Mr. Munger by.

Later in the morning the head of sales drops by to talk about why your fund is seriously lagging the index so far this year. As you head to a luncheon meeting, the words "career risk" are rattling around in your head and you're wondering why you just bought an enormous house. By the time you get home to have a late dinner with the family, the weekend in Omaha is a distant memory.

If the professionals have too many short-term pressures to pursue the wisdom of Mr. Buffett and Mr. Munger, what about the individual investor? With a little translation, I think their basic principles are absolutely applicable.

Keep it simple. This has always been a hallmark of Mr. Buffett's approach. For long-term investors, sticking to a simple package is very important. That way, you keep costs down and can easily assess how you're doing. A well-constructed mutual fund is a far better choice than a structured product that is too complicated to understand, has a high fee and an inappropriate time frame (three to seven years).

Stay with your competence. While this applies to Mr. Buffett and Mr. Munger, who have thousands of stocks around the world to choose from, it also applies to individual investors and advisers.

You have a gazillion stocks, mutual funds, structured products and banking products at your disposal.

No matter which ones you choose, you should always understand what you're investing in.

In the same vein, if you have an edge in a particular industry, you may want to use that knowledge to buy individual securities.

Diversification. Mr. Buffett and Mr. Munger both prefer to count their stock holdings on one hand. Mr. Buffett points out that "wide diversification is only required when investors do not understand what they're doing."

In the context of a mutual fund portfolio, investors should be cognizant of how many stocks they own. You likely own hundreds or even thousands of stocks (Yikes!) through your various holdings. If you believe in active management, as we do at Steadyhand, then you have to limit your fund holdings while still being diversified.

Uncertainty is your friend. As perverse as this sounds, if you are still building your wealth (i.e. contributing to your portfolio as opposed to withdrawing), then you should be smiling when everyone is complaining about a lousy market. Why? Because stocks are on sale. You can buy more shares of Suncor, Shoppers Drug Mart or Cisco for the same amount of money. Bull markets, on the other hand, make you feel good about your portfolio, but your additional purchases are done at full retail price.

The power of compounding. To quote Mr. Buffett, "it's not necessary to do extraordinary things to get extraordinary results." If investors keep their costs down and let the power of compounding work for them, they are usually amazed at the results. For example, if you invest $100,000 in your RRSP and achieve an 8-per-cent return (net of fees and commissions), your account will have $466,096 in it after 20 years.

Market timing and trading. "Wall Street makes its money on activity. You make your money on inactivity." No translation required.

Six

Become Your Own Hedge Fund Manager. Buy a Home

Excerpt from Tom Bradley's blog on June 21, 2007

My wife tells me I can be a real downer at parties. There are lots of reasons why she says that, but one is that I just can't help myself when people start telling me how well they've done on their real estate purchases. I'm probably just bitter because we haven't done as well, but in any case, I always feel obliged to point out that if they had invested the money in a diversified portfolio of financial assets, the returns would have been even better.

Lately, I've been trying to improve my party etiquette, however. That's partly because we should all keep working at this marriage thing, and partly because I've been wrong all these years. Well actually, I haven't been wrong "technically." If you compare the stock market indices to the house price indices over long periods of time, it would appear that I can keep being a downer for many years to come. But in reality, I've been very wrong.

The reason: leverage. Using the house price index in the comparison is not reflective of what homeowners' experience has been. Through the wonders of leverage in a rising market, homeowners have done much better.

Consider a simple example. Let's say you buy a house for $200,000 and put a $150,000 mortgage on it. If the house appreciates 50% in value to $300,000, your $50,000 of equity has tripled to $150,000. That's because you get to keep all the gain while the bank doesn't participate at all - it just gets its money back.

This simple math leads me to the point of this posting. If you think about it, home ownership is the closest many of us will get to being a hedge fund manager, or even investing in a hedge fund. Without knowing it, we are pursuing one of the most common strategies pursued by hedge funds. We are borrowing 'short' to buy a 'long-term' asset. Mortgages of one to five years certainly qualify as short-term borrowing. The house, on the other hand, is a long-term asset: it is not easily tradable and the magnitude of price changes can be dramatic. So like a hedge fund, we win big when the market for our long-term asset is going up. And it has been a good market for all long-term assets since 1981 when interest rates peaked and started their inexorable decline over the next twenty-five years.

The reason the capital markets, and guys like me, are so worried about a housing decline in the U.S. is that leverage works the other way as well. Equity can also disappear quickly if there's a big mortgage on the home.

Very few individual investors have the money or connections to participate in hedge funds. It's a game for people or organizations with big money and lots of resources. But through home ownership, we are all behaving like a typical hedge fund. The financial leverage that allows us to buy the house also has the effect of amping up, or down, our returns on the investment.

So the next time you want to impress someone at a party, don't follow my strategy. Instead, break the ice by telling them that you're running your own hedge fund. Even better, tell them you're living in it.

Seven

Knowing When to Sell is Key to Smart Investing

The Globe and Mail, Report on Business
Published June 9, 2007

One of the reasons I've recently focused my career on the individual investor, after years of working with pension clients, is because there is a huge disconnect between their understanding of what investing is all about and what the reality is.

Even well-educated investors often have unrealistic expectations. Their time frame is too short and they think their fund manager can be at the top of the standings year after year.

Given that my partners and I recently started a new mutual fund company, you may be surprised by the question I've chosen to illustrate the gap between expectations and reality: When should you sell a poor-performing fund? It's not something that fund company executives, such as myself, typically want to talk about. But I encourage investors to assess our funds, and any others, using the criteria presented here.

Before we get to the sell criteria, however, let's try to understand why a fund might be lagging. It might happen for good reasons (hold the fund or buy more) and bad reasons (sell).

On the good side, a fund may be underperforming because its purpose doesn't call for it to do otherwise. Many funds have a specific objective or specialty - steady income, low volatility, exposure to a specific industry sector or asset class - that often leave them out of synch with the overall markets.

At times they might be shooting the lights out in their specific niche, but performing poorly against the market.

Too many investors think that their fund managers have it all figured out, but they don't. Take it from an insider - the investment world is far too complex for that. At best, managers make well-researched decisions based on what they think will happen. Call them educated guesses. If they get it right 60% of the time, they're probably a superstar.

It's like basketball in this regard. Even Steve Nash misses roughly half his shots. And he can look down right bad some nights, which leads to my point here. Like athletes, fund managers have slumps.

Insiders also know that portfolios can get stale. Stocks that have done well in the recent past and carried the portfolio to the top of the standings get fully priced, or over priced. As much as the manager might try to reduce the fund's reliance on these stocks, the reality is that it takes time and guts to do. It's hard to the sell stocks that have put a halo around your head.

Now, let's get back to the question at hand. When do you sell?

First of all, there are some bad reasons for selling. You shouldn't sell a fund solely because it hasn't done well in the past couple of years and you want something that is doing better. This is called performance chasing and it is the surest route to disappointing returns.

Related to my earlier comments, a fund that is delivering on its specialized mandate shouldn't be sold unless you no longer require that type of investment. Nor should you sell a fund that is going through a tough patch if it still has a good long-term record and the manager and investment approach hasn't changed.

But there are a number of factors that should cause you to sell.

If the medium to long-term returns are poor despite a favourable environment for the fund, it's time to act. An example of this would be a value-oriented equity fund that performed poorly in the weak markets of 2001 to 2003.

You should consider selling if the fund manager (i.e. the one pulling the trigger) has changed. This happens more than fund companies like to admit. In general, if there's a lot of turnover on the investment team, it's not a good sign. You end up in a situation where the people that established the philosophy and built the long-term record aren't there.

One of the most reliable sell signals is when a fund, and/or manager of the fund, gets really big. It's perverse, but in the investment management industry, too much success is a bad thing. In the Canadian market particularly, there is a profound difference between managing hundreds of millions and multibillions.

You should always be wary when the mandate and/or name of a fund changes. It is often a sign of desperation and lack of stability. With a change, the fund company may be trying to catch on to a current trend or is just hoping to solve a nagging problem. In recent months, quite a few funds altered their focus and added the words "dividend" or "dividend income" to their name.

Finally, if the fee is too high, you have the best reason to sell.

Eight

What "Unconstrained" Means

Excerpt from Tom Bradley's blog on June 6, 2007

Steadyhand has a very definite investment philosophy. We believe our funds should be (1) absolute-return oriented; (2) concentrated on the managers' best ideas; (3) unconstrained; and (4) have low turnover (i.e. tax efficient).

The least understood of these four tenets is the notion of being "unconstrained." What do we mean by that?

At its most basic, we mean that our fund managers should have the freedom to go wherever they find the most attractive opportunities. Too often managers are constrained by diversification rules ("don't stray too far from the index!!!") or style guidelines. On the latter point, the industry consultants like to put funds into nice tidy boxes. When a fund has been categorized as growth versus value, or small cap versus large cap, or domestic versus foreign, the box becomes the sand box the manager plays in.

At Steadyhand, we want our managers to have a very big sandbox to play in. We are style agnostic. While the consultants are trying to categorize our funds, we want our managers focusing on making our clients money.

We're not suggesting that Steadyhand's managers have no constraints on them. In laying out the mandates for the funds, we've ensured that our managers are being responsible as to diversification and are in the sweetspot of their investment skills. When we started our manager search, we had a view as to what our funds should look like. But ultimately, we fine-tuned the mandates to fit the managers' strengths.

What does "unconstrained" mean to Steadyhand clients?

- It means that our Global Equity Fund is allowed to invest anywhere in the world, including Canada. If Edinburgh Partners finds something in our market that is attractive in the global context, we want them to own it.
- It means that our Equity and Global Equity funds have the scope to own large and small cap stocks. It means that Wil Wutherich, our small-cap manager, can buy anything from micro-cap (i.e. I've never heard of them) to mid-cap stocks.
- It means not worrying about whether more than one of our equity funds owns the same stock. Currently, we have two funds that own HSBC, Nokia and Shoppers Drug Mart. If more than one of our managers thinks a stock is a great value, then we're happy to see our clients own more of it. Having said that, there's typically not a lot of overlap between our funds' holdings.
- It means not worrying about the index weighting of a particular stock or industry sector. All of our equity managers invest in stocks or sectors where they see the best opportunities. The terms "underweight" and "overweight" are irrelevant in the investment process.
- It means allowing our fixed income manager to have almost all the Income Fund's bonds in corporate issues if valuations are attractive, or virtually none in corporates if valuations are poor. They also are free to make the call as to whether bonds or income-oriented equities have the best reward/risk characteristics.

As with many aspects of Steadyhand, we've tried to make sure that industry norms are not dictating what is best for our clients. We don't have a high enough regard for the mutual fund industry in general to be locked into its standard practices.

Our investment philosophy is the most important part of what we do. Keeping our fund managers as unconstrained as possible is an important element of that philosophy.

Nine

Structured Products - Warning Flags

Excerpt from Tom Bradley's blog on May 23, 2007

Over the last few weeks, a couple of warning flags have popped up that reminded me that with closed-end funds and structured products, it's "buyer beware".

The first flag was an announcement that Sceptre Investment Counsel was merging its two income trust funds (closed-end) into one and converting it into a mutual fund. There's nothing wrong with this change (indeed, the unitholders will benefit), but it is an example of the massive amount of restructuring going on in the closed-end fund world.

The restructuring, some of which comes within a year or two of the product's initial offering, tells me that the products were either improperly structured or were designed strictly to capture a short-term trend. Buyer beware!

The second flag came from reading a monthly update from a Canadian hedge fund manager this week. This manager has a specific strategy aimed at taking advantage of the discount that structured product holders must accept if they want to sell between redemption periods. In simple terms, the hedge fund buys the units at a discount to net asset value (NAV) and then holds the units until the redemption date when they're entitled to redeem at full NAV. They likely hedge the purchase in some way and importantly, they lever it up to make the return more attractive.

The fact that hedge fund managers are profiting off of the individual investor tells me that many of these structured products are not designed very efficiently. They're already feeding lots of mouths - investment bankers, securities lawyers, and financial advisors - and now we can add another - the clients of hedge fund managers. Buyer beware!

As I said in a recent Globe and Mail column, closed-end funds are suitable for some types of investments: when there is a high expertise quotient; when leverage is used as part of the investment strategy; when the fund invests in illiquid assets that are inappropriate for an open-end fund; and/or when the fund is amenable to a split share structure. But the concept has been overused. Before investors buy a structured product or a closed-end fund, they should assess whether the structure makes sense for the asset class or investment strategy. In many cases it doesn't, it's just a low risk way for the product sponsor to sell the units and build an asset base.

Buyer beware!

Ten

The Argument Against Canada-only Equity Funds

The Globe and Mail, Report on Business
Published April 6, 2007

As we take Steadyhand on the road over the next few weeks, we anticipate that one of the most frequently asked questions we'll face will be: Why don't you have a pure Canadian equity fund? It's certainly a legitimate question. We are a Canadian mutual fund company, after all. When we made the choice to not include a Canada-only equity fund, we expected to get some flack for it.

But we had reasons for making the choice we did. Some were specific to our firm, including the fact that we didn't want a long list of funds in our lineup. A Canadian equity fund would fill a valuable slot that could be used for another fund. Also, we had looked extensively at how high-end wealth management companies managed money for rich people, and they rarely limited their equity managers to Canada only. They usually had the scope to complement their Canadian holdings with foreign stocks.

Beyond our specific reasons, other factors weighed heavily on our decision, and these have an impact on how all investors must think about the Canadian equity market. We felt that the Canadian market was too limiting for our managers. We also didn't think the makeup of the Canadian market was an appropriate starting point to properly diversify a portfolio. Both reasons are related, but I'll tackle them one at a time.

If you are a portfolio manager charged with managing a large Canadian equity fund, your choices are limited. Of the top 10 stocks on the S&P/TSX Composite Index, seven are financial services companies and three are oil and gas producers. Of the top 25, you get a few other types of companies, but it's still pretty limited. In that 25 there's only one technology company (Research in Motion) and no health care, consumer product, retailing or manufacturing companies.

The full impact of the narrowness of our equity market has not been fully felt yet because the sectors that make up virtually the whole market - financial services, energy and mining - have been performing exceptionally well.

But if you do some what-if scenarios, it gets downright scary. What if energy and/or mining go out of favour for a few years? What if we lose Shaw or Ma Bell to further consolidation in the telecommunications industry? Or RIM gets swallowed up by Nokia? If Canadian equity portfolio managers want to reduce or eliminate their fund's holdings in energy, mining or banks, where do they go?

Personally, I don't want our talented portfolio managers forced to hold stocks that don't meet their criteria because they have to stay in the Canadian market.

Ask yourself the question - would my manager be dabbling in Nortel if he or she could be buying Cisco or Intel or Nokia? Perhaps if he or she were a deep value manager in search of broken companies, but for a mainstream Canadian portfolio manager, it's a bit of a stretch. If your equity manager weren't limited to Canadian stocks, would he or she be considering Biovail or MDS to gain exposure to the enormous and growing health care industry? I think not.

The limited opportunities in the Canadian market relate to the second reason we decided not to have a Canadian equity fund. The shape of the Canadian market, as determined by the market capitalization of our public companies, is not a proper basis for portfolio diversification.

As noted above, our market is dominated by a few industries where Canada has a competitive advantage. But our overall economy doesn't reflect that industry mix, nor should our portfolio managers' choices.

In other words, the shape of the S&P/TSX Composite Index is not a proper basis for diversification. In Canada, that will always be the case, but right now the market index is particularly distorted and therefore of limited use.

Looking back, the Canadian stock market has gone through an unusually prosperous time in the past few years. The commodity markets have been as hot as a cheap pistol and our currency has risen significantly against the U.S. dollar. Looking forward, however, investors have to structure their portfolio based on what makes sense. I don't think the foundation of an equity portfolio should be a distorted market with limited choices.

Eleven

Mutual Fund Wraps — Right Product; Wrong Fee Structure

Excerpt from Tom Bradley's blog on April 2, 2007

There is plenty of ink devoted to mutual fund wraps these days. Wraps are investment products that package a number of mutual funds together to provide individuals with one simple solution to their investment needs. Firms that sell these products typically have a number of versions so investors can find the one that fits their particular situation.

The banks all offer wraps. And a lot of the big fund firms and mutual fund distributors have their own versions.

The point of this posting isn't to review the positive features of wraps (diversification, professional oversight, regular re-balancing) or the negatives (high fees, over-diversification).

Rather, as I've been reading more about wraps, it struck me as odd that investors are paying their advisors or brokers on-going fees for advice on these products. It's odd because after the initial purchase is made, there is often nothing for the advisor to do. The wraps are built so that everything is taken care of - the money managers are monitored by a professional firm like Russell or SEI and re-balancing is done automatically. The advisor couldn't do anything even if he or she wanted to.

It is only when an investor's objectives or needs change that the advisor is required to step in and recommend an asset mix change. Personal circumstances change over time, but the advisor shouldn't be called upon too often to help make a change.

And yet, wraps are priced such that the advisor receives a trailer fee every year, as long as their client stays invested.

Mutual fund wraps are terrific products for advisors who want to focus their time and energy on building their business (and not managing their clients' money). They can be assured that their client is in good hands, they receive an on-going servicing fee (trailer) and they have little or nothing to do after the client signed up.

For investors, however, the fee structure makes a lot less sense. The fee they're paying reflects on-going advice from their advisor, but with a wrap, they don't really need it. It seems to me that wraps are products that are well suited to a one-time commission or advice fee at time of purchase.

Investors with the time and experience would be well advised to build their own wrap (you can even give it a creative name) using individual funds and ETFs (exchange-traded funds). By doing that, they can save between 0.5% and 1.5% in fees per year. That is a meaningful amount.

Twelve

When a Trend Reverses, the Slide Won't be Painless or Short

The Globe and Mail, Report on Business
Published March 23, 2007

In the investment industry, I'm what people call a "bottom-up" guy. That means I get my jollies from finding undervalued businesses to invest in, rather than predicting what the market or a particular industry sector will do over the next year. That stock-picker mentality is reflected in how I manage my family's money as well as who I've selected to manage Steadyhand's mutual funds.

Having said that, I've always enjoyed being a student of business and market cycles. I'm not referring to the little squiggles we experience in the market we experience month to month, but the longer-running trends that have a profound impact on market returns. I'm talking about the forest, not the trees.

As a student, I haven't developed any tools that allow me to predict the beginning or end of a long-running trend, although I have learned that nobody else has any either. There is one rule I do live by, however, and that is if a cycle has gone on for a long time and has reached extreme levels, the retrenchment period will also take time and be extreme in the other direction. Investors too often expect a short, harmless pause before the good times roll again. They are usually disappointed.

To put this in context, let's look at the U.S. housing cycle. It's pretty clear that the up-cycle is over, so it's fair to ask whether the worst of the downturn is behind us, or just getting started?

Based on my simple rule, I think we're closer to the first inning than the ninth.

The up part of the U.S. housing cycle was fueled by a number of positive factors acting in unison. These tailwinds included declining interest rates, unprecedented availability of credit, robust job growth, positive demographic and immigration trends, and a general sentiment that "if I don't get in now, I'll never get in." As with all great cycles, there was a mixture of cyclical factors (i.e. interest rates, job growth) and secular factors (demographics and immigration) at work.

I believe that we're still in the early days because not all of these factors have turned negative yet. Certainly mortgage rates have gone up a little, although they are still relatively low. Sources of credit have dried up (just try getting a high-risk mortgage today), which is negatively affecting housing demand. And while I'm not a demographic expert, I've got to think that the percentage of Americans that own a home, which is at an all-time high, has more chance of going down than up. On the other hand, the job situation in the U.S. is holding up well. Indeed, this down-cycle took hold while the U.S. economy was reasonably strong. If Americans start losing their jobs, or are worried they might, things could get a lot worse.

There are other factors that point to a prolonged retrenchment. As with most long-running cycles, excesses have built up, some of which will take time to unravel. In the past few years, speculators have become a big part of the mix. With little prospect of price appreciation, these players are moving from the demand side of the equation to the supply side.

Further, the use of more exotic mortgages has become commonplace in the past few years. According to CIBC World Markets Inc., interest-only mortgages in the U.S. made up 20% of all new mortgages in 2006. And half of those were variable-rate mortgages. In general, subprime mortgages accounted for 22% of originations in 2006. In Canada, where we have very little in the way of unconventional mortgage financing, these numbers are mind boggling.

Earlier I touched on the buyers' attitude. Generally before the next up-cycle begins, we need to see a sentiment change such that buyers and investors want nothing to do with the sector. Sentiment is changing pretty fast right now, but we've got a long way to go on this measure.

In a long-running cycle everyone lines up in the same direction and conventional wisdom starts to reflect a continuation of current trends. That doesn't sound so bad, but it creates problems when people riding the trend don't know why they're doing it, other than the fact that everyone else is making a lot of money at it. When the cycle turns, these trend chasers end up bailing out as indiscriminately as they bought in.

The point here is that when a powerful trend turns in the opposite direction, the downturn won't be painless and it won't end in a matter of months. U.S. housing is under the microscope today. At some point, we'll be trying to determine how long the downturn will be for other supercycles, including commodities like copper and oil, the Chinese economy and trends like private equity.

Thirteen

RRSP Nightmare: Too Many Funds in Your Basket

The Globe and Mail, Report on Business
Published February 9, 2007

We were driving to Whistler last weekend and out of the blue my wife Lori said "it's RSP season and you still haven't written that column". It took me a minute to clue in, but what she was referring to was a piece she wanted me to write about a Financial Facelift column we'd seen last summer in the Globe and Mail (August 12th).

Lori got really worked up about this particular column because she just couldn't believe that someone could get themselves into the situation the Canmore couple found themselves in. The featured couple had registered retirement savings plans totaling $170,000 that were spread across 29 mutual funds. "Twenty-nine funds. How does that happen? What were they thinking? Where was their advisor through all of this? Tom, when are you going to do a column about this?"

Because I didn't have any other brilliant ideas for a column this week and do value my marriage, I thought I'd give it a go.

Holding 29 funds is ridiculous whether you're investing $170,000 or a million dollars. It demonstrates that you don't have a financial plan. There's no focus and certainly no commitment to the funds you own. If you're not willing to add money to a core group of funds (5-10), then why do you own them?

Owning this many funds also makes it difficult to figure out what your asset mix is. It becomes a major project every time you want to figure out whether you're still on plan.

But more than anything, owning 29 mutual funds means you're seriously overdiversified. A little math would be useful here. Let's assume that 20 of the 29 funds are equity funds and on average these funds own 60 stocks. We have to assume that there are lots of stocks that are owned by more than one fund. In the case of Canadian equity funds, the overlap may be as high as 60-70% between some funds. Indeed, it is conceivable that you own Royal Bank or Manulife in 10 to 15 funds.

If we assume that there were 45 unique stocks per fund, that's 900 stocks plus the ones that showed up in multiple funds. Let's say you own 1000 stocks. What you really own is a very expensive index fund.

Through exchange-traded funds (ETFs) you could get the same market exposure for an average fee of 0.25 to 0.30 per cent a year on their management expense ratios. I hazard a guess that the couple in the article were paying in the neighbourhood of 2.5 per cent. It is no wonder they were disappointed with their mutual fund returns.

How does this happen? I don't really know, but I imagine it is a combination of things.

Each RRSP season has its own themes. While foreign funds are the dominant sellers one year, it could be tech funds the next and clone, income trust or lifecycle funds in other years. If you are prone to chasing past performance and your advisor is inclined to take the easy road (that is, give you the current best seller), you could easily add two to five new funds a year.

Where was the advisor through all of this? Clearly, he or she never said, "XYZ fund has been out of favour for a while and I think you should put more money in it this year. Think of it as being on sale." While the Canmore couple continued to add funds, they weren't willing to sell any on the other side because of the redemption fees they would incur.

In general, I believe that patient, long-term investors don't need a lot of advice. It is more important that you keep your costs down. Occasional advice and low fees is a great combination. Having said that, I recognize that some people are in need of more help and that costs money. Unfortunately, this couple was getting the worst of both worlds. They were paying for advice they desperately needed, but they weren't getting it.

The Financial Facelift article that got Lori so worked up is obviously an extreme case, but over-diversification is definitely an issue for many mutual fund investors. In actual fact, holding even half the number of funds this couple owned could still result in an overdiversified portfolio, depending on what kind of funds they were.

If you haven't made a contribution to your RRSP for 2006, or even better, are contemplating what to do for 2007, I'd look first at the funds listed on your quarterly statement. If there was a good reason to buy a fund in the first place and those reasons haven't changed, then you might ignore the "flavours of the month" and show commitment to what you already hold.

And if the one you choose hasn't been doing well in the last year or two, all the better.

Fourteen

Don't be Afraid of Market Risk; It Can Lead to a Better Retirement

The Globe and Mail, Report on Business
Published December 1, 2006

I was talking to a friend last weekend about our new mutual fund company. After I took him through the fund lineup, he asked me what our hedging strategy would be. I thought he was referring to currency hedging, but he wasn't. He was asking whether we were going to eliminate, or hedge away, the market risk from our equity funds. My answer came very quickly, but let me keep you in suspense for a moment while I provide some context.

Despite the robust markets we've been experiencing, protection against downside risk still seems to be front and center in investors' minds. That's evident when you see how much ink and money hedge funds are receiving, even though their fees are high and overall returns have been modest. Closer to home, evidence of this focus on downside risk is demonstrated by the immense popularity of principal-protected notes (PPNs). PPNs reduce long-term returns in exchange for the comfort of knowing that the saver (I can't bring myself to call PPNs investment products) is protected from a highly unlikely occurrence (negative market returns over five to seven years). As an aside, if I was the supreme ruler of capital markets (I'm available if anyone should ask), I wouldn't let anyone under 60 years of age buy a product with principal protection. But that's for another column.

"Risk/reward" is a business term that has crept into our vernacular. I find myself using it when I'm talking about sports, cards and traffic avoidance. But it's an unfortunate term because I think the two "R" words are in the wrong order. It should be "reward/risk". I know, it doesn't sound right. I've tried to change it, but people just look at me funny when I do.

In any case, reward is not a dirty word. In today's investment dialogue, however, it is a forgotten word. What does reward mean to an investor? It means that if you invest $100,000 in a registered retirement savings plan and it compounds at 8 per cent a year for 20 years, you will have $466,096 in your account. To be sure, you will have experienced some zigs and zags along the way. That compares to strategies that are designed to avoid short-term volatility (the other R word). If they compound at 6 per cent a year, you will have $320,714 after 20 years. The result is less sleepless nights, but less money to spend in retirement.

Now back to my friend. I should tell you that he works in the U.S. and is surrounded by hedge fund managers. In that world, exposure to the overall market, or what we call beta, has become a dirty word. Everyone talks about "market-neutral" strategies. Therefore, it was natural that he would ask if we are going to hedge away the market risk inherent in our equity funds.

So what was my answer? I said, "Hell no! I want the market return." I told him that despite all its ups and downs, over the long haul the market provides the most reliable return available. I don't want to hedge it away. Bring on the beta.

My response may strike you, and my friend, as odd given that "alpha" is the glamour word in the investment world today, not beta. Alpha is a fancy word for added-value, or excess return over and above the market return. It is beta's rich, plugged-in and very cool cousin. It has lots of cachet, while beta has none. Indeed, beta can be bought through any investment dealer and the fee is rock bottom. In Canada, you can exactly replicate the return of the S&P/TSX 60 by buying the iShares XIU units, which have an annual management fee of 17 basis points (A basis point is 1/100th of a percentage point).

But who wouldn't want alpha? The problem with beta's rich cousin is that there is no guarantee that a money manager is going to produce it. Alpha can be positive or negative. No matter how good the money manager, it will come and go. Unfortunately, we all get lazy and after we've thrown the term "alpha" around a few times, it starts to sound like a given. And that's reinforced when we read about the alpha that people like Eric Sprott has produced for investors. We just assume if we buy a hedge fund, the alpha will be there.

But what we don't read about is the managers that failed to deliver —- the anti-Eric's. If your take a look at the Globefund performance standings and go to the Alternative Strategy category, you'll see what I mean. The median return for three years is 7.1 per cent and for five years it's 5.6 per cent. For both time periods, there are a slew of funds with negative returns.

The point of this column is not to trash alternative strategies or discourage investors and money managers from pursuing alpha (Steadyhand will pursue alpha vigorously), but to point out that taking on market risk is not such a bad thing. It will cause pain from time to time, but it is the path to a better retirement.

Fifteen

Principal-protected Notes Give Investors Worst of Both Worlds

The Globe and Mail, Report on Business, Guest Column
Published August 1st, 2006

As I contemplate starting a new investment company, I've had to assess what form it will take. Specifically, I've been trying to decide whether the good ol' mutual fund is still a valid investment vehicle, or is it going the way of the 8-track (fortunately, I was lucky enough to avoid that stage of the audio evolution). As part of that assessment, I've been looking at alternatives and quite frankly I've been overwhelmed.

Individual investors now have a wide array of options as to how they own financial assets. These so-called "structured products" as they are called include principal-protected notes (PPNs), closed-end funds, split shares, WRAP's and separately managed accounts. In essence, investors are buying the same thing - stocks and bonds - but making choices as to how they want them packaged.

In my view, there are very few of these packages that truly make sense for the investor. One of the most popular - and also one of the most abusive - is the principal-protected note. We can't turn anywhere without being offered principal protection, and yet I think this is the most over-rated (and over-used) feature I've seen in many years. To be blunt, it's a consumer rip-off. Here's why.

First of all, most of these products have terms of five to seven years, some even longer. If you go back and look at the market data, there are only a couple of five-year periods where the markets didn't provide a positive return (and when it was negative, it was only modestly so). There has never been a 7 year period when the S&P/TSX Index provided a negative return. What downside are clients protecting themselves against?

Second, these things are very expensive. Owning these notes requires the investor to pay underwriting fees, selling commissions, management fees and insurance premiums (the principal guarantee). In bringing a PPN to market, there are a lot of hungry mouths to feed.

Related to the high cost, it is hard to see how PPNs can provide a higher return than a diversified, fixed income portfolio over the next five, seven or more years. The most likely scenario for equity markets is for single-digit returns, which assumes stocks earn a reasonable risk premium over Government bonds, which currently yield about 4.5%. With a PPN, the packaging costs effectively offset the risk premium.

Fourth, the transparency on PPNs is horrendous. It is very difficult to figure out how exactly they work and virtually impossible to figure out what fees are imbedded in the package.

Fifth, while PPNs have ”potential” to generate a higher return, they also have “potential” to generate a lower return. For an income-oriented investor, they provide no certainty of income.

And finally, principal protection sounds a lot better than it is. If you only get your capital back in seven years, you must remember that inflation will have eroded your purchasing power significantly. In 2013, it will cost $1.19 to buy what costs $1.00 today, assuming a 2.5%-per-cent inflation rate.

I recently came across a National Bank Securities advertisement for the latest offering in their Blue Chip Note series. It's not my intention to victimize the National Bank, but this Euro-Pacific note is a good example of what I'm referring to. It guarantees that you get your investment back in eight years if the stock portfolio (30 well-known international companies) doesn't generate a positive return. If the portfolio is up after eight years, the investor participates fully in the return after netting out the annual 3-per-cent fee.

There is one caveat, however: The bank can redeem the note after four years if the annual return has been above 10 per cent. So if the portfolio was to do well in the first four years, the return is maxed out at 10 per cent.

Effectively, the client is buying an international index fund with a 3-per-cent fee. It could be argued that the eight-year principal guarantee is worth something, but I would suggest that it is more than negated by the performance cap in the first four years.

I think PPNs are a bad compromise. They serve neither equity nor income-oriented investors very well. Equity investors buy stocks to generate higher long-term returns on their portfolio. Higher returns come from taking more risk and being subject to some short-term volatility. If you take the risk out of the product (that is, principal-protection), it follows that you will also take out the excess return. Fixed income investors, on the other hand, buy bonds for the certainty they provide. PPNs provide no such certainty.

PPNs are like the elephant in the room. Everyone in the investment industry knows these products are not good for the client, but they're keeping quiet about it. Why? Because PPNs are big sellers and generate terrific profit margins. Financial executives may ignore the elephant, but investors would be advised to give it a wide berth.

Sixteen

Three Keys to Investment Success

The Globe and Mail, Report on Business
Guest Column April 12 2006

A while back, Ira Gluskin recommended the new Barton Biggs book, Hedge Hogging, in his column. I've enjoyed reading Mr. Biggs since his days at Morgan Stanley and I've never been one to doubt Ira, so I dutifully went on-line and ordered a copy.

Early in the book, Mr. Biggs spends considerable time describing the agony he went through with one of his strategies that wasn't working out. He was bearish on the prospects for oil and was selling the commodity short. This part of the book resonated with me because I too have gone to the short side of that same &#@&*$?* commodity. I sold short a selection of large-capitalization energy firms as a way of reducing the oil exposure I have through my mutual fund holdings.

There are learned arguments on both sides of the oil debate, but I feel that this cycle will play out like any other. High prices will create more investment, demand growth will soften and new technologies (including alternative fuels) will gain market share. I also don't think China's growth will be uninterrupted. A few years ago when oil was in the low teens, it was hard to find arguments as to why oil would ever go up. Now, it is equally hard to find reasons why it will go down.

Like Mr. Biggs, shorting is new to me. I've always been told that it is difficult and requires a different psychological makeup. Indeed, there is a chapter in the book entitled "Short Selling Is Not For Sissies." Also, like Mr. Biggs, my experience has been painful, so far. It has reduced my portfolio returns, but the worst part is having to absorb the body blows inflicted by the daily headlines ("Energy stocks were up again") and my wife's questioning ("How did oil do today?").

On the positive side, it has sharpened my focus on the three keys to being a successful investor - discipline, patience and courage. Whether you are investing in stocks, bonds, mutual funds, real estate, art or antiques, you need a healthy dose of all three attributes to win at the game.

Discipline means sticking to your strategy and not losing sight of your long-term objective. To be disciplined, of course, you have to know what your strategy is, as well as what you're good at and not so good at (shorting oil stocks?). For individuals, the best way to be disciplined is to write down your objectives and time frame, and define your long-term asset mix.

Patience is required to let your strategy play out. In the case of an individual's financial plans, we're talking years, not weeks or months. Investing is a marathon, not a sprint. As the calendar is working for you, you'll invariably have times when your investment strategy isn't performing well, or at least not as well as that of others. Patience is certainly required at those times, but it will always be required to some extent because disciplined, long-term investing is dead flat boring a lot of the time.

The third component of being a successful investor is courage. If you're going to be disciplined and patient, you'll also need to be courageous. It takes guts to hang in when your plan hasn't worked for a while (it's been eight months for me on this damn short position).

Perversely, the best time to invest in a security is when it feels the worst and the most courage is required. The truly great opportunities don't come gift wrapped with a bow. They'll be covered with dust and dirt, and undoubtedly they'll have a few warts. Jenny Witterick, who manages international equities at her own firm, Sky Investment Counsel, is one of my favourite money managers. She has a nose for value and a great track record to show for it. Jenny likens buying a stock to cliffdiving in Acapulco. To be successful (which in this case means living to see another sunset), the divers must time their leap so they hit the water when a wave is coming in. To do that, however, they have to jump when there are only rocks below. I don't think it takes as much courage to buy a stock, or rebalance your portfolio, but you get the idea.

As for my oil short, I haven't seen anything that makes me change my mind (which takes just as much courage), so I'll stick with it. If it works out and I recoup my losses, or perhaps make some money, my wife will hear about what a patient, disciplined and courageous investor I am. If it doesn't work out, she'll no doubt remind me how stubborn I am.

Seventeen

U.S. Housing: Long, Extreme Up Cycle... Quick, Painless Down Cycle? Not Likely

Excerpt from Tom Bradley's blog on December 16, 2006

There was an article in the Wall Street Journal this week (December 13, 2006) which suggested that first-time buyers were starting to look at homes again. The reasoning was that prices had come down a little and affordability was better. It was an interesting read because all the positive news it put forward was anecdotal (mostly sound bites from real estate agents), while the offsetting negative news they included had some concrete fact behind it.

As I opined in a previous posting in June (An Orderly Decline of the Housing Market? Not), I don't believe that it's realistic to expect a modest and/or short down cycle for U.S. housing. Cycles that go on for a long time and reach extreme levels (in price and psychology) take time to correct. It's unrealistic to expect otherwise.

In any case, the WSJ article had some interesting stats in it. Last year in the U.S., 43% of first-time buyers put no money down. This year, the number is 45%. Wow!

The article also had a table showing the "Rent vs. Own" ratio. If the ratio is below 1, then owning is more expensive. If it's above 1, renting is more expensive. In 2001, the ratio was neutral at 1.02. In the 3rd quarter of this year, the ratio was 0.79, which heavily favours renting. Interestingly, the "Own" calculation only includes principal and interest payments on a 30-year mortgage. No other expenses, such as insurance and property taxes, are included. Whether this ratio has improved or not, it doesn't look to be very encouraging to first-time buyers.

I can't help but feel that we're experiencing a dead cat bounce in the U.S. housing market. Much like equity investors who started buying tech stocks after they dropped 20, 30 or 40% in 2000 and 2001, I think the optimists are premature on housing as well. House prices aren't going to decline like tech stocks, but they will go down some. But more to the point, it could be a long time before they go up in a meaningful way.

Eighteen

ETFs - I've Seen This Movie Before

Excerpt from Tom Bradley's blog on December 8, 2006

Exchange-traded funds (ETFs) are a great product. They provide exposure to the equity market for a reasonable price. If you buy the iShares XICs, you can be assured of getting the return of the S&P/TSX 60 for only 0.17%. That's a good deal.

But things are changing dramatically in the ETF world. New offerings are coming at us fast and furiously and it's starting to look very much like a movie I saw in the 80's and 90's. I think it was called "The Mutual Fund Diaries".

Tell me if this doesn't sound like a remake:

- There is now a regular stream of new ETFs coming to market from Barclays and other firms like Claymore Investments and Horizons BetaPro Funds.
- A large number of these funds are targeting areas of the market that have done really well over the last few years.

- The offerings are becoming increasingly specialized. You can buy ETFs for any industry you want. There are a few targeting high dividend stocks. In the U.S., Claymore has an ETF based on neglected stocks and another based on favorable trends in insider buying. These are sure to come to Canada.
- Fees are creeping up. MERs of 60-70 basis points are now common and there are lots above that, even going as high as 150 basis points.
- Claymore now offers a set of ETFs that pay trailer fees to financial advisors.
- And the market leader, Barclays, has seriously ramped up its advertising.

If this remake continues to be faithful to the original plot line, there are some consequences to be wary of.

ETFs may move away from what they're really good at - **providing broad market exposure at rock bottom prices.** As the funds get fancier, they will lose some of their simplicity, transparency and price advantage.

The more specialized ETFs become, the more tempting it will be for investors to become sector rotators and/or market timers (indeed, the current ad campaign from Barclays encourages this). It's a slippery slope towards performance chasing when investors can easily load up on a particular type of stock - energy, technology, healthcare, dividend-paying, etc. As for market timing, the new product from BetaPro takes it to another level by allowing the investor to leverage up their bet on the direction of the market.

The bear market of 2000-2003 was tough on everyone's net worth, but the worst damage was inflicted by the proliferation of specialty technology funds in the late 1990's. Where were all those funds in the early 90's? Where were all the oil and gas, gold or dividend-paying ETFs 5 years ago?

With the product proliferation that's coming at us, we will most certainly have some really neat tools at our disposal. But there's no doubt the ETF market is going to be more complex and have higher fees in the years to come. It will be interesting to watch this movie unfold.

Nineteen

Structured Products - Proud to Shroud

Excerpt from Tom Bradley's blog on February 27, 2007

I like to read Doug Steiner's columns in the ROB Magazine. You never know what he's going to write about. You do know, however, that he will have a strong view on whatever it is.

In this month's issue, Doug introduces us to the notion of "shrouding", a word coined by David Laibson of Harvard and Xavier Gabaix of MIT. Shrouding means "hiding key information from consumers." The academics divide the world into two types of businesses - those that inform their customers up front about everything they need to know about the service or product, and those companies that don't. Doug gives us a few examples of shrouding, but he doesn't wade into the murky waters of retail investment products, perhaps because the examples of shrouding are too numerous to mention.

I, along with other independent voices, have ranted and raved about the lack of transparency of most of the structured products being sold today. The banks and other big distributors have clearly taken a shrouding strategy to sell billions of dollars of principal-protected notes and other closed-end funds:

- Investors don't know what fees they're paying.
- They don't know if they even need insurance built into an investment product (i.e. principal protection).
- They don't know the investment tradeoffs they are making (i.e. limited upside in exchange for no risk of capital loss).
- And they don't know how (un)likely it is that they will achieve the advertised rates of returns.

On the latter point, a few months back I wrote about a CIBC product (PPNs III: Believe Me. I'm Not Making This Up) that advertised in bold letters that the annual return would be "up to 10% per year". As my simple analysis showed, you'd have better odds of winning big at the lottery than getting a 10% return.

I think the shrouding strategy that the big distributors are using is one of the most shameless activities going on in business today. Everyone knows these products aren't good for the client, but nobody is willing to stop selling them. PPNs and other structured products are just too profitable. Taking them off the shelf would mean a big hit to the bottom line and make it impossible to meet the budget for wealth management earnings in the year ahead.