

---

# It's Not Rocket Science

Plain-English Advice for Managing Your Investments

---



TOM BRADLEY

It's Not Rocket Science



# It's Not Rocket Science

Tom Bradley

October 2010

© 2010 Tom Bradley  
All rights reserved

Published by Steadyhand Investment Management Ltd. [www.steadyhand.com](http://www.steadyhand.com)

Printed in the World

10 1

First edition: October 2010

---

# Foreword

---

I shouldn't need these articles. After all, I've been investing in retirement savings plans since I was in my mid-20's (I'm in my early 40's now). I've read countless articles about asset allocation and long-term investing. Hell, *I work at a mutual fund company.*

And yet, as I write this, I'm paralyzed. Due to liquidating some non-financial assets, my family's portfolio is about 30% cash. I know I should be getting back in the market, but the volatility and economic conditions make me wonder if I should hold off a few months and invest then. In relatively stable times, I know that I'm not smart enough to time the market; so why do I think that I can when conditions are uncertain?

That's where these pieces come in. They're a collection of blogs and articles written over the past four years by my friend and mentor, Tom Bradley, the other good-looking co-founder of Steadyhand. I've packaged them together into a short book to reinforce some of the investing lessons I've learned from him.

As with any book consisting of articles that were published on a variety of topics over several years, we struggled with how to organize the contents of the book. In this case, we grouped the articles into eight major themes. I hope you find them useful.

Neil Jensen  
COO and Co-founder, Steadyhand Investment Funds

October 2010

---

# Contents

---

Foreword iii

## **I Discipline**

- 1. There are No Quick Fixes 3
- 2. Three Keys to Success 7
- 3. Temperament is Key for Managers 11
- 4. Keep Emotions in Check 15

## **II Diversification**

- 5. Feeling Comfortable? 21
- 6. If a Country is Too Good to be True 25
- 7. Not-So-Fine Dining 29
- 8. RRSP Nightmare 31

## **III Risk**

- 9. Risk and Stacking the Odds 37
- 10. Taking Calculated Risks 41
- 11. Why Volatility Doesn't Always Equal Risk 45
- 12. Yield and Risk 49

## IV Time

- |  |    |
|--|----|
| 13. Focusing on the Short Term           | 55 |
| 14. Investment Industry's Perverse World | 59 |
| 15. Getting Back In                      | 63 |
| 16. A Good Money Manager                 | 65 |

## V Allocation

- |                                    |    |
|------------------------------------|----|
| 17. How to Invest                  | 71 |
| 18. Asset Allocation and Hindsight | 75 |
| 19. A Recipe for Poor Performance  | 79 |
| 20. Rebalancing When Needed        | 81 |
| 21. Making a Go of it              | 83 |

## VI Returns

- |  |    |
|--|----|
| 22. Unrealistic Expectations                 | 89 |
| 23. I'll be Happy With 10%                   | 91 |
| 24. Assessing Performance — Don't be Sloppy! | 93 |

## VII Industry

- |  |     |
|--|-----|
| 25. The Investment Profession Tug of War | 99  |
| 26. "It Will Sell"                       | 103 |
| 27. A Cluttered Landscape                | 107 |
| 28. You're Paying Too Much If...         | 111 |

## VIII Success

- |  |     |
|--|-----|
| 29. Stick to the Fundamentals                | 115 |
| 30. Complacency a Major Misstep              | 119 |
| 31. We Know They're Mistakes                 | 123 |
| 32. Benefit From the Buffett Doctrine        | 127 |
| 33. Got Money to Invest? Buck Stops with You | 131 |
| 34. Sensitivity Training for Clients         | 135 |





Part I

Discipline



# One

---

## In Investing and Exercise, There are No Quick Fixes

---

*January 12, 2007*

The YWCA that I go to is always busier in the early part of January. This year is no exception. As part of our New Year's resolutions, we all start the year determined to get in better shape.

Given how low the success rate is on these gym resolutions, it's probably not a good idea to relate our workout regimen to the investing process, but I can't resist. Many of the challenges we experience when we go to the gym are the same ones we face when managing our investment portfolio.

*It's not a sprint, it's not a marathon ... it's a bloody ironman.* People often hire a trainer with the goal of getting back into the shape they were in when they were in their 20's. And they want to be there by the time they head to Florida in March. Well, it doesn't work that way for training or investing. In both endeavours, the key variables, sweat and risk, are multiplied by a second variable, time. It takes a long time to get in shape and accumulate wealth.

*Unrealistic expectations are dangerous.* If you don't have a good un-

derstanding about what's ahead and you're looking for instant results, there's a risk that you'll be easily discouraged. Too often trainers and financial advisors are guilty of overhyping their solutions. It's part of the sales pitch. Unfortunately, it reduces the chance of success. To attain a difficult goal, human beings need encouragement. If expectations are sky high, there is little chance of positive feedback along the way.

*Beware of trying to do too much, too soon.* For the casual athlete, the consequences of this are obvious. For an investor, trying too hard to achieve short-term gains will likely translate into chasing past performance (whether it be a stock or mutual fund) and spending too much money on commissions and fees. Unlike athletic training, where charging out of the gate has no chance of success, a few investors may get immediate results, if they're lucky. But it's important to recognize that it will be a result of luck. Short-term investment results are totally random and unpredictable. In all the studies I've seen, individual investors have a perfect record when it comes to chasing trends. They always get it wrong.

*Both exercise and investing are subject to lots of fads.* Someone always has a quick fix. They say you'll attain the results you want with a lot less effort, or risk. In both cases, the marketers are blowing smoke. There is no free lunch, whether the currency is sweat or risk, and there is no substitute for time. The current fad, which has gone on for too long, is principal protection. There are many of these products that allow you to buy risky assets, like stocks, mutual funds and hedge funds, with no chance of losing your capital. Higher returns with no risk. Go figure. If we go back further, we'd find hybrid income funds and clone funds, among others, tucked away in the basement beside the NordicTrack and Bowflex. Fads are more dangerous to investors than they are to exercisers. Buying the latest exercise gadget wastes a few bucks and clutters up the house. Chasing an investment fad can cost considerably more and use up valuable time.

*No pain, no gain.* This age-old sports expression sums up the training analogy. The infomercials tell us that we can get in top condition by exercising three times a week for as little as 20 minutes. I don't buy it, nor should you when it comes to investing. The equivalent of physical discomfort in investing is risk, which the professionals define as short-term volatility. Taking risk comes from owning long-term assets like stocks, bonds and real estate. Investors cannot achieve attractive long-term returns without having their portfolio bounce around a little. If they want the good times, like we're experiencing now, they must be willing to live

through the tough patches.

As I noted earlier, the odds of success at the gym are low. After a week or two it gets harder to drag yourself out of bed and brave the winter weather to get to the gym before work. The success rate should be better for investors, however, because after the initial work is done, there's very little to do. As opposed to physical training, you can be a disciplined investor while lying on the couch and eating chips with the Raptors game on the tube.



# Two

---

## Three Keys to Investment Success

---

*June 28, 2006*

A while back, Ira Gluskin recommended the new Barton Biggs book, *Hedgehogging*, 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 shorted 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 plan, 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 cliff diving in Acapulco. To be successful (which 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.



# Three

---

## Temperament, not Technique, is Key for Managers

---

*August 24, 2009*

Being an analyst or portfolio manager means you are destined to make lots of mistakes.

They say the great ones are right 60 per cent of the time, which means they're wrong 40 per cent of the time. There aren't too many professions where you're allowed to miss that often. Baseball or basketball players, perhaps, but if you're an air traffic controller, heart surgeon or goalie, you won't last long at 60/40.

When I'm hiring a portfolio manager, or monitoring one, more than anything else, I'm studying their temperament and investment process. That's because I assume that all candidates have the technical skills and experience, but the ability to deal with failure and keep to a discipline in good and bad times is a rare trait.

Temperament covers a lot of ground. It means having the confidence to stick to your convictions in the face of noise and distraction from clients,

media and other industry players. It's difficult to prevent extraneous information from obscuring the important variables in a decision. For instance, if poor short-term earnings or management changes are negatively affecting a stock, it may be an opportunity to buy at a lower price rather than a reason to abandon a long-term investment thesis.

A manager with the right temperament has the ability to buy stocks while others are panicking and sell when they're euphoric. It's easy to say that the best opportunities occur when the consensus is strongest, but at such times of great certainty, it takes a special person to go the other way. The analysis might point toward bold action, but when it comes to moving on it, there's no support or reinforcement from others. The manager feels as though he or she is totally on his or her own.

To get a sense of a manager's temperament, it's important to look at how she's dealt with adversity in the past. I'm referring to periods when returns were negative and/or performance was poor relative to the indexes and the competition. Did she stick to her philosophy and decision-making process at a time of maximum stress? Or did she make matters worse by bending her own rules or implementing major changes at the bottom?

The great managers don't let a bad patch freeze them up. They know that if they're going to have good calls in the future, they have to continue making calls. If they get too focused on trying to eliminate the bad, they miss the good.

In addition to temperament, I want managers that know how they are going to succeed. There are plenty of ways to skin a cat and a manager needs to know how he is going to do it. Essentially, I'm looking to see if he is analyzing his own business and personal franchise with the same skill and intensity he brings to his portfolios. It's always been surprising to me how many managers dive headlong into annual reports and spreadsheets and forget to assess what their competitive advantages are, in which sandbox they want to play and how they are going to win at the game.

That was particularly evident to me when I interviewed firms to manage the Steadyhand funds three years ago. Two of the short-listed candidates for the global equity fund used the same stock (Tesco, a British grocer) to demonstrate their investment process. In both cases, the work was impressive and thorough, but it was a stark reminder that there are a whole bunch of smart people out there doing the same thing. It's hard to consistently out-analyze, out-spreadsheet or out-interview the competition,

especially when it comes to large, well-covered companies.

Since last fall, I've been asked many times what I'm watching for in our fund managers. As always, results are important, but the analysis has to go further, especially in extreme markets such as the one we've been going through.

I'm looking to see if the investment process is being followed — is it still bottom up, stock by stock, or are economics and technical analysis suddenly having greater influence? In light of the fact that everyone in the industry is beaten up, I'm watching to see if our managers have lost their nerve — is their assessment of value reflected in the trades they're making and the positioning of their fund? And, specific to the recent period, I was watching to see if they had more risk in their portfolio after the meltdown (when there was less risk in the market).

In this always perverse profession, managers are going to get many things right, but they'll make lots of mistakes in getting there. That's why the right temperament and an entrenched investment process are so important. For my money, the next best thing to being right for the right reasons is being wrong for the right reasons.



# Four

---

## Keep Emotions in Check and Stick to the Plan

---

*August 20, 2007*

Shouldn't I be doing something?

In historical terms, volatile markets like we're experiencing now are not unusual, so I don't want to overplay it. I'll admit, however, that I've been watching the screen more than I usually do.

It has been enough of a roller-coaster ride that I think it's useful to look at what portfolio managers are doing and what individual investors should be doing through this period.

Professional money managers are spending a lot of time doing what we're all doing. They're trying to figure out whether this is the end of the good times or just a little blip on the long-term chart. Even bottom-up managers who don't try to time the market can't help but wonder if the stocks they are looking to buy are going to get even cheaper.

If managers use formal risk models, you can bet they're updating them daily to make sure the fund is positioned where it should be. Depending on the type of fund, this may refer to asset mix, bond duration or the



economic factors likely to affect the equity holdings. More active traders or leveraged hedge funds will be looking at their quantitative models in real time. And they will be looking for liquidity wherever they can find it so they can continue to trade.

Assuming the fund managers are not making radical changes (i.e. switching from aggressive to cautious or vice versa), they are likely freshening up their research on the stocks they want to buy on weakness. A stock that wasn't a compelling value two weeks ago may now be in their buy range.

In markets like we're experiencing, Mr. Market isn't very discriminating and often the baby gets thrown out with the bath water. The increased amount of indexed assets exacerbates this phenomenon because redemptions necessitate that stocks are sold across the whole fund. If active managers are willing to act, however, they can tap into excellent value situations.

Individual investors should also be doing some of these things, although their work won't likely lead to much action if their portfolio has been structured correctly.

The one thing they shouldn't be doing is trying to time the market. It's been shown that the professionals have limited success doing it, so it's hard to expect that someone at home can do any better. The individual investor may be very confident, but their bold view is likely laced with emotion and influenced by the current state of affairs. That's a bad combination and generally leads to poor decisions.

Peter Bernstein, a veteran analyst and economist from New York, says market tops and bottoms are defined by a "switch from doubt to certainty." He goes further to say that "in calmer moments, investors recognize their inability to know what the future holds. In moments of extreme panic or enthusiasm, however, they become remarkably bold in their predictions."

False confidence is not the only challenge for individual investors. The other big one is the overwhelming feeling that they should be doing something. For investors who have let their portfolio get out of line from where it should be — a larger-than-normal equity weighting, little or no foreign diversification or a huge bet on one sector — changes are in order. They should move swiftly to get their portfolio closer to its target asset mix.

On the other hand, investors who have stuck to their strategic asset mix will have nothing to do. At some point they will need to rebalance their portfolio, but that can wait until after the fireworks are over. In the meantime, it's best they enjoy the rest of the summer in the backyard, on the golf course or at the cottage.

With regard to asset mix, I've always been in the camp that it is impossible to generate consistent returns by market timing. This applies for everyone, whether they're sitting at home or in an office tower. Clearly, that view has influenced my approach to asset allocation.

In a nutshell, an investor should assess their objectives and risk tolerance and then commit to a strategic asset mix (read: long term). For the disinterested and/or unknowledgeable investor, that mix should be set numbers (i.e. 30 per cent Canadian equities, 30 per cent foreign equities and 40 per cent bonds).

For more engaged, experienced investors or professionals, the mix can provide a little more latitude (i.e. 25-35 per cent Canadian equities and so on). This gives these investors the ability to express a view, but prevents them from blowing themselves up if they're wrong. In both cases, I suggest rebalancing once a year or as contributions and withdrawals are made.

In my last column, I referred to the fact that I started tilting towards caution a year and a half ago. While I was too early and was out of sync with the sizzling market, my asset mix ranges kept me in the game and allowed me to generate attractive returns.

Market peaks and troughs are not a time to make big changes to your portfolio. Investors who feel they have to act at times like these often make poor decisions and seriously affect their long-term returns. If you want to watch the show, go for it. Just don't try to be a participant.



## Part II

# Diversification



# Five

---

## Feeling Comfortable? Maybe it's Time to Shake Up Your Portfolio

---

*June 22, 2006*

When I talk to investors, invariably I find myself reminding them that there is no free lunch in investing. If someone is promising you higher returns, then there is a cost in the form of higher risk. Conversely, if there appears to be little or no risk, then the cost comes in the form of lower long-term returns. A good example of the latter is principal-protected notes, which are big sellers right now. For the assurance of not losing any of your invested capital, you are required to accept lower returns and pay higher fees.

It's not totally accurate to say there's no free lunch, however, because there is one. It's called diversification. If you diversify your portfolio appropriately by owning different types of securities, then you can reduce the volatility without affecting long-term returns. In other words, the portfolio will zig and zag less dramatically in the short run, but end up in the same place at the end.

There are, however, two things you need to know about diversification.

First of all, it's boring. When your friend, who owns nothing but energy stocks, is bouncing off the ceiling with excitement, your portfolio will be achieving more modest gains. Gains that are almost invisible day to day or month to month. When your friend's portfolio collapses, you'll no doubt be feeling some pain, but your assets will be intact.

The other thing to remember is that if you're properly diversified, you're not going to feel good about everything you own. That's what diversification is all about. Not all parts of your portfolio will be working for you at once. If you're comfortable with everything in your portfolio, then you're not properly diversified.

This is particularly topical right now because we're at one of those times when it's easy to not be diversified. Some important market trends have been in place for a number of years, and the longer they go, the more distorted portfolios get. Simple mathematics and investor psychology lead to this situation. If a type of security outperforms the rest of the capital markets, then portfolios will become more heavily weighted in that security, unless the investor does some selling. But it's more than just math. The longer these trends persist, the more comfortable we get with them. It becomes part of our investing context, and may even take on the status of conventional wisdom. Oil prices will keep going up. The Canadian dollar is heading toward par. Canadian stocks will always beat U.S. stocks. Income trusts are better than growth stocks. This is how the world is going to work in the future. Of course, the opposite is true. The longer these trends go on, the less likely they are to persist.

With the markets we've had in recent years, Canadian investors are less diversified than they should be. They own more real estate and Canadian stocks, specifically income-oriented and natural resource stocks, than they have in quite some time. This is not unexpected because low interest rates encourage us to borrow (buy bigger homes) rather than lend (invest in bonds). And from a stock market point of view, it's not surprising we own more Canadian stocks because the S&P/TSX composite has solidly beat U.S. and international markets in each of the past four years. And bank stocks, income trusts and resource stocks have been the stars.

Where we are today feels like the flipside of a situation we had in the mid to late 1990s, when people chased growth stocks and clamoured to get their money out of Canada.

Statistics published by the Investment Funds Institute of Canada (IFIC) confirm these trends. Over the past couple of years, the flows into mutual

funds have been dominated by dividend funds and monthly income funds.

Investors that have had exposure to these long-running trends should be very pleased, but shouldn't let themselves get too smug. If your net worth is dominated with holdings in the hot sectors, then you are setting yourself up for some disappointing years ahead. But it doesn't have to be that way. You can systematically rebalance your portfolio toward areas where you have little or no exposure. Large-capitalization U.S. and international stocks are attractively valued and may be candidates. Depending on your situation, it may be prudent to buy short-term notes, bonds or just pay down the mortgage.

Whatever rebalancing you do, however, be assured that it will feel lousy. You won't get any positive reinforcement for doing it. The negatives will overwhelm the positives. Who is going to tell you that investing in U.S. stocks right now is a brilliant move? Don't you know that American consumers are stretched to the limit, the country is running huge deficits and the auto sector is failing? You're crazy moving your money out of Canada.

Perhaps, but I think it's time to make sure you're properly diversified, even if it means getting a little more boring and a lot less comfortable.





# Six

---

## If a Country is Too Good to be True ...Then Diversify

---

*October 18, 2009*

Oh Canada! In the constant debate about whether this rally is for real or not, there is an underlying subtext. It relates to how much emphasis investors should put on Canada. In the discussion, there are many who are asking the question, why bother putting any money outside our borders?

The Canadian stock market has been the star of the show over the past decade. With the help of a strong currency, the S&P/TSX Composite Index has beat the S&P 500 in eight of the past 10 years (in Canadian dollar terms), and nine out of 11 when 2009 is included. And there are persuasive arguments why this will continue.

A report by Scotia Capital entitled “Why you want to own Canada” nicely summarizes them. It points out that Canada’s main attributes are: 1) emerging-market exposure with lower volatility; 2) cheaper valuations relative to the MSCI World Index; 3) stronger domestic fundamentals; 4) Canadian dollar strength relative to the U.S. dollar and British pound; 5) proximity to the U.S. economy; and 6) above-average market capital-

ization companies in financials, materials, technology and industrials.

In a recent *Globe* column, David Rosenberg referred to Canada as a “low beta [less volatile] way to play the emerging markets via commodity exposure.” He went so far as to say, “this period when the Canadian market outperforms its southern peers is barely halfway done.”

Individual investors seem to agree. Today, they are generally tilted more toward Canada than even the most bullish strategists are recommending. I regularly see portfolios that have little or no foreign exposure. The arguments for staying at home are compelling, but investors need to understand the strategy they’re pursuing when they go all-Canada all the time.

It is important to make a clear distinction between the outlook for the Canadian economy and the arguments for investing in the Canadian stock market. For one thing, the stock market has more exposure to emerging markets than the country does. In the real economy, Canada has done a poor job of penetrating the high-growth, developing markets, outside of the resource sectors. For manufacturers, China isn’t a large, growing market, but rather an intense competitor. These companies aren’t China plays, but rather “high beta” bets on the U.S. economy. The fact that our resource-rich country is now running a trade deficit illustrates the point.

From an investment point of view, however, manufacturing hardly registers in the market index, so the “Buy Canada” arguments are more applicable.

Of course, going all-Canada is not only a vote of confidence in our dollar and socioeconomic standing, it also means betting heavily on financial companies (31 per cent of the index), energy (28 per cent) and materials (19 per cent).

It means having little or no exposure to consumer products, technology (outside of Research In Motion) and health care, all of which are large, profitable industries with world-leading companies. It could be argued that the best “low beta” plays on emerging markets are these franchise companies that have a global reach, the likes of Procter & Gamble, Coca-Cola and General Electric.

When the current run started in 1999, our market had lagged the U.S. for eight of the previous 10 years (sound familiar?). Canadians were scrambling to increase their exposure to foreign stocks and new investment

products were being created daily to help skirt the 30-per-cent foreign content limit on registered retirement savings plan accounts (remember clone funds?). The pendulum of investor sentiment has now swung completely the other way.

To my way of thinking, the long-term mix of an all-equity portfolio should be in the range of 50/50 domestic and foreign. (I'm comfortable with the diversification that comes from holding a variety of currencies, but for investors who aren't, there are products that remove currency from the equation.) If such a portfolio is reflective of the indexes, which most are, the energy and materials weightings would be reduced to a still significant 20 and 13 per cent, respectively. Financials would drop a little to 26 per cent, while consumer, technology and health care stocks would start to play a meaningful role at 14, 8 and 5 per cent. The portfolio would still have a heavy bias toward Canada's favourite sectors.

At times like this, I can't resist dredging up my favourite quote from the late Peter Bernstein who said: "If you are comfortable with everything you own, you're not properly diversified." Commodity stocks were in the uncomfortable category in 2000, as were government bonds in 2007 and equities in general just eight months ago. Today, anything outside our borders feels uncomfortable.

Perhaps Mr. Rosenberg and crew will be right, but nine years of out-performance over the past 11 doesn't feel like halfway there to me. No matter which way it goes, however, betting on the home team still needs to be done in the context of a diversified portfolio.



# Seven

---

## Not-So-Fine Dining

---

*Posted June, 2009*

If diversification is the only “free lunch” investors have, then what is over-diversification? A sub-par meal at an expensive restaurant?

Our industry has gone way too far with the diversification mantra. We have run steadily and without constraint to a point where clients today own hundreds, and in many cases thousands, of stocks in their portfolios.

There were many people involved in getting us to this state of affairs.

At the product level, too many mutual funds and structured products have bloated portfolios, owning hundreds of securities. In the minds of the designers (marketing departments and investment bankers) and money managers, there is a perceived need to stay close to the index and have exposure to all types of stocks and geographic areas.

At the dealer level, advisors build portfolios with a variety of funds and other products (some of them bloated in their own right) such that the security count is multiplied many times over.

As for the clients, they may use multiple providers, including one or more

of the following: account executive; bank branch advisor; discount broker; and neighbour's counselling firm. In too many cases, nobody involved has a grasp of the full picture, including the client.

As a new player in the wealth management industry, our team has had an opportunity to meet refugees from all parts of the business. What we're finding — crowded, high-cost portfolios that do a fine job of replicating the indexes — is good for business. It's easy to come up with something that's more focused and cohesive.

So what kind of meal should we be serving our clients? Should they own 25, 50, 100 or 1,000 securities?

On this topic, the research is all over the map, and not particularly helpful. But, with regard to equity-only portfolios, most studies show that after 20 to 25 stocks, the diversification benefit becomes negligible. In other words, adding a 26th stock does little to dampen down short-term volatility.

While a portfolio of 20 stocks and a few government bonds were just fine for our parents a generation ago, it's probably not enough today. But for a portfolio that is pursuing higher returns through active management, the number of securities should be closer to that end of the spectrum as opposed to the other end where the indexers reside.

To move our clients into the appropriate diversification envelope, we don't need to read an academic paper or do a statistical analysis. Common sense will work just fine. Clients need diversification across asset classes and a mix of company types, countries and currencies. Holding managed products with significant overlap in their holdings can easily be avoided. (How many places does your client need to own Potash Corp. or Encana?). And a risk-management system isn't required to make sure that the portfolio isn't hinging on one theme or bet — like the never-ending growth of 'Chindia', or \$200-a-barrel oil.

If the clients' overall portfolio looks like an index fund, then the fee should reflect that. On the other hand, if they are paying a premium fee for experience and expertise, they should have a portfolio that's focused on fewer securities.

Like a fine restaurant, the menu is limited and the entrées are delicious.

# Eight

---

## RRSP Nightmare: Too Many Funds in Your Basket

---

*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 overdiversification 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.

*Postscript: After posting this article, I received a flurry of emails from investors and advisors sharing their 'RRSP Nightmares'. The worst of the lot — one advisor came across a prospective client that held more than 50 funds. Yikes.*



# Part III

## Risk



# Nine

---

## Investing is About Risk and Stacking the Odds in Your Favour

---

*March 10, 2008*

During the RRSP season we were barraged with ads from the banks and insurance companies. In light of the recent market turbulence, the emphasis has been on their 'risk free' products, such as index-linked notes and principal protected notes (PPNs).

These products, and others like them, guarantee that the buyers will get their money back, even if markets prove to be difficult.

I mention this because these products expose a serious divide between the professional investor and the amateur. Let me explain.

I've been at this gig for 25 long and weary years (which is also the way Lori describes our marriage). On every one of those days, I go to the office in search of one thing. An asymmetric bet.

In other words, an investment or business strategy where, in my judgment, there is limited downside if it doesn't work, and big upside if it does. That is an investment manager's Holy Grail.

In searching for such a situation, you won't see an investment professional buying a 'risk-free' investment, other than a government bond. That's because 'risk-free' or principal protected securities, are an asymmetric bet in the wrong direction. The odds are stacked against the purchaser.

Over the term of these risk-free products (usually five years or longer), the chances of losing money on the underlying investments (stocks, mutual funds, indexes) varies from nil to remote.

I would put balanced or income-oriented products in the category of having no chance of losing money. For terms of five years or more, I would put equity funds or indexes in the category of having a 'remote' chance of losing money.

Over the last forty years, there has only been one period (ending December, 1974) when the S&P/TSX Composite Index had a negative five-year return (-1.4 per cent). Over the same period, there were no seven-year periods in negative territory.

The other side of capital protection is the cost, and the costs of PPNs are high. The higher the fees, the less money that is available to you the investor. While the loss protection is unlikely to be of value, reduced returns are guaranteed and may be substantial.

In a recent Steadyhand blog, my partner Scott Ronalds went through the math. Some of the banks were running ads that show off the returns of recently matured index-linked notes, which on the surface look pretty attractive. In the fine print, however, you discover that the cost of downside protection was a 40-per-cent lower return. If investors had bought the index return through an exchange-traded fund (ETF), which includes dividends, their return would have been that much higher.

It is not my intention to use hindsight to pick on one particular product. Investment strategies are all about a variety of possible outcomes. Unfortunately, very few of those outcomes in a packaged 'risk-free' investment favour the buyer. The reward/risk profile of a PPN — a slight chance of avoiding a small loss versus the certainty of lower returns, perhaps substantially lower — is the opposite of what a professional is looking for. Which leads me to my main point.

Investing is about taking risk. Being thoughtful about it. Prudent. And stacking the odds in your favour when you can. Risk is the fuel that drives a portfolio. It must be present to generate returns in excess of the risk-free rate, namely Government bonds.

Tony Gage, my old partner at Phillips, Hager & North (he is older than me), used to talk about the four types of risk, all of which investors should have some exposure to.

The first two relate to his favourite pastime — bonds. Interest rate risk means owning longer-term fixed-income securities. They are more sensitive to interest rate changes, and therefore are more volatile than short-term issues, but you are rewarded with a higher yield.

The second is credit risk, which refers to the possibility that a borrower (i.e. the corporation issuing the bond) will not be able to pay back the loan. The riskier the borrower is perceived to be, the higher the yield.

The third is liquidity risk. It is usually forgotten, but often provides the best reward/risk opportunity. You are taking advantage of this type of risk if you invest in a security that doesn't trade regularly, such as a mortgage, private company or private equity fund. In purchasing a less liquid investment, you expect to be rewarded with a higher return.

Finally, the fourth risk is the one everybody focuses on — equity risk.

There is a wonderful piece written by Francois Sicart, the chairman of Tocqueville Asset Management in New York, in which he describes his unbreakable rule. He says, "*I never invest in a situation in which I cannot lose money.*"

It's unlikely Mr. Gage and Mr. Sicart own packaged 'risk-free' products and it's unlikely your financial adviser or portfolio manager does either. If you ask, they should tell you that they are investors and investing is about taking risk to generate higher long-term returns.

So while principal protected products were a big sales winner this RRSP season, they are not showing up in the portfolios of people in the industry. That's because on this side of the divide, we're too busy looking for asymmetric bets that are in our favour.





# Ten

---

## Taking Calculated Risks Can Win the Gold Medal

---

*February 20, 2010*

Watching the Olympics, the notion of risk is very clear. Athletes need to push it to the limit in order to get to that top spot on the podium. But to obtain the advantage, they risk missing a gate, catching an edge or taking an untimely penalty. They may risk injury or even death, as we found out tragically on Feb. 12.

Like elite athletes, investors need to take chances to succeed. Risk is the fuel that drives long-term returns. But as opposed to the clarity of sport, it's a more muddled concept when it comes to investing. Consider the following three examples where there is often confusion around the risks.

*Gold.* Appropriately, the first is gold. Is the shiny metal a high- or low-risk investment? Well, it depends.

As a stand-alone holding, gold is extremely risky. There is no income stream that flows from it, and no promise of one. The buyer is speculating that the price will go up over time.

Of course, gold bugs don't see it that way. In their view, it's ordained that gold will rise. But an analysis of its price history, supply-and-demand fundamentals, and role in government reserves would suggest that price appreciation is far from assured.

As a part of a diversified portfolio, however, gold can reduce risk. In the past, its returns have had a low correlation to other asset classes, so it has the potential to smooth out a portfolio's overall performance. And if it's bought at the right price, it can also enhance returns.

*ETFs.* Exchange-traded funds are often viewed as being lower-risk investments because of their broad array of holdings. But lower risk versus what? When compared with the indexes the funds are replicating, there is little chance that investors will be surprised. The return they see in the headlines is what they'll get in their portfolios (minus fees and commissions).

But in terms of absolute return — the kind that pays the bills — index-based ETFs are generally more volatile than actively managed funds. That's because a majority of ETFs are market-capitalization based, which means the largest stocks make up the biggest proportion of the fund. The higher a stock goes, the more money that's allocated to it. This "momentum" style of investing tends to ride higher in good times and fall further in tough times.

For investors with a long time horizon, there is nothing wrong with sharper zigs and zags, but they need to be prepared for them.

*Asset Mix.* The third instance where the notion of risk gets confusing is with regard to asset mix.

It is generally considered less risky to have money parked in a bank account, invested in guaranteed investment certificates (GICs) or stuffed in a mattress. Compared with the stock market roller coaster, it's much safer.

In the very short term, that is the case, but when the objective is to increase capital and protect against inflation over a number of years, the mattress strategy is as high risk as you can get. To help replace a paycheck after retirement, investors need their portfolios to generate a return well in excess of inflation. To do that, they have to commit to owning long-term assets because, over time, bonds will beat cash and stocks will beat bonds.

Investors who held bonds and stocks over the last 25 years have benefited from the decline in interest rates and have seen their capital grow. They are affected by low current yields, but not as much as long-term GIC investors, who didn't use the bull run in bonds and stocks to build up their capital.

*Real Risk.* What we need to remember is that any definition of risk depends on what the objectives and time frame are. When short-term security is important, stocks and real estate are inappropriate. But for long-term investors, owning secure savings vehicles is the risky strategy.

Before I go back to the unambiguously safe vocation of watching the Olympics and taking in the party, I should highlight a risk that applies across all situations. It is one that, if not heeded, will guarantee that investors fail to achieve their goals. It's the risk of paying too much. No matter what the goals and strategies, it's important to pay a fair (or preferably better-than-fair) price for growth, income or a good mattress.



# Eleven

---

## Why Volatility Doesn't Always Equal Risk

---

*October 15, 2010*

When investors open their quarterly statements this month, they'll be pleasantly surprised. Despite all the doom and gloom, the last three months have brought a year's worth of returns.

But despite the fact that the most recent quarter will bring the fifth good news statement out of the last six, it won't change the fact that investors are worn out and discouraged.

I'm generalizing grossly of course, but there are strong indications that many people are losing faith in stocks and investing in general. Balanced portfolios have earned 3 to 4 per cent annually over the last 10 years, which feels like nothing compared with the previous 10 (and may literally be nothing if a few mistakes were made along the way). In hindsight, a similar return could have been achieved by rolling five-year GICs.

Disappointing returns are at the core of investor disillusionment, but I think an equally important factor is the volatility that has gone along with

it. In 10 years, investors have had two hair-raising bear markets and two equally impressive recoveries. The swings between quarterly statements have been nothing short of remarkable and have spooked investors. Now they're saying, "I want some growth, but I can't take any more losses."

For those who are drawing on their portfolio for income and have a shorter time horizon, volatility is certainly something to beware. These investors can't afford to have markets dip just when they need money.

But for investors who have the luxury of time, volatility doesn't equal risk, not in theory anyway. These investors can hold assets with a higher potential return knowing that short-term price swings are inconsequential. Long-term returns are what matter. Risk is holding overpriced assets, being too concentrated on one type of investment, and having no protection against inflation. Risk is having a portfolio that doesn't fit with their objectives.

John Thiessen, manager of the Vertex Fund, captured this issue well in a recent note to unitholders. "Every day we start our day trying to reduce risk in our portfolio but not necessarily volatility. Volatility in the short term is hard on stomachs and nerves but in the long term will deliver better investment returns. Investment policies suffer from a tendency to equate volatility with risk and an indifference to whether assets are cheap or expensive."

While John is able to put theory into practice, the same can't be said for most amateur investors, and more professionals than I'd like to admit. The reality is, volatility brings with it so-called execution risk — the risk that investors won't be able to hold on when prices are down and sentiment is negative (or control their enthusiasm when times are good). It's great to say you'll buy when stocks are at their lows, but it's quite another to consistently do it. Indeed, in the face of peer pressure and marketing hype, it's easier to do the wrong thing. Even a simple strategy of regular contributions and re-balancing can get off track in highly volatile markets.

A high-potential, high-volatility portfolio should generate better returns over time, but it has to match up with the investor's psychology. As investment professionals, we run the risk of doing what trainers at the gym do. Too often they develop textbook programs with all the required exercises, but fail to take into account their clients' time, willpower and exercise history. Routines that are shorter, less perfect and more fun would have more staying power and get better results.

In the investment context, Dan Hallett of Highview Financial Group has done research that suggests investors in less volatile balanced funds have a longer holding period and achieve better returns than those in all-equity portfolios.

For long-term investors, volatility shouldn't be a risk factor, but it clearly is. Today it's showing itself in client portfolios that have strayed far from their long-term asset mix. Investors are holding too much cash and are slow to invest new money. They are likely to delay doing any re-balancing. In general, they're frozen. Investment professionals must make sure that our recommendations are realistic for our clients, but we've also got to help them absorb more volatility. I don't know what the markets are going to do over the next year, but I do know that portfolios that are trying to avoid downside volatility will not meet their goals in the long term.





# Twelve

---

## Don't Let Your Search for Yield Blind You to Risk

---

*January 23, 2010*

There's no question about it. The defining feature of the capital markets right now is the search for more yield. Individuals are doing it. Institutions are doing it. And new product development is totally focused on it.

I get an e-mail almost every day announcing a new fund with income in the name. I'm trying to convince my partners that we need to come out with a product that has it all — the Steadyhand Enhanced Global High Yield and Growing Dividend Weekly Income Fund, or SEGHYGDWIF for short.

Before I discuss some issues and strategies around yield seeking, it's useful to pull back and look at what's happening here.

With low-risk securities yielding next to nothing, investors are moving up the risk scale. Instead of a guaranteed investment certificate (GIC) that yields 3 per cent, they're buying Brookfield bonds, BCE preferreds or BMO shares that yield 5 to 6 per cent. This is an asset mix shift

that brings with it credit risk — the risk that the issuer of the bond or preferred can't make the payments — and equity risk. Trusts, real estate investment trusts (REITs) and dividend-paying stocks all have the potential to go down in price.

Holding a diversified portfolio certainly decreases the chance that a default or stock market decline will meaningfully affect long-term returns, but it still brings with it more volatility. For investors in the accumulation phase, volatility is not a risk, but rather an opportunity — when stocks are down, they can buy more. For investors living off their portfolio, however, it's a different matter. Making withdrawals when markets are down means eating into capital, which leaves a smaller asset base to ride back up with and generate future income.

In most cases, “reaching for yield” is perfectly appropriate and works out well, but the expression always makes me uneasy.

That's because the risks attached to “reaching” are not always obvious and tend to creep up on investors. If income is flowing and the strategy is working, they don't see the risk. They only know it's there when things stop working. We can go back a few years to when fixed-income investors shifted from bonds to income trusts. They were ecstatic about the extra income until they ran into distribution cuts and abrupt price declines.

Also, when there's a lot of reaching going on, it usually means that high-yielding securities are getting overpriced. Again, the early trust market was an example of this. These securities were getting priced off their yield — the higher the better — with little regard to what the underlying businesses were worth.

So when you go on a yield-seeking mission, there are a few things to consider.

First off, it's likely that fixed-income returns are going to be lower going forward. If your portfolio isn't providing enough income, taking more risk may be a viable option, but learning to live on less has to be the first priority.

Secondly, we have just had a “once-in-a-career” run in the credit market and as a result, it's harder to find value in corporate bonds today. There is still extra yield to be gained by owning corporate over government bonds, but you have to ask yourself two things: Is the spread wide enough to justify the added risk? And is the basis of the spread calculation

(government bonds) fairly valued? If you believe that Canada bond yields are artificially low as a result of problems in the U.S., then the spread is not as generous as it appears.

Thirdly, money managers who took full advantage of the opportunities in 2009 have gaudy numbers to advertise, but they can't keep it up. Our Income Fund, which has a diversified mix of income securities, was up 22.5 per cent last year. But with lower bond and stock yields, and recent reductions to the high-yield bond allocation, it's now yielding less than 5 per cent (pre-fee). Even with favourable markets, there is no potential for our manager, Connor Clark & Lunn, to replicate the 2009 return in the coming years. Suffice to say, if products or advisers are making promises based on last year, it's best to steer clear.

And finally, when taking more risk is appropriate to meet your investment needs, it shouldn't be done by searching for yield to the exclusion of other strategies. There are many ways to generate an income stream. It doesn't have to come from a coupon payment or monthly distribution, especially if high-yielding securities are poor value. A viable alternative is to combine a short-term savings product with a portfolio of high-quality stocks. High-interest bank accounts are being used as loss leaders, so they can be of reasonable value at times. And there are still lots of low-yielding stocks that are underpriced. With one or more years of cash needs parked in savings, the investor is liberated from owning just high-yielding securities to enhance returns.

As the old saying goes, "More money has been lost reaching for yield than at the point of a gun." Income-oriented securities are no different than other types of investments. The price has to make sense, no matter how great the need.



# Part IV

## Time



# Thirteen

---

## Focusing Too Much on the Short Term Can Lead to a Short Career

---

*February 8, 2009*

I've been having trouble sleeping, so I dusted off a research report written by my friend, J.J. Woolverton, who is the chairman of Guardian Capital LP (he makes me read these things). The report was called Performance Inhibitors (or The Seven Deadly Sins).

Before your imagination gets carried away with the title, this is a heavy-duty treatise aimed at institutional investors. It goes through seven factors that “have the potential to materially impact overall performance results.” I was almost asleep when I came to Deadly Sin #3 — time — in which he discusses how the multitude of players involved with a pension plan all have different time frames.

The plan itself may have a time horizon of more than 40 years, while the investment committee is looking out five-to-10, the investment manager is at four (J.J.'s optimistic view), the actuary one-to-three, and so it goes.

Sin #3 speaks to one of the great disconnects in our industry. We are managing assets to offset liabilities that are 15 to 40 years away, and yet



all the inputs and strategies that go into our process are short to medium term in nature.

We hold five-year notes rather than 25-year strip bonds that would more closely match our investment horizon. We trade our portfolios based on short-term expectations rather than long-term value creation.

All that would be fine, and indeed not a sin, if short-term focus produced good results, but it doesn't. If we are interested in making educated guesses and finding bets that are stacked in our favour, which we are, then short-term timing is the most difficult way to add value and produce superior returns. How much of an edge can we develop when everyone is trying to figure out what a stock, or the market overall, is going to do next? Our sandbox gets pretty crowded.

David Swensen, chief investment officer of Yale University, said: "Stock pickers hoping to beat the market quarter in and quarter out accept a formidable challenge. In attempting to find securities with both material mispricings and near-term triggers... the money manager places substantial limits on the available choices. Operating with a longer investment horizon increases the opportunity set of choices, dramatically improving the odds of creating a winning portfolio."

So if time frame is such a huge issue for investors, both professional and amateur, why do we keep focusing on the near future? Isn't this a structural inefficiency that a smart investor can exploit? The answer is yes, but it's really, really, really hard to do.

Even when we start out with an objective that is aligned to our needs — above-average returns over the next 30 years — we immediately start executing a plan using short-term inputs.

We ask questions like, "When should I get into the market? What's going to do well this year? What sector should I rotate into?" and then base our decisions on the answers.

Even those of us who don't ask the questions, too often allow ourselves to answer them. It's hard not to, because that's what we talk about in this business.

It's particularly hard because the information coming at us each day is short term in nature. The media is focused on yesterday's news and what the next week or month will bring, which is their job.

The financial analysts are looking further out, but the requirement to estimate quarterly earnings also keeps them focused on the here and now. Too many words are spent discussing whether Shoppers Drug Mart “met expectations” as opposed to whether its cosmetic and generic initiatives are enhancing its market position. I can’t think of a bigger waste of brainpower.

Indeed, the reporting cycle, or feedback loop, for the whole industry comes around every three months. Companies report their progress to the Street, analysts assess the numbers and update their recommendations, and advisers and money managers report back to their clients on what’s happened since last time.

The scary thing is that the investment business entrenches the short-term focus. Compensation drives behaviour and there are still too many professionals who are paid bonuses based on how they did over the past 12 months. Who are we kidding? If a manager’s decisions are based on long-term considerations, then one-year performance is virtually random.

If you’re waiting for a punch line to this column, there isn’t one. I don’t have a list of tips. I believe thinking long term will lead to better results, but it isn’t a silver bullet. There will be years like 2008 when looking ahead causes us to miss a pothole that is lurking below our headlights.

One thing I do know for sure — successful money managers have long since let go of the notion that they can time the market.

And speaking of time, I’d better get back to the matter at hand. Hmm... Sin #4 — committees — that ought to do it.



# Fourteen

---

## Investment Industry's Perverse World: Pray for Bad News

---

*September 5, 2006*

If I had to choose one word to describe the investment industry, I'd pick 'perverse'. It is like no other industry I know.

That word came to mind early in my career when I found myself hanging around with bond fund managers. I realized that these people were happiest when the economic news was the worst. When it came to bond prices, bad news was good and good news was bad.

At first, I thought it was only bondies who couldn't cheer for the home team. At least us equity guys could celebrate good news and enjoy a period of economic growth and strong earnings. But as the years have gone by, I've come to realize that the bond guys weren't alone. The whole business is wacko.

I tell this story because I think it illustrates one of the biggest struggles that non-professional investors have. Too often they don't realize that things are not as they appear. Indeed, the reality may be the exact

opposite. A former colleague of mine, Ian Mottershead, liked to say, "If it appears obvious, it is probably untrue."

We see it time and again when economists or analysts all line up on the same side of an issue. Invariably it turns out that they were looking in the wrong direction. The overwhelming consensus from economists in the U.S. a month ago was that the housing market will experience a soft landing and nobody will get hurt. Look out below.

That is different from the real world. If you find that same consensus when you're looking to buy a car, you're delighted. If Consumer Reports, Car & Driver and your colleagues in the staff room all think the Honda Accord is a great car, it probably is. On the other hand, if multiple publications and lots of people (including taxi drivers, hair dressers and fitness instructors) tell you that something is a great investment, you'd better run for the hills.

At the core of this perverseness is the concept of time frame. An Accord is all about the here and now. The ride, the comfort, the acceleration, and for me, the sound system. Investing is about what lies ahead. Putting a stock or mutual fund in your portfolio does nothing for you today. It is all about a future stream of income. Investors often have trouble making the distinction between the two.

This time frame issue is something that we have to struggle with constantly. We are barraged with short-term information. It's in front of us all the time and hard to avoid. And because it is so plentiful, it takes on an undue aura of importance.

Indeed, some people get pretty good at analyzing short-term events like interest rate moves by the U.S. Federal Reserve or quarterly earnings. But as Charlie Munger (Warren Buffet's side-kick) says, "If something isn't worth doing, it isn't worth doing well." The fact is, the here and now has little or no value when it comes to generating long-term returns.

Unfortunately, the good stuff (a sound assessment of the long-term fundamentals) is harder to come by and has no guarantees attached. It's just educated guess work. For every expert who tells you that the outlook for a company or industry is good, there is another who can tell you why things will turn out badly. Both views will be well reasoned and convincingly presented.

So what is one to do? How does a normal, well-balanced person success-

fully navigate through the perverse world of investing. First of all, accept the fact that the investment business is perverse.

Second, get suspicious when everyone is talking about the same things and thinking the same way.

Third, don't pay too much for good news of the past or predicted success for the future.

Fourth, always stay diversified so you're not totally caught off guard by the unexpected. In the words of Peter Bernstein, one of my favorite analysts: "if you are comfortable with everything you own, you're not diversified".

And finally, pray for bad news.



# Fifteen

---

## The Hardest Question - When to Get Back In

---

*December 16, 2009*

Maybe the hardest conversations we have today are with prospective investors who got out of equities in 2008 or early this year and did not get back in. What do they do now?

There is really just one answer to the question and then a bunch of execution issues.

The answer: *Make a plan to get your portfolio back to its long-term asset mix and get started.*

A plan can take many forms, but in general it should lay out the timing and amounts for re-investment. For example, if you're going to take a year to get back to a 50/50 mix of bonds and equities, then you might move 10% into equities today and another 10% at each quarter-end.

There are all kinds of factors that will shape what the plan looks like:



- *The valuation in the market.* We are currently advising caution with regard to asset mix, so we're recommending clients move into the market at a slower pace than usual. Last year at this time when bond and stock valuations were particularly compelling, we encouraged clients to move faster.
- *The risk tolerance you have with regard to the funds.* Long-term retirement savings that need to earn a return well above inflation should be treated differently than a new inheritance that represents your mother's life savings. In the case of the former, bolder steps are necessary.
- *How far from the ideal mix you are.* To go back to the earlier example, if you hold zero equities and your long-term asset mix is 50/50, then the early steps in the plan need to be more meaningful. The first step might get you half way there, with smaller increments to follow.

This is one of the toughest situations an investor can find themselves in. It's gut wrenching and there's no way to know what lies ahead (investors in this situation know that better than anyone). Which makes it all the more important that you methodically layout a plan as to how and when you are going to get back into the market.

A key part of executing the plan is acknowledging three things. First, this is about looking forward, not back. Second, you're not seeking perfection. A plan that gradually works you back into the market will by definition be imperfect – the purchases will either be too early or late. Guaranteed. And third, what is the alternative. A week, month or year from now, there won't be sirens going off telling you "now is the time". And if there are sirens, they have a good chance of being wrong.

If your asset mix is far from where it needs to be, then it's an imperative that you get a plan in place and start executing right away.

# Sixteen

---

## A Good Money Manager is Brave Enough to Say “I don't know”

---

*October 21, 2006*

There are plenty of sports analogies that are appropriate to investing, but I find golf provides the most fertile ground. With both golf and investing, it takes only a small taste of success to keep us coming back for more. No matter how bad we are at either, we feel obligated to share our secrets of success with others (and we actually think they care). And both golf and investing turn us into prolific liars.

This column focuses on one other similarity. When at the driving range, most golfers practice the wrong things. We feel obligated to whale away on our humungous driver, knowing full well that we'd be far better off if we spent the time practicing our chipping and putting. Too often when we talk to our clients as investment professionals, we are talking about the wrong things. This valuable time is spent discussing matters that, at best, add little to the investment process, and at worst lead to poor investment decisions. We, too, are whaling away on our driver. We need to change the kind of dialogue we have.

Here are some examples of what I'm referring to.

Think about the time spent discussing what happened in the most recent quarter. For most firms, the reporting cycle is quarterly, so it's natural to talk about what happened since the last report. We talk about recent economic data, how the markets and portfolio did and what stocks or industries contributed to the results. To an investor, three months is a very short period and returns over that time frame are virtually random. In-depth analysis of the last quarter can only be described as noise.

When talking about where to invest new money, we like to talk about what has been doing well. I liken it to the sports predictions that come out prior to a new season. Last year's champion is always amongst the top picks. That makes sense if it's a team that has a profound competitive advantage such as the Yankees payroll, the Oilers' number 99 or Duke University's Coach K. But if last year's winner was a solid playoff team that happened to put it all together for four weeks, it's quite a different matter. Unfortunately, in the investment management field, recent results don't reveal competitive advantage (i.e. superior research, a savvy portfolio manager). Long-term performance does. The single biggest reason that individual investors achieve poor returns is performance chasing. They too often buy last year's winner and end up with next year's loser.

What are the markets going to do for the rest of the year? The answer to this question shouldn't take up any air time, but it often dominates the conversation. It shouldn't take time because the answer should always be the same – "I don't know".

I talked to Doug MacDonald recently. Doug is one of the pioneers of the fee-only financial planning community. He was reflecting back on the development of his firm, MacDonald, Shymko & Company, when he said "it became much easier to do our job once we realized that nobody, including us, knows what is going to happen in the future".

There are other examples. Too often we talk about principal protection instead of building wealth by taking prudent risk. In the case of income trusts, the talk is mostly about current yield and very little about what the business is worth. And as for investment products, there is plenty said about convenience and all-in-one solutions (i.e. WRAPs, structured products, balanced funds) and very little about cost.

Looking ahead, it won't be easy to change the dialogue. I know from experience that clients want answers, even if the questions are unanswer-

able. For twenty years my father-in-law has been asking me which way the bond market is going. It's one of those things he expects me to know, and I'm starting to feel the pressure to make a prediction. Advisors have to deal with the same pressure on a daily basis.

Progress can be made if the investor, advisor and money manager all play a role. Individual investors can take a stronger hand in guiding the conversation by asking lots of questions. How is the portfolio positioned for the future? Are the mutual funds I own still being managed by the same people and with the same approach I bought in to? Rather than investing in a new product, should I put more money into something I already own? How much am I paying each year for advice and money management?

For our part as investment professionals, we can say "I don't know" more often. We can use unanswerable questions as a segue into what will make a difference to future returns: where the portfolio sits compared to the client's long-term asset mix; what the fundamentals look like for the firms in the portfolio; and how the client's future cash flows will be deployed.

Improving the dialogue will require more discipline on the part of both clients and advisors, but it's time we stop worrying about our distance off the tee and start sinking a few putts.



Part V

Allocation



# Seventeen

---

## It's Not a Question of When, But How

---

*April 4, 2010*

“Tom, is now a good time to invest?”

When I get that question at a party or reception, I freeze up. It's weird because I'm reasonably competent at social banter, especially when I have a cocktail in my hand, and I certainly have views on these kind of things. But I find myself quickly shifting to another topic. “How about those Canucks?”

The reason I hesitate is because the question runs against how I think about investing, so answering it seems inappropriate in a social setting, to say nothing of being a conversation-killer.

The question investors should be asking is not whether it's time to invest, but rather, are there any reasons not to? The starting point for any decision should be a fully invested position as represented by their long-term asset mix.

Now I know this is pretty basic stuff, but unfortunately, many people are not wired this way. They are savers at heart, not investors. Their default



position is the safety of a bank account or mattress, both of which put them at a disadvantage when it comes to achieving their financial goals.

For an investor, a long-term or strategic asset mix is the key element of their strategy and the one that has the most impact on future returns. It's an educated guess at what the best combination of cash, bonds, stocks and other investments (including real estate) is for their situation. It takes into account their objectives, time horizon and tolerance for short-term volatility.

Near-term predictions about which asset types are going to provide the best returns are at best unreliable. But when making projections over longer time frames, the crystal ball gets less cloudy. We know, for instance, that stocks will beat bonds, and bonds will beat cash ( $S > B > C$ ). And the range of possible outcomes gets narrower the further we look out.

For example, bond returns are difficult to call in the next year or two due to swings in yields and credit spreads. But looking out 10 years or more, we have a reliable indicator of what returns will be, namely current interest rates (3 to 4 per cent). For stocks, the range is wider, but it's more like 5 to 9 per cent as opposed to plus or minus 20 per cent.

I give investors a further advantage over savers because they can base their decisions on more reliable data, including long-term projections.

Investors first need to set an asset mix. For those with a long time horizon, this is not rocket science ( $S > B > C$ ). And then they need to determine how they want to manage the portfolio around that mix.

Some investors try to time the market and actively shift the mix. Others, like me, could best be described as tilters, leaners or shadders. Our allocations are adjusted to reflect our views on valuation and market sentiment, but we only move away from our baseline when there's a compelling reason to do so, and always within a set range.

For investors who don't have the wherewithal or inclination to outguess their long-term targets, it's best to set the portfolio mix and keep it there.

What does it mean to make all your investment decisions in the context of a strategic asset mix?

It means you agree with the long-range projections ( $SBC$ ) and accept the

fact that it's impossible to know when to get in and out of the market.

It means that you'll always be diversified, which in turn means that you're not trying to get everything right all the time. This will make you boring at parties (take it from me) because you won't be the one bragging about how you made a killing on oil, high-yield bonds or emerging markets. But you'll be comfortable knowing that you too benefited from those trends, just not in a 'go big or go home' way.

It also means there won't be all that much to do. New 'flavour of the month' product offerings won't hold much appeal. And the mind-numbing decision of what to do at the RRSP deadline will be an easy one — allocate your contribution in line with your long-term mix.

These days I'm doing three things in my portfolio and emphasizing the same with Steadyhand clients.

First, I'm being careful not to get carried away with the great returns of the last year. Indeed, I've moved my equity allocation towards the cautious side of the range. That has required some rebalancing towards bonds and cash.

My reasons for caution have been outlined in previous columns, but suffice to say it's based on valuations (reasonable), market sentiment (are investors living dangerously again?) and the economy's inevitable transition from The Great Debt Transfer to The Great Debt Reckoning.

Second, as part of the rebalancing, I've used the strong loonie to opportunistically increase my weighting in foreign stocks. They have lagged behind my domestic holdings, mostly because of currency.

Finally, I'm paying special attention to cash flow management. It's easy to get lazy about setting money aside, but now is not a time to be lazy.

Now to get back where we started... Can you believe Steve Nash is having another MVP-like season?



# Eighteen

---

## Asset Allocation and Hindsight Bias

---

*March 25, 2009*

I received an email from a reader who suggested that someone should offer a balanced fund that is more focused on preserving capital. Rather than being stuck on a set asset mix, as most balanced funds are, the fund would have the scope to move between fixed income and equities. As he described it, “[The fund’s] fixed income portion would vary from 50 to 75% as markets change. When equity markets are undervalued, the manager would step up the equity percentage to 50%. Conversely when equity markets seem overvalued, the cautious thing to do is to rebalance to lower levels of equity investment.”

The reader was fortunate enough to anticipate the downturn and had rebalanced his own portfolio. Other people he knew had done the same. He feels that professionals should have seen it too and acted more decisively to preserve their clients’ capital.

In responding, let me first say that I am sympathetic to the view that most funds are too constrained by rules and limitations, and firms are

unwilling to have the performance deviate from what similar funds are doing. As a result, even conservative balanced funds get caught up in the performance game and are slow to batten down the hatches.

And I'm in agreement that we should be willing to shift our asset mix in the context of market conditions. Indeed, we have set up Steadyhand with the express notion of addressing this issue. Our fund managers have few constraints on them and can move decisively to where they see value. And while they are aiming to beat the indexes and competition in the long term, they pay them little heed in the short term.

But, and there is a but, we have to be careful in thinking that we can be so confident in our market view as to consistently get our asset mix shifts right. Given what has happened, it's easy to think that our current predicament was foreseeable by everyone. At times like this, we are prone to suffer from *hindsight bias*, which is “the inclination to see events that have occurred as more predictable than they in fact were before they took place.”

Our reader is to be congratulated for his sound judgment and good fortune, but he has to realize he beat the odds. What he did is hard to do because it involves making a correct call on the future outlook as well as assessing how much of that outlook is priced into the market. And then those two things have to be done again when the shift is reversed.

I'm not trying to be defeatist here, nor am I suggesting that every decision has to be perfect to enhance returns, but we need to go into it knowing how complex and challenging it is to be an asset mix shifter.

At Steadyhand, our approach to asset allocation is simple, and I'm sure somewhat unsatisfying to many investors. It goes like this:

- The key is having a long-term (strategic) mix — i.e. if you're young, you own lots of equities; if you're older and drawing on your portfolio, you own mostly fixed income; and a few variations in between.
- For most investors, asset shifts should be as automatic as possible — i.e. periodic rebalancing back to the long-term mix. The goal is to take emotion and market-timing out of the equation.
- More experienced investors, or ones that rely on an experienced advisor such as Steadyhand, can 'shade' their mix towards their

view of the world and market valuation. By 'shading' as opposed to 'shifting', they will benefit from good decisions, but not be blown away by bad ones.



# Nineteen

---

## A Recipe for Poor Performance

---

*June 18, 2007*

Early on in his book *Unconventional Success: A Fundamental Approach to Personal Investment*, David Swensen talks about market timing and asset allocation. His words reinforce how we feel about the topic.

After writing about how market timing has had little impact on returns for institutional investors, he says, “*the story differs for individual investors. The available evidence points to a pattern of excessive allocation to recent strong performers offset by inadequate allocation to recent weak performers.*” He goes on to say that investors can find themselves in this situation either actively (performance chasing) or passively (asset mix drift). The latter is more common. It happens when investors are reluctant to trim or sell something that has been good to them and find it hard to buy an asset that has been a laggard and nobody is focusing on.

Swensen again: “*Overweighting assets that produced strong past performance and underweighting assets that produced weak past performance provides a poor recipe for pleasing prospective results.*”

His comments are particularly timely right now as rising commodity stocks and the Canadian dollar are giving investors lots of positive re-



inforcement as to why they own domestic securities. But if your portfolio is overwhelmingly tilted towards Canada, it is a good time to do some rebalancing towards foreign markets. With the strong loonie, the same amount of money will buy you more shares in Nokia, Intel, Citigroup or any foreign equity mutual fund than it would have a couple of months ago. In Canadian dollar terms, foreign shares have been marked down.

If you have already started the rebalancing process and are frustrated with the early results, it's not time to lose your nerve. Rather, it's a great time to take another step in that direction.

# Twenty

---

## Re-balancing When Needed

---

*June 8, 2009*

Last week Chris and I met with Scott Robertson, a financial planner from Ottawa. Scott is a veteran and has a straight-forward, no-nonsense approach to his craft. That was clear when we asked him *when* and *how often* his clients re-balance their portfolios. He said without hesitation, “When they’re out of balance.”

That makes sense. Nice and simple. Why get hung up on quarterly or yearly. Just do it when you need to. Set a range as to how far the portfolio can stray from its long-term mix (5 or 10%), and then take action when the limits are exceeded.

I would only add that having a re-balancing rule based on the calendar (i.e. annually) requires less monitoring of the portfolio and totally takes the emotion out of it. It’s a crutch we can lean on when the heart is getting in the way of taking action. I think calendar-based rules are more ‘automatic’ than the range-based rules.

In either case, our view is that re-balancing makes sense for most clients given that (1) their long-term, strategic asset mix represents their best

guess as to what's appropriate for them, (2) calling the market in the short term is impossible and (3) it dampens down the volatility of a portfolio. A disciplined re-balancing regiment forces us to buy low and sell high without emotion getting in the way.

# Twenty-one

---

## Making a Go of it, Despite the Doom and Gloom

---

*July 24, 2010*

In my quarterly letter to clients I used the word “discouraged” to describe investor sentiment. In the few days since we published it, however, I’m starting to think a better word is “despair.” Too regularly I’m being asked whether it’s time to get out of the market.

The worry isn’t coming from portfolio returns in the first half of the year — balanced portfolios are down from zero to 3 per cent — but rather a deep concern about what’s going to happen in the second half and beyond. Investors don’t want to go through another 2008.

The despair seems to have common roots. It’s a news article about the world’s debt burden and its ramifications — higher taxes, unemployment and more “Greece-like” events. It’s the realization that growth is going to be tough to sustain after the government stimulation tap is turned off. Or it’s a gloomy economist pontificating on how we can’t get out of this mess without another debacle, or at least a very slow period of growth.

This stuff is hard to refute and I don't try. I've been in the "bumpy road ahead" camp for a long time and have been counselling caution since last fall. But that doesn't mean my nervous clients, friends and family will hear what they want to hear from me. That's because my strategy doesn't call for getting right out of the market. Far from it.

If I'm given time to respond to the question (and questioners don't always want an answer), I start by reviewing a few basics. It goes something like this:

Remember, Susan, Mr. Market is well aware of the issues out there. Security prices are always trying to anticipate future events. Your fears are shared by many investors and may already be fully factored into market prices.

Whatever you do, don't make radical changes at a time of maximum stress, or excitement for that matter. That's when the biggest mistakes happen, mainly because the shifts are made to conform to the consensus.

Yes I know, the consensus can be right for a time, but believe me, it's always wrong at the peaks and troughs. If investors are dead certain, then they're certain to be dead wrong. Yes, I did just make that up.

I think you know that getting out of the market involves two decisions, not one. After you sell, you have to get back in at some point. Any expectation of precision on either of those moves would be misguided. There will be no alarms going off telling you the way is clear.

Scott, I remind you that the "all-GIC strategy" that your dentist was bragging about always looks good when the stock market is down, just as an all-equity strategy does in the good times. If you only need a 3-per-cent return before taxes and inflation to live comfortably in retirement, then a "sleep well" strategy like that is an option. For investors who need more return, however, the potential of missing an up market poses just as big a risk as catching the down.

Jake, I want you to think about your portfolio in terms of ranges around a long-term asset mix, one that reflects your long-term goals and the odds of you winning at the market-timing game. For example, if your strategy is to have 60 per cent in stocks (or other higher-volatility investments) over the long run, then you might give yourself room to move the weighting between 50 and 70 per cent. The less experience and time you have for investing, the narrower the range should be.

Then you need to look at three things to determine where you should be in the range. The first is your outlook, which in this case is negative. But don't stop there. Next you look at valuation (pricing), because dire headlines don't preclude investors from making a pot full of money. Indeed, if all the bad news is factored into the market already, then it might be time to buy, not bail.

And then you need to take a reading of market sentiment. Are other investors positive or negative? The market's mood provides a good reality check, sometimes advising caution (when everyone is bullish) and other times pointing to areas of opportunity (bearish). It's that consensus thing I was talking about. Are you alone, or running with the crowd?

Now the crescendo: Brad, I want you to make an informed decision based on those three factors, not just that article you read. Right now I would make sure your higher-risk holdings (stocks, commodities, high-yield bonds) are in the bottom half of your range. With you running between 50 and 70 per cent, that means 50 to 55 per cent of your portfolio in stocks. I say that because I agree with you that the big picture isn't very pretty. But having said that, you should be getting prepared to do some buying because weaker markets have improved valuations and market sentiment is getting better (i.e. more despair).

If you have a specific need for money in the next year, set it aside in a high-interest savings account now. Cash management is always important, especially in a higher-volatility environment.

And Brad, be careful not to confuse economic forecasts or political ineptitude with the risks and opportunities for you in the market.



Part VI

Returns





# Twenty-two

---

## Unrealistic Expectations

---

*August 17, 2006*

I was golfing with a friend of mine a couple of Friday's ago. At the 19th hole, we got talking investments, which led us to the PH&N Bond Fund. He's owned the fund for years and has been very happy with it. When we were discussing performance, I pointed out how well it had been doing to which he said with a scowl, "not lately".

I was surprised by his comment and body language. I explained that the bond market has been very weak so far this year and that rising interest rates made it tough for any bond portfolio to provide positive returns. In this context, the PH&N fund had held up pretty well. Neither of us wanted to talk about bonds on a Friday evening, so we quickly moved on to discussing Michelle Wie.

Reflecting back, however, this brief conversation reminded me how unrealistic investor expectations can be sometimes. We have been experiencing terrific markets in Canada over the last 3 years. It's true that the 2nd quarter wasn't so hot. And certainly bond returns have moderated, but only after experiencing a 20+ year bull market, which had few interruptions along the way.

I'm continually amazed by investors' short-term thinking. I'm not sure how we change that, but one thing I often point out is that even the most successful professional money managers have bad patches, which might last a few quarters, a year or a few years. Think of Irwin Michael at ABC ... he wasn't always riding high. Bill Kanko had some dry spells in his Trimark days. Jerry Javasky, Francis Chou, Kim Shannon ... go down the list.

Good markets are made up of strong and weak periods and even superstar managers have slumps (which are part of their long-term batting average). To be a successful investor, our expectations have to be appropriate. Without that, we're likely to make some regrettable decisions (read: disastrous market timing, performance chasing, unwarranted risk taking).

As for Michelle Wie, I think people are making way too much of the fact that she hasn't won a tournament yet (she finished second in Germany that weekend). She's only 16 years old and yet is in the hunt almost every time she tees it up on the LPGA, especially in the most important tournaments. It's time to chill out and enjoy watching this great young golfer.

# Twenty-three

---

## I'll be Happy With 10% a Year

---

*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.

# Twenty-four

---

## Assessing Performance — Don't be Sloppy!

---

*February 21, 2007*

It's that time in the market cycle when we're all vulnerable to hearing how great someone else has done with their investments. Invariably, this kind of chatter leads back to comparisons with the mutual funds owned by the speaker or the listener. "I've had 30% returns from my own investments, but my funds have done nothing. A house down the street just sold for twice what we paid for ours ... I wish my mutual funds were doing that well."

As we start up Steadyhand, this is a good news / bad news story. It shows that there are people out there who aren't satisfied with their current mutual fund holdings (Yeh!), but ... it also shows that there is a strong negative bias against funds.

My comments below are aimed at the general perception, not how Steadyhand will do it better.

First, I will admit to being somewhat baffled by these types of comments.

Even in an industry where fees are generally too high, there are a ton of funds that have performed really well over the last few years.

- In general, Canadian equity funds have had a very good run. Data from Globefund shows that this category's median return for three years ending January 31st was 15.6% per annum (\$10,000 invested three years ago is now worth \$15,450). Even over the last five years (which included 2002 and 2003 ... ugh!), the median fund had a return of 11.3% per year.
- Income trust funds had a tough year in 2006, but have provided excellent returns over the last three years (10.7% per annum) and five years (15.6%).
- International stocks came roaring back in 2006. The median fund in this Globefund category was up 20.5% last year. And despite being a laggard previously, the three year return was 12.1% per annum.

I'm not trying to cherry pick funds or categories. My point is that markets have been good and mutual fund returns have been good too. (Note: By definition, half of the funds in the samples referred to above did not achieve a median return, but the other half did better.)

I think we are all vulnerable to sloppiness when we're making performance comparisons. We have to be careful we're not comparing apples (our 'fun' money) and oranges (our 'must be there when we retire' money). In the latter case, a typical portfolio will be well diversified and own fixed income securities as well as equities.

If we look back over the last few years, Balanced funds have done what they're supposed to do. Again using data from Globefund, a median Balanced fund has provided 8.2% per year over the last three years. If we include the wipeout years (2002 and 2003), then the annual return for five years was 6.4%. While Canadian and International equities carried the load over the last year, the fixed income securities saved the day during the bear market (will U.S. equities be the next asset class to pull its weight?).

All the measures we look at right now say that risk taking in the capital markets is off the charts, so it's not surprising the locker room talk is full of great stories. Before you shrink into your locker with embarrassment,

make sure you compare the chatter to what you've done with your speculative investments, if you have any. Otherwise, you might want to change the topic by asking "How did Stevie and the Suns do last night?"





# Part VII

## Industry



# Twenty-five

---

## The Investment Profession-versus-business Tug of War

---

*January 7, 2008*

Over the holidays I had a chance to read Michael Mauboussin's *More Than You Know: Finding Financial Wisdom in Unconventional Places*. From his perch as chief investment strategist at Legg Mason Capital Management (home of Bill Miller), Mr. Mauboussin has written an insightful book on investing and investment management.

Throughout the book he addresses the “tension — and perhaps growing imbalance — between the investment profession and the investment business.” He defines the profession as “managing portfolios to maximize long-term returns” and the business as “generating (often short-term) earnings as an investment firm.”

At the core of the profession-versus-business tension is the notion of time frame. In an ideal world, portfolio managers make investment decisions based on a multiyear view; they can buy underpriced securities knowing

that it may take a few years for the value to be reflected in the market. The more freedom managers have to push out their time frame, and take advantage of the myopic nature of the markets, the better chance they have of creating wealth for their clients.

But with that freedom comes a downside. A truly long-term portfolio is more likely to be out of sync with the market for a considerable period of time. Of course, out of sync “first quartile” is great. Out of sync fourth quartile, however, takes the sales team out of the game and puts the business plan at risk.

An asset management firm also has to find a balance on how far out of sync it is willing to be compared to the competition and the industry benchmark - for example, the S&P/TSX Composite Index. In the short run, clients won't fire a manager for lagging the index by a few percentage points, but they might if the portfolio is 10- to 15-per-cent behind.

The starkest example of this dilemma I've ever seen occurred in the late 1990s when Nortel was in its glory. The stock was going up so fast and was such a big part of the market — it accounted for over 30 per cent of the S&P/TSX at one point — it was defining firms' short-, medium- and long-term performance records. Managers who didn't own Nortel watched as their hard-earned record rapidly deteriorated. It was a time when investment decisions were being made for business reasons: “We have to own this thing or we'll lose clients.”

In the end, the firms that stuck to their investment disciplines and absorbed the criticism made the most money, but that wasn't revealed until much later, and, in many cases, redemption came after clients had already left the fold.

The profession-versus-business tug of war also affects the types of securities portfolio managers can own. It is all right to go wrong with a company that is well financed and highly regarded. Clients aren't too critical of that. If a controversial name hurts performance, however, the manager is likely to hear about it. And the comments are hard to respond to: “I thought you were more prudent than that. What were you thinking when you bought that company? It's obvious there was no value there.”

My former partners at Phillips Hager & North and I faced this situation in 2002 when we held a position in Rogers Communications. The company was overleveraged and had a poor reputation for service (remember the controversy around negative option billing?). Canadians loved to hate

Rogers. In that context, our portfolio manager was convinced (rightly) that the cable and wireless assets were severely undervalued, but the stock had been pummelled. I remember more than a few client meetings when I took grief for holding Rogers. We stuck with it, however, and in the end ultimately made them money.

Finally, one of the most difficult tradeoffs relates to how big a firm is allowed to get. Generally speaking, scale is good for profits, but bad for client returns. It is widely accepted that the larger the asset base, the more difficult it is to produce superior results. As firms get bigger and busier, there are less securities for them to invest in, and the founders and key money makers get further removed from the decision-making process.

But it's tough to turn down new clients. As sure as rain in Vancouver, there comes a time in a firm's performance cycle when nobody is knocking at the door and existing clients are looking elsewhere. Knowing that, it is a far-sighted and gutsy management team that will close for new business to protect the returns of its existing clients.

In the end, all of us in the industry have to ask ourselves where we are on the spectrum between asset manager and asset gatherer. How do we balance the needs of our portfolio managers — time, freedom to be different and a right-sized asset base — with the conflicting needs of our business managers?

For me, Charles Ellis, a renowned thinker on investment management, sums it up best when he says, "The optimal balance between the investment profession and the investment business needs always to favour the profession."

*Postscript: Since this article was written (nearly three years ago), there has been a proliferation of bond and income-oriented funds hitting the market, as fixed-income securities have performed well — especially relative to equities — over this period. With bond yields near their historic lows, the upside potential of these products is limited and investors are being set up to be disappointed. Clearly, the investment business has been winning the tug of war.*



# Twenty-six

---

## “It Will Sell”: A Tipoff for Bad Investment Products

---

*April 6, 2009*

As the wealth management industry works through this bear market, investment products that promise certainty and limited downside risk are going to be popular. With guaranteed investment certificates (GICs) offering minuscule yields, stock-market-related products with “guaranteed income” and “principal-protection” will be big sellers.

I think that’s unfortunate for two reasons. First, we’re now in a favourable environment to take more risk, not less. And second, investors give up a lot of return for the fancy features they’re buying. Such things as downside protection, tax deferral or arbitrage and convenience come with a price.

My purpose here is to illuminate some of the tradeoffs investors make when they go beyond plain vanilla.

But first some background. I developed an aversion to complex investment products and packaging about 10 years ago. I was at Phillips, Hager



& North at the time and we had a number of investment bankers come through our offices pitching us on their newest creations. They wanted to work with us because we had a good brand name that would lend credibility to the products. At the sessions I attended, I always asked the same question: “Is this good for the client?” I never once was told that it was. There was some diverting of eye contact, hemming and hawing, and on a couple of occasions, the answer was simply: “It will sell.”

We once committed to working with one of the banks on a product that saved high-tech executives taxes when they exercised their stock options. We thought it looked like a reasonable idea, but as we got further into it, we became increasingly uncomfortable. We calculated that the executives could achieve higher after-tax returns without a complicated structure. Fortunately, we were able to escape our commitment honourably when the high-tech bubble burst.

From that point on, I’ve done research (sometimes vicariously through much smarter colleagues) on many new packaged products and rarely have I come up with a different answer to my question. What I got was a notebook full of issues.

*Lack of transparency.* We should always understand the basics of what they’re investing in, even when an adviser is involved. But products like principal-protected notes (PPNs) and guaranteed income funds are complicated and hard to figure out. Too often investors don’t know how they work, what the underlying assets are and how much they’re paying.

*Misalignment of objectives.* A lack of understanding often leads to investors buying products that are ill-suited to their needs. For example, a 40-year-old with a 30-year investment horizon shouldn’t be buying short-term stability or principal protection, no matter how appealing it sounds. A bumpy 8 per cent return is what she/he needs, not a smooth 4 per cent.

*The marketing imperative.* My undergrad degree was in marketing, but when it comes to product design, that area of business should play a secondary role. Sales and marketing departments want things that will sell, which means looking in the rear-view mirror. The easiest sale is whatever worked last year (I recently saw an ad for a “bear-resistant” fund). In general, marketing-driven products encourage investors to “buy high.”

*Overdiversification.* “One-solution” products, including some wrap funds,

are convenient, but tend to be too diversified. By having multiple managers in each asset category, the product (I'm reticent to call it a portfolio) owns hundreds or thousands of stocks. Effectively, it's an index fund with an annual fee that's two percentage points higher than it should be.

*Complexity risk.* In many packaged products, there are so many moving parts that it's difficult to determine what risks are being taken. That complexity sometimes results in outcomes that were unforeseen by bankers and advisers (liquidity drying up; the worst bear market in 80 years; global bank failures). Other times, however, the risks have been identified, but not communicated. The creators of PPNs (the type known as Constant Proportion Participation Insurance) have always known that their notes were path dependent (i.e. if the underlying asset goes too far down in value before it goes up, eliminating any chance of a positive return). That potential outcome is never openly discussed with potential buyers, even though it reduces the value of the note.

*Degrees of separation.* It's best if money managers live and die with the performance of their funds. Managers should be invested alongside clients. With packaged products, that accountability gets diluted with every person that gets between the client and the portfolio of stocks and bonds.

*Cost:* With every degree of separation comes more fees. When investment bankers, lawyers, traders, money managers, insurers, marketers and salespeople get involved, they need to be paid. As a result, structured products are expensive.

*Who's insuring who?* There is a common misconception about fancy investment products. Too often buyers believe that someone else is paying for the insurance and guarantees. Wrong. There is no new source of return being invented. Additional costs come directly out of what is earned by the underlying stocks and bonds.

There are other issues scribbled down in my notebook — poor liquidity, misunderstood by advisers, bad names — but I'll stop there.

I liken structured products to Viagra. The industry is hooked on them because they stimulate sales. They're a specialty product that should be used by few, but are sold to many. And the buyers get instant gratification, but pay for it in the long run.



# Twenty-seven

---

## ETF Providers Have Cluttered a Pristine Landscape

---

*April 17, 2010*

Four years ago my business partner Neil Jensen and I were sitting on Kits Beach contemplating a new mutual fund company. As we looked out at the competitive horizon, we could see a wave coming at us. It was called ETFs (exchange-traded funds), and we knew it would be a tough, low-cost competitor to Steadyhand.

What we didn't anticipate was that the wave would turn into a tsunami. In no time, Canadian investors were flooded with new ETF offerings. By our count, there are now 145 funds traded on the stock exchange and a steady flow of new ones coming out from Blackrock (iShares), Claymore, Horizons BetaPro, Bank of Montreal and PowerShares. During the past year in particular, the marketing machines have kicked into high gear.

As a consequence of the swelling numbers, the ETF sector has profoundly changed how it's positioning itself with investors, and how it competes against other investment firms like ours.

*Not So Simple.* For starters, when investors are looking for “simple and transparent”, ETFs are no longer the default. There still are many clean, easy-to-understand ETFs to be had, but they’re harder to find among the proliferation of new products.

Indeed, ETFs no longer take a back seat to closed-end funds or mutual funds when it comes to complexity, opaqueness and fine print. Investors need to ask the same questions they would of any packaged investment product. Will I own stocks, commodities or derivatives? Is there any leverage? What index is the fund replicating? Is it currency hedged? How well does it trade? Are there other fees or costs?

In the rush to catch the wave, the ETF providers have cluttered what was a pristine landscape just a few years ago.

*Not so Predictable.* It used to be that investors knew what to expect from an ETF. If the market went up X per cent, that would be the fund return, minus a small fee. The emergence of BetaPro’s leveraged ETFs blew that notion out of the water. If an investor held their ‘Plus’ funds (two times market exposure) for more than one day (yes, one day), the returns were totally unpredictable relative to the index or commodity they were tracking.

But the unreliability of returns is not limited to the high-octane funds. The returns from some currency-hedged equity funds diverged widely from their expected targets in 2008 and 2009. And in general, the tracking error of ETFs (the amount a fund’s return diverges from that of the target index) have widened over the past few years. According to the Wall Street Journal, U.S. ETFs on average missed their targets by 1.25 per cent in 2009, more than double the 2008 gap.

*The Fee Halo.* Over all, ETF fees are lower, but the scene has changed here too. From a rock-bottom start with the original iShares funds, fees have steadily crept up. If an investor uses some specialty funds and trades a few times a year, the cost of an ETF portfolio can easily push into the range of low-priced mutual funds.

In another disturbing innovation, some ETFs are being launched as closed-end funds and then converting to open-end at a later date. These funds are prohibitively expensive for the initial buyer.

Despite the trend to higher fees, there is still a halo around ETFs. This was particularly noticeable recently when some actively managed ETF’s

were rolled out and the 20-per-cent performance fee was hardly mentioned in the commentaries.

*Trading at a Price.* One of the advantages of ETFs is that investors can buy or sell at any time. For day traders and institutional investors, including hedge fund managers, this is what makes them so attractive.

However, many of the new funds are extremely illiquid and require trading experience to ensure that the price paid is at or near the value of the fund. For long-term investors who are looking for cheap, broad-based market exposure, negotiating a trade in the open market and paying a brokerage commission is not always so great a deal. For some, buying a mutual fund after the market closes at net asset value (calculated to four decimal points) may be more appealing and practical.

*The 90/10 Rule.* The marketing of ETFs has gone from being all about cheap, broad-based and passive to being focused on specialization and active trading. Most new products are designed to allow investors who “have a view” to implement their strategy with surgical precision. An investor can now get exposure to virtually any commodity, country or industry sub-sector, and as of this week, can speculate on spread trades between like commodities (i.e. long oil and short gas).

It’s all about market timing, sector rotation and trading. In other words, we have arrived at a point when 90 per cent of new offerings are suitable for only 10 per cent of investors.

*Stop Generalizing.* When we drew up our business plan, we made lots of mistakes, including underestimating how big a competitor ETFs would be. Going forward, the biggest error we could make would be to oversimplify the differences between ETFs and mutual funds. Other than the way they are transacted, the lines between them have almost disappeared.

We can no longer naively say that ETFs are simple, low cost, index-based, tax efficient and have a trading advantage. Or conversely, that mutual funds are none of those things. It’s time to stop generalizing and go back to the beach in search of the next wave.



# Twenty-eight

---

## You're Paying Too Much If...

---

*August 23, 2006*

Jonathan Chevreau of the National Post is known for continually pounding away on the fee issue. He had lots of ammunition this week when he got his hands on a U.S. academic study called “Mutual Fund Fees Around the World”. The study, which is at the draft stage and is being circulated for industry comment, shows that Canada is the highest cost mutual fund market in the world.

Brenda Vince, President of RBC Asset Management and chairperson of IFIC (Investment Funds Institute of Canada), takes issue with the numbers and says that without higher-cost segregated funds, the numbers would be lower. That wouldn't make a big enough difference to change the story, however. And what Brenda doesn't say (because it's not under her purview) is that if all the structured products (principal-protected notes, closed-end funds, etc) were included, the comparisons might even be worse.

One of the amazing things about Canada (and the reason the stats look so bad) is how much of the market is in high-fee product. I don't know the exact number, but I think it's fair to say the market share for high-



fee product is ... 'almost all'. In the U.S., low-fee fund families like Vanguard and T. Rowe Price have had more success in penetrating the market and low-cost index funds and ETF's (exchange-trade funds) are more commonplace than in Canada.

To drill down on the fee issue, I suggest we ask the question: when are you paying too much? While fees are generally too high in Canada, there are some specific situations where they're particularly egregious.

You're paying too much if ... you don't need advice. More sophisticated investors, the "do-it-yourselfers" if you will, shouldn't own high fee funds that have an advice component built in.

You're paying too much if ... you need help, but aren't getting it. Most distributors (brokers, planning firms, banks) have improved their advice offering over the last 10 years. Their advisors are better trained and have more tools at their disposal. But there are still far too many cases where the client is paying for help (via a higher fee on their funds), but not getting sound, objective counsel.

You're paying too much if ... you're a steady, disciplined investor who is sticking to a long-term strategy (i.e. not making changes all the time). I would suggest that 99% of non-professional investors are not in a position to pursue "tactical" or market-timing strategies with their portfolio. They're far better off to lay out a long-term strategy and set up a portfolio to execute it. A "strategic" investor won't be making changes all the time and doesn't need to pay for on-going advice. An occasional tune-up is more than adequate.

You're paying too much if ... you're a large investor. I fully recognize that advice costs money. If a high-fee mutual fund is helping a small investor receive professional help, then it's probably not such a bad deal. Larger investors, however, would be far better to whip out their Visa card and pay for advice on an "as needed" basis. If a \$300,000 investor is paying an extra 1% for advice, that's \$3,000 a year. If you wanted to get a bi-annual tune-up, you could get a lot of help from a fee-only planner for \$6,000. In reality, it would cost you a fraction of that.

Bottom line: There are all kinds of nuances to this issue, but in the end, Canadians pay too much for professional money management and advice (through mutual funds and other packaged products).

# Part VIII

## Success



# Twenty-nine

---

## Stick to the Fundamentals and Good Things can Happen

---

*November 12, 2007*

As an equity guy, I don't like to admit it, but I recently spent some time with the bond team at Connor Clark & Lunn Investment Management. Bondies aren't known for being the most exciting people. The good news is that they make my personality look downright bubbly.

In any case, we at Steadyhand selected CC&L a year ago to run our income fund. They got the nod because they bring a wide range of skills and strategies to the fund, which in the past has translated into consistently good returns for their clients.

During the presentation, Brian Eby, the head of the CC&L team, outlined the strategies used, which include predicting interest rates, positioning on the yield curve and switching between government, corporate and global bonds. The strategy that produces the best results, however, is their selection of individual corporate bonds. Their skill at doing credit analysis has translated into more added value per unit of risk than any of the other strategies in their tool box.

Now CC&L's client pitch isn't particularly unique. All managers will tell you about the many strategies they deploy. What makes CC&L and other good managers successful, however, is their ability to focus on the most reliable strategies. By doing that, they are able to produce more predictable and consistent "alpha" (returns in excess of an indexed portfolio).

As I've previously noted in this column, you should never assume that a manager will generate alpha. It is a tough thing to do. Indeed, if you want to bet on something, you're better to go with alpha's poor cousin "beta." We know the market indexes (beta) will go up over time. Alpha has no such guarantee.

But if you are seeking returns in excess of the index as we are, you want to invest your money with managers that have an approach that has consistently worked in the past — managers that use strategies that are repeatable, but don't expose the portfolio to more risk.

Everyone has an opinion as to where to best find high quality alpha. I'll tell you where I go looking, although I don't expect that my views will receive unanimous support.

Money managers that make the big macro calls garner the biggest headlines because they have the potential to win big, or lose big. There are successful managers who make bets on currencies, commodities or interest rates, but they are few and far between. To me, big picture predictions in our highly integrated world are a crap shoot.

Asset mix calls are slightly more reliable, although there have been plenty of surveys showing that managers add little or no value by shifting the portfolio between stocks, bonds and cash. Long-term assessments of relative value can add to return and reduce volatility, but trying to catch short-term moves is not something I want to pay for.

I also think sector rotation is a tough way to make a living. We often hear managers talking about where market leadership is going to come from next: "It's resources today, but real estate will lead the way over the next quarter." The managers who bill themselves as sector rotators tend to be at the top of the charts one year and at the bottom the next.

Similar to shifting between industry sectors, some managers rotate between investment styles: value versus growth, large capitalization versus small cap. The challenge with this approach is the same one that afflicts

all macro strategies. If you're wrong, you can be wrong for a long time. For example, some U.S. managers started calling for large-cap growth stocks to assume market leadership three or four years ago. It wasn't until recently that it happened.

To my way of thinking, security selection is the highest quality alpha you can get. If managers conduct comprehensive research, focus on stocks or bonds they understand and are valuation conscious, good things can happen. They will get it wrong lots of times, but their batting average will be higher than the macro managers. The big picture stuff (interest rates, currencies, economic growth) will influence stocks or bonds in the short run, but a portfolio of underpriced securities will eventually find its value.

The challenge all investors have, be it amateur or professional, is devising an approach that features their most reliable alpha. Unfortunately, it is easy for overconfidence and too much information to lead investors into making decisions based on factors that have less chance of success. They let the poor quality strategies obscure or negate the good ones.

It's important to understand the strategies your managers are using to earn the money you are paying them. You want to know where the alpha is expected to come from. If out-guessing the Federal Reserve Board or making a call on the dollar is part of the plan, I'm inclined to move on and continue looking for someone to manage our clients' money.



# Thirty

---

## Complacency: A Major Misstep of Mutual Fund Investors

---

*September 19, 2009*

Individual investors (and their advisers) are far too patient when it comes to dealing with changes in their mutual funds. They're quick to make moves based on short-term trends and performance, but slow to recognize the impact of fundamental shifts in personnel or investment approach.

I bring this up because fund mergers and manager changes have become a constant in our industry. In recent weeks, we've seen Trimark change managers on a few of its major funds. Ethical and Northwest Mutual Funds are going ahead with 18 fund mergers. Bank of Nova Scotia is making organizational changes throughout its asset management platform. And there are certain to be numerous changes that come out of Manulife's purchase of AIC.

Volatile markets, slower asset growth and industry consolidation have contributed to the current wave of activity, but the reality is, the industry's marketing machine has left us with too many funds in Canada.



But before I address the patience question, let me provide some background.

When I moved to the buy side in 1991, I started in an institutional role. The clients I served were pension plans, endowments and corporations. Each had a formal process for picking and monitoring their money managers and they were usually assisted by a consultant who scrutinized performance, style and organizational changes. They were hyper-sensitive to any shifts in philosophy or personnel.

I learned early on that we had to be very clear about what we were offering — investment philosophy, people and business practices — and stick to it. Obviously performance was of paramount importance, but if we took care of those three things, we could build a sustainable business. If, on the other hand, clients came to us solely in pursuit of past performance, then we would eventually lose them when our approach was out of favour and returns were lagging.

The philosophy, people and practices criteria are still relevant to me in building a private wealth business at Steadyhand, and they should be important to all buyers of investment services. A fund's performance will ebb and flow, but its principles and people should not.

So, why do I say investors are too patient? Because too many of the changes they are subjected to don't stand up to the three criteria.

Consider the following example. You receive notice that your international equity fund is being merged into a global dividend fund. You're told the new fund has performed better and has the same fee. (Note: This is not an extreme example — over the past five years a slew of conventional equity funds became "dividend" funds.) So what has changed? Well first, the mandate of the fund has been altered by expanding the geography (global includes the U.S., international doesn't) and restricting the investment approach. The fund is now constrained to dividend-paying stocks, so it's unlikely that technology, resources or emerging markets will be included. And you have a new portfolio manager.

What looks like a simple name change on your statement represents a dramatic change of personnel, approach and role the fund will play in your portfolio. And in some cases, by merging a poor performer into one that is in a hotter category, the fund company is doing exactly what it doesn't want you to do — chase performance.

Measuring your funds against the philosophy, people and practices is not easy. The portfolio manager and investment philosophy are intertwined and sometimes they're inextricably linked. Indeed, it's hard to separate the two when it comes to investors like Eric Sprott, Frances Chou or Frank Mersch. They are the philosophy.

If you own a fund because of a particular manager, and that person goes elsewhere, the decision is easy. It's time to move on. I can think of two striking examples of this in recent years — Alan Jacobs' move to Sprott and Kim Shannon's shift to Brandes. In both cases, Sceptre and CI replaced their stars with capable managers, but nonetheless, the client's reason for owning the fund had been taken away.

Sometimes the investment approach has a history and is more enduring than any one individual. At Burgundy and Beutel Goodman for instance, the investment teams are fine-tuned from time to time, but the approach never changes. The "who" is important, but not as much as the "how."

So every change is different and they don't all necessitate the client taking action. But like my old institutional clients did when there was a significant shift in investment philosophy, people or business practices, you should at least put the fund on a watch list. In a well-constructed portfolio that holds between five to eight funds, every slot has a purpose. If someone else is making changes to it, you need to pay attention.



# Thirty-one

---

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

---

*October 1, 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.



# Thirty-two

---

## Small Investors Can Also Benefit From the Buffett Doctrine

---

*July 9, 2007*

Avner Mandelman's column in the Globe 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.



# Thirty-three

---

## Got Money to Invest? Buck Stops with You

---

*March 13, 2007*

It sounds corny to say that investing is a team sport. Of course it is. But sometimes there is too much focus on the individual player and as a consequence, effective teamwork suffers. I think of my favourite team sport, basketball, in which too often offence revolves around the star player going one-on-one. Indeed, until recently the kind of team-oriented game that Steve Nash and the Phoenix Suns play was considered quite novel. But as the Suns keep chalking up wins, the concept of team play is getting talked about more frequently.

Like the National Basketball Association, the mutual fund world can get too focused on an individual player. A star fund manager or savvy investment adviser is seen as a way to attractive returns. Certainly fund managers and advisers (if the investor has one) are key components of the team, but in my view, the most important player is the individual investor. Ironically, it is the investors that are held up to the least scrutiny. They are rarely told that the team is losing because of their actions or indifference.

The money manager's role is the most glamorous on the team. As fund manager, this player is responsible for selecting the securities that go in the portfolio. This involves doing lots of due diligence and building a portfolio that will perform well.

The mutual fund company has the responsibility of designing funds that make sense for the investor, and then picking managers to run them. In bringing funds to market, the fund company does the promotion and makes sure that all the regulatory hurdles are cleared. And as a valued member of the team, it has an obligation to find a balance between marketing and keeping the cost of investing down.

The adviser, who acts as the fund distributor in most cases, is the quarterback of the team, and is paid accordingly. The adviser's main job is to help the client set up a financial plan that has realistic expectations and an asset allocation strategy. If advisers haven't done that, then they've flat out let the side down. Their second most important role is to keep their client on track with the plan. This requires providing some backbone once in a while when they have to say things their clients don't want to hear.

Advisers also provide their clients with options and recommendations on which investment vehicles to use (individual securities, guaranteed investment certificates, mutual funds, structured products, wraps — accounts offered by investment dealers whereby an investor is charged an annual management fee based on the value of invested assets). And after a few years they should be able to help their clients determine how they've done (i.e., an objective assessment of investment performance). Finally, if an adviser is invited to be part of the team, he or she should also be focused on keeping clients' cost of investing down.

Which brings us to the most important player on the team, the individual investor. Whether or not the investor is skilled, keen and/or has the time, there is a minimum load that he or she has to carry. They must have a financial plan — some kind of road map that says where they want to go and how they plan to get there.

Second, they have to make a decision about who is going to take them there. If they have the expertise and inclination, they may want to do it themselves. If they don't, they need to invest some time up front to find a professional to take care of it for them.

Third, they need to prepare themselves to be a patient investor. Each

route on the map has its fast and slow spots. The investor can't be changing lanes every few months in hopes of catching the latest momentum.

And finally, like the other team players, the individual investors have to figure out how to keep the costs down. Ultimately, they hold the purse strings and determine what the total cost of investing will be. In the context of today's 4-per-cent interest rates, any investment team that is costing 2.5 to 3 per cent a year is doomed for failure.

These are things that even the least engaged investor must take the time to do. As you can see, it's a long list — and the role of the investor, whether he or she likes it or not, is key to the success of the team. Obviously, interested investors can do considerably more and save some money along the way. Whichever camp you're in, however, I suggest that you ask lots of questions of other team members. Does this plan make sense? How does that investment fit with the plan? What will it do to my overall costs? What are you adding to the team? How am I paying you for your service? And the most important question of all, am I keeping up my end of the bargain?



# Thirty-four

---

## Sensitivity Training for Clients

---

*January 9, 2010*

A lot is written about how to pick a money manager, but it's also important to know how to be a good client. A manager-client relationship should last a long time and be rooted in confidence, empathy and stability. Both sides are working toward a common goal.

The following is a perspective on how one money manager would like to work with his clients. It is intended to be one-sided and personal. Call it my client 'pre-nup.'

*Tell me how I fit in.* You're working with me because you buy into my philosophy, experience and long-term track record, but I need to know how I fit into your life. Are these assets at the core of your retirement savings, or are they a small slice of a bigger pie? Am I supposed to spice up the portfolio, or be the Rock of Gibraltar? Do you want me to be pro-active with recommendations, or just act as a sounding board and provide calm at critical points in the market?

*Show me you care.* You're delegating responsibility to me to select securities and implement a strategy. I won't be needy, but you have to work



at the relationship too. You need to make an effort so you know how you're doing, what you own (in general terms), how much you're paying me. When we talk, I want you to have questions.

*Don't avoid me when things are good.* When the quarterly statement shows big returns, it's easy to put off getting together. We shouldn't. Those meetings are important in preparing us for when the numbers aren't so good. It's a time when I can reconfirm our philosophy and remind you why we're together. It gives me a chance to discuss the dogs in the portfolio without looking like an idiot. We can reassess the assignment you've given me and confirm that it's still appropriate — this is when we should make strategic changes, not at times of crisis. And most importantly, it lets me have a little fun once in a while.

*No fruit cocktail please.* When you're assessing how I've done, all I ask is that you make it an apples to apples comparison and pick an appropriate time frame.

Because you have more than one relationship (I'm learning to deal with it), you will naturally want to do a comparison. If your managers have the same objective and have managed your money for a reasonable amount of time, then that makes sense. If, on the other hand, you're comparing my 'stay at home' balanced portfolio with a fling you're having with a broker, it's not fair. He'll always look better when markets are hot, but you'll be happy I'm around when it's tougher going.

If you don't compare my performance to the appropriate measures, you'll give me credit I don't deserve and blame me for things that aren't my fault.

Time frame is also important. It is not useful to assess me based on a few quarters, or even a few years. We're in this for the long haul and our strategies are designed with that in mind. The most common mistake other investors make is getting too short term in their judgments — "I bought this fund six months ago and it's done nothing. I'm getting out." I want us to be better than that.

*Accept that I will not always be right.* The level of trust between us shouldn't go up and down with every decision I make. There are lots of things that go into a trusting relationship, but being right all the time isn't one of them. A wrong decision shouldn't negate the fact that I call you back right away, am always candid, invest personally in the same things you do and don't make administrative errors (or if I do, I fix them

right away).

This is the investment business. Even Warren Buffett isn't right all the time. You shouldn't question my credentials and integrity just because I'm out of sync for a while. As Coldplay says, "Just because I'm losing doesn't mean I'm lost."

*You won't always like what I'm doing.* You pay for my counsel, and if I'm doing my job, you will disagree with some things I'm saying and doing. I might buy the ugliest stock on the board one day and sell a favourite of yours another. I'll make you squirm by buying when the world is coming to an end or selling when everything is rosy. It's part of the deal.

*It's not you, it's me.* If you want out, please say so. I'll be shattered, but dragging it out is harder on both of us. Just tell me why you're leaving and let me start rebuilding my fragile ego. I'll tell my colleagues we're going to see other people.



