It's still Not Rocket Science

Plain-English Advice for Managing Your Investments

Tom Bradley

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Foreword

Seven years ago when Tom and I first started sketching out what Steadyhand would look like, we spent a lot of time thinking about the funds and the operational structure of the business. While we knew service was important, we didn't spend as much time on it. When it did come up, we tended to use phrases like "crisp", "efficient" and "providing a steady hand".

It took me five years and a market meltdown (2008) to really appreciate that perhaps the most important service we can provide our clients is to educate them and help them to be better investors. After all, clients are only truly better off in the long term if they gain a deeper understanding of investing, and use that knowledge to make better decisions. I view this as *collaborative investing.*

Our role in collaborative investing is providing sound counsel, both in person and in print. The articles in this book are a step in that direction. They are pieces that were published over the past three years (2010-13) in either the Globe and Mail or on the Steadyhand blog*. They are categorized by topic, rather than date, and serve to explain and reinforce some of the most important principles in investing – in plain-English. It's our belief that anyone can be a successful investor if they have the right tools, temperament and knowledge. And as for the latter, don't worry, it's *still* not rocket science.

Neil Jensen
COO and Co-founder, Steadyhand Investment Funds

November 2013

*It's Not Rocket Science (Volume I) is a collection of articles from 2006-2010 and is available from Steadyhand upon request.

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Part I

Behaviour

One

The Duffer's Guide to Investing

Posted on July 22, 2012

If you really want to delve into someone's personality and character, take them golfing. There are few pastimes that are more revealing. Golf takes four to five hours to play, is laden with emotion and is mankind's greatest equalizer — it humbles everyone.

As it turns out, golf has many similarities to investing and on this weekend of the Open Championship at Royal Lytham, it seems appropriate to explore a few of them.

Predictably unpredictable

I felt great warming up on the range and then played a horrible round. After walking off with 98, I was ready to give up the game. The next week I shot an easy 86 and was riding high again.

In the short run, the stock market is as random as our golf games. Nobody, not even Warren Buffett, knows where it's going over the next week, month or even year. But that doesn't prevent us from being subjected to a steady flow of predictions, often based on the market's recent direction and tone. And as with golf, the predictions get more authoritative and expectations more positive after a period of good results.

It's perverse, but the good golfers are the ones who grumble about "not having a clue," while the high handicappers like me think we've figured it out and want to share our new-found secret with anyone who'll listen. Experienced, successful investors are also more humble about their ability and rarely offer investment advice at cocktail parties. They have no expectation of making accurate short-term calls and expect to make lots of mistakes.

What did you shoot, honey?

When asked about their score, you can bet a golfer's answer will have nothing to do with reality. The missed two-footer won't be on the scorecard and the 8's were put down as circle 7's (appropriate for a handicap calculation, but not bragging rights). When you get right down to it, golf turns seemingly honest people into liars.

Investors lie too, although it's more often to themselves, and not always knowingly. That's because few actually know how they've done. The wealth management industry doesn't provide a scorecard and most investors don't take the time to calculate their overall return.

Misdirected efforts

One of the biggest mistakes golfers make is focusing on the wrong things. It's well documented that chipping and putting is the quickest way to a lower score, and yet our practice time is spent pounding the driver on the range. Or even worse, instead of practising, we buy new clubs.

Investors also want to take action when short-term results are poor. They tend to trade too much and are quick to get off an underperforming stock or fund. And they're just as vulnerable to an ad for a fund with great past performance. Buying it feeds the need for change, even if it doesn't increase the chances of getting better returns in the future.

If buying on recent results is the equivalent of whaling on the driver, then looking at other factors such as fund manager, investment philosophy, quality of firm and fee level is practising around the green.

Local bias

Canada has the highest proportion of left-handed golfers in the world, which I attribute to our passion for hockey — shoot left, golf left. I also contend that at least half of the southpaws should be playing right (pretty swing, no power or consistency), though I've had little success persuading any of them of this.

Investors have their domestic biases too. For instance, a Canadian's idea of diversification — the S&P/TSX composite index is made up of 45 per cent resources and 30 per cent financial services — would be considered an aggressive, specialty portfolio in other parts of the world.

Emotionally challenged

I walk onto the green thinking birdie and stomp off with a bogey, after 3-putting from 10 feet. At that point, the odds of me hitting a good drive on the next hole are not very good. Investors too are less likely to make rational, long-term, valuation-based decisions when they're at extremes of the roller-coaster. Their biggest mistakes are not related to IQ, but rather EQ (emotional intelligence). For both golf and investing, temperament is the key.

There's plenty more to talk about — risk/reward decisions, which tips to follow and dealing with distance envy — but I'm heading to the range to demo a new driver.

Two

Staying on the Long-term Track

Posted on January 7, 2012

My holiday reading included two journal articles that challenge the notion that investing for the long term reduces risk.

The message: It's all well and good to recommend that an investor take the long view and not worry about short-term market dips, but quite another for that investor to truly maintain the strategy over multiple decades. While it's easy to be a long-term investor in good times, it's quite a different matter in times of euphoria or panic. Most investors can't resist the temptation to become short-term oriented at extreme points in the market cycle.

The researchers have plenty of evidence on their side. Academic studies consistently show that investors achieve poorer returns on average than the funds they invest in. This shortfall, which is called the behavioural gap, primarily results from too much trading and a tendency to buy what's done well in the recent past.

Many other factors can also take investors off track and expand the gap. Sometimes a change in life circumstance — a new job, a divorce, a mid-life crisis — will lead to an untimely strategy shift. There's always the promise of the cool new products that are focused on what's popular at the time — technology, gold, China, food, covered calls and/or dividends. And then there's the psychological imperative (most common in males) to just do something when markets are moving.

Clearly, it's hard being a committed, consistent long-term investor, but it can be done. During my time on the buy side, I've met thousands of investors who have let the power of compounding work for them and done well as a result.

As we start a new year, it's worth reviewing a few of the keys to staying on a long-term track. I've got five.

First, you need to recognize that investing is like no other product decision you make. It's perverse. Your best moves will feel terrible when you're making them. Your well-thought-out plan will appear to not be working for long stretches of time. And, like golf, there will always be someone telling you they've figured out a better way (usually someone who posts higher scores and lower returns than you).

Second, you should stop doing the obvious things that are causing the behavioural gap. Contribute less to the profitability of the financial services industry by trading less and avoiding high fees. And don't screen potential investments based solely on how they've done in the last three years. Look forward, not back.

The third key: You need to work from a Strategic Asset Mix. This is a plan, a place you go when you're confused, disappointed, frightened or over confident. Your SAM should be the basis from which all decisions are made. "How does this new product fit into my portfolio? Should I be buying or selling these lousy foreign stocks?" Your SAM won't vary much from year to year and should never be changed drastically at extreme times. When markets are going wild, it's time to lean on your plan, not change it.

Fourth, you need to eliminate the word "if" from your vocabulary and substitute "when." You're more likely to be surprised by ifs, as opposed to being prepared for whens. For example, when the stock market goes down 20 per cent, you'll gradually add to your equity funds. When your foreign stocks smoke the rest of your portfolio, you'll re-balance back to Canada. And when it seems you're going against what everyone else is doing, you'll smile and pour yourself a nice glass of wine.

Finally, to be a successful long-term investor you need someone to lean on. You need a veteran who has a better investing temperament than you and has experienced the end of the world a few times. We all need a touchstone (for years I've leaned on Bob Hager, Warren Buffett and Jeremy Grantham), although you shouldn't expect them to be right all the time. Rather, you're looking to benefit from their calmness, thought process and most importantly, their longer-term perspective.

It's easy building a long-term portfolio. It's tougher sticking to it. But it's not rocket science. If you're committed and consistent, the markets will present you with some wonderful opportunities and the process will be very rewarding.

Three

Your Portfolio Performance Needs a Regular Check-up

Posted on January 21, 2012

A meeting I had with a prospective client a few years ago has always stuck with me. She told me her adviser had done well for her in the previous five years, but had been letting her down more recently. After reviewing the data, we discovered the opposite was true. Her portfolio was actually holding up well in the current year relative to a weak market, but had performed poorly over the longer term — the return didn't nearly reflect the strength of the post tech-wreck markets.

Most investors know how a few of their individual stocks have done, some may have a sense of whether a mutual fund has been good or bad, but a vast majority have no idea how their overall portfolio has performed. This knowledge gap, which is especially evident at this time of year when clients are opening their year-end statements, is a unique and disappointing element of wealth management.

How has it come to be? There is plenty of blame to go around. Investment companies spend time and money selling products with the promise of better returns, but rarely show returns on their statements. Buy side firms (investment counsellors) do a better job than sell side dealers (brokers and banks), but no one is where they need to be. And neither are the clients. Few investors maintain any kind of discipline around monitoring their portfolio, despite the fact that their financial health depends on it.

In the face of this sad state of affairs, our firm just updated a report that helps clients assess their returns. It covers a wide range of topics, but some key themes permeate throughout.

This is important!

With the decline of the defined benefit pension plan, responsibility for investing is increasingly falling to the individual. To make the necessary decisions about asset mix and security selection, investors need to know how they're doing and what's working for them. Without an accurate assessment of the past, making future decisions is challenging to say the least.

Context

As my story at the beginning illustrated, what's most often lacking when clients assess their results is an understanding of the environment their portfolio is operating in. They don't know if losing 2 per cent last year or earning 4 per cent over the last five years is good or bad.

Ideally, investors should construct personalized indexes. This default portfolio, or benchmark, would blend the returns from various market indexes in proportion to their particular long-term asset mixes (cash, GICs, bonds, Canadian stocks, foreign stocks). The investors then have something to compare their returns to, and assess how their strategies and hired help have done.

Unchanging criteria

Too often a fund is bought for long-term reasons and then judged by how it's done for the short time it's been in the portfolio. It doesn't make sense. If a fund was selected using the four Ps — philosophy, process, people and performance (long-term) — then it should be consistently measured against those same criteria.

This is particularly important for investments that have been weak performers. After all, not all components of the portfolio do well at the same time (if they do, then the portfolio is not properly diversified). Staying focused on the initial selection criteria will help investors determine how likely it is that the laggards will one day take their turn carrying the load.

And importantly, it will give them the confidence to allocate money to these areas of weakness when their plan calls for it.

I should note that it's hard not to focus on the laggards when reviewing a portfolio, but it's important to also look critically at the current winners. Short-term glory shouldn't obscure the need for an ongoing assessment.

Action and inaction

In the end, a thorough portfolio review produces lots of grey. Black and white conclusions, such as consistently poor performance, personnel or philosophy changes, and excessive fees, are the exception, not the rule. Most performance gaps require more study and patience. On that note, I can say unequivocally after 28 years of observation and painful experience, the biggest weakness investors have is impatience. They don't wait long enough for their strategies to play out and as a result, sell when the assets are most attractive. In my view, a proper performance assessment helps foster that much-needed patience.

Four

Being Greedy Requires Careful Planning

Posted on June 23, 2012

So here we are. The economic outlook is bleak. Systematic risk is high. Investors are scared. And Warren Buffett's words are ringing in my ears, *"We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful."*

After living through the crash of 1987, the tech wreck and the 2008 banking crisis, I have a good sense of how opportunities come out of distress. Markets always overreact and go to mouth-watering extremes. I learned from some great investors I've worked with (Bob Hager and Art Phillips, to name two) that when markets are down and the news is ugly, you don't go away and hide. You need to draw on your best valuation work and act decisively. Concerned clients, uncertain staff and a shrinking net worth can't get in the way of pursuing risk/reward situations that are jumping off the screen.

So have we reached Mr. Buffett's moment of greed? Obviously, we won't know until later. We may have more bad months ahead, or already be near the bottom in some asset classes. In any case, it's not too early to explore what a great investing opportunity might look like.

The bad stuff

Every greed moment comes with a wall of reasons not to invest. Markets wouldn't be down without a recession looming, profit estimates being reduced and a lack of trust in the financial system. At the time of maximum opportunity, we're always going to feel lousy after reading the Report on Business.

The other thing to remember is that a substantial part of any market recovery will come before the news and economic statistics improve. The market cycle will be well ahead of the news cycle.

But beyond the usual concerns, are there elements of the current predicament that negate the investment opportunity? Every period has its "world coming to an end" feel, but this time the sheer magnitude of the debt burden stands out. As we've seen, it's causing short-term shocks and will undoubtedly slow the economic recovery.

Another scary feature is that we're operating without a net. Governments, our usual safety valve, have no extra money to spend and their go-to strategy of lowering interest rates is used up. Indeed, rather than being our saviour, governments are at the core of the problem.

In the shadows

For current stock prices to represent a special opportunity, there has to be plenty of room for the fundamentals and investor sentiment to improve, and conversely, limited scope for them to get worse. Certainly, the debt burden will get worse, but in the shadows is a long list of factors that are turning favourable, or at least have a bias to the positive.

The developing world, with its unlimited room to grow, is playing a larger role in the global economy. While we sit mired in the slow-growth, debt-burdened West, there is plenty of activity elsewhere.

With new-found natural gas, technological advances in oil, cleaner coal and more fuel efficiency, we're heading into a period of cheaper energy.

Related to energy and emerging countries, the ever-accelerating pace of innovation is making economies more adaptable and resilient than ever. In many cases, the developing world won't try to recreate what we have, but instead skip ahead to new ways of doing things.

And importantly, much of the prep work has been done on the next cyclical recovery. Inventories are down and pent-up demand is building due to restricted spending. The housing market south of the border has found a bottom. And takeover activity, which spurs investors to action and improves stock valuations, has nowhere to go but up (European companies are now in acquirers' sights).

Valuation

The one truly reliable thing we can latch on to in times like this is intrinsic value — an assessment of what a company's long-term cash flows are worth. On this and other valuation measures, we're most of the way to a Buffett moment. The price-to-earnings multiples in North America have come down over the past decade to where they're nearing 1982 levels, without the help of double-digit interest rates. European and Asian stocks are already there.

The well-publicized bad news, hidden upside, depressed stocks prices and intense fear tell us we're entering an interesting place. At a minimum, we have to start getting ready for the opportunity. Being greedy requires careful planning.

Five

Look for Good Money Managers When They're Down

Posted on April 15, 2011

Value managers make a habit of scanning the 'new lows' list on the stock page. They're hoping to find good companies that have stumbled and are oversold.

Buyers of the funds run by those same managers, however, rarely do that. They most often go for the 'new highs.' Typically, money flows into funds, and fund categories (technology, precious metals, energy), that have done well in recent years. While other factors come into play — such as the manager and firm's reputation, marketing efforts and long-term returns — good recent results are buyers' prerequisites.

This bias is unfortunate because it narrows the field unnecessarily. If the best managers are going through a tough patch, which they invariably do, then their funds may not be considered. It's particularly unfortunate because those are often the times when managers are feeling the best about their portfolios.

The performance requisite can also suck investors into what I call the Cycle of Hope. By consistently rotating to funds or sectors that have done well in the recent past, they can get caught in a downward spiral. They're positioning themselves for what's already happened instead of what might be. As a result, their returns suffer.

Can a fund that's led the way in your portfolio continue to do well? Absolutely. It may stay at the top of the rankings for years and deliver excellent long-term returns. But be assured that it too will experience some down times.

There are a number of reasons for this. First and foremost, it's impossible to be right all the time. Even top managers have periods when they're out of sync with the market.

Also, when stocks go up, so do valuation multiples. Funds that have done well aren't as cheap as they previously were. Managers make adjustments — sell expensive stocks and buy cheaper ones — but it's difficult to do completely. And it isn't easy to part with companies that fit perfectly with the manager's philosophy, particularly in Canada where there are so few alternatives.

It's important to remember that what works in one environment may be totally unsuitable in another. For instance, a manager with strengths in resource stocks will thrive in an inflation-driven market, but will likely struggle in an economic slowdown.

And we shouldn't forget about luck. It definitely has an impact in the short term, but the last I checked, it evens out over time.

Can investors fight this tendency to chase performance? I think so. A number of years ago, I had an experience where a client did just that. My partner and I were given the opportunity to present to a pension committee that was looking for both Canadian and U.S. equity managers. We thought the only chance we had was on the U.S. side, where our numbers were smoking hot. Our Canadian returns were just okay.

When the decisions were made, they hired us for ... wait for it ... Canadian equities. The committee liked the firm, people and approach. As the CFO said to me, *"We're pleased to be hiring a good manager when they're down."*

Now jump ahead a number of years to when I was doing a semi-annual review with the committee. It went well and they were pleased with the returns. But later that day I met with a newer client who had hired us after our returns had improved. Their choice was more influenced by short-term returns and as a result, the session had an entirely different feel. The relationship was fine, but it never attained the same level of confidence and the returns (since inception) weren't as good. Same portfolio.

Same personable manager. Different result.

I've always had a high regard for the first committee, because they did something that few investors do. They ignored the short-term results and chose us for the right reasons. And they were rewarded.

So it's not a bad thing when the short-term data are misaligned with the long-term factors. There's a lot to be said for going against the grain and hiring a proven manager whose strategies have yet to play out. Your cycle has more chance of being a virtuous circle than an 'always hoping' death spiral.

Six

Different This Time?

Posted on December 19, 2011

"Tom, I agree with your view on stocks, and boy, you're so right about how negative people are, but ... I can't help but wonder if it's different this time." — email from an analyst friend.

It's different this time. I've been trained to never utter these words. They're the most dangerous four words in investing.

So when I hear my friends, clients, readers, competitors and, in some cases, idols, telling me they don't like what they see, I'm torn. I know how bad the global economic/debt situation is. I know there will be dislocation, shocks, volatility, perpetually gloomy headlines and earnings misses. And I know we're navigating all of this without a (government) net.

But it's not that simple because:

- Mr. Market knows all this. He figured it out in April and has been worried ever since.
- The corporations we're investing in have never been in a better position to take advantage of economic and competitive dislocations. They're the antithesis of weak, overstretched, running-out-of-options governments.
- Recessions are all about cleansing and adjustments. The gloomy outlook does not take into account the fact that consumers, com-

panies, cities and countries are adjusting to the new reality. The U.S. is learning to live without a real estate market. The resource industries are adjusting to shortages by spending record amounts on developing additional supply. Huge investments are also being made on more efficient power grids, solar panels, networks, air conditioners, cars, buses, aircraft, billing systems, medical procedures and the list goes on. The pace of progress on many fronts is accelerating, which means when the turn comes, it will be faster than expected.

- When sentiment is so firmly planted on the fear side of the fear/greed meter, the downside risk is significantly reduced. Stocks could still go down, but it's less likely and the magnitude of decline is likely less.

It feels like we've entered the *"it's different this time"* zone again. Certainly there's a lot that will be different over the next 5, 10 and 25 years, but I'm not convinced stock market behavior is one of them. The market will continue to over-react to short-term news, trade well below (and above) the intrinsic value of underlying companies and it won't wait for complete resolution or perfect information to turn around. If the market doesn't do these things, it will indeed be different this time.

Seven

How Seasoned Managers Stack Up Against the Up-and-comers

Posted on May 27, 2011

"What I find of particular interest is the speed at which changes in communication technology are happening. It's causing a great intergenerational knowledge gap, which is rather worrisome because many decision makers are still part of my old-fart generation."

This comment by my friend John Rogers, a lawyer and technology entrepreneur, got me to thinking about my industry. Is there a similar gap in asset management? And if so, who does it favour?

Given that I'm burdened with grey hair at a ridiculously young age (I think of it as premature wisdom), I'm desperately hoping there is a gap that favours the seasoned over the newly brilliant. It seems to me that the buy side is one industry where tenure should be an asset.

To test my thesis, I sought out seasoned portfolios managers who've successfully guided their funds and firms through many market and performance cycles. I asked this esteemed and highly biased group one question: What advantage do you have over the young bucks?

I started with Bob Hager, co-founder of Phillips Hager & North. Unfortunately, Bob is extremely humble and spent more time rhyming off reasons why the youth have the upper hand. Their technical skills are more current and they're quicker to embrace "the new stuff," which means they gain the early spoils.

I tried to cut Bob off because that wasn't what I wanted to hear. I know all about the disadvantages. A veteran's energy level isn't as consistently high. They have more distractions including management duties and other activities that success brings (speeches, media appearances, art collections, season tickets, southern homes). And they have a tendency to lose the edge that made them successful — i.e. stock pickers become big picture thinkers — and focus too much on protecting their legacy.

Despite a rocky start, I continued my survey and quickly found consensus — experience really shows through at market extremes. Tony Arrell (chairman and CEO of Burgundy Asset Management) felt strongly that a veteran has the most value at the "critical moments." *"There is no substitute for having gone through the intensity, confusion and hysteria of a market event."* Bob Krembil (co-founder of Trimark) added, *"You can't learn it from books. You have to experience it."*

In extreme circumstances, veterans can provide a steady hand. They're less likely to conclude that it's different this time. Larry Lunn (Connor Clark & Lunn), whose firm managed through the 1987 crash as well as anyone, told me, *"I've been through the end of the world a number of times."*

Having talked a lot about bear market moments, I asked Bob K. about the other extreme. Interestingly, he felt that experience, and the strength to apply it, was even more important in euphoric times. It's then that a patch of poor performance puts the most pressure on a manager to change strategies. Clients are quicker to leave at peaks because, in Bob's view, *"greed is more powerful than fear."*

Some of the grizzled felt that experience was essential in sorting through the flood of information that hits them each day. Differentiating between what's urgent and what's important is an acquired skill.

Related to that, a few talked about how experience gave them the ability to pull back and get away from the day-to-day noise. Tony Hamblin (retired from Hamblin Watsa) likened it to being an army general whose job is to command from a distance. This perspective is necessary to help pick up on inflection points in the market and understand the nature and durability of trends — how they take off and how they inevitably unwind.

Perhaps what the years bring more than anything else is the ability to make simple, ‘tried and true’ fundamentals a usable part of the investment process. I’m talking about the real basics. Patience is key. Leverage is a double-edged sword. Don’t invest in anything you don’t understand. And don’t let a good story, positive investor sentiment or lack of alternatives be substitutes for value.

Dennis Starritt (a principal at Bluewater Investment Management) summed up my research as only a portfolio manager could. *“Experience is hard to value. It’s like an intangible on the balance sheet.”* Certainly it’s no substitute for brains and discipline, but for my money (and my clients), I’ll take the old farts every time.

Part II

Risk

Eight

Risk-free? Be Careful What You Wish For

Posted on February 18, 2011

> *"Risk-free investing. Yes, it does exist."*

These words are featured prominently in a financial institution's ads we're seeing this season. And every time I see them, it sets me off. Why? Because investing is all about taking risk. Without it, we get risk-free returns (currently 1-2 per cent). François Sicart, chairman of Tocqueville Asset Management in New York, captured it best when he said, *"I never invest in a situation in which I cannot lose money."*

Investors should go on full alert whenever they hear the words risk-free and safe. Our industry throws them around too freely, or at least, allows them to be misinterpreted too easily.

Safe spread

Bill Gross of Pimco recently coined the phrase 'safe spread' to describe his firm's use of corporate bonds, U.S. agency mortgages and emerging market bonds to enhance yield. Certainly Pimco has been astute at navigating the credit markets, but putting 'safe' and 'spread' in the same sentence is a dangerous precedent. The reason their clients receive a higher yield is because they own bonds with a greater chance of default. They're taking more risk.

Gold

In some quarters, investing in gold is presented as a safe strategy. The shiny metal is perceived to be a store of value at a time when governments are doing their darnedest to devalue their currencies. Owning gold has merit in terms of diversification, and may indeed produce positive returns, but it should be recognized for what it is — pure speculation.

Gold generates no income, so it's difficult (or should I say impossible) to value. And with 80 per cent of it locked up in vaults, the price is driven by how investors are feeling, rather than supply and demand. It's the ultimate sentiment-driven asset.

'Buy Canada'

Another prevailing sentiment these days is that having all your investments in Canadian securities is safer. Canada has a stable government, sound banking system, healthy housing market, strong currency and abundance of natural resources. Why would an investor go anywhere else?

Well, there is a flip side to the all-Canada, all-the-time story. At a fundamental level, Canada is now running chronic trade deficits, despite the commodities boom, and the quality of exports is deteriorating — we're now shipping logs from British Columbia instead of wood furniture from Quebec. We have failed to penetrate the emerging markets or develop industrial leadership in anything other than energy and raw materials. And it's not clear if Canada is going to participate in the manufacturing renaissance that's beginning in the U.S.

As the Canadian economy becomes more resource dependent, so too have Canadian investors. Owning an index-like portfolio of Canadian stocks means having a large exposure to the highly cyclical industries, specifically energy (24 per cent of the S&P/TSX composite index), materials (17 per cent) and industrials (5 per cent). A bulk of our economy — health care, consumer products, technology and utilities — accounts for just 10 per cent of the index's capitalization.

So while we take comfort from Canada's strong economy and world-beating market returns, our portfolios have become more speculative, higher priced and increasingly focused on a few industries. And going forward, returns will be constrained by some of these same comfort factors, namely a less competitive currency and dearly priced real estate market.

What To do

What can you take away from all this?

First, a prudent investment strategy involves owning a combination of risks, including Canada, Europe, Asia, emerging markets, dividends, growth, resources, large caps, small caps, bonds, real estate and cash. Canada alone does not represent a well-diversified portfolio.

Second, it is possible to have a safer Canadian portfolio by owning stocks that more closely reflect the Canadian economy and less closely the S&P/TSX's industry weightings.

Third, nobody knows when the resource boom will end, but it's important to remember that it's a cycle, not a secular trend. For all commodities, high prices lead to more supply (higher production, innovation) and less demand (delayed purchases, substitution), which ultimately translates into lower prices and sales volumes.

And finally, in pursuit of safety, you should be careful what you wish for. You may end up with risk-free returns.

Nine

Why Volatility Doesn't Always Equal Risk

Posted on 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.

Ten

The Distortions of Too-low Interest Rates

Posted on June 24, 2011

We've had low interest rates for years, and really low rates for almost three. We're used to them, and may even be getting complacent. I had more questions and concerns from clients about rising interest rates a year or two ago than I do now.

Well, I'm here to tell you that it's not a time to be complacent. Quite the opposite. Low rates are causing enormous distortions in the economy and financial markets, and it's important to understand them, and try to be on the right side of the divide.

Before explaining, I want to be clear that I'm not calling for interest rates to rise next week. I have no idea where they're going short term, nor is our bond manager calling for a big change.

But taking a slightly longer view, investors and borrowers need to recognize that interest rates are artificially low. By that I mean, the normal mechanism for setting prices has been tampered with.

The U.S. Federal Reserve is holding short-term rates near zero in hopes of stimulating the economy. As a result, the U.S. government, and other more creditworthy institutions, are able to issue bonds at rates that don't even offset expected inflation (i.e. the real or after-inflation yield is negative). A five-year U.S. Treasury bond is yielding 1.5 per cent.

This Fed subsidy serves to transfer wealth from the lender to the borrower. Bill Gross of Pimco describes it well. *"The artificial yields, in effect, act as a tax on savings, undercompensating asset holders and transferring the haircut benefits to the debtor nation."*

Unfortunately, Fed chairman Ben Bernanke can't control who he subsidizes. So while helping out indebted home owners and the government, he's also giving a boost to borrowers who don't need any assistance, including profitable corporations, hedge fund managers and Canadian home buyers. Here come the distortions.

For starters, people saving for retirement, or already living off their investments, are being stolen from. Returns from their bond portfolios won't be adequate to live off of going forward, let alone keep up with inflation. To attain a reasonable amount of income, they're forced to take more risk.

By encouraging more risk-taking across a broad range of assets, too-low interest rates push prices up. Corporate bonds are the most visible example, but stocks, real estate and other long-term assets are also affected.

Real estate is a great example. Prices are driven by a number of factors (the economy, jobs, location and, in the current context, Chinese buyers), but they're always linked tightly to interest rates. With rates where they are, prices on both commercial and residential properties have risen steadily in Canada, with some income properties now being transacted at 'cap rates,' or yields, under 4 per cent. A property manager I know describes the availability of cheap credit as 'rocket fuel.' Real estate is all about location, location, location, but these days rates, rates, rates aren't far behind.

So it's not a great time to be a lender. Yields are low and the assets being financed may be on the pricey side.

Is it a good time to be borrower? Certainly, if you're refinancing existing obligations, it's the best. Your cost of borrowing goes down while the value of your asset is going up.

But what about borrowing to buy an asset? Would you rather buy an expensive house with a cheap mortgage, or buy a cheap house with an expensive mortgage?

Of course, there's only one answer to that question. As an owner, you live with the price forever. Buying low always make the economics work better. Favourable financing terms, on the other hand, are transient. There is a risk that the mortgage has to be renewed at a much higher rate. Unless you're a government or corporation that can raise 25-year money, you can't match your liability — your mortgage, in the case of home buyers — to the life of the asset.

Low-cost financing is intoxicating, and it's nice to be subsidized, but we need to keep our intake in check. And we need to make sure that the valuations on our assets make sense, not just today, but in non-artificial times as well. It's not a time to be complacent about too-low interest rates and the impact they're having on the economy and our investment portfolios.

Eleven

Younger Retirees Need Risk in their Portfolios

Posted on September 1, 2012

Just as the baby boomers brought us free love and rock 'n' roll, they're also leading the way into pension-less retirement. Those who are near or just into retirement are in a tough spot. They have a long time horizon and need investment returns that are well in excess of inflation. And yet, low-risk investments provide minimal return (negative after inflation), and owning higher risk securities has been harrowing and less-than-rewarding over the last five years.

While most people entering retirement feel some level of anxiety, it is those who don't have a defined benefit (DB) pension plan and don't know if they'll have enough to fund their retirement who experience the most stress. What they want more than anything is certainty, but that's hard to come by in today's low interest rate environment.

There are no easy answers to the no-DB dilemma, although any solution should start with a financial plan. Rather than wondering and worrying, some work up front with an adviser or fee-for-service planner will bring clarity to the issues, if not peace of mind. And as devoted followers of the column below this one (Financial Facelift) know, a proper plan will likely recommend a combination of strategies.

Work longer

It's not what people want to hear, but the best way to set up the next 30 years may be to work the first two or three. Every year adding to the nest egg, as opposed to drawing on it, improves the retirement calculations significantly.

Spend less

There are three variables in the calculation — life span, investment return and spending. Everyone wants to maximize the first, so the conversation is most often focused on the second. "How can I get a better return?" As Andrew Rice of the financial planning firm, Stewart and Kett, reminded me, however, the least considered variable — spending — has the most impact on what the numbers look like.

Increasingly, I'm seeing our clients build flexibility into their spending patterns. They make adjustments based on how their portfolio is doing. When their capital base is temporarily depleted due to weak markets, they dial down their spending and postpone the new car, kitchen renovation or world cruise.

Take more risk

The most common response to the no-DB dilemma is to reach for a higher yield by owning riskier securities. Instead of getting regular income from guaranteed investment certificates and government bonds as investors did 10 years ago, corporate bonds, income-oriented stocks and structured products are now playing a bigger role.

Most of the time, the income flow from these higher octane securities feels the same as the GICs and government bonds of the past, but there will most assuredly be market-related jolts from time to time. The corporate bond market is known to shut down at inconvenient times (2002 and 2008 being prime examples), which means corporate bond prices will experience significant price declines. And even the most conservative stocks will be taken down in a bear market.

Taking more risk should be a core strategy, but young retirees need to be careful not to focus too much on acquiring current income such that they put future income at risk. Higher-yielding investments don't necessarily produce a better return (Yellow Media being an extreme example), especially when the yield entices investors to pay more than what a company is worth.

Focus on total return

So income seeking has to come in the context of a portfolio that's structured to produce the best total returns (interest, dividends and capital gains). For an investor with a 20- to 30-year time horizon, there has to be a balance between generating current income and building a capital base that will produce future income.

Despite the headlines, stock investing still has the highest probability of achieving returns in excess of inflation, although the journey is sure to be bumpy. Investors need to go beyond the banks, pipelines and REITs, and build portfolios that have exposure to resources, health care and technology, include small and medium-sized companies, and go beyond our borders with U.S. and international stocks.

I don't expect retired investors to embrace market volatility the way young investors should, but it's important that they plan for and use it appropriately. The current investing environment requires that early retirees find a balance in their lifestyle choices and the risks they take in their portfolios. While every situation is different, people in early retirement still need at least 50-per-cent equities in their portfolio.

Twelve

A Simple Risk Management Tool

Posted on November 12, 2010

It's only been 18 months since the nadir of our once-in-a-lifetime financial crisis, but it feels like we're already forgetting some of the lessons learned. I'm referring to the fact that in this market full of cross currents, we have another major asset class getting frothy and investors making bigger bets in their portfolios than ever.

Inflating the gold bubble

We're still talking about how ridiculous it was that so few people saw the housing bubble coming, or the tech wreck for that matter. But are we doing it again with gold?

Certainly we can check off a number of boxes on the bubble checklist. The shiny metal has been on a 10-year rocket ride and there are authoritative voices predicting even higher prices ahead (check). Nobody is calling for a pullback, at least not publicly (check). It's not like 1979-80 when people were lining up on the street to buy bullion. Now they're queuing at their investment dealers and Bay and Wall Street firms are responding with a rash of new gold-related products to meet the demand (check). Precious metals funds will end up being some of the largest IPOs of 2010 (check).

But the scariest feature of this cycle, in my view, is that investor purchases now make up approximately 40 per cent of the demand for physical gold (check, check, check). This percentage is up from a token amount 10 years ago when gold started its move from $250 (U.S.). If the speculators stop buying, let alone start selling, there's a lot of downside in the price. As Sir John Templeton once noted: "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." Like the tech stocks that traded at huge valuations at their euphoric peak, gold and gold stocks will have a lot of air under them when the cycle ends.

Market timing gone mad

I don't have hard evidence, but it appears that investors are making bigger market timing bets than ever before. There are two aspects to this that are noteworthy, but not totally consistent. The first is that many investors are keeping large amounts of cash on the sidelines due to concerns about the economic outlook. They've sold stocks, or delayed making new purchases, such that their portfolios are nowhere near their long-term asset mix. In other words, they are making a big bet against the stock market.

The emergence of specialized exchange-traded funds has also encouraged more market timing and sector rotation. ETFs were once billed as a low-cost way to invest for the long term, but the reality is they've become market timing machines. The advertisements tell us that we can click a button and make a bet on the oil sands one day, shift over to natural gas the next, and finish the week owning gold.

These quite different bets — the cash build-up and active sector rotation — both imply that investors are more confident in their ability to time the market, but that's not the case. It's more likely that a decade of poor returns, a lack of trust in the old way of doing things and some effective marketing are what's causing it.

Risk control 2.0

In face of these issues, I have a risk management tool for investors to consider. I suggest it with great trepidation because the risk management industry has fallen into disrepute in the last few years. It turns out that the statistical models, despite their brainy elegance, didn't work when we needed them. Mine, on the other hand, is simple, reliable and easy to remember.

You just need to calculate what percentage of your purchases are going into securities that have done well in the recent past. You should also assess your overall portfolio on this basis. If all the money is flowing into the high fliers of last year — in today's terms that means gold, high yield bonds, Canadian resource stocks and emerging markets — then an alarm will sound. It's signalling that you're investing while looking solely through the rear view mirror.

To keep the model's alarm from going off, there needs to be a better balance between what's been working and what's most likely to work in the years ahead. As David Swensen, the chief investment officer of Yale University so eloquently put it, "Overweighting assets that produced strong past performance and underweighting assets that produced weak past performance provides a poor recipe for pleasing prospective results."

Part III

Allocation

Thirteen

The Benefits of Saving are Certain

Posted on February 18, 2012

The RRSP season ain't what it used to be. In the 1980s and '90s when investing was fun, it was a focal point on the investment calendar. You couldn't open the newspaper or walk a block without seeing an advertisement. Banks stayed open late to accommodate last-minute contributions and all firms brought in extra staff to deal with the February rush.

Investing hasn't been as much fun in recent years and the RRSP season is now more of a necessary evil. But January and February are still when most investors spend time thinking about their portfolio and making decisions on where to put their money. So whether it's fun or unpleasant, here are a few things to consider when going through the RRSP ritual.

Wrong question

The most commonly asked question during RRSP season is, what should I buy? Certainly, the question needs to be asked, but it should be down the list. The first is, what do I need? In the context of your long-term plan, where is your overall portfolio underinvested? A new investment has to make sense in the context of what you already own (RRSPs and other financial assets).

Last year, there was a wide dispersion of returns. Bonds were strong, U.S. stocks were up, but Canadian and international stocks were down significantly. Small cap and emerging markets were particularly hard hit.

Coming out of 2011, your portfolio may now be over-invested in asset classes that have done well (bonds for instance) and under long-term targets in others. Registered retirement savings plan and tax-free savings account (TFSA) contributions are an effective way to redress any imbalances.

Look inside first

After narrowing down what you're looking for, you need to be proactive in your search. I say that because RRSP season is a time when investment companies barrage you with hot, new products. The latest and greatest are on full display. Unfortunately, too many portfolios are littered with prior years' RRSP solutions — technology (1998 or 1999), agriculture (2008), gold (2010) and silver (2011) — and don't have a clear direction.

So while the spotlight is on the new and exciting, your first stop is to look for the old and boring in your existing portfolio. You've previously made choices as to how you want your money managed and know what you're getting (people, philosophy, long-term performance). Unless a change is required, allocating more capital to existing strategies and funds makes a lot of sense. If a manager or fund has performed poorly in recent periods, all the better. You can lower your average cost.

Gap attack

I write often about the behavioural challenges that investors face. These obstacles are best illustrated by the Behaviour Gap — a rather depressing statistic that shows the degree to which investors' returns lag behind returns of the funds they invest in. The gap, which is significant, exists for many reasons, but the primary ones are too much trading and a propensity to chase last year's winners. In Canada, the RRSP noise (subdued as it is) and end-of-February deadline don't help matters.

But there are some things you can do to narrow the gap. The first is to contribute every year, no matter how good or bad it feels. Don't blink because of what's going on in the markets. If you look back, you'll undoubtedly find that the "feel bad" contributions were actually the best timed. The benefits of saving are certain, while market timing is anything but. Just do it.

Second, make decisions in the context of an overall portfolio strategy. You shouldn't be buying what's hot — unless it's what the portfolio needs.

And third, take advantage of the longer time horizon and locked-in nature of your RRSP. You don't need to worry about selling when markets are down. Indeed, when the gloom gets heavy, you can use it to build your portfolio at more attractive prices. So in today's environment where most investors are pursuing the impossible dream — growth with no downside — you can embrace the uncertainty and volatility. It will give you exactly what you need — capital growth with bumps along the way.

Fourteen

The Joy of Cash

Posted on March 18, 2011

Over the last two years, I've spent most of my time encouraging people to get invested. As a result of the 2008-09 market meltdown, there were, and still are, too many investors who have strayed significantly from their long-term asset mix and are out of the stock market. I'm speaking of those who have a longer time horizon and want to build their financial wealth.

More recently, I've altered my view and been forced to do something that's very hard for me. I'm preaching the joys of cash. Yes, the stuff that earns 1 per cent. Investors who are on their long-term plan (and are therefore fully invested) should be carrying a modest amount of cash (5 to 10 per cent).

It's hard because I'm trained to be fully invested and feel uncomfortable when I'm not. In my early days at Phillips, Hager & North, my more worldly and wise partners (read: older) pounded into me that in the long run, bonds beat cash and stocks beat bonds. It went something like this, *"Tom, you can't call the market in the next month or two, so why do you have that much cash in the portfolio? Don't you know that . . . ."* To which I'd invariably respond, *"I know, I know — lower returns, no inflation protection and how do I know when to get back in?"*

Certainly that is one school of thought. Over time, stocks rise and cash returns will lag. A portfolio manager has to really be struggling to find well-priced securities before he or she should carry a significant cash reserve.

The fully invested approach particularly comes into play with specialty assignments for institutional clients. What matters to a manager of the Canadian equity portion of a pension plan is not whether returns are positive or negative, but how they compare to the S&P/TSX composite index. And because the index has no cash in it, anything above a token amount represents a bet against the market.

As I work almost exclusively with private clients now, I find myself moving away from the relative approach of asset allocation and toward the other school, which is grounded on absolute valuations. I want to own bonds and stocks because they're cheap, not just cheaper than something else. If I can't find enough undervalued securities to fill out a portfolio, I'm happy to hold low-yielding cash.

To be clear, I'm not any better at timing the market than I used to be (so I don't try) and I still want to beat the cashless indexes over the long term, but I'm more valuation driven today. I hate holding cash, it's true, but I hate holding overpriced assets more.

In a recent report, James Montier of U.S.-based GMO LLC brings the differences between the two approaches into the current context. *"One of the 'arguments' for owning equities that we regularly encounter is the idea that one should hold equities because bonds are so unattractive. I've described this as the ugly stepsisters' problem because it is akin to being presented with two ugly stepsisters and being forced to date one of them. Not a choice many would relish. Personally, I'd rather wait for Cinderella to come along,"* he writes.

Despite the decidedly non-current analogy (couldn't he have used frogs and princes?), Mr. Montier's point is a good one. Methods that allocate capital based on relative valuations have a major flaw — they fail to predict long-term returns for either asset class.

The current market environment is very revealing of money managers' fundamental approach to investing. I say that because many that I talk to seem to have less and less enthusiasm for what they own. They can rhyme off the merits of resources, dividend-paying stocks and/or corporate bonds, but are quick to point out that bargains are harder to come by. Conversations are punctuated with phrases like "it's not as cheap as last year" and "we're being selective." For managers using a relative value approach, this means reallocating from expensive assets into something cheaper. For the more absolute oriented, sale proceeds go into a growing cash reserve, while the search goes on for frogs with prince potential.

Fifteen

Gold — A Dizzying Change in Sentiment

Posted on April 22, 2013

I'll never forget an interview I did with Michael Hainsworth on BNN. It was almost exactly two years ago. Michael started the interview very directly, *"Tell me, why no gold?"* After I explained why our managers didn't own any gold stocks, he then asked, *"And no interest in base metals?"* When I said we had no mining stocks in our funds, Michael was beside himself. *"Do you at least own some energy stocks?"*

When I walked out of the studio on to Burrard Street, I felt like I'd been hit by a truck. Were our clients' portfolios really that off base?

I tell this story because it captures the investor sentiment of the time. In 2010/11, if you didn't own gold, copper and other commodities that were part of a China-driven 'super cycle', you were branded a contrarian (as I was that day). It stands in stark contrast to where we are today, and perhaps explains why the downdraft in gold and gold stocks is occurring.

Despite all the headlines and hyperbole, investors shouldn't find the swing in gold to be particularly remarkable. I say that for a few reasons:

- Gold went from $400 to $1,900 over 6 years (2005-2011). That's a stupendous run and it may just have been time for a breather.

- There were lots of violent price moves over the course of those years, mostly to the upside. Commodities, stocks and other assets (including houses) that experience big price increases should be expected to also experience big downswings from time to time.
- The investors who want to own gold have had lots of time to get in, which makes it less likely that there will be a big surge of unexpected or untapped demand.
- While the price more than quadrupled, there was no change to gold's ability to generate income. In 2005, a Troy ounce produced no cash flow or dividends. Today, it produces no cash flow or dividends.

Is the bull market over for gold? I have no idea. Amongst the myriad of factors that impact the gold price, I haven't been able to sort out what drives it. It's just not as simple as inflation or financial crises.

Is gold no longer a safe haven? It never was (at least, you never read that it was in this space). As a stand-alone investment, gold is highly speculative. It has no income stream to value, so it's driven by market sentiment. In the context of a balanced portfolio, however, a modest position in gold is a good diversifier. It reacts to different factors and tends to lead and lag at different times. For instance, while the stock markets have been rolling over the last year, gold has been trending down.

Am I surprised by the swing to a negative sentiment towards gold? Given my comments above, I shouldn't be, but I'll admit, it has been a remarkable turnaround, especially given how strong views were just two years ago. It's still rattling around in my head — THIS MAN DOESN'T OWN ANY GOLD!!!

Sixteen

Distracted by the Dividend Obsession

Posted on March 3, 2012

Would you rather see your portfolio earn 3 per cent per year and provide monthly distributions of 5 per cent, or earn 5 per cent with irregular payments totalling 2 to 3 per cent?

It may seem like a ridiculous question, but it's reflective of the choices being made today. The focus on income and dividends is so intense that it's distracting investors from what they really need, which is attractive 'total' returns. Indeed, the pursuit of convenient, tax efficient, GIC-beating yield is getting downright unhealthy.

Why do I say this? First of all, I hear it constantly from investors. "Do you offer a monthly income fund? How big is the distribution? This fund has been a dog, but I don't want to sell it and lose my 6 per cent."

I also see this obsession revealed in where dollars are flowing. Income-oriented ETFs have grown many times over in the last few years. There's been a rash of new products touting high yields and fancy strategies, including the again-popular covered-call writing. Some income-oriented closed-end funds are trading at premiums to their net asset value. And I watch with interest as Kevin O'Leary builds a fund company and media career based on dividends, dividends, dividends.

Income is clearly important, particularly for older investors, so how can it be wrong to focus on it?

To answer that, we need to go back to basics. Interest and dividend payments come from corporations (government bonds excepted). To compensate bondholders and shareholders, businesses need to make a profit. Earning a return on invested capital is what's important. The dividend policy developed by the board of directors is the easy part.

It's similar for investors. Building a portfolio that will earn a total return of 5 to 6 per cent (3 to 4 per cent after inflation) from a combination of interest, dividends and capital appreciation is what's important. Figuring out how to extract a paycheque from the portfolio is a secondary consideration, and not a particularly difficult task.

So, while investors need income to live off of, pursuing investment strategies that focus solely on the tap (current yield) instead of the source of long-term return is, in my view, misguided. This is especially so when the income flow comes with a higher fee or has features that structurally inhibit long-term returns, such as guarantees (guaranteed income funds), caps (principal protected notes) or limited scope (financial services stocks only).

Now, before you sit down to send me a scorching e-mail, let me say that I fully appreciate the merits of dividends. I know they've accounted for 50 per cent of the S&P/TSX composite's return over the last 30 years. They're a good indicator of a business's quality and management's ability to allocate capital. They can grow over time to offset the ravages of inflation. And in the Canadian context, they're tax efficient. But hear me out.

Declining interest rates has been a constant tailwind for all types of income securities over the last 30 years, and high-dividend stocks, along with bonds, have been great vehicles to ride. Interest rate risk was amply rewarded. But with stocks like Enbridge now trading at over 20 times earnings and government bonds yielding 2 per cent, the wind is shifting.

No longer can income investing be an excuse to not be diversified. A larger portion of investor returns needs to come from other types of risk — corporate bonds, a broad range of stocks (the other 50 per cent of the stock market return), and perhaps some illiquid investments and alternative approaches (arbitrage, short selling, derivative strategies).

If you're in the twilight of your investing career, withdrawing 5 to 6 per cent of your portfolio each year while earning a secure, sleep-easy return of 3 to 4 per cent makes sense. For longer-term investors, however, it's important to build a portfolio that can generate profits well in excess of inflation. One that takes advantage of all the opportunities that are out there, including dividend-paying and heaven forbid, non-dividend paying. And most importantly, a portfolio that clearly focuses on the source of wealth creation, not what's flowing from the tap.

Seventeen

Dividends at any Cost

Posted on February 5, 2013

In the Report on Business last week, John Heinzl, fondly known as the 'Yield Hog', dedicated his column (How a Focus on Dividends Can Transform Your Investing Approach) to a dividend-oriented portfolio managed by a real investor, Rob. It looks like a pretty good portfolio and there's lots to like about what Rob is doing. He has specific criteria for approving stocks. The portfolio is limited to 20 holdings and is ultra low cost. And the companies have a history of growing their dividends.

Rob's Portfolio

Banks/Financial Services

- Bank of Montreal
- Bank of Nova Scotia
- Sun Life Financial

Energy/Utilities

- Algonquin Power and Utilities
- AltaGas
- ARC Resources
- Fortis

REITs

- Calloway REIT

- Canadian REIT
- Canadian Apt. Properties REIT
- Dundee REIT
- H&R REIT
- RioCan REIT

Pipelines

- Enbridge
- Pembina Pipeline Corp.
- TransCanada Corp.

Telecoms

- BCE
- Rogers
- Shaw
- Telus

But what does not come out in the article is any notion of valuation or risk management. Rob buys stocks that have a yield between 3% (*"I didn't want anything below 3% because it's not much of a return"*) and 6% (*"... if it was higher than 6% I wasn't sure how sustainable it would be ..."*), but there's no mention of how he determines what the companies are worth.

I raise this, because stocks are not like bonds - yield is not a valuation tool. Dividends come as a result of making a profit, and dividend growth is a consequence of profit growth. So while Rob's portfolio is positioned as a conservative one, a key element in measuring risk, the price of an asset, does not appear to be front and center.

Also on the topic of risk, too often dividend investors run with relatively undiversified portfolios (a generalization of course). In Rob's case, the portfolio (listed below) has exposure to five sectors of the economy — financial services, energy/utilities, REITs, pipelines and telecommunications — which means it's narrowly focused and highly interest-rate sensitive. There's no technology, healthcare, consumer products, retail or resources.

As I talk to investors and people throughout the industry, yield, steady income and dividends continue to be the dominant theme in the market. It's off the scale really. And as a result, funds with the highest yields garner the biggest in-flows, lower quality bonds sell out in minutes and almost every new retail product has yield, income or dividend in the name.

Certainly there is plenty of demand for income from the baby boomers who are starting to retire, but there's more to this trend than that. There are other forces at work, the prime one being past performance. Rob's strategy has done well over the last five years ... really well ... and as a result, we see all kinds of investors running with income portfolios, even younger investors who have 20 plus years until retirement.

As I said at the beginning, there's lots to like about a portfolio of companies that are growing their dividends, but it needs to be done in a balanced way that gives full consideration to risk and valuation.

Eighteen

What About Stocks?

Posted on March 13, 2013

I've been a bit of a downer lately, writing negatively about bonds and real estate, and pointing out that risk premiums (the opportunity to generate returns in excess of government bond yields) have narrowed for many other investment strategies.

These views on valuation come at a time when pension funds and other institutional investors are increasing their allocation to real estate and alternative investments (including everything with a high yield). In most cases, the money is coming out of plain vanilla stocks.

Now I realize I'm comparing a short-term phenomenon (narrow risk premiums resulting from near-zero interest rates) to a longer-term, strategic shift, but nonetheless, it does beg the question, what do equity risk premiums look like right now? What are the potential returns in the asset class they're selling?

Well, as I look across the spectrum of possible investments, I think that stocks will produce the best returns over the next 3-5 years (6-8% per year). Here is my reasoning:

- In a world that's burdened with too much debt and is generally spending more than it's earning, corporations are solidly profitable and awash with cash. Indeed, Bank Governor Carney has been complaining that companies are sitting on too much cash.

- Investors' focus on dividends is forcing management teams to be more disciplined in their capital allocations. This can only be a good thing.
- Companies that aren't growing their dividends (or don't pay one) and have a few warts on them are being severely punished. The valuation gap between predictable, dividend-growing companies and the less shiny, more cyclical ones is unusually wide. 'Unusually wide' anything in the investment management business is also a good thing.
- High quality corporations are able to borrow at ridiculously low interest rates. Some are raising money even though they don't have anything to spend it on. Needless to say, they're ready for whatever opportunities or challenges come at them.
- Price to earnings multiples (P/E's), which are key valuation tools for stock investors, have moved up over the last four years. They've gone from being ridiculously low in 2009 to pretty average today. There's a great debate on where the overall market is trading, but most measures show P/E's are still in normal territory (the teens). The measure I lean on the most (the Valueline P/E, which covers a broad array of companies, mostly in the U.S.) shows stocks trading at 16 times earnings, which is dead on its long-term average.
- By definition, a period of average valuations means half the market is expensive based on history and the other half is ... you guessed it ... fertile ground for active managers.
- It's also important to consider that while P/E's are in a normal range on an '*absolute*' basis, they are jumping off the page on a relative basis. In other words, when comparing stocks to bonds, the valuation gap favouring stocks is as wide as any time in my budding career (it's been 30 years since I got hired out of grad school).
- And finally, from a sentiment point of view, I don't mind scouring for bargains in an asset class that people are reluctant to own.

How are stocks going to do over the next few months, or 2013 overall? I have no idea. This year could turn out to be a pleasant surprise or a total bummer. But if we want to avoid owning expensive assets (the best risk control measure I know) and have a majority of our portfolios invested in securities with the highest potential return, then it seems to me stocks have to be a significant part of the mix.

Nineteen

China — A Cycle Like Any Other

Posted on April 1, 2012

I'm wired to be a contrarian. That means I tend to be early getting on and off trends. I was worried about the U.S. housing cycle in 2004 and thought the Rolling Stones were over the hill two decades ago (was I wrong?). I'm still calling for Cheez Whiz to make a big comeback (think Mini and VW Beetle).

Putting my tendencies aside, I have two hard and fast rules when it comes to economic and market cycles. First, it's impossible to time the beginning and end. And second, if the cycle has gone on for a long time and reached extreme levels (i.e. significantly above or below trend), then the retrenchment period will also take time and go to extremes.

These rules are applicable to all kinds of cycles and trends, including some of the current, long-lasting ones like housing (Canada good, U.S. bad), interest rates (31 years and counting), gold and China. As per Rule No. 1, we don't know whether these have years to run or have already turned.

Let me explain Rule No. 2 by first saying that all sustained up cycles, whether it's for a product, company, industry or country, are driven by strong fundamentals — favourable supply and demand; technological change; new markets; demographics and prior under-investment. As a cycle gets extended, however, it starts to pick up baggage that serves to magnify the unavoidable downturn when it comes.

For instance, it's often the case that the integrity of a cycle — what's behind the sales and growth — deteriorates as it gets extended. The quality of customer is poorer and more leveraged, and their reasons for buying are less about utility and more about chasing the trend. In the investment business, we talk about shares going into weak hands — buyers who aren't committed long-term holders and who may not know why they own the stock or how it's valued. As the adage goes, "What the wise man does in the beginning, the fool does in the end."

Weak hands and unknowing buyers are inevitable with the flow of good news that accompanies an enduring trend. More people hear about it and the media coverage and cocktail conversation is heavily biased to the positive. With time and attention, however, comes complacency. What is a cyclical upswing comes to be regarded as a secular trend, or even paradigm shift. What was an uncertain variable becomes a given. Participants are less prepared for a negative outcome because the risk factors are obscured. As a result, speculators play a bigger role. If leverage is involved, debt ratios go up. And portfolios get tilted heavily toward the prevailing trend (sometimes at the price of prudent diversification).

I've written about all of the cycles mentioned above with the exception of China. Its economy has been growing at 10 per cent plus. It has parlayed abundant, cheap labour and a supportive government into manufacturing dominance. And now the rural-to-urban migration is helping fuel the growth of the middle class.

Until recently, all the economic news on China was good. It was characterized as "an unstoppable machine." But the quality of growth has deteriorated. Wage inflation is starting to eat away at its competitiveness (although there's still a large cushion) and economic activity is increasingly being fuelled by easy credit and government-supported capital spending. (As an aside, China's unwillingness to tolerate a slowdown is reminiscent of the Bush/Greenspan era in the U.S.) It's widely accepted that China's next leg of growth will come from the consumer, but that transition is not yet happening as government subsidies and incentives continue to be funnelled in the direction of the inefficient state-owned enterprises.

As for complacency, news coverage on China is more balanced than it was a year or two ago, but still almost nobody can bring themselves to consider the possibility of a "hard landing."

Long cycles die hard. Whether it's China, housing or Cheez Whiz, the timing of the start and finish is unknowable. The outcome, on the other hand, is more predictable. The warning signs will be obvious in hindsight, stories of extreme hardship and bad behaviour will come out of the woodwork (and be the basis of many books) and the turnaround will take longer than expected.

With that conclusion, can you blame me for being early?

Twenty

When Dividend Investing Doesn't Pay Dividends

Posted on November 12, 2011

I recently watched a promotional video that outlined the reasons for owning dividend-paying stocks — tax-efficient income, lower volatility and you get paid to wait for markets to recover. I agreed with all the fund manager's points, but he failed to mention that investors tend to get sloppy when it comes to income and dividends. The level of analysis and discipline that goes into buying tech or industrial stocks for instance, isn't always evident when higher-yielding stocks (and structured products) are involved. Too many decisions are made for the wrong reasons. Here are a few of them.

Yield

For income investors, one number takes on disproportionate importance — yield. If I invest X dollars, how much regular income will I receive? Is it 4 per cent, 5 per cent, 6 per cent?

It's perfectly appropriate to build a portfolio from a subset of securities that have a yield above a certain level, but once a stock qualifies on that basis, it's time to determine what it's worth. Is the price reflective of the company's assets and growth prospects? Can the underlying business support the dividend payments over the long run?

The early days of income trusts provide a great example of when current yields unduly influenced purchase decisions. Trusts were a burgeoning area of the market and, as a result, the analysts tended to be less experienced. Too many of them were valuing trusts based on the yield spread above government bonds, instead of determining what the businesses were worth. Incredibly, interest rates were perceived to be a bigger risk factor than revenues and profits.

Return of capital

Today, the wealth management industry has embraced an exciting not-so-new tax deferral strategy. It's called "return of capital" and it works like this. A product has an advertised yield of 6 per cent, but is earning only 3 per cent from interest, dividends and capital gains (after fees). The investors' capital is used to cover the rest of the distribution. It's a marketer's dream. The client makes up the shortfall and it's positioned as a selling feature. "Buy now and you'll receive a tax-efficient 6 per cent yield."

There are investment products where return of capital is part of the design and is communicated as such. There are too many others, however, that aren't quite so forthcoming.

Diversification

I have a friend whose parents live in Ireland. For years they invested most of their savings in Irish banks and insurers. When the financial crisis hit in 2008, they lost virtually everything. I tell this story because Canadian investors love their banks too. Layered throughout their portfolios are bonds, preferreds and common shares issued by the Big Five.

Now, I'm not here to bash the banks. They're some of the best in the world and play a significant role in my portfolio. But that doesn't get around the fact that they're highly leveraged businesses and are all driven by the same economic factors. Income investing isn't an excuse to not be diversified across different types of companies and asset classes.

Opportunity cost

In poor markets, it's easier to hold on to a stock that's paying an attractive dividend. As long as the income stream is secure, it's a good thing. Conversely, that same dividend can cause an investor to hold onto a stock when it gets expensive. "I don't care if it goes down ... I'll get my dividend."

But consider the following example. You hold 100 shares of Company A priced at $10. It's yielding 4 per cent, but your adviser thinks it's getting overpriced. You decide to sell A and buy 100 shares of Company B, which is also $10, but looks considerably cheaper. Over the next year, A goes down to $8, while B rises to $12. At that point, you reverse the trade and find yourself with 50 per cent more shares in A and 50 per cent more income.

This trade is a favourable example for sure (and transaction costs and taxes have not been accounted for), but it's meant to reinforce the point that there's a cost to holding an overpriced stock, dividend or no dividend.

When it comes to income investing, yield and tax efficiency are important, but they have to take a back seat to diversification and valuation. Sometimes the best strategy is to accept a lower current yield and own a broader range of securities.

Twenty-one

Getting Back in the Market

Posted on December 8, 2012

My editors want me to at least occasionally write about something topical. At first glance, a column about getting back into the market doesn't appear to fit the bill, but it does. That's because now is the time to do the groundwork for what is often the most difficult decision in investing.

There are a large number of investors (the most I've seen in 30 years) who've been frozen by the possibility of another 2008 and don't own any stocks, or at least are well below their long-term target. Unfortunately, they've missed out on some good returns. Since the end of 2008, Canada's S&P/TSX composite index has had a cumulative return (including dividends) of 53 per cent, while the MSCI World Index was up 29 per cent (in Canadian dollars).

To be clear, I'm not expecting the under-invested to load up on stocks at this still volatile, debt-burdened time, but I am hoping they'll start to plan for that eventuality. I say 'plan' because the decision to buy stocks again won't be easy. It wasn't easy over the last three years and almost no set of circumstances will make it any better over the next three. Even if there is a big market drop, which would be the perfect scenario for the under-invested, there's no guarantee of action. A bear market will confirm all the negatives, and make buying just as difficult.

A plan is also necessary because it's not ordained that the stock market will ever drop back to a hoped-for level. It might, but the power of compounding is undeniable and markets do rise over time, leaving previous levels behind forever. Investors waiting for the TSX to retreat to 2,000 in 1983 never saw it, nor did those who set their buy target at 4,000 in 1995.

If you're in this situation and want to plot a re-entry strategy, there are some basics you have to come to grips with. You have to believe that your biggest risk is losing ground to inflation (not volatility and market dips); that stocks will provide higher long-term returns than fixed income; and that a bumpy 5 to 6 per cent return is preferable to a smooth 2 to 3 per cent.

If you're good with that, there are a few things to think about as you prepare to buy stocks.

First, you need to refresh your investment plan and confirm what proportion of your portfolio should be invested in stocks.

Second, you need to immediately stop reading the doomsday scenarios (they're possible, but you already know them) and start monitoring asset prices. With few exceptions, investors who stayed out of stocks did so because of big picture concerns. Little or no consideration was given to the valuations being placed on companies. But you need to give valuation at least equal time, even if economists and the media don't. It is the most reliable predictor of long-term returns.

Remember that tech stocks didn't plummet in 2001 because the Internet failed to live up to its promise. They went down because valuations were in the stratosphere. And the current run that started in early 2009 wasn't fuelled by a rosy economic outlook, but rather by too many stocks getting ridiculously cheap.

Third, you need to stop pursuing perfection. It's not something you try to achieve at other times in the investing cycle, and you shouldn't strive for it now. You'll never get invested if your goal is to make up all the lost ground with one brilliantly timed purchase.

I'd suggest you buy in stages and pursue a goal of being 'approximately right.' If you currently hold 20 per cent in stocks and your strategic asset mix calls for 60 per cent, then you might consider narrowing the gap with four purchases of 10 per cent each (i.e., going from 20 per cent to 30 per cent, then 30 per cent to 40 per cent, and so on) over the next six to

18 months. This approach will mean that your purchases are either too early or too late (i.e. before or after the market low), with some being better than others. Not perfect, but practical.

Being out of stocks during a rising market is a tough spot. It's a huge bet against your long-term plan and there's no perfect solution. If you're in this situation, I strongly urge you to set a plan for re-entry and then take some baby steps towards getting back on track.

Twenty-two

Real Estate as an Investment? Look Elsewhere

Posted on March 17, 2012

As an active manager of stocks and bonds, we've always considered our biggest competitor to be the market indexes. Over time, our clients expect us to beat them. These days, however, we're facing another formidable foe. It's called real estate. Investors (young and old) have a significant portion of their net worth invested in their homes, and we're seeing more of them consider adding an income property to their portfolio.

I wanted to see what we're up against, so I put residential real estate through my usual research process. Just as I do with stocks and bonds, I looked at houses and condos from the perspective of economic fundamentals, valuation and market sentiment.

Starting with the economics, it would appear the supply side of the equation looks manageable (except maybe condos in Toronto). Housing starts have exceeded household formation for a decade, but the inventory of unsold homes is not excessive. The demand side, however, is less encouraging.

What drives real estate over the long term is income growth (i.e. jobs). As Canada becomes less competitive in the global markets and our governments stop prescribing stimulus, employment trends aren't too exciting. In the meantime, our home ownership rate has gone from 62 per cent 15 years ago to 70 per cent today, slightly above the level attained in the U.S. in 2006.

Still on the demand side, the demographic charts show the segment of the population that's the strongest net buyer of houses (those aged 25 to 34) is about to start declining, while the pool of potential sellers (over 65) is continuing to increase. The situation is the opposite to what prevailed in the 70's and 80's when the early boomers had a huge wave of buyers following behind them.

While supply and demand factors are important, what's really driving real estate these days is financing. Sellers can charge fancy prices when buyers are plugging 2 to 3 per cent into their mortgage calculators. But here too, the trends are worrisome. Rates have little room to drop (despite Bank of Montreal's efforts) and consumer debt levels are now equivalent to the U.S. at its worst (we seem intent on pursuing the American way).

Overall, the fundamental trends in favour of housing investment are getting tired, and in some cases reversing.

Moving on to valuation, it's important to remember that cheap, abundant financing is transitory, while the price paid is forever. On that front, the affordability indexes show that most housing markets in Canada are near their long-term averages. Even with Vancouver included, the RBC Housing Affordability Measures show that on average 42 per cent of pre-tax household income is required to service mortgage payments and pay the taxes and utility bills on a 1,200-square-foot bungalow (two-storey houses are higher, condos lower). As high as that number sounds, it's just slightly above the long-term average.

But — and there's a big but — these calculations are based on current mortgage rates. When we return to a time when Bank of Montreal is advertising five-year mortgages at 4.99 per cent instead of 2.99 per cent, the measures will look ugly. In other words, valuations are okay in most markets at artificially low interest rates, but poor in all markets at higher rates.

An analysis wouldn't be complete without a word on sentiment. In the capital markets, the mood of investors has a significant impact on prices. Real estate is no different. In this regard, I'll say only that homeowners are definitely not prepared for prices to go down. Real estate has enjoyed a long upward cycle and with 12 good years comes a high degree of complacency.

When I pull together the economic fundamentals, valuation and sentiment, real estate, as an investment, doesn't look very attractive. The distribution of potential outcomes looks asymmetrical to me — limited upside and plenty of possible downside. But what really screams out at me is how many important factors are at extremes ... bad extremes. One or two off-trend numbers can be explained away, but too many are jumping off the charts – price increases, mortgage rates, loan growth, consumer debt and home ownership levels.

To invest in an asset class that is illiquid, has high holding and transaction costs and involves large amounts of leverage, I want a significant margin of safety. Right now, there are more warning signs than guardrails.

Part IV

Industry

Twenty-three

Canadian Banks — The Next 25 Years

Posted on June 6, 2013

It's confirmed. We have the healthiest banks in the world. They've all reported their second quarter earnings and the numbers are spectacular. Industry leader RBC had a return on equity of 19%, while CIBC and National Bank were over 20%. Yes, 20% in a 2% inflation world.

These results are important because Canadian investors are highly dependent on their banks. Bank stocks account for 21% of the S&P/TSX Composite Index and play an even larger role in most investment portfolios (especially when preferred shares and bonds are taken into account).

In contrast to other countries, Canadians have made a potful of money on bank stocks. It's been a great twenty-five year run in which the Big Six saw their profits grow from $2 billion a year to almost $8 billion a quarter. Before I take a peek into the next twenty-five, it's informative to look at what's fueled the growth.

Interest rates have been a significant factor. Rate declines have meant a steady diet of capital gains and trading profits on the banks' bonds and other security holdings. They also led to rising house prices, which has made the consumer lending business truly hum (in the second quarter, the return on equity of Scotiabank's Canadian consumer business was 35%).

Indeed, favourable real estate markets, along with the banks' marketing and product innovation, have helped facilitate the indebtification of their customers. Since the late 1980's, Canadians' debt to income ratio has doubled to a world beating 160%.

As for corporate lending, Canadian banks have shown superb discipline after learning from a series of crippling losses on third world and energy loans in the 1980's (remember the LDC crisis and Dome Pete?).

They've also been savvy in buying and developing new businesses that fit their client base — products and services that can be promoted through the branch network. Brokerage and investment banking came in the late 1980's, followed by the trust companies a few years later. Wealth management started to get traction after the millennium. Each new initiative helped the banks transition from being service providers to where they are today, sophisticated sales organizations.

Like I said, it's been a good run, which begs the question — What will the next five and twenty-five years look like? Certainly, some of the tail winds I've outlined are going to shift, or already have.

The banks' biggest and most stable money maker, the Canadian retail business, is getting tougher. In aggregate, Canadians have little room to add debt and may indeed be forced to de-leverage if house prices and/or the economy weaken. Competition is sure to intensify because loans, mortgages and credit cards are just too profitable to risk losing ground.

In wealth management, the banks have become dominant players, so market share gains will be harder to come by. Also, profit margins may have seen their peak due to lower fixed income returns and higher regulatory standards for reporting fees and performance.

Other changes are in the wind, including increased capital requirements, but they're not all bad. At home, the Federal Government continues to be accommodative. It's put up barriers to foreign competition and hasn't pressed too hard on conflicts of interest between the banks' business units. In other words, the oligopoly will be maintained.

Beyond our borders, Canadian banks now have greater opportunities in international and corporate banking, areas where the competition is in full-on, 'post crisis' retreat. RBC is building a world scale capital markets and asset management business. TD is already a prominent player on the eastern seaboard and Scotia has a stake in the ground in almost every country with warm weather and a beach.

When all the gusts and swirls are taken into account, it's hard to bet against these inherently profitable companies. The banks' ability to generate sales, make acquisitions, pay dividends and buy back stock is unparalleled. And they still have lots of room to reduce expenses, something they haven't yet fully embraced.

We'll continue to have healthy banks (thank goodness), but it's going to be tougher for them to maintain their torrid pace, especially if their most profitable, reliable businesses hit the wall.

Twenty-four

Lessons Learned in the Wealth Management Trenches

Posted on April 14, 2012

We're celebrating our firm's fifth birthday this week, which has brought on lots of reflection. Before we started up, I sought counsel from as many people as possible under the theory that if you want money, ask for advice. As it turned out, I got little money and lots of advice. For instance, *"Finance the firm as if you won't win a client for three years." "No matter how good your offering is, you've got to sell it."* And my personal favourite, *"Tom, get a real job before people forget who you are."*

I ignored some of the pearls (at my peril), but heeded most of them. What I couldn't ignore, however, were lessons the markets, competitors and my team taught me over the ensuing five years. So now when entrepreneurial managers come asking for money, I've got plenty of advice to offer.

First off, I'd repeat the maxims about financing and selling. No matter what the projections say, it will take longer than anticipated to build a client base. With few exceptions, time is required to build a record and get the message out.

From there I'd start in on what I learned in the wealth management trenches.

This stuff is hard

For your clients, investing is perverse, unpredictable, emotional and often harrowing. You need to fight the natural tendency to make it even more complicated and daunting. Your work with clients has to be explainable and kept as simple as possible.

Living the long-term

While it's hard for some clients to understand all of what goes into an investment strategy, it's even harder to sustain that strategy over a long period. Keeping clients on track requires an entire ecosystem — appropriate securities, clear communications, timely feedback, ongoing counselling and compensation that's aligned with their objectives. You can't design solutions without thinking about how they're going to be executed years from now, and in all types of markets. It's not a better ride if your passengers get off at the wrong stop.

A bias toward change

The investment industry has the attention span of a 4-year-old. Two of its key drivers — compensation (fees and commissions) and past performance (what's done well recently) — lead to changing strategies and a steady stream of new products. Unfortunately, this hyperactivity kindles clients' psychological need to take action (especially males). It makes a 'stay the course' strategy, which is often the best option, difficult to maintain. In this context, it's important to communicate what's being done on the clients' behalf (research, buys, sells, rebalancing), even if it doesn't add up to substantial change.

David and Goliath

Over the last 15 years, the big banks and insurers have come to dominate the investment business. Their reach is now so broad that in addition to owning most of the asset managers and brokerage firms, it appears they'll soon own the stock exchange. The only way to succeed against such competition is to be substantially different and emphasize aspects where you have a clear advantage — personal, custom, patient, nimble, low fee, non-benchmark, small-cap, employee-owned and other elements that scale precludes. I heard Tom Waits say recently, "If both of you know the same things, one of you is unnecessary.” As a David amongst Goliaths, you can’t afford to be unnecessary.

Shifting winds

On that note, it’s important to focus on your sweet spot and not get too locked in on any one competitor. If someone is eating your lunch, just wait a few quarters. It’ll change. Exchange-traded funds (ETFs) were a good example of that for us. We initially viewed them to be our toughest competitor. But ETFs became a less important part of our competitive landscape when the number of funds proliferated, cost and complexity increased, and the need for advice became more apparent. Adapting our strategy to just compete against ETFs, or another firm or product for that matter, would have been a mistake.

Skating to open ice

This brings me to my last piece of advice. When it comes to generating client returns, the investment industry has plenty of what I call structural inefficiencies — short time horizon, over-diversification, high fees, high turnover (staff and stocks), complexity and an overemphasis on macroeconomics over valuation. For you and your clients to win, you need to exploit as many of these enduring inefficiencies as you can, and conform to few or none.

Twenty-five

The Conflict Between Clients and Business

Posted on October 15, 2011

I've written in the past about the tension between the investment profession and the investment business. As asset managers, we need to find a balance between managing portfolios to achieve the best return for our clients, and making a profit for our firms' shareholders. In a recent paper published in the Financial Analysts Journal, Charley Ellis says the industry has failed to find that balance. *"We are losing the struggle to put our professional values and responsibilities first and our business objectives second."*

Mr. Ellis is a thoughtful, well-connected industry observer. He's consulted to investment firms for decades and written a number of books, including an industry standard, *Winning the Loser's Game: Timeless Strategies for Successful Investing.* In his article, entitled "The Winners Game," he outlines three errors that are leading to this inappropriate balance between values and business objectives.

First, we're defining our mission incorrectly. It's no longer reasonable to tell clients that our focus is on beating the market. Evidence shows that it's hard for active managers to outperform the indexes because there are so many skilled, well-informed people competing against each other. As Mr. Ellis said to me recently, *"The more smart people there are trying to beat the market, the less likely it is to happen."*

The second error cuts to the heart of the profession-business balance. Mr. Ellis says we have our priorities wrong. *"As investment management organizations have been getting larger, it is not surprising that business managers have increasingly displaced investment professionals in the senior leadership positions or that business disciplines have increasingly dominated the old professional disciplines."* He goes on to say, *"When business dominates, it is not the friend of the investment profession."*

I could write at length about these two errors of commission, but it's the third error, one of omission, where Mr. Ellis's perspective is the freshest. He calls it, *"the largest problem and the best opportunity for our profession going forward."* While we've been trying to beat the market, outsmart each other with innovative products and feverishly gather assets, we've given short shrift to something that will help our clients more than anything else — effective investment counselling.

In conversation with Mr. Ellis, it becomes clear that he doesn't consider investment advice to be rocket science, but rather basic blocking and tackling. From my perspective, it involves putting a plan in place with a prescribed long-term asset mix. It means executing the plan in a simple and consistent way. It means looking ahead and preparing for the down periods as being inevitable as opposed to being a surprise. And most assuredly, sound counsel means spending more time with clients when markets and emotions are at extremes, not less.

The industry's biggest failure is not its products and services per se, but how clients use them. It's been well documented that, in aggregate, investors suffer from a behavioural gap — their portfolios don't do as well as the funds and products they invest in. That's because they trade too much, chase past performance and generally stray from their plan. Don't get me wrong, there are plenty of bad investment products out there, but the gap comes largely from misuse.

Unfortunately, the industry is doing more to widen the gap than narrow it by advertising last year's best performers and introducing a constant stream of new products. Pumping a hot fund through multiple distribution channels is hugely profitable, but ensuring that it's used correctly by the appropriate clients is not. Investment counselling is bad for business in the short term — it takes time, costs money and is not very scalable.

Mr. Ellis's article may serve as an indictment of the industry, but as the title implies, there is plenty to be positive about. If we recalibrate our priorities a little, be more ruthless about eliminating products and business practices that hurt clients, and think more about client returns as opposed to fund returns, we'd be taking a big step in the right direction. All of this might hurt profitability (and I'm not even sure about that), but as Mr. Ellis points out, it's certain to be successful. That's the kind of risk/reward tradeoff all investment professionals are looking for — possible short-term pain, certain long-term gain.

Twenty-six

A Coffee Shop Education in Investor-speak

Posted on April 1, 2011

In Toronto last week, I was waiting for a friend at my Starbucks office. As I browsed the Sports section, I couldn't help but overhear a nearby conversation between two investment types. The checked shirt was leading the discussion.

"My overweight in energy is really working. I'm 300 beeps ahead, even though my TE is sub 4. If this holds until quarter-end, my one-year number will be first quartile. I don't know if it's enough to get on any short lists though. My moving fours still suck."

I was getting bored reading about the Leafs' momentary playoff run, so I tried to descramble the jargon. What I think he said was: So far this quarter, his portfolio has achieved a return that is 3 per cent (300 basis points) better than the index he's trying to beat. This has occurred because a larger percentage of his fund is invested in oil and gas stocks, which have done well, compared to the index.

Tracking error (TE) is a statistic that predicts how much the portfolio's return is expected to deviate from the index — the lower the number, the more closely the portfolio will mirror the index.

I also picked up that if the shirt does okay in the remaining days of the quarter, his one-year return will look good and be in the top 25 per cent of funds he's competing against. Unfortunately, one good year won't be enough to make his longer-term results look attractive; specifically the four-year periods ending March 31, 2011, 2010, 2009 and possibly further back. The manager hasn't been getting invited to compete for any new institutional accounts recently.

Unfortunately, the other geeky-looking guy was a bond manager. "It doesn't make any sense to own Canada's when I'm getting 75-80 beeps in Ontario's. More of our risk budget is in provies than I can ever remember. Where I'm struggling is with the credit bucket. I want to sell some Trucks and Boats, but can't find anything to replace them. I need something in the belly of the curve that's better than bank paper."

Bond talk is more challenging to translate, but I take it that Mr. Corduroys has a large position in provincial bonds in lieu of Government of Canada bonds. By holding Ontario, B.C. and other provincials, the fund is getting an extra yield of three-quarters of 1 per cent. In the corporate bond portion of the portfolio, he's planning to sell specialized income securities issued by Royal Bank ("Trucks") and BMO ("Boats"), but hasn't figured out what to replace them with. In his opinion, the extra yield he gets by owning six- to 10-year bank bonds isn't attractive enough to justify the risk.

As the lattes were disappearing, it became evident that I was the only one doing any listening. The shirt motored on.

"This focus on cheap beta is killing me. It's all the consultants and media can talk about. That hottie from AON Mercer Towers keeps reminding me that index-like returns are free. She doesn't seem to get that my fund doesn't go down as much as her beloved XIUs. But I might have got through to her this time. The propeller heads did a chart for me that shows my bear capture at 73 per cent."

Whoa, maybe bonds aren't so bad after all.

Beta is an industry term used to describe the return of the overall market. For pension funds, and other large institutions, index investing (beta) can be done at an extremely low fee (a few hundredths of 1 per cent). On the other hand, active managers, who are out to beat the index funds, charge considerably more and are under pressure to justify their fees to clients and consultants (male and female).

Most active managers beat the indexes in weak markets, which can be shown by a ratio that statisticians call Bear Market Capture. In this example, the shirt's portfolio had a bear capture of 73 — in down markets, it declined only 73 per cent as much as the index (as represented by the iShares exchange-traded fund — symbol XIU).

Thank goodness my friend arrived so we could relax and talk about the Canucks' PK, Stevie's triple double and where the Wildcats were seeded in the West regional. No translation required.

Twenty-seven

For Money Managers, Small Can be Beautiful

Posted on February 4, 2012

Boyd Erman wrote an article before Christmas titled “Squeeze Is On For Smaller Investment Firms.” When I saw the headline, I shuddered a little. Was he going to talk about firms that don’t have billions of dollars under management? Was he going to burst my bubble?

Well, after a couple of sentences I realized the article was about the ‘sell’ side of the Street in these treacherous markets — the investment dealers that research, sell, trade and underwrite securities. Phew.

But what about the asset managers? How does the size challenge reveal itself on the buy side?

Let me say off the top that it’s not nearly as scary. Certainly, the smaller independent firms would like to have more scale in areas such as sales and marketing, compliance, processing and administration. But there are some significant differences that make the buy side a friendlier place for the small fry.

First and foremost, asset management is not a capital-intensive business. Investment firms that manage money for clients need enough capital to fund operations and satisfy regulatory requirements, but a large capital base is nothing more than a drag on profit margins.

As for what drives money management — investment research — the playing field was leveled in 2000 when Regulation FD came into effect in the U.S. Reg FD prevents the selective disclosure of nonpublic information. In other words, an analyst from a mega-firm can't (or shouldn't) hear something from a CFO that hasn't already been disclosed to the public. Today, when corporations do their quarterly conference calls, small managers can listen in just like the big players.

But more importantly, the buy side is less threatened by large firm domination because it's an anti-scale business — the bigger a manager gets, the more difficult it is perform. While this adage has generally proven out, each area of the business is affected differently.

In general, our relatively illiquid Canadian market is a challenge for large firms. Equity managers with a few billion dollars to invest are forced to concentrate on the largest 80 to 100 stocks.

Size is less of a constraint outside of Canada. The U.S. and overseas markets offer a broad array of companies to invest in. Indeed, it's possible to be too small for international investing, as a minimum commitment is necessary to deal with the number of offerings, longer travel distances and different regulatory regimes. It can be done with a small, experienced team, but a global footprint helps overcome these hurdles.

A manager also needs critical mass for bonds. Canada's corporate market is still relatively illiquid, but if managers are too small, they won't see bond offerings until all the big guys have been filled (or have passed). Also, the market is getting more complex, which requires a serious research effort. Early in my career, small investment counsellors were stock pickers. If bonds were needed to balance out a client's portfolio, the admin assistant phoned a broker and bought some Government of Canada bonds. Not so today.

Clearly, in some asset categories, having horsepower is an advantage, but there are tradeoffs. More people in more locations means the decision-making process is prone to slippage and compromise. Bigger engine, but clunkier transmission.

I can't finish this comparison without mentioning fees. This is an area where the buy side has a greater ability to differentiate. On the sell side, trading commissions and underwriting fees are pretty standard across all dealers, but asset management fees can range from a few basis points for indexing to a 2-and-20 arrangement (2 per cent base plus 20 per cent of the return) for more specialized categories such as hedge funds. Small buy side firms that deliver a unique product can charge more and, as a result, be profitable on fewer assets.

Now don't get me wrong, it's no treat operating in the shadows of the big players. The banks and insurers are marketing machines and have plenty of advertising dollars to throw around. The large foreign firms have seemingly unlimited resources. But in the asset management business, their challenges are just as tough as the small firms' — they have to manage their anti-scale.

Twenty-eight

Funds vs. ETFs: Peeling Away the Myths

Posted on July 7, 2012

There's one research report in my reading pile I've been avoiding, although it eventually worked its way to the top.

Vanguard, the giant U.S. mutual-fund company ($1.8-trillion U.S. under management) produces some great research, particularly in the area of investor behaviour. In conjunction with the launch of its exchange traded funds in Canada, Vanguard published a paper entitled A Case for Indexing — Canada.

In it, the authors pointed out that Canadian equity mutual funds have failed to keep up with the indexes, a conclusion that echoes other comparisons of this type, including the often-quoted SPIVA Scorecard (Standard and Poor's Indices Versus Active Funds).

Now even though I run a firm that offers actively managed funds (hence my procrastination), I take no issue with the conclusion of these studies. That's because the state of active equity management in the Canadian mutual-fund industry is abysmal.

Fees are high, too many funds own too many stocks (hundreds in some cases) and too many managers hug the index rather than try to beat it. In addition, fund stewardship is sorely lacking — fund holders are often subject to manager and mandate changes, which result in inconsistent investment philosophy. There are plenty of well-managed, efficiently designed funds in Canada, but the overall fund complex is a picture of mediocrity.

Having said that, I do take issue with these studies because they overstate the case for indexing. They compare apples to oranges — "after-fee" mutual-fund returns to "pre-fee" benchmarks returns.

Apples

The cost of owning a mutual fund is captured in the management expense ratio. An MER is the full-meal deal — it includes the manager's fee, all legal and regulatory expenses, any sales commissions paid and in most cases, a charge for ongoing advice, known as a trailer fee. While the cost of owning mutual funds in Canada is generally too high, and there's little transparency around who is getting paid for what, investors can be assured that the returns reported by the funds are after all costs.

Oranges

In the studies, however, mutual funds aren't measured against actual index portfolios, but rather market indexes that have no costs attached. Unfortunately, investors can't replicate these benchmark returns. ETFs have MERs too, and when they're bought or sold, trading commissions are charged and a small premium/discount to net asset value is absorbed. My indexing friends tell me it costs about 0.5 per cent (all in) to run a balanced ETF portfolio at a discount broker. Investors wanting advice would expect to pay an additional 0.75 to 1.25 per cent at a full-service firm.

Like mutual funds, ETFs can also miss their performance targets. A report published in May by Morgan Stanley showed that of more than 700 ETFs in the U.S., 47 per cent lagged their benchmark by more than just the fee. These shortfalls (they're rarely additive) vary depending on the type and size of fund and market conditions.

Levelling the field

So the question is, would these studies arrive at a different conclusion if mutual funds were compared to ETFs instead of uninvestable indexes?

It's hard to say definitely without getting into the data, but a rough assessment based on the Vanguard numbers would suggest that Canadian equity ETFs would still be leading an albeit closer race. If a charge for investment advice was factored in, it would be a dead heat, with some categories going to ETFs and others to mutual funds.

Regardless of any adjustments to the numbers, investors shouldn't expect to hear that the average mutual fund has beaten the indexes because, as noted above, too many funds in the sample aren't trying hard enough. For reasons of size, risk management and marketing strategy, many managers can't or won't stray far from their assigned benchmark. A Canadian equity fund holding 15 to 20 of the top 25 stocks on the S&P/TSX 60 Index (four or five banks, one insurer, Barrick, Suncor, Encana, either Potash Corp or Agrium, CN or CP Rail and two of Bell, Rogers or Telus) shouldn't be expected to generate a return that's different enough to offset its fee disadvantage.

In the long run, everyone would be better served if more rigour was brought to the active-versus-passive comparisons. ETFs have a good story to tell without tilting the playing field. And fairly priced funds that are consistently managed and distinct from the index shouldn't be dismissed simply because they're categorized as mutual funds.

Twenty-nine

Cracks in the ETF Halo

Posted on May 13, 2011

Personal disclosure: I'm a dyed-in-the-wool active manager, but admit to having used exchange-traded funds in my portfolio. I've tread on the dark side for tax planning purposes and, occasionally, to hedge certain long-term positions. I also must confess that I've taken no issue with our clients using ETFs, despite the fact that our company offers a simple, low-cost mutual fund alternative.

With that out of the way, I must also say that I get pretty steamed about the lack of scrutiny ETFs get. They seem to have an impenetrable halo over their heads, which emanates from their noble roots — cheap, simple and diversified. I grumble because the ETF landscape has been changing at breakneck speed and is now far from halo perfect. Fees are edging up (there are even performance bonuses in a few cases), complexity is emerging as a real risk, and performance often lags behind the target indexes.

I recently read a report on ETFs published by the Financial Stability Board, which is an international body set up to "assess vulnerabilities affecting the financial system." The report points out that "the speed and breadth of financial innovation in the ETF market has been remarkable in some large financial systems [countries] over the past five years, and has brought new elements of complexity and opacity into this standardized market."

The authors focus on the structural issues around ETFs and some of the new risks. For example, in Europe, 45 per cent of ETFs are "synthetic," which means they obtain the desired return by entering into an asset swap with a counterparty, usually a bank. This derivative strategy is in contrast to "plain-vanilla ETFs" that own the actual securities of the index they aim to replicate. The report is balanced in its commentary and sounds an early warning to regulators and market participants about potential areas of concern — illiquidity, counterparty risk, poor disclosure and misaligned incentives.

If the Canadian regulators or industry were to commission such a report, it might raise some of the same issues. Uncertain liquidity and lack of transparency are obvious ones. Fortunately, the structural risks are less of a worry in Canada because, thus far, most of the ETFs are of the plain-vanilla variety.

But where a Canadian report should focus its attention is on the behavioural aspects of the ETF market. While providers pay lip service to the importance of long-term investing, they are enthusiastically encouraging widespread speculation. The reality is that a small portion of the $40-billion in ETFs in Canada are used to form a low-cost foundation for long-term portfolios.

We're now approaching 200 ETFs in Canada after having just a handful 10 years ago. The flood of new offerings (reminiscent of mutual funds in the 80's, 90's and ... er ... well, today) has steadily carved the bond and stock markets into smaller and smaller pieces. The race is on to achieve first-mover advantage, whereby firms try to get their ETFs established as the standard, or benchmark, in as many sectors as possible. As a result of this proliferation, many of our ETFs are highly illiquid — they trade like micro-cap stocks — and need to be bought and sold with great care and patience.

The ETF firms are playing to the active traders and speculators, whether they be individuals in their basement or professionals in office towers. Trading volume and assets under management are focused on the hot and, dare I say, more speculative areas of the market. All of this is fine for the purposeful trader, but the Financial Stability Board isn't worried about them, and neither am I. It's the investors who are unknowingly investing less, and speculating more, that is the concern.

I came across a quote a few years ago that reinforces this point. John Bogle, the father of indexing, was credited with saying: "As the splinters get thinner, they grow sharper, and the odds of folks hurting themselves with these pointed objects now approach 100 per cent."

Thirty

The Rise of the Independent Money Manager

Posted on December 10, 2010

We're going through another wave of consolidation in the asset management industry. Last summer, Sceptre Investment Counsel merged into Fiera Capital. More recently, CI Financial bought Hartford's mutual funds, Bank of Nova Scotia made an offer for DundeeWealth and AGF bought Acuity.

Will there be even more consolidation on the horizon? Before addressing the question, it's useful to look back. When I started in the business in the early 80s, most professionally managed money was in the hands of big institutions, namely trust and insurance companies.

Fortunately for me, a shift was in progress toward independent firms owned by their employees. Investment counsellors, run by people who had built their records and reputations at the institutions, were winning all the pension mandates and were wooing wealthy individuals away from brokerage firms. With mutual funds going mainstream, independents like Mackenzie, AGF, Trimark, CI and Templeton jumped to the fore.

In recent years, we've seen the other side of the equation. The big institutions have been keen to grow their asset management businesses at a time when the founding shareholders of independent firms were looking for an exit strategy. This happy circumstance led to a decade of deals in which bigger firms swallowed smaller ones.

Banks were major players in this consolidation. It wasn't too long ago that the Big Five were considered to be second-tier investment managers. Indeed, when I was at Phillips Hager & North, I made a few of my partners angry when I was quoted in the paper as saying the banks were our competitors. It was an insult.

But the comment proved to be prophetic. Banks are now big players in mutual funds, private counsel for wealthy individuals, structured products and brokerage. Acquisitions accounted for some of the growth, but it came primarily from banks improving their investment capabilities and using their brute distribution force to sell products through branches and brokers.

This industry transformation has been so complete that it's become downright scary to be an independent. To compete with banks that have the massive budgets required to advertise on Hockey Night in Canada, firms need to have bank-like scale or something else going for them in terms of performance or product innovation.

Will the acquisition trend continue? At the risk of again being called crazy, I think the tone of the next decade will be quite different. We're heading into a new phase of the industry life cycle, which I'll call "The 80s — Part 2." It will be a time when many new investment managers start up, and some small and mid-sized firms emerge from the pack.

Some of the factors driving the growth spurt will be the same as in the 1980s — available talent, entrepreneurial juices and the desire to escape slow-moving institutions. Are Dundee's stars, like David Goodman, Rohit Sehgal and David Taylor, going to be bank employees a few years from now? Not likely. Out of the great consolidation comes a band of rich, capable investment managers who still want a say in running the business, and will increasingly cherish the freedom that bank bureaucracy and tens of billions of dollars in assets doesn't permit.

Institutional investors will welcome these new, smaller money management firms because pension plans and consultants increasingly view the established players as being too big to take on more domestic assets.

Changed compensation structures will also encourage entrepreneurial managers to head out on their own. With the emergence of hedge funds, clients are used to paying performance bonuses in addition to a base fee. This compensation arrangement makes it enticing for portfolio managers to go out on their own because they don't need a large asset base to make a living.

So will there be more deals? Yes. Will the banks be the giants? No question. And will there be a renaissance in the asset management industry? Only if you believe that things go in cycles, size is an investor's enemy, and client returns are more important than shareholder returns.

Thirty-one

How Bay Street Can Bridge its Credibility Gap

Posted on February 4, 2011

Bay Street, we have a problem. A PR problem. Our clients think we can do more than we're capable of. Some think we know which stocks are going up and when to get in and out of the market. We're setting them up for disappointment and as a consequence, hindering the growth and stability of our business.

The gulf between client expectations and the realities of the wealth management industry covers a lot of ground. Investment returns are at its core — what's hoped for versus what's achievable — but there are other factors that serve to widen it.

Overselling

We all want to win new clients, so naturally we put our best foot forward. We trot out all the great things we've done in the past. Savvy stock picks and prescient interest rate calls are duly highlighted. We advertise the funds that are performing the best right now.

We do it because it works. Managers and advisers with the most appealing "recent past" look the smartest and win most of the business. Industry statistics consistently show that money flows into funds and firms with good short- and medium-term returns.

But what makes it worse is that we continue overselling, even after the client has been won. We take credit for too much. Way too much. If a stock does well, it was a great call. If it goes down, it was a problem with the market. Our clients are led to believe that we have a higher batting average than we actually do.

Predicting the unpredictable

In overselling our abilities, we imply there's a level of precision in investing that just isn't there. When we confidently predict the market will be "up 8 to 10 per cent this year" or "the dollar has little downside from here," we weaken our client relationships. Too many factors come into play in a stock, currency or asset mix decision to project anything more precise than a range of potential outcomes. Sorting out the visible, quantifiable variables is hard enough; let alone factoring in the lesser-known triggers that lurk in the shadows. (How many prognosticators had Greece or Egypt in their forecasting models?)

Charlie Munger, Warren Buffett's trusty sidekick, refers to it as physics envy, or the tendency for economists (in this case, investment professionals) to put false precision into a complex system. *"[The profession's] search for precision in physics-like formulas is almost always wrong."*

It's a perverse world

But the gulf is not all our fault. The nature of investing makes it extremely hard to communicate clearly with clients. Capital markets are volatile, unreasonable at times and most often counterintuitive. Think about it. If everyone you know is recommending an appliance or car, then it's likely to be a good buy. If, on the other hand, they all like a stock, it's time to run for the hills.

In the perverse world of investing, it's hard to remain credible with clients when we're telling them their best moves will be the ones that make them feel the most uncomfortable. Or poor short-term results will translate into higher returns going forward. Or they should ignore a heavily advertised fund and buy more of the boring one in their portfolio.

In spite of these challenges, there are things we can do to solve our PR problem.

Narrowing the gap

When returns are really good, we can do a better job of talking them down. My former partner, Bob Hager, was a master of this. When he had great numbers to report, he went out of his way to point out the missteps he'd made. He primed his pension clients for a time when the numbers wouldn't be so good.

We can talk with certainty about uncertainty. It's not a matter of "if" an equity fund goes down 20 per cent, but rather "when." By framing it in these terms, expectations are more realistic and clients better prepared.

We can cast risk in a more positive light. After all, it's the fuel that drives returns and we're the risk managers. So rather than advertising our risk-free approach to investing, we should illuminate the risks our clients are taking.

And finally, we can represent the markets for what they are — totally and utterly perverse.

Part V

Success

Thirty-two

Five Essential Elements of a Successful Investing Framework

Posted on August 3, 2012

As a young analyst at Richardson Greenshields, I worked with a big guy with an unusual name, Pentti Karkkainen. After years as a highly regarded oil analyst, Pentti now plies his trade in Calgary at KERN Partners, a private equity firm he co-founded. I introduce him here because I've always liked his investment framework. The KERN team doesn't just look at two commodities when making an energy investment, it looks at five — oil, gas, capital, time and people.

I've kept the notion of five commodities in mind, partly because of the elegance of Pentti's presentation and partly because I wanted to adapt it to the process an individual investor goes through. What are their commodities, or essential elements of their investing framework?

My initial list had 10 items, but I forced myself to align it with Pentti's five. Like his, the first two are raw materials. The other three are how to successfully extract them.

Time

The law of compounding is very powerful. If you invest $100,000 over 25 years and earn an annualized return of 5 per cent, the market value will grow to $338,636. Investors, whether they are private equity managers or disinterested amateurs, simply need to let the calendar work for them.

Risk

Like oil, risk can be messy, but it's not a dirty word. Indeed, when combined with time, it's the fuel that drives returns. Diversifying across the four basic risks — interest rate, credit, liquidity and ownership risk — is what investing is all about.

Notice I didn't define risk as short-term volatility, as investors most certainly are doing today and the investment industry does all the time. Risk in its truest form is permanent loss of capital, but for investors who are properly diversified, it's better defined as the possibility of not achieving their long-term return objectives. However you define it, using this commodity properly means embracing volatility, not avoiding it.

Road map

Having an investment plan that sets out where you need to get to and how you're going to get there, is the most basic of investing disciplines. (I hate to waste space on it because it seems so obvious, but far too many investors don't have one.)

A good plan encompasses the crucial components of successful investing: a strategic asset mix, a process for rebalancing and managing cash flows (in and out) and a framework for assessing performance and costs. Without one, investors are ruled by the unexpected and irrational short term, rather than the more predictable long-term.

Temperament

Investing is a perverse activity and investors need to be wired accordingly. The market goes down when it's not supposed to and up when it couldn't possibly. Investors are regularly required to buy when it feels awful and sell when things couldn't be better. And they'll only know if their plan is working years later, even though they'll be barraged with meaningless, short-term signals (positive and negative) along the way. To be successful, investors need the ability and discipline to make decisions, the patience to let them play out and the fortitude to stick to a plan when they trust it the least.

Division of labour

'People' is on my list too, but I'm talking less about raw horsepower and more about alignment and co-ordination. While there are do-it-yourself investors who can do it all, most people need help with some or all aspects of the process. If they don't have the knowledge, time or temperament for investing, they need to latch on to someone who does — an adviser, money manager, friend or family member.

Investors need someone on their team who is thinking about how the overall portfolio fits together. Someone who is reading the covenants on the Telus bonds, picking between Intel and Cisco, and deciding which mutual fund and ETF to hold. Someone who will make tough decisions at market extremes. And someone who is tracking how the portfolio is performing and importantly, losing sleep when it's not doing well.

Investors don't always think about the division of labour and either pay heavily for duplication or have gaps in their roster. What's most often missing is the overall co-ordination — lots of players but no quarterback.

You don't have to agree with how Pentti and I constructed our lists, but thinking about what the essentials of your investment strategy are can only increase the chances of success.

Thirty-three

Keys to the Game

Posted on October 25, 2013

Sports broadcasts usually start with the color commentator providing viewers with the 'Keys to the Game'. For the Maple Leafs, it might be: (1) contain Crosby, (2) pound the Penguins' defense and (3) pray. I don't watch enough sports to be definitive on this, but it seems to me the predictive value of these 'keys' is very low. The Leafs could shut down Crosby, pray and still lose. Or they could watch Crosby have a four point night and win (more intense praying perhaps).

Sports is all about entertainment, but this type of short-term analysis is not all that different from what we see in the investment world. When asked, strategists, analysts and portfolio managers are quick to offer predictions about where the market is going this week, next month or the rest of the year, along with a reasoned explanation as to why.

A year ago, the commentators' keys would have included some mix of: interest rates will stay low; the stock market is range bound; avoid troubled Europe, growth will come from the emerging economies and by all means, stick to dividend stocks.

Unfortunately, the post-game analysis tells quite a different story: in the spring, the market was surprised by a 1% rate rise, stocks went steadily higher, European stocks performed particularly well, companies with emerging markets exposure did poorly and high-yielding REITs and utilities were hit hard.

There's a reason shorter-term forecasts are regularly off the mark. Markets, like sporting events, have a myriad of variables that feed into the final result and these variables interact in different ways at different times. The market's spotlight might be on one or two high profile inputs (quantitative easing, budget negotiations in Washington, Chinese consumers), but there are thousands of other variables lurking in the shadows. Some of those variables will turn out to be the unsung rookies and fourth line call-ups that play a big role in the final score.

Also, the front page news may not even be important in determining the short or long-term value of the market. Our recent experience is a good illustration of this. When talking to investors over the last month, the negotiations around the U.S. debt ceiling came up repeatedly and clearly influenced many investment decisions. It's been my observation that the sitcom in Washington always has an undue influence on investor behavior, despite having little or no long-term impact on market values.

Unreliable forecasts are harmless in the sports arena, and can be for investing too, although there are times when they get in the way of sound decision-making. For example, negative market predictions for the dreaded September/October period might prevent investors from buying a stock that's trading well below its true value. Or conversely, a rosy forecast from an eminent strategist may entice investors to overpay. In both cases, a guess (I won't dignify short-term market predictions as being educated guesses) about the market direction ends up overruling long-term fundamentals and valuation. The outcome of the former is random, while the latter has a reasonable chance of success.

It's also tough to make money off of short-term forecasts because they generally reflect the current consensus. What coach wouldn't try to contain Sid the Kid and what investor is going to avoid dividends? This tends to mean that the headline variables are already factored into the market. They may prove to be right, but it's hard to make money off them because the information is already built into security prices.

If the Leafs manage to contain Crosby and pound the Penguins' blueliners over 10 or more games, they will likely win a few (despite their relative talent deficit). And a portfolio with a focus on dividends and emerging markets may prove to be a winner. But in both cases, these strategies will be totally unreliable in determining what happens in the short term.

You might listen to the 'Keys to the Game' for entertainment and to see where the consensus lies, but don't let them influence your long-term investment decisions. If your money manager or advisor is constantly offering up his or her latest market call, I'd change the channel and look for someone who can help you make investment decisions based on more reliable long-term factors.

Thirty-four

Rewiring Investors' Brains

Posted on September 18, 2010

Every summer Lori and I make a pilgrimage to the famous Highland Cinema in Kinmount, Ont. This summer's movie was *Inception.* While I had mixed feelings about the film (movie — 2 stars; conversation after — 4 stars), I found the premise of being able to implant ideas in people's brains to be intriguing. So in subsequent weeks, I've been asking the investment pros I meet with to play Leonardo DiCaprio's role. If they could implant one idea, concept or skill to help investors generate higher returns, what would it be?

The mind altering suggestions I got fit into three general themes.

Implant No. 1: Make judgments based on longer-term information.

There's a real frustration with how short term investors' focus has become. Investing is an endeavour we do to offset long-term liabilities (i.e. provide a paycheque in retirement). And yet we're wired for instant feedback. The dialogue, strategies and reporting are all focused on what's happening now. In a world where patience is defined by the 24 hours it takes to get the results for *Dancing with the Stars*, waiting a few years to see whether a fund is going to perform or a strategy will play out seems out of the question.

The frustration comes from the fact that, in the world of investing, short-term price moves are totally random, and judgments based on it have little impact on long-term value creation. Rather, returns come from letting the power of compounding do its magic over time.

I must admit that I didn't expect to hear professionals who are managing billions of dollars saying: "Get started early, have a long-term plan and stick to it." It's hard to believe we need to implant something so basic in our brains.

Implant No. 2: The stock market does not equal the economy.

People tend to expect the market indexes to reflect what's going on in the economy, but the fact is that when this alignment occurs, it's a total fluke. That's because the market is continually looking forward, having long since absorbed the current situation. It doesn't always predict the future correctly — I remember Paul Samuelson, the Nobel laureate economist, saying that the stock market predicted nine of the last four recessions — but it's always trying.

This disconnect constantly confuses investors, amateur and professional alike. Shouldn't the market ultimately reflect what's going on in the economy? Yes, ultimately. But it's a sloppy, unpredictable relationship.

Along with the time frame issue, there is the volatile linkage between the economy and the market, namely valuation. What the market is willing to pay for corporate profits will vary with interest rates, investor sentiment and a variety of other factors.

So even if we get the economy right, we can be totally wrong on our market call. For instance, those who predicted in the fall of 2008 that there was a recession ahead were absolutely right, but if they weren't fully invested in 2009, they left a lot of money on the table.

As one of the portfolio managers said to me, *"People have to stop trying to figure what the economy and market are going to do and start buying good companies."* We've made investing as complicated as *Inception*, but unfortunately we don't have whiz kid Ellen Page (woefully miscast) to save us.

Implant No. 3: Stop running with the herd

It's important for investors to realize that if they're applying the investment basics correctly, they'll sometimes be out of sync with a majority of the people around them. That's because the crowd is chasing past performance, buying flavour-of-the-month products and/or trading too much. And because of that, their results are poor. We might take comfort from being with the crowd, but we don't want their returns.

A consultant I spoke to had a simple strategy for fighting the herd mentality — find a good manager and hire them when they're at the bottom of the industry rankings, when everyone else is ignoring them.

Similarly, at market extremes when investors are wallowing in negativity, it's important to realize that poor 'past' returns lead to better 'future' returns (and vice versa). At such times when markets are fertile, planting seeds for the next cycle makes sense, but it's guaranteed to be a solitary pastime.

One executive gave me a line (which he credited to Hall of Fame oil man Jim Gray) that sums up what I heard from a number of people: *"If you're getting a warm feeling about what you're doing, it's probably because you're in the middle of the herd."*

Do we need Leonardo to help us lengthen our time frame, look beyond what's going on in the economy and prepare to be lonely? Well yes, we all need a little rewiring.

Thirty-five

Loyal to a Fault

Posted on May 27, 2013

Lately I've been part of too many conversations that go like this.

What brings you to Steadyhand? *"I haven't been happy with my existing advisor. The returns have been lousy and the service has fallen off to the point where I never hear from him."*

Do you know how you've done? Does he provide that info? *"Well, I was up last year. That was nice. But no, I guess I really don't know how my account has done."*

So are you going to make a move? *"I know I should, but I feel some loyalty to my broker. I've been with him for 13 years and we know each other really well. He's a nice guy."*

But you said he hasn't been meeting your needs. *"Yah, I know. I should do something."*

This conversation drives me to distraction, not just because I want these investors to join us at Steadyhand (I do), but because I can't stand seeing such a misalignment of loyalty.

Investors should be loyal. Intensely loyal. But it should be directed to their financial plan, and the philosophy and process behind it.

Investing your hard earned money is too important to let misguided loyalties persist. It's your money. It's your future. It will help determine the quality of your retirement.

If you're not happy with your current situation, and don't have faith in the person you're dealing with, it's time to do the research, interview some alternatives, make a decision and then ... make that awkward call.

Thirty-six

In Times of Crisis, Approximation Beats Perfection

Posted on May 16, 2010

As we ride the market volatility caused by Europe's economic turmoil, I can't help but think back to Oct. 19, 1987, a date that will forever be imprinted in my memory.

Black Monday saw the Dow drop 23 per cent, while the TSX was down 11 per cent. As an aspiring analyst at Richardson Greenshields, I had just published two 'Buy' reports — Laidlaw and Investors Group if I remember correctly — in which I wrote glowingly about the companies' long-term fundamentals, competitive position and attractive valuations.

All of that good stuff went out the window, however, when the market went into free fall. Everything was going down including my shiny new recommendations.

Fortunately, I was smart enough, or devastated enough, to abandon my desk and go hang around the traders for the rest of the day. I just sat there stunned and watched the insanity.

Black Monday was my first experience with a serious market decline — a crisis that garnered coverage in the front page of the newspaper. Looking back, it didn't matter that I froze up. I wasn't managing money at the time and the sales team and clients had more important things to do than listen to me.

But the day didn't go to waste because I learned some lessons that have served me well in subsequent crises.

More information, less knowledge

When a crisis hits the front page and information is flowing fast and furiously, you have to know two things. First, the markets have already absorbed most, all, or more than all of the bad news. When people are talking about it at the water cooler, the markets have already moved on.

And second, the quality of information is poor. Very poor. It's heavily tilted toward the negative. And because it's often something we've not gone through before (crises tend to be that way), it doesn't fit into anybody's model. We look to the experts to make sense of it, but without the necessary time and data, they are winging it just like the rest of us.

Under-react

When the experts are guessing and emotions are running high, it's not a time to take a strong view. Big shifts in strategy at times of crisis lead to bad decisions. The potential for blowing up a portfolio, or asset management firm, is very high. Investors who sold all their stocks at or near the bottom last year have devastated their retirement savings, just as many did 10 years earlier when they got carried away with technology.

When things are coming apart, we all desperately want to take action. But trust me, under reacting is good.

Back to fundamentals

That's not to suggest that there aren't things to do. Even if no radical shifts are planned, it's important to know where you stand with regard to your long-term asset mix and what your next steps might be.

While everyone else is looking at the big picture, it's important to get back to what matters — fundamentals and valuation. Even if earnings and multiples don't seem to matter at the moment, they ultimately will. So, watching for securities that have been unduly penalized by the crisis is time well spent.

Baby steps

When there are large dislocations in the market, it is likely some portfolio rebalancing will be required. Last month's asset mix will no longer be in place. I'm a big proponent of taking incremental steps to get where you need to be. Market extremes are not a time for perfection, but rather approximation. Investors who aim to make a bold move at just the right time, usually end up doing nothing because the stakes are too high. They can't afford to be wrong. It's better for investors to take small steps that in aggregate are approximately right, as opposed to not doing what they think might be brilliant.

I'm so excited

The Pointer Sisters had it right. Certainly for investors in the accumulation phase, market crises are a time to get excited. It's a gift. New investment dollars buy more in depressed markets and the value of existing holdings are never impaired to the degree that short-term prices imply. When securities are being dumped for uneconomic reasons — automatic sell programs, fund redemptions, and good old panic — you want to be buying.

Europe has serious economic and political issues. The crisis will have an impact on economic growth and capital markets. Indeed, the world's debt overhang is a major reason why I've been cautious in recent months. But as the support programs, spending cuts and tax increases play out, I'm prepared to do some rebalancing. I have my buy list ready if markets experience a sustained decline (which they haven't so far). And while I'm not planning on freezing up like I did in 1987, I'm also not expecting to do much. I'm afraid my under-reactivitis condition is chronic.

Thirty-seven

When Fear Rules the Market, it's Time to Say 'Buy'

Posted on August 21, 2011

"We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful." — Warren Buffett

"My best trades turned out to be the ones when my hand was shaking as I gave my trader the blue ticket." — Bob Hager, co-founder of Phillips, Hager & North

In light of the recent weakness and volatility in the stock market, both statements are particularly poignant. It's easy to agree with the logic and simplicity of Warren Buffett, but not so easy to behave like him. My former partner's shaking hand reinforces just how hard it is to buy at uncertain times, and how rewarding it can be.

With markets in serious fear mode, investors with a time horizon of five years or more need to ask themselves, "Am I hiding under my desk or excited about the opportunities? Am I giving up on stocks or getting prepared to buy like Messrs. Buffett and Hager?"

I've talked before in this space about being 'approximately right', which is what my firm calls our approach to asset allocation. Approximately right means keeping your portfolio stuck on its long-term asset mix (strategic plan) most of the time. This part of the process is dead flat boring, even when rebalancing is required. But approximately right also means taking advantage of extremes in the markets — extremes in terms of valuation (cheap or expensive) and investor sentiment (fear or greed). This is the more interesting, and dare I say, challenging part of the process.

Eight months ago was one of those times when we recommended that long-term investors move away from their strategic mix and build a cash reserve. We didn't think stock valuations were fully compensating for the economic risks, and had concerns about the distortions caused by artificially low interest rates. In this column I wrote, "It's a sellers' market now, but as the extremes come back to earth, as they invariably do, suppliers of capital (buyers) will regain the upper hand."

Well, we've gone a long way to redressing the imbalance. Even though the outlook for economic activity and profit growth has deteriorated (and is getting worse with every month of political dithering), stocks have adjusted, or over-adjusted, to the new reality. They're factoring in bad news. With prices down and fear running wild, however, expected returns for stocks have gone up. As Tony Arrell, chairman of value manager Burgundy Asset Management, said to me on one of the particularly gloomy days, "these are opportunity-laden times."

Meanwhile, uncertainty has driven interest rates down to unsustainable levels, such that bonds are less appealing. Safety is even more expensive than it was, while risk is back on sale.

This divergence in value between stocks and bonds reveals itself in the gap between the stock market's earnings yield (the flipside of a price-to-earnings ratio) and bond yields. With the S&P 500's earnings yield at 8 to 9 per cent and bonds at 2 per cent, the gap is as wide as it's ever been (there was little or no gap throughout the 1990s). For it to narrow, I suspect that both numbers will move toward each other — bond yields will rise over time and earnings yields will move down to more normal levels.

Nobody knows where the market is headed in the months to come (and if you hear someone talking as if they do, politely excuse yourself so you can do something more useful). But we can be confident that buying securities at below-average valuations when investor sentiment is flashing FEAR will be profitable in the medium term. We can be almost certain that buying bonds with yields between 1 and 3 per cent will provide a negligible return. And we know absolutely that in this context any adjustments to a portfolio should be made within the constraints of a long-term plan.

To be clear, investors shouldn't expect their stock purchases to go straight up in price like they did in March, 2009. Indeed, they may get a chance to buy more at even lower prices. Mr. Buffett's investing tenet is not a precise timing tool, nor is my valuation work. They're both simply a way to get it approximately right as opposed to exactly wrong.