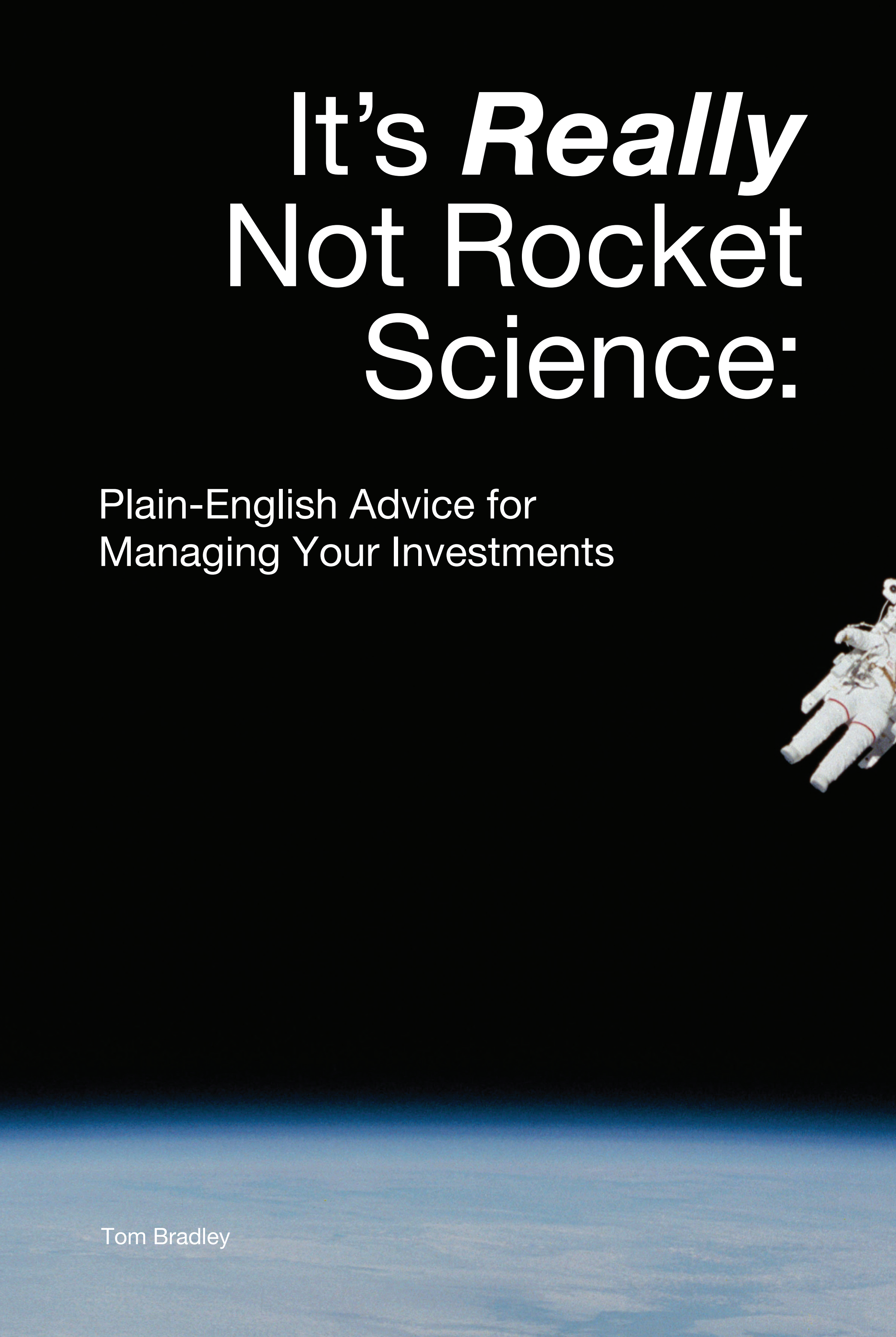
It's *Really* Not Rocket Science:

Plain-English Advice for Managing Your Investments



Tom Bradley

It's Really Not Rocket Science

Tom Bradley

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Foreword

At Steadyhand, we like to think our investing gene is strong. Our marketing one, not so much. In fact, we had one marketing firm (rightfully) advise us that our tagline at the time, *"Our clients are better investors"*, scared off prospects. It made potential investors feel like they either didn't know enough to invest with us or would have to work to educate themselves to become our clients. Oops. We dropped the tagline.

While that theme may have indeed scared off a few prospects, the simple fact is that we believe our clients *are* better investors. This is in part because we put great effort into creating quality content that is educational, interesting and easy to read.

Which brings us to this book. It's the third in our "It's Not Rocket Science" series and follows the same format as the other two — a collection of Tom Bradley's blogs and newspaper articles written for the Globe and Mail and National Post. The pieces are organized by topic (rather than date) and focus on some of the key principles of investing.

One might think that Canadians don't need yet another book on investing, but the recent crazes over cannabis stocks, Bitcoin ETFs and unicorn IPOs have proven that sound investing principles never go out of style.

This book wouldn't have happened without Scott Ronalds, our Director of Communications. Not only has he worked closely with Tom on this edition, his hands are on every piece of content we produce (they edit each other's work). I hope you enjoy 'version three' and learn a thing or two. And if you're not yet a Steadyhand client, what are you waiting for? See, there's that recessive marketing gene again.

Neil Jensen
CEO and Co-founder, Steadyhand Investment Funds

Contents

Most of these articles were originally published in either the Globe and Mail or National Post. They are being republished with permission.

Part I

Mr. Market

One

The Market's Behaviour is Erratic, But We Still Can't Live Without it

At our firm, we keep our employee reviews simple. We focus on three things done well and three that need to be worked on.

With this process fresh in my mind, I've prepared a mid-year review for our most challenging employee, Mr. Market. I'll call him Mark.

What you've done well

Mark, I'd like to start with the positives. There are plenty to talk about.

First, you should be commended for providing such excellent investment returns. Sometimes your domestic stocks lead the way and other times it's the foreign ones. When you put them together (50/50), your record is exceptional.

You've earned 10 per cent per year over the last ten years and six per cent over last twenty. The latter is lower, but I think more impressive given that it includes two tough periods — the tech wreck and financial crisis of 2008. Both numbers are well in excess of inflation.

There are always doubters who want to shift to fancier investment products, but you've consistently built wealth for our clients.

Second, a portion of your return is remarkably stable. I'm speaking of dividends, which generally rise over time and are tax efficient (if they come from Canadian corporations). At a time when yields on GICs and bonds are so low, this is an important feature of your return stream.

The other accomplishment I'll focus on today is your ability to find true value. It sometimes takes a while, but you sort through the many variables and come up with an appropriate price. Companies can be over or under-valued for months or years at a time, but you eventually get it right.

I will acknowledge that you've been getting more help lately. Private equity managers have so much money to spend (US$2-3 trillion including leverage) that they're increasingly bidding for your public companies. There's nothing like an auction to establish fair value.

Mark, you're an excellent contributor to our portfolio team.

Need for improvement

As you know, we can't do these reviews without talking about things we'd like you to work on.

I won't mince words — your behaviour is erratic. We just don't know where you're coming from most days. Your returns have little to do with current news or what's happening in the economy.

The things you key off seem to change without notice. One day it's tariff wars. The next it's growth in Asia. And the next it's interest rates. We appreciate that you're a forward thinker, which is always imprecise, but if you were more predictable, we'd be able to accord you a better valuation.

The second area of improvement is also behaviour related. Mark, you really go overboard sometimes. You get carried away when things are going well and when they're not, you're downright gloomy.

Let me give you a concrete example so you understand what I mean. In his latest letter, Howard Marks of Oaktree Capital reviews nine issues that you're wrestling with. Real hard-hitting stuff. Is a recession avoidable? Do government deficits matter? Can interest rates stay perpetually low? And so on.

The interesting thing, according to Mr. Marks, is that you're optimistic about all nine. In other words, current securities prices are based on endless monetary stimulation (low interest rates), no recession, low inflation, and governments and corporations continuing to run up debt with impunity. And when it comes to valuation, growth is driving stock prices more than profits.

Mark, do you really think all these complex issues are going to turn out better than they have in the past?

Finally, you're not sensitive enough to investors' needs. I'm referring to your habit of not doing what people are expecting. Indeed, you seem to relish in doing the opposite. When everything is rosy, commentators are brimming with bullishness and investors are being more aggressive, you fall off the table. And when investors have fear in their eyes and are shifting to cash, you inconveniently go on a long, strong run.

Mark, your position is secure, even if your fellow workers think you're unpredictable, unreliable and prone to exaggeration. What's the old expression: We can't live with you, but we can't live without you.

July 5, 2019

Two

No One Can Predict the Future — Not Even Financial Advisers

In Canada, there's been an increased effort by financial and public institutions to educate investors. Out of this have come some exceptional students, but as a whole, Canadians are still lingering in the early grades.

If I were to do a report card, I'd say that investors understand that asset mix is an important driver of returns. They sort of get that higher returns come with greater volatility. And they grudgingly accept that the long-term is what matters.

But despite this knowledge of basic principles, investors can't break the habit of trying to call the market. As a result, near-term forecasts invariably play too big a role in their investment decisions.

In doing my marking, I'm not excluding myself and other portfolio managers from this plight. For us, predicting the market is an occupational hazard. Clients ask all the time and there's only so many times we can say "I don't know." And when we win a new client and are implementing their strategy, we can't help but want their initial experience to be good. A negative return right out of the gate makes for unpleasant phone calls.

But talking about where the market is going is investing's lowest common denominator.

It's like talking about the weather, except it has less chance of being right.

The S&P/TSX Composite Index is ultimately driven by the profitability of companies in it, but in the short term, its direction is influenced by a myriad of factors. They range from those in the spotlight (currently oil, currencies and a strong U.S. economy) to ones lurking in the shadows — revenue, profit margins, technological change, price-to-earnings multiples, debt levels, credit spreads, regulatory policy, corporate governance, investor psychology, demographics, wars, weather and thousands of others.

So if predicting the market is so hard, why do we spend so much time doing it? As noted above, the investment industry and media contribute to this misallocation of intellectual resources, but at the core, human nature is the problem. Investment professionals want their clients to believe that they know more than they do; the media want readers to care about the daily news flow; and investors, who naturally want to grow their money, not lose it, are constantly fighting the twin demons of fear and greed.

Investors are particularly vulnerable to hindsight bias, or the tendency to see an event as having been predictable, even though there was no basis for predicting it prior to its occurrence. In this regard, I've lost track of how many people have told me they predicted the tech wreck. In a decade, the list has grown from a handful to almost everyone.

What can you do to break this nasty habit? Well for sure, you need to stop asking your adviser or portfolio manager where she thinks the market is going. If she offers her view unsolicited, politely cut her off.

Remind yourself how difficult it is to predict the market by looking for patterns on a long-term chart of the S&P/TSX or S&P 500. From year to year, or decade to decade, you won't find any consistency or symmetry. The trend up and to the right is irresistible, but the path is anything but predictable.

If you're serious about reform, there's nothing like real money to learn more about investing. You might consider carving off a small part of your retirement portfolio and managing the money at a discount broker. This will allow you to act on your market views and keep track of how you're doing. But a cautionary note — don't allocate more money to the strategy, or talk about it at parties, until you've been through a full cycle. Short-term results are meaningless.

Or you might consider the approach with the highest chance of succeeding

— determine an appropriate long-term asset mix and stick to it by using contributions and withdrawals to rebalance your portfolio. The more automatic you make the process, the less influence market noise will have on your investment decisions.

Doug Macdonald of Macdonald Shymko & Co., one of the pioneers of fee-only financial planning in Canada, had it right when he told me, “It became much easier to do our job once we realized that nobody, including us, knows what is going to happen in the future.” We all need to learn that lesson.

January 15, 2019

Three

Everyone is Scared and Prices are Down — And For Long-term Investors, it's a Beautiful Thing

My grey hair and creaky knees should tip you off that I've been doing this awhile. I started as a stock analyst in 1983, which coincided with the beginning of a major bull market. Indeed, my whole career has had a tail wind behind it in the form of declining interest rates. As a result, bond and stock returns have been excellent.

Along the way, however, there were a few bumps in the road. As a cocky, young analyst, I sat on the edge of the trading desk and watched the market meltdown on Black Monday (1987). I was CEO of one of Canada's largest investment management firms when the tech bubble burst. And wouldn't you know it, we were just getting started with Steadyhand when the financial crisis hit.

Those were the doozies that I'll never forget, but there were lots of lesser declines along the way. This brings me to the market gyrations of the last ten days. This explosion of volatility doesn't belong on the list, at least not yet, but perhaps it's a good time to dust off some truths about bad markets.

1. Going through down markets is a necessary part of being an investor. It's not a matter of 'if' a bear market will occur, but 'when'.

2. Despite the inevitability, there's no certainty as to a bear's timing, depth, shape or character. Therefore, it's not to be avoided, at least not if you want to participate in the equally unpredictable up markets.

3. You won't know until after whether the initial declines (like last week's) turn out to be an imperceptible blip on a long-term chart (most are), or the beginning of a more fundamental adjustment. Today, many argue that a serious decline is not possible because of the strong global economy. Others point to historically high valuations, rising interest rates and excessive speculation as catalysts for a bigger selloff. Unfortunately, Mr. Market doesn't issue warnings or hand out a program.

4. Don't believe everything you read. In a highly charged market, the quality of information is generally poor. There's plenty of it, but it's more reaction than in-depth analysis.

5. There will be comparisons made to previous cycles. It's a favourite pastime of economists and commentators. From my experience, cycles are too different (economic backdrop, sector leadership, capital flows and valuation) for them to be of any use.

6. There's one thing that's the same with every bear market. It starts with bullish investor sentiment, what Warren Buffett refers to as greed, and ends with extreme bearishness (fear). Art Phillips and Bob Hager, two of the founders of Phillips, Hager & North, taught me to use investor sentiment as a contrarian indicator. For example, if my cab driver or golf buddy are recommending a stock, it's time to be careful. Investor sentiment is a gut check that makes sure you're not charging off the cliff with the herd.

7. Don't get too entrenched on one point of view. The late Peter Bernstein was my touchstone on this. He said, "In calmer moments, investors recognize their inability to know what the future holds. In moments of extreme panic or enthusiasm, however, they become remarkably bold in their predictions."

8. There's no time for gloating. Bear markets are a godsend for long-term investors. Everyone is scared and prices are down — it's a beautiful thing. But if you get too caught up celebrating a stock you shorted, or bragging about your timely selling, you'll miss the opportunity. Down markets have a way of changing relative valuations between stocks, industries and geographies. You must be ready to shift gears.

9. Don't spend all your money in one place. I'm a big believer in taking baby steps. If prices move into an attractive range, get started, but keep some buying power in reserve. Prices could get even better.

The drama of last week may not amount to anything more than a blip, but it was a good wake up call. If you found it alarming and couldn't sleep on Monday night, then you have some work to do. There's no excuse for not being prepared for the next bear market.

February 12, 2018

Four

Five Things Happening in the World That Truly Matter for Investors

When I'm travelling, I find myself watching business television — BNN, Bloomberg TV and CNBC. It's not something I do regularly, but I can't resist turning it on while I'm getting ready for the day.

Business television has little to do with long-term investing and a lot to do with market timing, trading and, of course, entertainment. Unfortunately, I'm finding it more aggravating than amusing these days because of the daily focus on the U.S. Federal Reserve and Brexit. For me, these two obsessions are numbers 22 and 242 on the list of things investors and business people need to be thinking about.

If I were at the controls (ratings be damned), China and India, the growth engines of the world, would get regular coverage, as would alternative energy and the environment. The following topics would also be on the focus list.

Technology disruption

The world is changing faster than ever. Consumers, businesses and even governments are doing things differently and they're taking no prisoners.

As a result, investors need to look for companies that understand what their competitive advantage is and are using cheap computing power, intelligent software and algorithms, mobile applications, GPS and social networks to grow and better serve their customers. The Amazon effect, and others like it, means that no business can take its revenue and profit for granted.

Consolidation

When researching the purchase of a consumer item, we used to have seven or eight options. Now, we have three or four, or maybe just two. This reflects a change in the type of business deals done today. In the eighties, research revealed that most acquisitions didn't work — empire building was good for the chief executive's ego, but not the shareholder's return. Over the past two decades, however, deals have been more profitable because of a narrower focus — mergers and acquisitions are all about market share and cost efficiency in existing lines of business.

In other words, more scale and fewer competitors. In most industries, consolidation is forcing analysts to change their assumptions about risk and profitability.

Debt out of control

The level of debt we have in the world today means we're operating without a safety net. Canadian consumers, for instance, have little room for error. Higher interest rates, increased unemployment and/or government cutbacks will cause severe hardship.

Governments are in a similar bind and may already be hitting the wall. Ontario and Quebec desperately want to upgrade deteriorating infrastructure and stimulate their economies, but are being forced to start living within their means. Many countries, including post-Brexit Britain, are in cutback mode at a time when the opposite is required.

High debt loads inhibit growth — yesterday's debt-induced consumption cuts into today's sales and economic activity. It also widens the range of possible outcomes, good and bad.

Government and central bank intervention

One of the good things about capitalism is that it goes through down cycles from time to time. I say good because these periods help to sort out the winners and losers, normalize supply and demand and, importantly, expose and extinguish the excesses of the previous cycle.

Since the Bush/Greenspan era, governments have had little appetite for sorting, normalizing and extinguishing. Any kind of slowdown is perceived as bad for a politician's prospects. Central bankers, despite their supposed independence, have dutifully changed their job descriptions, focusing more on cheerleading for growth and less on protecting the integrity of the financial system.

This micromanagement has led to distortions and unsustainable extremes. I'm speaking of debt levels, negative interest rates, pension deficits and particularly, Toronto and Vancouver housing prices.

Demographics

And finally, there's one that's always in the top 10 but is often forgotten: The world is getting older. The impact of changing demographics makes the preoccupations with Brexit and the Fed look ridiculous. We should be talking about the impending shortage of skilled labour, escalation of health-care spending, pension deficits and shifts in housing needs and shopping patterns.

Okay, I'll stop throwing things at the TV and get back to what I'm supposed to be doing — eating breakfast, getting dressed and building diversified portfolios for our clients that take into account all of this boring but important stuff.

August 22, 2016

Five

Bear Market Truths

At this point in the stock market cycle, there's lots to debate and little to resolve. There are, however, features of bad markets that are irrefutable. In a column early this year I started to compile a list of bear market truths. I'm going to build on it.

Everyone becomes an economist

As I noted in February, nobody has a clue where markets are going at any time. There are too many factors driving stock prices, only a fraction of which show up in media and research reports.

In more volatile, emotional times, however, commentators and investors get more confident for some reason. At dinner parties you'll hear, "This market is definitely going lower. I can feel it." Or, "We're at the bottom and I'm buying."

Everyone becomes an economist in bad markets and tends to forget what they don't know.

Higher expected returns

Markets overreact to short-term news and macro-economic concerns. You just have to compare a stock index to charts showing corporate profits and economic growth. All three follow the same up and to the right pattern, but while profits and GDP wobble, stocks gyrate.

The reality is, the long-term value of a diversified portfolio changes very little with the news of the day. Companies are valued on their future stream of cash flow and dividends. The next few years, let alone few quarters, account for a small part of that value. New information may increase or decrease the long-term potential for an individual company, but it's much harder to move the dial for a broad mix of businesses.

The implications of this concept are profound — when stock prices go down more than is justified by a change in fundamentals, the projected return of the portfolio goes up. In weak markets investors should be raising their expectations for stock returns, not lowering them as is so often the case.

At Steadyhand, we provide clients with a five-year projection for market returns. It's not meant to be exact or definitive, but rather a guideline for planning purposes. Over the past two years, our range for stocks has been a modest four to six per cent per annum due to high valuations and growing debt loads, which steal economic activity and profits from the future.

In response to the stock market weakness, however, we've now moved the range up two points to six to eight per cent, which is closer to the historical average of eight to nine per cent.

New narratives, old facts

What's fascinating about bad periods is how the narratives change, often with little or no change to the fundamental outlook.

Consider how the commentary on Apple has swung seemingly overnight. In August, the company hit a trillion-dollar valuation on the back of strong profits, skyrocketing cash levels and seemingly unstoppable growth. Now the dominant narrative is that iPhone sales are peaking, growth has come from unsustainable price increases and it's no longer a clear-cut technology leader.

In bear markets, the pendulum can swing quickly. Companies' warts are no longer airbrushed away. They're in clear view.

A new boss in town

Weak markets are a necessary part of investing. Investors can't benefit from the good times, like the last nine years, without also going through tough periods. The dips only hurt long-term returns when you let the market take over the management of your asset mix. Let me explain.

If you or your portfolio manager haven't done anything to your portfolio in the past few months, then your asset mix has changed. Stocks have decreased as a percentage of total assets due to price declines, while cash, GICs and bonds have increased. Mr. Market has made this change without being asked. To prevent it, you either need to do some rebalancing or use contributions and withdrawals to get your mix back to where you intended.

It's a truth that your long-term returns are destined to be subpar if you consistently go down with more stocks than you go up with.

What's the plan?

A former colleague once said to me, "You trust your investment plan the least when you need it the most."

Down markets have the most potential to impact your returns, good and bad. It's not a time to toss out your strategy and cede control of your portfolio to Mr. Market or worse yet, your emotions.

December 3, 2018

Six

Don't Get Fooled Into Investing Based on What's Happening Now — The Future is All That Matters

I was looking at an analysis of the Canadian banks recently. It made for compelling reading. The banks are well capitalized. They continue to be highly profitable (the oligopoly is alive and well). And yet their valuations are below historical levels.

As for concerns about the financial health of their customers, the report said, "Canadian housing and consumer debt continues to spook global investors ... however, as long as employment is strong, incomes are growing, and increases in debt service ratios remain manageable these concerns are likely overblown."

At this point, I stopped reading. Not because the banks aren't a good buy, but because this analyst fell into the same trap that many investment professionals do. He addressed a concern about the future with data from the present.

How does telling me that "as long as the consumer is doing well, everything is good," allay my fears about how the banks' highly-levered clientele will impact future profits? It doesn't. High debt levels are rarely a problem when times are good.

This kind of rationale is common in investment reports. For instance:

1. The employment outlook is excellent (future) because the economy is growing (present).

2. The market will continue to rise (future) because profits are strong (present).

3. The resource stock is a buy (future) because commodity prices are high (present).

4. Corporate bond spreads will remain narrow (future) because defaults are low (current).

In all these, the current data sounds comforting, but has little or no impact on future asset prices.

There's another example I put in this category, although I struggle with it. We sometimes hear that there's cash on the sidelines waiting to go into a certain type of investment or asset class. An abundance of cash chasing a limited number of assets causes prices to go up, but I wrestle with the reasoning because capital flows are fickle.

When conditions change, the inflow that everyone was counting on can disappear in a heartbeat. And when the tap turns off, investors are left feeling like Wile E. Coyote hanging in the air after going off the cliff.

The fickleness of capital flows is particularly apparent in cyclical industries and asset classes that are driven by investor sentiment such as gold and cryptocurrencies.

In pointing out this flawed reasoning, however, I'm not saying that current data can't support a forecast. For example, I'll positively adjust the outlook for a company that meets the following criteria: It is tightly run and has an excellent record of capital allocation; it is well financed and has no need for additional financing; and it has a clear competitive advantage with regard to products, distribution or cost structure.

And I'll dial up my forecast if a company is operating in an industry that's consolidating down to fewer, less-disruptive competitors.

I started by picking on an analyst, but it's not just professionals who mix up the 'present' and 'future.' Individual investors are doing the same thing when they're confounded by market moves that run counter to the latest economic statistic or political headline. A common refrain in recent years has been, "The world is a mess! Why is the market going up?"

As I've said many times in this space, stock prices aren't a reflection of what's happening now.

They're an educated guess as to what's going to happen in the future.

Be careful when the present is being used to predict what that will be.

March 11, 2019

Seven

Why You Should Embrace Your Ignorance When Investing

I recently found a crumpled piece of paper in my jacket pocket that said, “Embrace your ignorance.” I can’t remember where or when I heard the phrase, but I’ve taken up the cause since my discovery in hope of better assessing my own blind spots and weaknesses regarding investing.

I’m not going to confess my darkest secrets here, but re-reading the piece of paper reminded that I’m not the only one in the investment industry who fails to embrace his ignorance: My counterparts are often found to be supremely confident, able to answer all questions and never lost for a prediction.

Indeed, when I look at the industry through this unique lens, I see professionals who regularly defy all logic and evidence by explaining the unexplainable and predicting the unpredictable. Here are three examples.

Cause and effect

During my first week in the industry, Don Dillestone, one of the wily veterans in our research department, pulled me aside and said, “Tom, when you hear that the market went up for such and such reason, ignore it. Commentators like to find a cause for every effect, but it doesn’t work that way. All kinds of things move the market.”

He was referring to sound bites such as, "The market rallied on Boeing's strong first quarter," or, "The market went down today because of renewed trade concerns." Over the past 18 months, U.S. President Donald Trump has been regularly credited for moving the market.

But Boeing, trade and Trump are just three of the many thousands of factors that impact stock prices, which, in turn, add up to the index number reported on the news. In reality, most days, we're totally ignorant of what moved the market.

Economy and market

Investment professionals love to tie their market view to economic factors. We're often hearing phrases such as, "The economy is strong, so stocks will keep rising."

Evidence suggests, however, that the linkage between the two is somewhere between haphazard and non-existent.

Mr. Market isn't reading today's economic data and deciding where to go. He's straining his eyes to read what will be in the news 12 to 18 months from now. The market is all about the future, not the past.

Growth, inflation and money supply can certainly impact capital markets over time, but there's no evidence that an accurate prediction of these or other economic factors will lead to a useful market forecast.

Pontificating about the economy sounds brilliant and may dazzle some clients, but when it leads to a market call (with no mention of other factors such as valuation), it reveals quite the opposite.

Throwing darts

Which brings me to the age-old question: What do you think about the market?

You often get the impression economists, market strategists and portfolio managers know where the market is going in the coming months. For instance, a portfolio manager on CNBC last week said, "We reduced our equity weighting at the end of the second quarter. We're bracing ourselves for another five-to-eight-per-cent pullback in Q3." I desperately wanted Becky, the show's host, to ask him what he based that on.

Most market forecasts stay close to the historical averages, but next year's return is almost assuredly not going to be that. I looked back 60 years and the average annual return of a blended equity portfolio (Canadian and foreign stocks) was 9.8 per cent per year. Over that period, there were only four calendar years where the return was between nine per cent and 11 per cent — four out of 60.

It's not clear why my industry keeps trying to be precise about something that's anything but.

The investment industry is full of brilliant people. Some know more about yield curves, inflation, productivity, capital flows and trading patterns than the rest of us could ever hope to. But where their brilliance betrays them is when they try to use that knowledge to predict the timing and magnitude of the next market move.

The next time your adviser or portfolio manager wants to make a change based on an economic view or market action, push the pause button. Ask about his long-term track record on such calls and if you get a soft answer, suggest he too embrace his ignorance.

August 13, 2018

Part II

SAM (Strategic Asset Mix), Your Best Friend in Good Times and Bad

Eight

Unless You Can Predict the Future, Stick to Your Portfolio Strategy

I see it all the time — people unwilling to invest in stocks because of the debt situation in the United States, Europe, China or Canada, the economy's dependence on central bank stimulation or China's slowdown.

Their hesitation may pay off one day, but I think investors who base their portfolio strategy and investing intentions on a handful of macroeconomic factors have to take a long, hard look in the mirror and think about changing their approach.

In my view, the economic "issue of the day" plays far too big a role in investors' decisions and negatively affects returns. While the concerns mentioned above have been topical over the last two years, global stock markets have appreciated 50 per cent.

Investing is too complex and multi-dimensional for us to get entrenched on a single economic or market theme. Let me explain.

First, no matter how certain you are, you're going to be wrong a lot. As Yogi Berra said, "It's tough to make predictions, especially about the future." Indeed, you don't need to go back very far to see how easy it is to get a big call wrong. Just three years ago, there was strong consensus around China's growth, gold's pre-eminence and the decline of the American empire. All proved to be overstated, or at least inconveniently premature.

Second, the interesting, sometimes alarming, issues that investors and the media lock in on rarely turn out to be as important in influencing securities' prices as the ink and volume would imply. Recent budget negotiations in Washington were a great example of this divergence between attention and impact. I don't know of another macro event that weighed on individual investors more (and delayed investments), and yet had less of an impact on market values.

And finally, even if you identify the important issues, and get the call right, you still have to predict how the market will react. If few others have your insight, then you've discovered a genuine money-making opportunity. If, on the other hand, many market players are expecting the same thing, it will be a non-event. Valuation, the linkage between fundamentals and prices, and the closest thing we have in investing to the law of gravity, is rarely included in macro-economic discussions.

I'm not saying that we can't enhance returns by reading the economic tea leaves. But most investors aren't attuned enough to the markets to act on their macro views.

Most investors should religiously stick to their strategic asset mix. For those who do want their portfolio to reflect their big picture biases, it's worth thinking about how to do it. Your bets should be made in the context of your overall portfolio.

For instance, if your target for stocks is 50 per cent to 70 per cent of assets and you're feeling bullish, you'll want to make sure you're in the upper end of the range. Not 100 per cent, but mid to high 60s. Vice versa, if you're worried about stocks to the point of not sleeping, then the low 50s makes sense. Not zero.

In other words, put limits on how far you take your view. You don't want it to cripple your portfolio if the world doesn't unfold the way you expected. A constrained approach also leaves room to go further at a later date. If the strategy goes against you initially, you'll be able to add to the position at better prices.

We all love to talk macro. It's fun and interesting. But as investors, we have to be realistic about how our views impact our investment returns.

Acting on a strong opinion without considering the myriad of other factors, including valuation and the structure of your overall portfolio, is a tough way to build wealth.

February 19, 2014

Nine

Four Reasons to Choose Easy Over Hard in Your Investing Strategy

Over the years, my mentors have all told me the same thing. As they get older (and better), they've come to appreciate the importance of keeping it simple. Do the easy stuff and leave the hard stuff to someone else.

Warren Buffett talks about putting things in the "too hard" box.

There are several aspects to investing where I've made a decision to stay within my skill set and keep it simple. Maybe it's not easy, but it's easier.

Easy: Diversification

Hard: Getting in and out of the market

A diversified portfolio holds a variety of asset types and is exposed to different geographies, industries and company types. It derives returns from all forms of risk — interest rates, credit, equity and liquidity. Proper diversification won't avoid market downdrafts, but the ride will be smoother than the alternative.

Trying to avoid those downdrafts requires making two decisions — when to sell and when to buy. I've never seen anyone, professional or amateur, get this right consistently enough to make it pay. A myriad of economic, political and social forces make both decisions difficult. The second one particularly so because it comes with a lot of emotional baggage. Getting back in is the hardest thing an investor can do, especially if the market has been going up. Too hard.

Easy: Buying good companies at reasonable prices

Hard: Catching macro trends

It's called bottom-up investing — building a portfolio from the ground up, one stock at a time. Each company has its individual merits and trades at a reasonable valuation. There will be lots of small mistakes made along the way, which is why diversification is important.

Making the right call on an economic or market trend can pay off big time, but for me it's too hard. If you identify an economic shift, you must then determine if it's cyclical or secular (think the China resource boom versus online retailing). Then, you have to figure out how early you are. Are you getting on the wagon ahead of others and getting a good price as a result or are you paying up for a well-established, well-publicized trend?

Easy: Investor sentiment

Hard: Risk modelling

Investor sentiment is a contrarian indicator that is a valuable check and balance. If everyone around you is bullish, it's time to be careful. You want to be doing more selling than buying. And the opposite is also true. If everyone is running for cover, your bias should be to the buy side.

Reading sentiment can be done anecdotally (your cab driver or hairdresser) or through services that measure the mood of individual investors, portfolio managers, traders and strategists. I also look at the yield spread on high-yield bonds, which is a good indicator of investors' risk appetite.

Today, there are many brilliant minds working in risk-management departments at banks and investment managers. Using past data and fast computers, they develop impressive models that will generate higher returns with little downside risk. It's a beautiful thing until it doesn't work because correlations between asset classes change, risk premiums unexpectedly widen or something comes up that wasn't anticipated. Think back to 2008. Too hard.

Easy: Long only

Hard: Hedging

It's often forgotten, but the most reliable source of return is the market, or what investment professionals call beta. The market is volatile and unpredictable, but over time stocks go up and dividends accumulate. Being fully exposed to the market over the long run allows the power of compounding to kick in. For an investor who doesn't need the money in the near term, volatility and surprises should be irrelevant.

Strategies that hedge away all or some of the market risk are designed to limit the downside. They draw less return from beta and instead rely on added value generated by the investment manager, or alpha. It has the chance of working out brilliantly if the manager gets it right, but alpha can be expensive and unlike beta, it's unpredictable in the long term. It's not always there. Too hard.

We all have our skills and preferences. I'd encourage you to think about what you're capable of doing and the chance of success. If you aren't confident you have an edge and don't clearly see how your approach can work, then put it in Mr. Buffett's box and look for another, simpler solution.

March 6, 2017

Ten

Why the Income Fund?

Ballast /bal•last *(noun)*/ Any heavy material used to stabilize a ship or airship. Also: weight, bulk, stabilizer, balance, counterweight, counterbalance.

In a recent post I suggested that one reason clients are resistant to rebalancing their portfolios is that our outlook for bonds, and by association, our Income Fund, is pretty modest. Indeed, we've been warning clients in our writing and presentations over the last year that they shouldn't expect the Income Fund to produce the kind of returns it did over the last 5+ years.

So why should clients own the Income Fund when the expected return for bonds is 2-3 per cent per annum?

First, the textbook answer is that bonds expose a portfolio to different types of risk — interest rate and credit risk — which will contribute to returns (in excess of the risk-free rate). Because these returns come at different times than stocks, bonds help to smooth out a portfolio's returns. And of course, bonds provide a steady stream of income.

Second, there are behavioural reasons for owning bonds. By dampening down a portfolio's short-term volatility, they help investors stay on track during the tough times in the stock market. Sound decisions (and non-decisions) at critical moments are important contributors to long-term returns.

And third, the Income Fund is designed to beat the bond market. It pursues a number of strategies to generate higher returns, with a particular emphasis on corporate and high yield bonds, and income-oriented stocks.

It sounds like 'ballast' is a good description for the bond portion of your portfolio. When stock markets are flying, bonds feel like a heavy *weight* dragging down returns. In average times, they *stabilize* the portfolio and provide income. And when stocks are in the dumps, bonds are a good *counterbalance* (i.e. interest rates come down and bond prices go up).

In our advice to clients with balanced portfolios, we recommend a minimum load of ballast, er bonds, but not zero.

February 26, 2014

Eleven

Diversification vs. Returns — The Great Bond Challenge

Sprott Asset Management is running an ad that states in big, bold letters: "Bonds are broken." It guides investors to look at alternative strategies because yields on conventional bonds are so low.

The ad hits on the question of the day — should we own any bonds at all?

For investors who have a long time horizon and are contributing to their portfolios, it could be argued that the answer is no. The need for income is years away and volatility is something to be embraced, not avoided. Unfortunately, it's not so clear-cut because few accumulators can stomach the jolting drops that go along with an all-equity portfolio.

For retired investors who need income and stability, the answer is considerably harder. Before assessing alternative strategies, we need some background.

The greatest ever

Since 1981, bonds have been the Bobby Orr of asset classes. They've been great offensively (returns), and yet have not shirked their defensive responsibilities (diversification). In addition to providing a steady stream of income, bonds regularly generated capital gains — interest rates fell from the high-teens to near zero, causing bond prices to rise. It's been one of the great bull markets of all time.

Moreover, there were only three losses in 35 years and during every stock-market decline, bonds rose in value. Bobby Orr, indeed.

Going forward, however, the math would suggest that bonds' offensive and defensive skills have been severely eroded. I say that because the best predictor of future bond returns is the current yield, and unfortunately, the bond market, as measured by the FTSE TMX Canada Universe Bond index, is yielding only 2 per cent.

As the "Bonds are broken" ads suggest, there are a plethora of bond alternatives to consider. In assessing their merits, it's important to understand the potential returns, the downside risks and how they complement other parts of your portfolio.

High-yield bonds

I expect that a diversified portfolio of high-yield bonds will continue to generate attractive long-term returns. The higher coupon on these bonds more than offsets the inevitable defaults that occur. You should expect, however, a loss every four to seven years.

Where high-yield bonds come up short is on the diversification front. They are highly correlated to the stock market, meaning they go up and down together.

Dividend stocks

With dividend yields on many stocks now running above bonds, some investors have chosen to replace their bonds with bank, insurance, utility and real estate stocks. Offensively, there's no question these securities will be bond beaters over the long term. Unfortunately, at the defensive end, they're nowhere to be found. After all, dividend stocks are stocks, so they move in line with the higher-risk parts of your portfolio. Lest we forget, Canadian banks fell by over 40 per cent in 2008-09.

Indexed-linked notes

The advertising for these banking products would suggest the second coming of the Bruins' No. 4, but they fall far short. The promise of stock market participation with no downside risk misrepresents their abilities. Rather, the return from these notes is hard to predict because of fees, price caps, no dividends and mind-bending return calculations. Whenever I analyze an index-linked note, I'm reminded of the adage: The more complex the product, the lower the return.

In reality, index-linked notes are savings products, not investment vehicles, so it's not surprising they shine on the defensive end. At a minimum, you get your money back when they mature.

Balance is key

To determine how these and other bond alternatives fit into your portfolio, you need to know their unique set of risks and how they will behave in different market scenarios. If the fees are reasonable, most alternatives have the potential for higher returns, but they come with more downside risk. And any substitution guarantees that your portfolio will be more volatile because there's no better diversifier than high-quality bonds.

To my mind, the answer to the bond challenge is balance — a mix of cash or GICs, government and corporate bonds, mortgages, high-yield and perhaps something exotic, such as leveraged loans or hedge fund strategies. But along with this blend must come the realization that fixed income is unlikely to be your Bobby Orr, or even Erik Karlsson.

May 14, 2016

Twelve

Dividend Stocks are Being Touted as a Substitute for Bonds, But the Reality is Much More Complicated

Last week on Bloomberg TV, I heard a strategist from Credit Suisse excitedly pronounce that investors are going to shift from bonds to stocks because the dividend yield on the S&P 500 is now above the U.S. Treasury bond yield. He went on to point out that not only is S&P's income higher, but dividends grow over time while interest payments don't.

Here in Canada, this is old news. For years now, income investors have been shifting from fixed-income securities to shares of banks, utilities, pipelines and REITs. We have lower interest rates than the U.S. and a good list of blue-chip, dividend-paying companies.

The math works, but ...

The strategist's logic is correct, as far as it goes. Stocks will likely beat bonds in the coming years. Probably by a lot because the bar is very low. The Government of Canada 10-year bond is now yielding 1.1 per cent and 25 per cent of the world's bonds are in negative territory. Even the best performing bond managers are only going to earn 2-3 per cent per annum over the next decade.

The outlook for stocks is less certain, but for time frames extending beyond ten years, the combination of dividends and profit growth should produce returns in the mid-single-digit range.

There is a catch, however, and a particularly important one for retired investors. Banks, utilities, pipelines and REITs are stocks. The underlying companies may be big and stable, but their shares are priced on the not-always-rational stock market. Stock prices fluctuate considerably more than companies' fundamentals.

A prime example of this is the Canadian banks. During the 2008 financial crisis, the banks didn't go bankrupt or even cut their dividends, but their stocks dropped 40 to 50 per cent between May 2007 and March 2009.

I'm not anticipating another crisis of that magnitude, particularly for the banks, but the reality is, when shifting from bonds to stocks, you're making two big trade-offs. First, the income portion of your portfolio will provide little or no diversification. Bonds usually rally during weak markets, but all stocks go down. And second, your source of income will be less secure. Companies cut their dividends before they default on their debt obligations.

Gut check

For investors at all ages and stages, owning stocks makes sense, but it only works if — and it's a big if — you stick to the strategy when markets are down. Bailing out near the bottom negates the benefits and devastates long-term returns.

So, if you're receiving most of your investment income from stocks, or are contemplating going that way, I encourage you to do a gut check by answering the following questions.

What do the bad outcomes look like? Assume your stocks drop 25 per cent. What does this translate into in dollar terms? How does it feel to lose $250,000 on a million-dollar portfolio? And how will it feel if your income drops because a couple of holdings cut their dividends?

This may be a worst-case scenario, but don't kid yourself. If you own mostly stocks, it's not a matter of 'if' your portfolio drops by a meaningful amount, but 'when.'

How did you handle market downturns in the past? Think back to the tech wreck (2001 and 2002) and the great financial crisis (2008). Your past investment behaviour will give you a clue as to how you'll react to adversity in the future, although keep in mind that investing when building your wealth is considerably easier than when you're spending it.

How diversified am I? Canadian dividend-oriented portfolios are often invested in a narrow group of industry sectors that are interest-rate sensitive (they benefit from low rates) and dependent on the domestic economy.

Of these sectors, real estate is the one that you need to be most watchful of. Many Canadians have a large portion of their net worth in their homes and other properties. Add to that dividend stocks that are tightly linked to real estate (banks and REITs) and you have a portfolio that's heavily reliant on one factor — Canadian real estate.

This week, a real estate lawyer said to me, "I can't earn anything from bonds and stocks look fully priced. Why don't I just put my money in a few good REITs? They're yielding over 5 per cent."

If only it was that simple.

August 26, 2019

Thirteen

Beware of 'Unpredictable Diversification'

When stock markets are hitting new highs, there always seem to be more articles on downside protection. Which stocks will hold up when the rocket ride ends? Is there an industry that does better in tough times? Are ETFs a good place to hide?

There might be a stock or industry that does better but, short of timing the market and selling everything, a portfolio that's designed to grow with the markets will also retreat with the markets. There are no free lunches in investing.

There is one strategy, however, that comes close. By owning a broad mix of assets, you can smooth out your returns and eliminate the risk of permanent capital loss, without meaningfully reducing your long-term growth. Diversification doesn't eliminate the downside, but it softens the blows and ensures that you'll recover.

David Swensen, chief investment officer at Yale University, puts it this way in his book, *Unconventional Success*: "Diversification demands that each asset class receive a weighting large enough to matter, but small enough not to matter too much."

Building wealth

Every investor should be diversified, but not for the same reasons. For those who are building their wealth and have an emphasis on growth, the primary reason is to avoid a permanent loss of capital. A smoother ride feels nice, but isn't necessary. Indeed, accumulators should celebrate when stocks are down. They're buyers, not sellers.

But a significant hit to capital can put a dint in even the longest retirement plan. It's harder to recover if your portfolio goes off the rails because it's focused on one type of stock (e.g. technology, cannabis, banks) or perhaps real estate in one city.

Spending your money

Retired investors don't want to impair their capital either, but they also have to care about volatility. They're drawing a paychecque from their portfolio and don't want to sell when prices are down.

For this reason, de-accumulators need to go beyond stocks and hold other asset classes like cash, GICs and bonds for stability and income. Unfortunately, it's in this area where portfolios are less diversified today. I say that because they're holding fewer government bonds which are the most reliable diversifier there is.

When stocks are in freefall, you can be assured that interest rates are dropping and therefore, the value of government bonds is increasing. When stocks melted down in 2008, government bonds went up in price as they did during the downdrafts in 2011, 2016 and 2018 (Note: Cash and GICs also held their value but didn't appreciate).

Extremely low interest rates are prompting investors to look for securities and funds that carry a higher yield. In lieu of GICs and government bonds, they're holding riskier fixed-income securities, preferred shares and even dividend-paying stocks such as banks, utilities and REITs.

These are all valid investments and play a role in our portfolios, but they don't provide the same diversification. Take high-yield bonds for instance. In an economic slowdown when government bonds are rising, junk bonds (as they're known) are likely going the other way. In uncertain times, buyers demand a higher yield on riskier assets, which pushes prices down.

Historically, high-yield bonds have performed more in line with the stock market than the bond market. Dividend stocks are even more closely linked to the stock market. They're stocks after all.

Unpredictable diversification

To fill the gap, there's a growing number of exotic products that claim to have low correlation to stocks. In other words, their price movement isn't linked to what the stock market is doing. These 'absolute return' funds focus on generating a positive return by using a number of hedge fund strategies including shorting and arbitrage.

But there's a catch (beyond their high fees). The relationship to stocks is unpredictable. A fund might perform well in a market swoon, but it might not. These products provide what I call "unpredictable diversification."

Swensen says that if you're holding bonds for the purpose of diversification, they should only be government bonds. I won't go that far but, suffice to say, being measured and balanced is important. When you give up on high quality bonds and GICs in search of higher yield, know that you're playing offence, not defence.

May 6, 2019

Fourteen

The Toughest Decision in Investing

An interest-rate strategist at the Royal Bank of Scotland got his 15 minutes of fame this week, when his 55-page report was translated into two words: “Sell Everything.” This powerful headline reverberated around the world.

I read the report and am sympathetic to RBS’s gloomy view. I’ve been cautious for a while due mainly to the world’s addiction to what I call the "unsustainables" — near-zero interest rates, China’s growth and rising debt levels. Things that can’t last don’t provide a good foundation on which to build a portfolio.

But do I agree with the headline? No, not even close. Even if RBS’s bearish scenario was to play out, selling everything is not a winning strategy.

For those who are thinking about following RBS’s advice, it would be prudent to first walk in the shoes of someone who has previously sold everything. Meet Jason, a fictional investor who has been out of the market since September, 2011, waiting for the kind of turbulence we have today.

Tough call

Jason is feeling pretty good right now, but he faces the toughest decision in investing: when and how to get back into the market.

There are several things that make it hard. First of all, Jason, like others in his situation, is under a lot of stress after missing out on years of good returns.

Second, he's heavily invested in his negative view (he cut out the "Sell Everything" article). He's lived with it for a while and is well-versed on the reasons why he shouldn't hold stocks.

Third, he's waiting for something that will never occur — the perfect time to buy. That only happens in the movies. In real life there are no signals or flashing lights at the bottom of the market. In fact, it will be quite the opposite. The news on the front page of the paper will be abysmal, serving to validate his concerns.

And finally, nobody will be telling Jason to buy. In the history of the capital markets, there's never been a buying opportunity that wasn't obscured by extremely negative investor sentiment. There will be more people looking to join him than the other way around.

Indeed, Jason already has lots of company. According to a BlackRock survey, Canadians hold over 60 per cent of their financial assets in "cash-like" instruments — savings accounts, GICs and short-term notes. I repeat: if you get out, it's bloody hard to get back in.

Reality check

If Jason is going to be successful, he needs to do a reality check. He may be celebrating currently, but he's not in a good situation. He's taking a huge risk by betting against his long-term plan. In this period of near-zero interest rates, very few investors should have less than half their portfolio in stocks.

He also has to accept that he can't time the market. He's proven that, so he needs to get comfortable with the notion of being approximately right. Perfection is not an option.

And related to that, Jason should forget about setting predetermined buying targets. It's not ordained that the market will drop to a certain level. Stock markets rise over time and leave previous levels behind.

The road back

To get to a better place, Jason needs to determine what his overall asset mix should be for the long run. He needs to know where he's going, even if it takes a while to get there.

He needs to have a plan for getting there. It might involve a number of purchases over six to 18 months. And he needs to get started. He's been given a gift and he better take it. If the market goes down further, the next purchase will be even better. If it rallies as it could, he'll be glad to have done something.

It's hard being Jason

If you're thinking about selling everything, Jason's situation should give you pause. Being uncomfortable with volatile markets is understandable, but if you're planning on living another 20-50 years, you need to be willing to absorb some short-term ups and downs in order to earn a return in excess of inflation and build your wealth.

Broadly diversified portfolios have consistently served Canadian investors well. I'm not talking about ones focused on Canadian financial, real estate and resource stocks, but rather portfolios that hold cash, government and corporate bonds, and small, medium and large companies across a range of industries, geographies and currencies.

Through all the turmoil last year, diversified portfolios had positive returns. They won't always avoid market corrections, but as they did after the 2008 crisis and subsequent pullbacks, they recover.

Rather than following Jason, you should focus on making sure your portfolio is where you want it for the long term — approximately. You might use your RRSP and TFSA contributions (it's not the season to miss them) to adjust back to your long-term asset mix. Today, stocks make up less of your portfolio than they did a month ago. My former partner and mentor Bob Hager was a portfolio manager who thrived in uncertain markets. His mantra in times like these was simply, "Don't go back up with less than you went down with."

After that, get ready to take advantage of cheaper valuations and extremely negative sentiment, both of which will set you up for higher returns in the future.

January 18, 2016

Part III

Process, Process, Process

Fifteen

It's Getting Harder to be a Long-term Investor — Here's How to Keep Your Focus on What Really Matters

We all have pet peeves, and one of mine is waiting for equipment at the gym while the person ahead of me is checking social media and texting. Eight reps ... three texts ... eight reps ... two tweets. It drives me crazy. Not only does the insatiable need to be connected cause logjam, it results in less intense workouts (mine and theirs).

I relate this to an investment problem. Constant information flow also makes it more difficult to be a long-term investor. It compels us to shorten our time horizon and lose sight of the prize — long-term returns.

Think about what we're up against.

FOMO

Alerts on our phones are feeding us the latest news. The Dow and TSX are reported everywhere throughout the day. And headlines are designed to get our attention with words like 'plummet' and 'soar.'

Business television brings an urgency to whatever is happening, whether it's important or not. This month's iPhone sales, Trump tweets and the Federal Reserve's latest wink are elevated from the mundane to the seemingly significant.

Meanwhile, ads from discount brokers (offering hundreds of free trades) empower us to trade stocks and ETFs. It sounds fun and easy — "I picked Ovechkin in my hockey pool and Tilray for my investment account." If we're not playing the latest trend, we're missing out.

In other words, the investment eco-system is bent on shortening our time frame.

Easier said than done

At this point you might ask, why not focus on the here and now? Isn't long term just a series of short terms? What's wrong with zigging and zagging, especially if trading commissions are low and information is at our fingertips. If we get the short terms right, won't the long term take care of itself?

Unfortunately, predicting price movements is way harder than assessing long-term value. No amount of analysis will reliably tell you what a stock or market is going to do in the next week, month or even year. Securities will find their value, but the path is not determined.

But don't believe me, test yourself. On Christmas eve last year after stocks had fallen 20 per cent (since Thanksgiving), what did you think would happen in 2019? After President Trump was elected, were you buying or selling? And going further back to the summer of 2011, were you thinking the 20 per cent market decline was the beginning of another 2008 or just a pause in the bull market?

The shorter your time horizon, the more you're speculating and the less you're investing.

Long-term loneliness

Catching the latest trend is difficult but so is acting long term. You're not getting much help, so some structure is needed.

Be clear about the purpose and time frame of the money. This will go a long way to determining what your portfolio looks like and what risk means to you. For multi-decade goals such as retirement, you shouldn't care what route your portfolio takes. Time ensures that your chart will be up and to the right. For shorter time frames, the path is more important.

Measure your progress against your goal. We're all curious about what happened in the last quarter, but the number is only useful when put in context of the longer journey. Train your adviser to focus on long-term returns (if she's not already) and ask her to put your plan at the forefront of all recommendations.

Set realistic expectations. I'm not only referring to the level of future returns, but also their volatility. It's not a matter of 'if' the market goes down, but 'when.' Armed with appropriate expectations, you can prepare for the time when markets really plummet.

Fit your passions and hunches into the overall portfolio. If you want to own a cannabis or gold stock, it should complement your other holdings. For instance, when buying Tilray, the money should come from another high-potential, high-risk stock, not your GIC's.

And make investing as automatic as possible. Take the noise and emotion out of the process by developing a routine. Pre-authorized contributions to your TFSA and RRSP are an excellent way to put your portfolio in self-driving mode.

At the gym, having people around can inspire you to work harder. Unfortunately, successful investing is a lonely endeavour.

June 17, 2019

Sixteen

Evaluate Advisers, Not Just Institutions

We're constantly being exposed to ads for the wealth-management divisions of the large institutions. And it seems they sponsor almost every arts function we attend. This shouldn't surprise us, as wealth management is the No. 1 growth initiative for all the banks.

The ads invariably portray stability, insight and teamwork. What they don't say is that picking between RBC Dominion Securities Inc., CIBC Wood Gundy, HollisWealth (Scotiabank), BMO Nesbitt Burns Inc. and other investment dealers is not too important a part of deciding on a wealth manager. It's the individual adviser or portfolio manager at these firms that's crucial.

I say this because the big institutions don't have one distinct investment philosophy. Indeed, they don't have an investment philosophy at all. They put every investment product known to man on their shelves and leave it up to the advisers and portfolio managers to choose how client portfolios are built. As a client, you'll be pursuing a strategy that reflects your adviser's investment philosophy.

Obviously, the strategies cover a wide range. An adviser might help clients buy individual stocks, funds and/or ETFs. She might have a dividend, resource or growth focus. She may go all Canada or be big on U.S. stocks.

The point is, your decision shouldn't be between firms, but rather between qualified individuals. The dealer platforms they work from are indistinguishable. It's the advisers who are the differentiators.

I contrast this with investment-management firms such as Mawer Investment Management Ltd., Leith Wheeler Investment Counsel Ltd., Burgundy Asset Management Ltd., Pembroke Private Wealth Management Ltd. and many others, including our firm, Steadyhand Investment Funds Inc. These managers also have capable client-service people, but contrary to the all-product firms, have an established investment philosophy. In each case, the returns and approach are those of the firm, rather than the adviser.

If you're thinking about making a change, don't do it without interviewing at least three advisers or portfolio managers. When I'm assessing candidates, I like to use a framework known in the industry as the "Six Ps".

People: It's important that you can see yourself working with the person or team for a long time. In addition to assessing their credentials, I suggest you hold them up to the flight test – is he or she someone you'd like to sit beside on the plane?

Parent: As noted earlier, the platform is less important, but you still want to make sure the adviser has the necessary resources available to meet your needs. You also want to understand how the corporate agenda (i.e. sales) will affect how your portfolio is constructed.

Philosophy: You don't have to be an expert on investing, but you need to understand how your portfolio is going to be managed. It's important to discuss lots of examples of past and current strategies, both good and bad. Indeed, exploring mistakes provides some useful insights into the thought process and how realistic the sales pitch is.

Process: You want to know how decisions are made and how they'll be reflected in your portfolio. And importantly, how will the adviser report back on how you're doing and what you're paying.

Performance: Clearly, whoever you hire has to have a record of generating wealth for their clients over the long term. The key here is long term.

Price: This can be a touchy subject, but you need to know how much you'll be paying and how the adviser is compensated.

In addition to covering the Six Ps, you should stay alert to what I call the deal breakers. I'm talking about advisers who tout their recent performance, recommend a strategy before understanding your situation, hesitate when asked about fees or betray the confidentiality of other clients — i.e. name drop.

It's also a deal breaker if the adviser appears to have never made a mistake. Someone who got it right during the tech bubble, 2008 crisis and bull market of the past six years is not well grounded in reality, or humility.

Clearly, there's no one right way to go when picking an investment professional to work with. It depends what you're looking for. It's important to recognize, however, that the ads you see are focused on the least important part of the equation. The people and investment approach are the biggies.

June 4, 2015

Seventeen

When Picking a Portfolio Manager or Adviser, Remember the 'Seven Ps'

How did you find your advisor or portfolio manager? Was he your Dad's broker or a recommendation from a friend? Did your bank manager guide you?

When picking a person or team that you hope to work with for many years, there should be more to it than that. At Steadyhand we recently changed the manager of our Global Equity Fund. This difficult decision was the result of an extensive evaluation process by my partner, Salman Ahmed, and me. We used a framework called the Seven P's to help sort out all the information that came from many interviews and slide decks.

When assessing your current advisor or looking for a new one, you too may want to look at People, Parent, Philosophy, Process, Price, Performance and Passion.

People

People is at the top of the list, specifically the quality and continuity of the team. Financial models, algorithms and big research teams all contribute to investment returns, but ultimately, it's the final decision-maker who makes you money. Your advisor should have a skill set that matches up with what you're asking her to do — i.e. financial planning;

stock picking; portfolio construction; trading; and/or administration.

When assessing managers, an important ingredient for me is 'accumulated regret'. I want someone who's survived bear markets, periods of poor performance and corporate disruptions.

Parent

Parent refers to the work environment and culture of the firm (I know, I stretched to make it a P). Your team needs resources, support and freedom to ply their trade. There must be a fit with the company's philosophy and business practices. For instance, if your advisor will be forced to further the corporate agenda by pushing new products and cross selling other services, you might want to look for someone else. Your best interest has to be their number one priority.

I look for firms that have a stable team who invest in the same securities they've bought for my portfolio.

Philosophy

Philosophy speaks to how the money is managed. There are many ways to do it — stock picking; buy and hold; growth; value; indexing; macro strategies; frequent trading; all dividend stocks; all Canadian; or globally diversified. You want to know what the advisor's approach is and if it fits with how you think.

It's important to note, philosophy isn't about products, but rather how securities are selected and put together in a cohesive portfolio. A preference for mutual funds or ETFs reveals nothing about an advisor's investment philosophy.

Process

Process is how the philosophy is implemented. Is it one person who makes the decisions or team consensus? In either case, the execution should be repeatable trade after trade, year after year.

Price

Price should be an important factor in your decision. In an environment where interest rates are two to three per cent and stock returns may be lower going forward, you must be receiving value for your advice fees, trading commissions, fund management fees and service charges. Saving a half to one per cent over decades makes a big difference.

Despite initiatives by the regulators, I still find that most investors don't know the full amount of what they're paying and what service they're entitled to.

Performance

Performance is another area where investors are often in the dark. In the 7P's framework, it's long-term returns we care about. Has the team generated wealth for their clients over a full cycle (good and bad markets)? If the sales pitch emphasizes this year's returns or the latest stock win, you need to do more digging.

Passion

Passion is not one you'll find on many lists, but it's important to me. The investment industry is full of smart people who are technically proficient and present well to clients, but what I'm looking for are investment geeks, not sales people. Managers who are consumed by what they're doing, constantly curious and losing sleep when my returns are lagging.

My team accuses me of P proliferation. Your list may be more compact, but it should cover all the same elements. There are no guarantees when picking an investment professional or team, but these factors are better predictors of future returns than what investors often use — a casual recommendation, glossy brochure or good recent returns.

September 24, 2018

Eighteen

How Millennial Investors Can Learn From Their Parents' Mistakes

We get asked to help young investors all the time. Sometimes, the question can be as straightforward as, *'How do I get started?'*

Instead of answering that with a 'How to,' I'm going to take a different tack and focus on ways the next generation can be better investors than their parents.

You got it: millennials versus boomers.

But first, a few basics.

Saving

The first step is to make sure your personal finances are in order. Credit cards must be current. No amount of investment brilliance can overcome credit-card interest. Your student loan doesn't need to be gone, but the payments should be reasonable and the balance declining.

In his book, The Wealthy Barber, David Chilton promoted the idea of saving 10 per cent of every paycheque. Too few of his generation followed this advice but you have a chance to entrench the habit.

Purpose of the money

The next step is to determine what the money is being invested for. Is it going to be used to buy a car or make a down payment? Or is it for retirement? Investors often make the mistake of not being crystal clear on what their objective is.

If you have more than one purpose, don't despair. You can put the money in different buckets — condo, retirement, etc. — and invest each accordingly.

Asset mix

One dial on your investment dashboard is more important than all the others. 'Asset Mix', which is the blend of cash, bonds and stocks you hold, has the most impact on your return and risk, so it needs to be a part of every investment decision.

'This is all I have. I can't lose it'

The risk piece is often misunderstood because it varies depending on time frame and objective. For money needed in two to four years, market dips are a big risk. The money has to be there, so any attempt to generate a higher return must be tempered by the need for stability.

Conversely, volatility isn't a risk at all for longer-term money (i.e. retirement). You won't be touching it for decades, so weak markets are only good news. They give you a chance to buy shares at lower prices (Warning: When stocks are down, loud demonstrations of glee may offend older investors).

The fear of losing money, which is human nature, often results in asset mixes being too conservative (i.e. invested in savings products like GICs). This is a crucial mistake because with the benefit of time, you can take more risk (stocks), which is the fuel that builds wealth.

RRSP, TFSA, OMG

Your parents started investing when it was fun, even cool. In the '80s and '90s, it was all about RRSPs (Registered Retirement Savings Plans). To be clear, RRSPs and TFSAs (Tax-free Savings Accounts) are account types, not investments. How you use them will depend on your goals, flexibility and tax situation.

For most young investors, the priority is to participate in any matching program at work. You never want to turn down free money. Next comes the TFSA. Don't let the name fool you. TFSAs are for investing, not saving.

And later when you're in a higher tax bracket and can take advantage of the tax deduction, a RRSP may enter the picture.

Just do it

There are a few clinchers that will guarantee you win the generational race. They relate to your behaviour and discipline, which will have the most influence on your investment success.

- The earlier you have real money at stake, the faster you'll learn.
- Establish a routine that includes reviewing your statements quarterly and making regular contributions (however small).
- Read an investment book a year and subscribe to a blog.
- Unlike the boomers, don't spend a minute obsessing about where the market is going. It's impossible to predict. Focus on what you invest in, not when.
- Start by investing in low-cost mutual funds and ETFs that offer diversification and professional oversight. If you want to buy individual stocks, do that after you've been through some ups and downs and have enough money to put in a separate bucket.

And do something your parents' generation don't do nearly enough of — ask questions. The investment industry is anything but transparent, so it's important to understand what fees you're paying, how you're doing and what service you're entitled to.

August 12, 2019

Nineteen

Why the Biggest Risk for Wealth Accumulators is Often Not Taking Enough Risk

Risk is one of the most misunderstood words in investing. Consider the different interpretations.

Large financial institutions define risk as volatility. They worry about short-term ups and downs in the stock market and have designed their risk management systems accordingly.

Some investment managers believe risk is the amount their returns deviate from the index. Too much dispersion, or tracking error, is bad. Indeed, it can be career-ending if the gap is to the downside.

Individual investors too are shaken by market volatility, but their biggest worry is permanent loss of capital.

Before addressing what risk is to you, let's eliminate a couple of possibilities.

Things that aren't 'risk'

First off, high tracking error is not a risk. This one strictly belongs to investment professionals, who are rewarded for how they do relative to an index. Beating the benchmark without significantly deviating from it is their holy grail, although it means little to you. Positive absolute returns build wealth, not relative returns.

Personally, I shy away from Canadian equity managers who target a low tracking error. Our market is skewed to a handful of industries, so hugging the index leads to an undiversified portfolio.

For investors who are properly diversified, loss of capital is also not a risk. A few poor stock picks aren't going to devastate returns. Neither are declining oil prices or debt issues in Greece.

I say this knowing that many Canadian investors get carried away with what's popular at the time. Portfolios were dominated by foreign stocks in the early 2000s (do you remember Clone Funds?) and were all-Canada ten years later. Along the way, there's been oversized holdings in technology, oil and gas, precious metals, banks and since 2008, cash.

There's a reason why diversification is called the only free lunch in investing. If you have broad exposure across industries, geographies and asset categories, the ride will be smoother without sacrificing returns. Negative events will impact your portfolio in the short-term, but a full recovery is all but assured.

It's personal

If tracking error and capital losses aren't risks, what about volatility? On this one I can't be as unequivocal. The answer depends on your stage in life.

A decade ago, I stepped away from the business for a short time and learned what it's like to be retired. A friend told me at the time, "Tom, living off your wealth is very different than building your wealth. It's a whole new ballgame."

He was so right. Retired investors must think long term, but also need to account for regular withdrawals. This brings volatility into the equation. Down markets always go back up, but when the weakness is prolonged, withdrawals chew into the capital needed for full recovery. Retirees must manage their cash flow with volatility in mind.

For investors who won't touch their money for at least 10 years, short-term market gyrations are not a risk. Indeed, they're a blessing. Volatility creates opportunities to buy at reduced prices. This requires, of course, that investors stay on plan through market tops and bottoms, both of which are breeding grounds for return-crushing mistakes.

It might surprise you, but I believe the biggest risk for accumulators is not taking enough risk. By this I mean having too conservative an asset mix and/or not having every available dollar invested to benefit from the power of compounding. It seems perverse, but holding secure, savings vehicles is a high-risk strategy. It doesn't in any way match the time frame (long term) or goals (building wealth and slaying inflation).

Your future with risk

Risk has four letters, but it's not a dirty word. When combined with time, it's the fuel that drives your portfolio. Without it, you're destined to achieve returns accorded 'risk-free' assets like GICs and government bonds.

But risk is a personal thing. It may be different from what others are worried about. To build a portfolio that fits your needs for growth and income, you need to allocate across all four types — interest-rate risk (bonds); default or credit risk (corporate bonds); equity risk (stocks); and liquidity risk (private investments). Your risk management system is getting the mix right, and resisting the temptation to deviate from it for short-term, emotional reasons.

January 15, 2018

Part IV

We All Need a Little Routine

Twenty

Want to be a Better Investor? Think of Yourself as the CEO

Much has been written about the flaws of the investment industry. Recently Michael Lewis stirred the pot with his book about high-frequency trading called *Flash Boys*. In this space, I've talked often about high fees, complex products, unattainable promises, and an emphasis on sales over advice. The industry is so focused on asset gathering, compensation and corporate profitability that client returns are often a secondary consideration.

But for every few columns I write about poor business practices, I need to write at least one about another impediment to better returns: the client. It's not politically correct to talk about it, but too many investors in Canada are letting the side down. They've abdicated all the control and decision making to their adviser or portfolio manager. They're going along for the ride as a passive, only slightly interested passenger, and are quick to blame someone else when their returns are suboptimal.

Indeed, not enough attention, and blame, is focused on: Who hired the adviser? Who invested without an overall plan? Who didn't ask what they were paying? Who approved, or even encouraged, the move to "get out of the market," go "all precious metals" or "never own anything in the U.S."?

In a report on investor behaviour that my firm published last year (Five Essential Elements to Being a Better Investor), we tried to draw attention to this shortcoming by titling the last section, *You are the CEO.*

Yes, when it comes to your retirement portfolio, you are the boss, whether you like it or not. It's up to you to set reasonable objectives and hold your team accountable for reaching them. You're responsible for hiring, monitoring and occasionally firing the people you're working with.

A good CEO watches revenue (returns) and expenses. She knows that if her manager can't clearly explain what he's doing, then he doesn't know what he's doing. When her calls aren't returned right away, she knows she's not an important client. And a good CEO is sensitive enough to know that if her suppliers hesitate or obfuscate when asked about fees, then there's a problem with the value proposition.

What's interesting is that most CEOs have limited choices when it comes to staff and suppliers. Canadian investors have a never-ending list of options.

Being the CEO of your portfolio means asking your adviser the hard questions. At least a portion of your review meetings should sound like a budget meeting, or a division manager reporting to head office. How have my returns been? How do they compare to my long-term target and the competition? What's on track and what needs to be improved? What did it cost me to produce the returns, and are there opportunities for savings? Are you recommending any changes?

From one CEO to another, let me suggest that a minimum commitment to managing your retirement assets should look something like this:

- Spend time up front to determine what your long-term asset mix is going to be. You have to have a plan.
- Do a thorough review of your entire portfolio once a year.
- At least one other time, go through your account statement(s) thoroughly, and read your provider's quarterly report.
- Meet your adviser/manager once a year, or attend a group presentation.
- And most important, ask lots of questions. The more you ask, the more revealing the answers will be.

Keep in mind, I'm throwing you a lob ball here — this is a bare minimum.

So yes, the investment industry deserves a scolding, but so do individual investors. They need to get with the program and realize this is one of the more important things they do. It's time they knew more about their portfolio than their cellphone plan or workout schedule. It's time they demanded better value for their time and money, and stopped tolerating mediocre results.

July 23, 2014

Twenty-one

Turn the Clock Ahead and Get Serious About Your Retirement Plan

My favourite scene from The Dick Van Dyke Show was one where Laura (Mary Tyler Moore) tricks Rob into getting out of bed by turning the clock ahead. I know I'm dating myself, but I reference this sketch for a reason. Like Laura, I want investors to turn the clock ahead. Let me explain.

Intense interest

As we grow our business and work with more Canadians, I've observed a distinct trend — people get really engaged in investing and their portfolio in their 50s. There's a noticeable change in intensity as they advance through this decade.

There are a number of things that trigger this increased interest. As their nests empty, the fiftysomethings have more time and discretionary income. Sometimes a market event may get their attention or (happily) their portfolios get too big to ignore. But the biggest reason for the engagement of those in their 50s with their financial well-being is that retirement comes clearly into view. Suddenly it's only one family reunion, two new cellphones and three diets away, and this realization brings with it a new sense of urgency.

What happens at this stage is all positive. Fiftysomethings read their statements more carefully and are proactive in dealing with issues that have been left unresolved for years — money sitting in a savings account; a poor adviser relationship; or RRSPs/TFSAs spread across 4-5 firms.

Investors in their 50s also ask more questions. How have I been doing? What am I actually paying to have my money managed? Does my portfolio match up with my pension? How much do I need to retire?

By getting answers to these questions and dealing with lingering issues, this cohort is more likely to experience higher returns going forward.

Turn the clock ahead

As to the Dick Van Dyke reference, it would be even better if investors started reaping these rewards sooner by getting engaged in their retirement plan in their 40s.

You might ask, why not even earlier? Isn't it proven that if people start investing at a young age, they'll be set for life? Well of course, the earlier the better, but I'm trying to be realistic. It's a big ask as it is, and younger investors have limited funds to invest due to the demands of raising children and buying a house in an expensive market.

Fortysomethings have financial challenges too, but if their goal is to retirement at 65 or earlier, then they're going to need 20 years of healthy contributions and a properly structured portfolio to get there.

No downside

In an industry where there are no sure things, the benefits of picking up the intensity sooner are undeniable. It was Albert Einstein who declared the power of compounding to be the eighth wonder of the world. People in their 40s may regret not having started in their 20s, but the math related to getting started earlier is still compelling — a dollar invested today can double twice in two decades.

Focused fortysomethings also have a better chance of investing smarter, even if they can't contribute more initially.

- They'll develop a better savings discipline.
- With retirement not yet in sight, they'll be more comfortable with a

growth-oriented asset mix that befits their extended time horizon.
- They'll catch on sooner to the fact that their asset mix should take into account all their financial assets, including any pension plans.
- They won't have any lazy money sitting around doing nothing.
- They'll get their fees under control and stop paying for services they're not receiving.
- And importantly, they won't put off the hard decisions about the person and investment firm they're dealing with. For investors who are on top of their portfolio, saying "My adviser is a nice person" is not a good enough reason to stay in an unsatisfactory relationship.

If you're in your 40s, I encourage you to talk to your "ancient" friends and family members. Try to channel their new-found intensity toward investing. And then one-up them by turning up the dial before you hit the big five-oh.

February 26, 2015

Twenty-two

A Client Manifesto for Taking Control of Your Investment Portfolio

It feels like we've arrived at a point in time when investors are going to stand up and be heard. I say that for two reasons. First, baby boomers are moving into retirement and have more time to pay attention to their portfolios. And second, we have new client-reporting standards that are bringing fees and returns into the spotlight. The time when advisers can slough off awkward questions such as, "What am I paying you?" or "How am I doing?" is coming to an end.

For all investors (not just my generation), it's a great time to start getting a better handle on all aspects of your investment portfolio. It starts by asking more and harder questions of your investment professionals. If you need something to motivate you, I'd encourage you to go on YouTube and watch last year's ads from Charles Schwab. They make fun of how few questions clients ask their advisers. Questrade's current campaign takes the point a step further. Their ads are getting lots of attention right now.

If you're ready to step up your game, I've composed a letter to help you get started. Feel free to cut and paste from it liberally.

Dear adviser/money manager,

I've been a client for a long time. As I get closer to retirement, I realize

I need to pay more attention to my money and get a better sense of how and what I'm doing. I've delegated most things to you, but ultimately, I'm the CEO of my portfolio. I read an article recently that used that expression and it stuck with me.

With the new fee and performance report you sent me last week, it seems like now is a good time to get started on upping my game. I'd like to schedule a meeting for later this month. Here's some of what I'd like to cover.

1. On the annual performance report, you've shown me one-year returns. I'd like to see numbers that extend back to when we started working together.

I remember you telling me that one- and three-year returns aren't meaningful. If I remember correctly, you've even said I need to be careful reading too much into five-year numbers — for example, the past five years have mostly been up and don't capture all types of markets. If I can, I'd like to include 2008 in my review.

Although the longer-term numbers aren't on the new report, I'm told you can print them out for me. My friends who use discount brokers have all the numbers at their fingertips, so I assume you can do this, too.

2. What should I compare these returns to?

Is there an index or fund or something that would give me a sense of what an average performance was over the various time periods? I'd like to have some context when looking at my returns.

3. Beyond what I'm paying you, I'd like to get a full account of my total costs.

It's been enlightening to finally get some information on what it's costing me to invest with you, but I've read a number of articles that say the total you provided doesn't cover everything. The fees related to my ETFs, mutual funds and that one closed-end fund aren't included in the $5,880 I'm paying, are they? And what about the index-linked thing we bought? I'd really like to know my total costs.

4. What kind of service and advice should I expect for the fees I'm paying?

You and I haven't met very often over the last few years, although you always call me during RRSP season. I think I get some free trades for my $5,880, but are there other services I'm eligible for? Do you do any financial planning? As I take more command of my portfolio, I want to do a thorough review of my situation.

I realize I'm asking you a lot of questions here but, as I said, I want to get a better handle on my investments and the information you provided doesn't give me the whole picture. On this note, is there anything you would ask of me to help me achieve my goals?

I'll see you in a few weeks. Thanks,

Your long-standing client

February 2, 2017

Twenty-three

Technique is Everything: What a Spin Class Can Teach You About Investing

It's 6 a.m. on Wednesday morning. I'm still a little groggy, but am sitting on an indoor bike ready to get beaten up and contemplate life.

Yes, my spin class offers both. That's because Steph Corker is not only an iron woman and thoughtful instructor, she's also a pop philosopher. She always gives us something to think about while we're grunting away. She loves Seth Godin, one of my favourite bloggers and even talks about Warren Buffett occasionally.

Spinning with Steph prompted me to think about what cycling and investing have in common. Here's how her coaching aligns with my investment advice.

"Warm ups are important to get your body ready for some high intensity intervals."

Investing is counter intuitive. It's not like any other consumer decision you make. Returns come when you least expect them. If everyone else is doing something, it's likely the wrong thing to do. And what appears to be good news sends stocks tumbling and vice versa. Needless to say, it takes time to understand.

So, the earlier you get started, the better off you'll be for when the amounts are bigger and the 'intensity' amps up. Even young people focused on saving for a down payment or pounding down their mortgage should put a few thousand dollars away and start learning. Consider it a long, slow warm up.

"The hard stuff provides the most benefit. It's all about effort. Pushing yourself when you feel like you have nothing left."

In the case of investing, this means putting money aside when you'd rather spend it. Reading your statement when you know the news is bad. And making the hard call to change your adviser, even if you consider her a friend.

"Time. Time. Time."

When I'm out biking, I still get passed by commuters on cruiser bikes, but I'm getting stronger and ever so slightly faster. This riding thing takes time. The great thing about investing is you have the power of compounding working for you (earning returns on your returns), which is even more of a sure thing than getting in shape (sorry Steph). But as with riding, the multiplier is time.

"Stick to a routine."

Steph talks often about her health priorities: (1) sleep, (2) meditation, (3) good, green food and (4) sweat. But she always adds at the end, "Never miss a workout!" Having an investment routine is an essential part of successfully dealing with the ups and downs of the market and, more importantly, your psychological weaknesses. When possible, make the process as automatic as possible. For instance, set up monthly contributions, review and understand your statement every quarter, and meet with your adviser or portfolio manager annually.

"Technique is everything, because how you do anything is how you do everything. It doesn't matter how far into the workout you are, your technique should never be compromised. Technique is more difficult as we get fatigued, which means we need extra focus to not be mediocre."

Steph is at her best here, but I admit, I couldn't see the analogy to investing at first. After all, isn't it all about time and sweat? Is technique really that important, especially for an amateur like me?

But after further reflection (and grunting), I came around. Having a plan (asset mix and investment approach) and sticking to it is paramount. Not letting it break down when it's getting boring or hasn't been working lately. And not changing your mix at the most extreme and emotional times in the market. Those are the times you need technique the most.

I've tried to stay true to Steph's advice, but I'll admit to leaving out the parts about "endorphin highs" and "sleep is king." I couldn't see how they'd increase your returns. In any case, I'll give her the last word.

"There is something really special about the feeling of topping a mountain where the work and effort builds progressively. Imagine if our money grew like that too!"

Yes, imagine.

January 29, 2018

Twenty-four

Why the Best RRSP Season Strategy May Be to Take RRSP Season Out of the Equation Altogether

RRSP seasons aren't what they used to be. You may remember the 1980s and 90s when they were a big deal. Banks stayed open late so we could get our contributions in, and there was advertising coming at us from all directions.

Today, the hoopla isn't there, but January and February are still the busiest months for investment firms. RRSP and TFSA contributions are a part of that, but it's also a time when investors sit down and evaluate their portfolios. They have their annual account statements in hand, and more indoor time to consider next steps.

In the spirit of the season, here are some things to think about this year.

Old or new?

Investors are often looking for something new to buy when making contributions. They want the latest and greatest.

This tendency is apparent when I see portfolios with a multitude of holdings. They are like time capsules. I can link the holdings to what was being sold in specific RRSP seasons such as technology in the late 1990s, energy in 2008, and more speculative holdings like cannabis and Bitcoin companies in 2018.

A new stock or fund may be the answer, especially if an additional piece is needed to properly diversify your portfolio (we see too many portfolios that are solely focused on the domestic economy). But the RRSP deadline (March 1 this year) shouldn't cause you to rush into buying something that duplicates what you already have, or you don't understand.

Indeed, your first step should be to look at what you already own. If you like your portfolio, you may simply add to your major holdings pro-rata, or focus on a stock or fund that's been underperforming and needs topping up.

Staying on track

Speaking of topping up, contributions are useful for rebalancing your overall portfolio back to its intended asset mix. I say "overall" because it's important that you bring into the equation all assets that are dedicated to retirement. This might include GICs, non-registered accounts, income properties and pensions.

This is an important concept: By adding to your registered accounts, you have an opportunity to rebalance the entire portfolio.

Last year was a good example of where rebalancing came into play. If you did nothing to your portfolio in 2018, you likely started 2019 under-exposed to stocks relative to your target. That's because they were down in 2018 while cash and bonds held steady. When the recovery started over the holiday break, your portfolio held a smaller percentage in stocks than it did during the decline. Going up with less than you went down with is a sure way to reduce your returns.

Pension plans

Many investors fail to consider their company or government pension plan when investment planning, even though it may be their biggest asset.

Every situation is different, but in general, if you have a defined benefit plan that is well funded or backed by government, it's reasonable to categorize it as fixed income for the purposes of setting your asset mix. This allows your other investments to be more equity oriented.

For Group RRSP and Defined Contribution plans, your fund choices should match up with the goals, risk tolerance and time frame you're using for your other accounts. If your employer doesn't have an option that fits your situation, you can make adjustments using your other accounts. For instance, if you're in your 30s or 40s and are only offered a balanced fund, you could tilt your personal assets towards stocks. The result will be a more growth-oriented portfolio that's appropriate for your situation.

Eliminate the season

The most effective RRSP strategy is to develop a routine that eliminates future RRSP seasons. If you make contributions throughout the year, your money starts working for you sooner and you needn't worry about deadlines.

Automatic monthly contributions are one of the simplest and most effective investment strategies available. The money is gone from your bank account before you can spend it, your emotions stay out of the way and the cost of your annual contribution is averaged across a variety of markets.

Hype or no hype, this time of year is a great time to tune up your portfolio, and RRSP and TFSA contributions are handy tools to make any adjustments.

February 25, 2019

Part V

The Stuff of Legends

Twenty-five

Lessons I Learned From an Investment Industry Legend

Last week I attended the Investment Industry Hall of Fame Dinner in Toronto. It was special for me because one of the inductees, Bob Hager, was one of my biggest influences.

Bob was not well known to the largely eastern audience, although most people had heard of the firm he co-founded, Phillips, Hager & North (now part of RBC). By the time he retired in 2001, PH&N was the largest independent asset manager in Canada.

That Bob wasn't a household name is not surprising because PH&N was headquartered in Vancouver and Bob avoided the limelight like the plague. Besides, the areas where he had the most impact weren't headline grabbers.

Bob was the conscience of a firm that was known for its conscience. His long-time partner, Dick Bradshaw, said that decisions were never made to benefit PH&N and build the business. Rather, it was "let's look after our clients."

Sharing the ownership in the firm was important to Bob. He didn't mind selling shares to a new partner if he/she made the business better. He was happy to own a smaller piece of a bigger success.

But besides being a builder and ethical pillar, Bob was a great investor.

There are many lessons my partners and I learned from him that are still applicable today.

KISS

Bob had a simple approach to investing. More than once he reminded us in our morning meeting that it's bottom-line profits that drive stock prices, not the fashionable EBITDA (earnings before interest, taxes and depreciation) or other more creative measures. He abhorred hyped-up structured products and would invariably point out that investment bankers hadn't created a new source of return. These securities would perform in line with their underlying assets, namely stocks and bonds.

Against the herd

Along with Art Phillips, one of his co-founders, Bob was a student of investor sentiment. It was important to know when investors were getting too greedy or fearful because at market extremes, he wanted to be going in the opposite direction.

Don't fear the bear

Bob's most lasting lessons came in bad markets. While he worried incessantly about his clients, it was weak markets and fearful investors that got his juices going. That's when he was at his best. I've kept a number of his notes and emails from those times.

"With every bear market, there are always unknowable concerns, and every time we're told that this bear market is different."

"If you wait for certainty, you'll miss the market."

Bob always felt that trying to figure out the implications of the world's economic problems was a mug's game. Weak markets were not a time for precision.

"My best trades turned out to be the ones when my hand was shaking as I gave Janice (our equity trader) the blue ticket."

Doing the right thing is usually a lonely endeavour. With blood in the streets, there won't be a crowd of people cheering you on when you're buying stocks.

"Make sure you go up with more stocks than you went down with."

Starting a bear market with 70 per cent of your portfolio in stocks and the recovery with 50 per cent is a sure way to lose ground. You don't want to let the market manage your asset mix.

An example of Bob's steely resolve came in September of 1998. Canadian stocks had dropped more than 20 per cent in August and the research team was shaken. A not-so-subtle note from Bob pushed us to start buying stocks.

"The Canadian market has been particularly hard hit in recent sessions. It is important to remember that picking the bottom of the market is virtually impossible. We are, however, starting to see some values in Canada that look quite compelling. We will be buying into these companies as the market declines."

In reflecting on Bob Hager and his contribution to the investment industry, I have one lingering regret. I wish he'd been better known in Eastern Canada where a bulk of the analysts and portfolio managers reside. The investment industry would be a better place if they'd been privy to his warmth, wisdom and integrity.

November 5, 2018

Twenty-six

You Must do These Two Things to Invest as Patiently as the Greats

It always sounds cool when people talk about "patient capital." There are deep undertones to these words. An agenda that's above the day-to-day fray. Big money that knows something we don't. Think Warren Buffett, Jimmy Pattison, the Desmarais family, Prem Watsa and, perhaps, Ontario Teachers.

For individual investors, living up to this moniker is difficult, but in many ways, they're best positioned to do just that. They have a long time frame, multiple decades in most cases. There's no board of directors asking hard questions and valuing the portfolio every quarter. And they aren't required by a pension authority to update their funding ratio every three years.

Indeed, if you expect to live 20 to 50 more years, you have a great opportunity to invest as patiently as Warren, Jimmy and the Desmarais. But you need to do two very difficult things. First, you must exhibit some of the same traits and second, you need to make sure everyone involved in your investment process buys into the program.

Traits

The great investors are all different, but they share a number of key attributes.

They have an independent view. They feel no obligation to invest in something because others are doing it or because it's a part of an index. Indeed, they prefer when a stock isn't popular or heavily traded.

They buy when opportunities present themselves, not when the money is available. Cash doesn't burn a hole in their pocket.

They buy assets that, in their reasoned opinion, will eventually be worth considerably more than they're able to purchase them for. The key word being eventually. Their time frame is only slightly shorter than that.

They don't get hung up on short-term events, although they do monitor them closely so they can take advantage of opportunities. Price movements and/or liquidity events may allow them to buy more or sell, and any new information can be used to update their valuation models.

You get the picture. Patient capital is focused on long-term value creation. It's comfortable being out-of-sync with popular trends. And it doesn't get distressed by market dislocations, it gets excited.

Pulling in the same direction

Of course, none of these traits are easy to live up to, especially if your team is not on side. So as chief executive of your portfolio, you need to make sure that everyone who touches your money buys into what you're doing. You don't need to be a great investor yourself, but you must hire (and fire) well, and religiously enforce the philosophy.

At home, you and your partner can vigorously debate which bonds, stocks or funds to own, but it has to be done with the long term in mind. Patient capital isn't about day trading or rotating the portfolio to catch the latest trend.

If you're working with a financial adviser, they have to understand and believe in the patient-capital approach. You don't want to hear about an idea for a quick flip of a stock or ETF. You don't want them recommending a fund manager because she or he has done well lately. And you certainly don't want them getting weak knees when short-term results are poor.

You want advisers and money managers who can live up to the traits listed above and, ideally, who are working in organizations that exemplify the same traits. You and your adviser have a better chance of being "patient capital" if the firm's sales, marketing, product development and investment strategies are aligned.

Baby steps

I'm not saying you should aspire to be the next great investor. They are rare people indeed. But the more you can align your process with their success factors, the better chance you have of generating the kind of returns you need. Having worked with both institutional and individual investors over my career, believe me when I say that you are in a better position to earn that title than most of the big pools of institutional money.

So, make 2017 the year you commit to being more patient and long-term oriented. Only buy securities and funds that you intend to hold for five years or longer.

January 16, 2017

Twenty-seven

Three Ways to Be a Contrarian Investor

It's hard to generalize about what makes great investors great, but one trait that's present in all of them is the ability to be contrarian. Certainly, American icons such as Warren Buffett, Jeremy Grantham and Howard Marks are able to go against the grain, as are our own Prem Watsa, Hanif Mamdani and Francis Chou, to name a few.

How does a contrarian streak contribute to their greatness? Well, oversized returns come when expectations for a company are low and the valuation on the stock is also low. This double-whammy means the risk is reduced, or at least well understood, and the upside is substantial if the investor is right.

As Oaktree Capital Management's Mr. Marks so aptly puts it, "The ultimately most profitable investment actions are by definition contrarian: You're buying when everyone else is selling (and the price is thus low) or you're selling when everyone else is buying (and price is high)."

Now, don't get me wrong. Heading west when everyone is going east doesn't guarantee success, but it tips the risk/reward balance in the investor's favour, setting up an asymmetric bet.

The reason there are so few great investors is partly because being contrarian is hard to do. It takes an open mind and lots of digging for the positives under the doom and gloom.

Contrarianism also runs again human nature. We take comfort from the warmth of the herd, rather than being out in the cold. And when we're shivering, nobody tells us how smart we are. Indeed, everyone will be going the other way and feeling supremely confident about it.

Professional investors know that the loneliest and riskiest time in their careers is when they're wrong on their own. It's way easier to keep their job, clients and bonuses when other managers have made the same mistake.

The wealth-management industry also makes it hard to be contrarian because its behaviours are decidedly pro-cyclical. The advice, advertising and product launches all reinforce the current cycle and tell us what's been working well.

In the late 1990s, when technology was running hot, there was a new tech fund created every week. In the early 2000s, after Canadian stocks had underperformed for a decade, fund firms began offering clone funds (which allowed investors to go all foreign in their registered retirement savings plans). And there was a wave of new gold funds five years ago after the price of the shiny metal had doubled.

Today, when expected returns for stocks are getting back to normal, ads for safe, principal-protected products are beginning to appear.

So, while new products and client flows aren't a perfect contrarian indicator, they certainly point to where the consensus is. And by definition, contrarians need a consensus to lean against.

How can you fight the pro-cyclical wave and be more contrarian?

First, you need to have a strategic asset mix in place. A SAM, as we call it at our firm, lays out how your portfolio will be allocated across different asset types. It's a road map that gives you the best chance of achieving your long-term goals and, importantly, prevents you from getting too caught up in the latest hot trend.

Second, put restrictions on how far you'll vary from your SAM. If you feel compelled to invest in an industry you know (or work in), or pursue a locker-room tip, then put limits on how far you'll go. If gold is the only thing that makes you feel comfortable, then make it 5 per cent to 15 per cent of your portfolio, but not 50 per cent. Whatever the strategy, it has to be done in the context of a diversified portfolio.

Third, be skeptical of new product offerings. Make sure you understand how they will help you implement your SAM and why they're better than what you already own. Rather that searching for something new every RRSP season, I'd suggest looking inside your portfolio first. Allocating RRSP and tax-free savings account contributions to securities and/or funds that have been lagging is the move of a contrarian.

And finally, commit to reading some Mr. Buffett, Mr. Marks or Mr. Watsa each year. They're all great communicators and don't have a procyclical bone in their bodies.

February 26, 2016

Twenty-eight

Live in the Future, Embrace the Irrational and Feel Terrible About Good Decisions

"Your investment philosophy is very interesting. What you're saying about investing, does that apply to how you live your life?"

I was asked this question at the end of a media interview. My response: "Hell no. They're very different. If I lived my life the way I invest, I'd wear shorts and flip flops in December, own the ugliest house on the block, drink tap water at Starbucks and wonder why I had no friends."

Investing is very different from almost every other aspect of our lives. And the differences make it difficult for normal, well-balanced people to be successful investors. Let me explain.

First of all, investing is totally perverse. It's irrational and stubbornly unreasonable. Markets go up when they should go down. Good news is interpreted as bad. And your best moves will feel terrible when you're making them. I hope your life has a more logical flow to it.

As an investor, you have to ignore the noise and hyperbole of the day-to-day markets. The more you can extend your time frame, the more successful you'll be. Investing is all about looking forward two or three years and giving strategies time to play out.

In real life, it's all about what's going on now. You're constantly reacting to the information of the moment, whether it be via texts, e-mails, tweets, traffic reports and weather forecasts. You have instant communication and Internet access in the palm of your hand.

A good investment plan is intended to be boring. It's about laying out a road map and following the signs. No spontaneity or flexibility. No 4 a.m. gold medal hockey parties.

Investing is all about making decisions based on as much information as you can gather. But as Bob Hager used to tell me, "If you wait for all the information, you'll be too late." Buying a stock isn't anything like buying a car. There are no Consumers Reports, online customer reviews or test drives.

In your portfolio, you'll own some stocks that have a few warts on them and aren't well liked. That's not the way you want to live your life, but successful investors know that any asset can be a good investment at the right price. Indeed, if you feel comfortable with everything you own, it's likely that you're not well diversified.

With regard to price, a purchase for your portfolio should never be made without considering the numbers. Valuation has to be at the core of every investment decision. When buying a home, however, valuation may be well down the list of factors being considered, after proximity to transit and schools, the feel of the neighbourhood and the all-important media room. And math doesn't even come into play on vacation properties, second (or third or fourth) road bikes, and grande skinny soy vanilla lattes.

Self-help books encourage us to commit to the moment and live every day like it's our last. There's no advice like that to be found in a good investment book or any of Warren Buffett's letters. Investing is about not getting distracted by the current and focusing on the future — about being measured in your moves, to the point of being boring. It's about being prepared to run against what your friends and the nightly news are saying. And when it comes to this perverse little part of your life, price is always important and good looks are highly overrated.

March 12, 2014

Twenty-nine

In High-flying Markets, the Forgotten Investors May Be the Wisest of All

I was reading the Chou Funds annual report this week. Francis Chou is someone I know and have followed for many years. He's got a great long-term record, although it's taken a hit recently. As a result, he's not topping the charts right now and you don't hear much about him.

I mention Francis because it illustrates a behavioural tendency we all have — we like to follow people who are doing well. The quarterback who's winning. The actress who is getting the nominations. And the analysts, portfolio managers and strategists who are perceived to have been correct in recent years and/or whose returns are first quartile.

But what about the previously brilliant? The people who were topping the charts a few years ago. Are they suddenly less intelligent because they're going through a rough patch? Is their analysis any less thorough?

Well, maybe some have lost their mojo, but for the most part, the answer is no. There's valuable information and insights to be found in the shadows of obscurity.

Now, before you accuse me of being a raging contrarian, may I remind you that the top money managers in the world underperform 3-5 out of every 10 years, including the best of them all, Warren Buffett. Their most compelling observations often come when they're in the doghouse because, by definition, they're non-consensus. And their portfolios represent the best value when nobody is watching.

Input diversification

In this world of customized news feeds and polarized media, it's easy to read only things that support your view. But that makes no sense. You want to diversify your reading just like you diversify your portfolio. Not everyone you follow should be on a roll, just as not everything in your portfolio should be performing.

Keep in mind, you don't have to agree with the conclusions. What you're trying to do is mine their work for nuggets that will inform your own view.

Conditional love

I'm not suggesting you blindly seek out everyone who is out of favour (although it may not be a bad strategy). I won't stick with someone just because they were good once. My contrarianism has conditions.

The forgotten must be doing the same thing they were when they were successful. For example, I'm not interested in a rock star stock picker who is now a strategist.

It's important that they're sticking to a tried and true philosophy, no capitulating and moving to the centre.

And importantly, I'm looking for people who are saying things I'm not hearing elsewhere.

Searching for non-consensus

I see a lot of managers over the course of a year and sometimes distinctive trends emerge. Last year, growth-oriented managers were riding high, which means they sounded smarter and their investment process oozed logic. Conversely, managers on the other end of the spectrum, often referred to as value managers, had a very different body language. They were on their heels. Their winners sounded less compelling and their losers, well, they looked like unforced errors.

I'm aware of this potential bias and am careful not to ascribe too much brilliance to the former category and too little to the latter. So in addition to following the managers who owned the high-flying technology and consumer brand companies, I kept in touch with what the value managers were doing, including Francis Chou, Seth Klarman (Baupost Group), Mason Hawkins and his team (Longleaf Funds), and Jeremy Grantham and James Montier at GMO.

Other fertile territory for non-consensus views are the newsletters of outspoken fund managers. Bill Gross, the (former) king of bonds, and John Thiessen, who runs the Vertex Fund, never hold back, which makes for interesting reading and tense discussions with the marketing department. And of course, short sellers are the ones with the most radically different views. It's no fun hearing them colorfully eviscerate one of our holdings, or question a theme we're pursuing, but it's a good gut check.

It's important that you diversify your information sources. You'll have to work harder at it and go where you don't normally tread, but it'll be worth it.

April 23, 2018

Part VI

Hedge Funds and Hodgepodge

Thirty

If You're Thinking of Investing in a Hedge Fund, Read This First

The first article I wrote for the Report on Business in 2006 was one of my most controversial. It questioned the value of hedge funds. Not how they invest, but rather their high fees, lack of transparency and, in general, client-unfriendliness.

These funds, which represent a broad array of investment strategies, have had their ups and downs since that time. They've grown significantly — the latest tally is $3.2-trillion (U.S.) — but have come under increasing scrutiny. Investors are saying, "I bought the sizzle, but where's the steak?" In general, actual returns have not justified the fees and complexity. As it turns out, the managers have done much better than the clients.

Nonetheless, hedge fund-like products are creeping into portfolios of individual investors. I'm referring to investment products where the manager shares in the profits, or what I fondly refer to as "fee impaired" funds.

To justify higher fees, these fund managers have to do things that are different and difficult. That might mean using leverage, shorting, private securities, and various forms of arbitrage and hedging. In addition, managers point out that performance fees better align their interests with clients. "When you do well, I do well."

If you're considering such a product for your portfolio, you and your adviser have some work to do. You need to know how it works, what the risks are, how much you're paying and, importantly, who you're dealing with.

Sources of return and risk

First off, you should understand where the profits are expected to come from. I mean the basics, not the details. The strategy should make sense and fit well with the manager's experience. Using leverage, shorting stocks and taking advantage of illiquidity require special skills and temperament.

Bob Hager, my former partner at PH&N, regularly reminded me that with any investment product, it always comes down to bonds and stocks. That's what drives returns. Well, he's right about that, but with additional strategies layered on top, the character and timing of the returns and risks can be different. Not to mention that increased complexity broadens the range of outcomes.

Hedge funds have risk profiles ranging from conservative to aggressive. A good rule of thumb is, if the product promises equity-like returns, then it has equity-like risk. Warning bells should go off if the marketing materials promise high returns with little or no risk.

How impaired?

The fees may be as hard to understand as the investment strategies, but it's important to know if the manager will be rewarded for exceptional performance, or simply because markets go up. If he loses money, is he required to make it up before collecting additional performance fees?

In a well-designed fund, the performance fee doesn't kick in until after a minimum return has been achieved. If the manager gets above the hurdle rate, as it's called, then he shares in the additional return, usually to the tune of 20 per cent. Unfortunately, many funds don't have a hurdle rate. In other words, they get 20 per cent of the first dollar earned.

Another element to look for is what's called a "high-water mark." The HWM requires that the fund recoup any prior losses before further performance fees are collected. The HWM should be perpetual, although some funds have an annual reset (they get to start fresh after one year). For me, if the HWM isn't perpetual, it's a deal breaker. I'm not willing to give the manager all the upside while limiting their downside.

The bar is higher

I've had experience with fee-impaired funds for two decades, both personally and on behalf of institutions. If the manager and fund structure is right, they can be a nice complement to the bulk of your assets, which hopefully is at the other end of the spectrum — understandable, low cost and transparent.

To justify client unfriendliness, hedge funds must be held to a higher standard. Before you write a cheque, make sure you know how the fund works, what the risks are and how much you're paying. After all, you want some assurance that you'll do well if your manager does well.

August 17, 2017

Thirty-one

The Pros and Cons of Private Equity

I have a friend who's a private equity manager. He loves to tell me the public markets are broken and investing privately is the only way to go. He argues that CEOs are too focused on quarterly earnings and not enough on long-term value creation. And stock prices are way more volatile than the underlying businesses.

Certainly, managers like him have fewer short-term issues to worry about. They can do deals that public companies can't do for fear of spooking their shareholders. That may include: buying private companies, tuning them up and taking them public at much higher valuations; rationalizing industries by amalgamating a number of smaller players; and carving out divisions from large companies. And it's all done using liberal amounts of debt.

I have to admit, he has many good points, but the discussion has another side to it. Private equity also has tradeoffs that investors must be aware of.

Reality check

As the name connotes, private investing means your assets are illiquid. You're committed for a number of years and even then, there's no guarantee you'll get your money back on schedule.

I'm referring to private equity pools with 10-12 year terms, private lending arrangements and investments closer to home like providing a mortgage to a niece or backing a friend's company.

Private investing is more labour intensive and as a result, costs more to access. Most funds carry a healthy base fee (usually 2%) and the manager gets 20% of the profits. This is not cheap at a time when you can index public equities for next to nothing.

Private equity managers talk about their freedom to pursue value, but rarely mention their biggest constraint. After capital is raised, they have to spend it within a certain period — a bulk of it in the first two years and the rest within three to five. If that period is characterized by high valuations and an abundance of capital, the results are likely to be disappointing. Like any investment, the most important factor driving returns is the price paid.

And I'd be remiss if I didn't point out that it's hard to compare the performance of your privates with your other investments. Managers show how many times your capital has multiplied, but rarely report in public market terms.

It's been discovered

Now, private equity managers like to tell you about the deal that nobody else saw, but the reality is their opportunity set has been diluted. Skulking in the shadows undetected is harder to do. Industry stats suggest firms have raised a trillion dollars from investors, which triples with leverage. Three trillion dollars to spend means more bidders at the table and higher prices. Purchase multiples are up 25 per cent over the last three years and the amount of leverage is on the rise. Indeed, many deals aren't private at all, but rather premium bids for public companies, sometimes via an auction.

A veteran manager told me the days of simply buying a company, cutting costs and taking it public are over. Current valuations require growth to make investments work.

In this regard, it's interesting to watch as private equity firms increasingly "pass the parcel," which refers to selling an investment to another private equity firm. In other words, a sophisticated seller transacting with a sophisticated buyer. It begs the question — who's the patsy?

Lingering questions

After years of researching private equity, I'm still wrestling with a number of questions.

How much of my portfolio should be in illiquid investments?

How much extra return do I need to justify the lack of liquidity and higher leverage?

Can I get into the good funds? The leading managers seem to be able to stay on top.

How critical is cheap credit? Lenders have thrown money at private equity firms in recent years. If they get stingier, will returns be impacted?

Does three trillion dollars overwhelm the potential opportunities?

If managers are increasingly bidding for public companies, should I try to be on the other side of the trade?

The debate rages on, at least in my mind. If you're ready to go private, however, be cognizant of the tradeoffs and ask lots of questions.

August 27, 2018

Thirty-two

The Asset Management Industry Life Cycle

Companies and industries go through life cycles. Oil and gas has one of the most predictable ones. To increase profits, large firms go into cost-cutting mode and sell off small, less-economic fields. This allows small firms and startups, which have a lower cost structure, to accumulate assets and build scale. Some of the small firms grow to become intermediates, although they don't stay there long. They either continue growing into large firms or get swallowed up by one.

Airlines also have a definitive cycle. Think about WestJet. It started out with a bargain-basement offering and matured into a full service, multi-aircraft airline. As the company evolved, it left room for the next WestJet to come along and scoop up price conscious travellers. Today, we're starting to see ultra-low-cost carriers (ULCC) in Canada, including WestJet's own downmarket brand, Swoop.

In other industries, the cycles seem to be getting shorter. Firms in technology, biotech and consumer products don't seem to last long before they're scooped up by industry leaders.

Banks bulk up

In asset management, we've being going through the consolidation phase of the life cycle. There's been a steady flow of transactions in Canada as the banks (mostly) and some industry consolidators have been buying independent, privately held firms. In 2017, CI Financial bought Sentry Investments while Sun Life added Excel Funds. This year, Scotiabank bought Jarislowsky Fraser in March and more recently announced it was purchasing MD Management. Fiera Capital filled out its lineup with CGOV, a highly regarded boutique.

I suspect we're at the tail end of the bulking-up phase because the pace of acquisitions has slowed. The banks' asset management divisions have reached a size where domestic deals no longer move the dial. They're increasingly looking outside Canada for growth.

The other side of the mountain

I don't know how the landscape will change going forward, but I've been around long enough to know there's another side to the cycle. In the 1980s and 1990s, we saw the rise of the independents as firms such as Phillips, Hager & North; Jarislowsky Fraser; TAL; Beutel Goodman; Trimark; Mackenzie; Connor Clark & Lunn; Sceptre; McLean Budden; Altamira; Gryphon; and Knight Bain became a force. The emergence of mutual funds and defined contribution pension plans fuelled their growth, as did the decline of the trust and insurance companies that had previously dominated the institutional part of the market. Of note, the banks were a non-factor back then.

These firms all followed a similar storyline. A few talented analysts and portfolio managers decided to leave large firms and go out on their own. They started with a narrow offering, usually Canadian equities. As they generated good returns and garnered assets, they expanded their product lines and distribution channels, which allowed them to grow further.

At some point, however, the senior shareholders in most of the firms wanted to cash out and thus the banks' bulking up phase began. In each case, strategic reasons were given for the final transaction (more resources, better distribution, product enhancement), but succession was always the root cause. In some cases, weak performance also came into play.

It's interesting that of the 12 firms listed above, only CC&L and Gryphon continue as independent firms today.

Rinse and repeat

Despite the high degree of absorption over the past 15 years, there are still many independents that have distinguished themselves through performance and/or asset growth (they usually go together). Also on the list are Mawer, Letko Brosseau, Burgundy, Canso, EdgePoint, Greystone, Leith Wheeler, QV Investors, Sprucegrove, Sionna Investment Managers, RPIA, Black Creek and Polar Capital. There are also many smaller firms that are rapidly moving up the rankings.

With the emergence of indexing and dominance of the banks, the asset management life cycle may not be as predictable as oil and gas or technology. But there will be a cycle. There are always talented, ambitious money managers who want to escape the bureaucracy and burden of managing billions of dollars to stake their claim and leave an imprint on the industry.

June 18, 2018

Thirty-three

Hoping to Turbocharge Your Returns by Borrowing to Invest? Read This First

"Should I borrow to invest?"

This question comes and goes, depending on what markets are doing and how available credit is. Today, with stock prices rising and financial institutions throwing money at customers ("do you want fries with your credit line?"), we're getting asked the question more. Indeed, with rates so low, there's almost an urgency for people to take advantage.

So, does it make sense to borrow money and invest it? What factors should you consider? And, are there alternatives?

Do the math

Theoretically, borrowing to invest in financial securities is no different than borrowing for a house. In both cases, the value of the asset rises over time, but can go through periods when prices are volatile, jumping up or down.

Borrowing to invest, however, has nothing to do with locating near a good school. It's all about making money, so the math must be compelling. If you can borrow around 4 per cent (the prime lending rate is 3.2 per cent) and earn a return in excess of that, it's a beautiful thing. It's even more beautiful if you're in a high tax bracket because interest on an investment loan is tax deductible.

So yes, 5 and 5 will work. If you and your banker commit to doing this for 5 years and your portfolio earns at least 5 per cent after fees and commissions, you're in the money. But before you run to the bank, there are things to consider.

Eyes wide open

First, debt strategies are often sold using current borrowing costs (low) and past investment returns (high). As you'd expect, the numbers really work on this basis. But keep in mind that the starting point for those past returns was higher interest rates and lower price to earnings multiples. Today's rates likely portend more modest future returns.

Second, for all of us, the psychological part of investing is the most difficult. When debt is added, the challenge gets a whole lot tougher. For instance, doing the right thing when stocks are in steep decline is hard enough, but when you add the fact that your portfolio is worth less than the loan value, the degree of difficulty skyrockets.

Before you borrow to invest, you must have a history of successfully weathering ugly markets such as the tech wreck, 2008 financial crisis or even the declines of early 2016. Did you hang in, do some buying, or did you sell?

And finally, if you want help to stay on plan, don't expect it to come from your lender. The bank has different interests than you do and is more likely to pile on than lend a hand. Their protocols lead them to offer you more love and money when things are good, and ask you to reduce the loan or increase the collateral when markets are challenging. Buy high and sell low.

Alternatives

A few years ago, a discussion with a client prompted us to run some numbers. We wanted to assess whether it was better to borrow and invest in a balanced portfolio, or hold all stocks with no leverage. After assessing the level and volatility of returns across a myriad of scenarios, we couldn't discern a meaningful advantage for either strategy.

This work suggests that if you want to take more risk and reach for higher returns, you should first increase your portfolio's equity content. Don't get your banker involved until you've gone through good and bad markets with an all-equity portfolio.

Conclusions

Cheap debt is intoxicating, but using it to invest is not child's play. It requires that you have experience and a history of success.

Make sure you look at both sides of the reward and risk equation. The promotional materials cover the upside, but you also need to get comfortable with less favourable outcomes, namely rising interest rates and/or negative returns in the early years before you've built up a cushion.

And if you're going to borrow to invest, make sure you have a plan for when the markets go down and the bank calls. Know what other assets you can pledge against the loan, or where you can get additional cash, because for the strategy to work, you absolutely can't bail out when the going gets tough.

November 20, 2017

Thirty-four

Six Valuable Lessons From Oil's Collapse

Good crises should never be wasted. They can lay bare poor business practices, weak players and bad public policy. They can also teach us valuable lessons, and with the oil collapse playing out, we've been given a chance to learn real time.

I didn't see that coming

The price decline seemingly came with no warning. Nobody was calling for it. Analysts weren't using $50 (U.S.) oil in their earnings models, or even $70 or $80.

In his quarterly letter, Jeremy Grantham of Boston-based GMO, an astute observer and predictor of bubbles, admonished himself for missing it.

From this collective whiff comes lesson No. 1. Never count on analysts and economists to call a major turn in the market, whether it be commodities or stocks. It's impossible to do with any precision and there's too much career risk in getting it wrong.

It's cyclical, baby!

Outside of coffee, toothpaste and bathroom tissue, there aren't many things that are non-cyclical.

Most everything is affected by the level of economic activity and is sensitive to changes in supply and demand.

High prices lead to more investment in the sector, the emergence of substitutes and less consumption. Low prices curtail investment, rationalize the competitive landscape and lead to increased demand.

The fact that oil prices were on either side of $100 for four years didn't mean the oil cycle had been repealed. Nor does an extended period of prosperity mean that real estate, bank stocks and high yield bonds are in the toothpaste category.

Diversification — always

Over the past 20 years, there have been some powerful themes that dominated investor behaviour, the most prominent ones being technology, the commodity supercycle, the loonie's rise and fall, gold, investors' love/hate/love relationship with foreign stocks and, of course, 2008. In each case, we saw too many investors diverge from their target asset mix and jump on the irresistible trend of the day.

The number of investors that loaded up on energy was fairly limited this time (outside Alberta), but the crisis is still a reminder that making a bet on a secular or cyclical trend has to be done in the context of a diversified portfolio. You don't want to be so heavily invested that you can't add more if the price goes down, or worse yet, have your portfolio devastated.

Swimming naked

Good economic times and low interest rates help paper over a lot of cracks, and invariably lead to regrettable business decisions. Companies with high cost structures and/or leveraged balance sheets are able to thrive. The rock stars are the fast moving CEOs and empire builders. Prudent management is not rewarded.

But as Warren Buffett has said, "You only find out who is swimming naked when the tide goes out." In other words, it's full cycle returns that are important, not two- or three-year runs. You want your CEOs and portfolio managers to be fully clothed at all times.

Dividends — not a valuation measure

The merits of dividends have been well documented. I hear it often from investors, “I love my dividends.” But it’s important to remember that a stock yield is not the same as a bond yield. It’s not a valuation tool. The highest yielding stock is not the necessarily the best investment.

Nor are dividends a risk control measure. In the oil patch, the high-yielding stocks were some of the hardest hit in the second half of 2014. The companies that cut their dividend saw their stocks get hammered, while the ones that maintained their payouts still got hit because investors anticipated a cut.

For dividend investors, the path to good returns at a reasonable risk is not the highest yield, but rather a portfolio of dividend-paying stocks trading at or below what they’re worth.

Opportunity

Mr. Market is prone to be overdramatic. He doesn’t like a change of trend, and more times than not overreacts to short-term news and economic jolts. As a result, every crisis and meltdown brings with it opportunity driven by overly conservative profit forecasts and low valuations. When profit turns up, price-earnings multiples usually follow, which makes for a powerful recovery. So don’t waste this oil crisis. There are important lessons to be (re)learned.

February 18, 2015

Thirty-five

Five Lessons From the Financial Crisis

I experienced Black Monday in October 1987 as a young analyst, and grinded through the tech wreck as CEO of a large asset manager. They were bad but turned out to be preseason games compared to the fall of 2008.

It wasn't plummeting stock prices that makes me say that, although the declines were precipitous. Nor the fact that I'd just co-founded an asset management company. No, it was because the foundation of the capitalist system was crumbling underneath us.

Iconic investment firms that just weeks before were strutting their stuff suddenly were going down (Lehman Brothers) or being sold for scrap (Bear Stearns, Merrill Lynch). Many banks were bankrupt and trust in the financial community had vanished. Nobody knew who was solvent — "If I can't deal with Lehman, who can I deal with?"

The fallout was huge, to say the least. With banks and bond investors in crisis mode, credit dried up and companies needing short-term funding were shut out. The biggest industry of all, North American autos, needed a bailout.

There's much to say about this remarkable period. I'm going to hit on a few things that remain imprinted on my brain.

'Limited downside' is an overused phrase

In good times, we're prone to fooling ourselves about how much downside risk there is. "The stock may go down, but it won't fall far." The reality is that if profits go down and/or weren't sustainable (as was the case with investment dealers and banks prior to the crisis), earnings forecasts can go down a lot.

If price-to-earnings multiples also drop to reflect weaker growth and failing confidence, there's a double whammy — lower valuations on lower earnings — which makes for big price declines. Investors benefit from this on the way up (higher multiples on higher earnings), but have trouble visualizing the possibilities in the rarer down periods.

When there's a lack of transparency and plenty of leverage, proceed with caution

When the crisis hit, it became apparent the mega global banks, which are levered by nature, were black boxes. Nobody really knew what was inside. We learned that when there's operating and/or financial leverage, cash flows need to be predictable and visible.

This lesson extends beyond financial companies. Valeant was a high flyer that came back to earth when earnings weren't real, the valuation shrunk, and the debt load became unmanageable.

The strong get stronger in times of stress

Profitable, well-financed, non-financial companies came through the crisis with flying colors. Sure, their stocks went down, but they didn't need to dilute their shareholders or borrow at usurious rates to weather the storm. Ultimately, their outlook improved as weaker competitors struggled or disappeared.

Down markets translate into higher future returns

In the depths of despair, I heard many investors say they no longer expected much from their stock portfolio. This couldn't have been further from the truth.

In bear markets, stocks go down considerably more than the prospects for the underlying businesses. There are exceptions but, with a diversified portfolio, investors should be increasing their return expectations, not lowering them. Shelby Davis once said, "You make most of your money in a bear market: you just don't realize it at the time."

Easier said than done

What struck me most about the crisis, however, was how fertile a setting it was for making serious investment mistakes. Weak markets are wonderful for long-term investors because stocks are on sale, but in the heat of the moment it's extremely hard to do the right thing.

In late 2008 and early 2009, many investors sold stocks or got out of the market completely. They couldn't afford to lose any more. Very few of them got reinvested in a timely manner. Indeed, the hangover from the crisis persists today.

Since that time, I've done two things in particular to prepare clients and myself for the tough, gut wrenching decisions. First, I never say 'if' a fund goes down. It's always 'when.' And second, I leave room to buy more. I don't want my cash and risk budget used up when I really need it.

I'm fully prepared to go through more bear markets and recessions. I just never want to go through another financial crisis like we had ten years ago. One was enough.

September 17, 2018

Part VII

What it All Comes Down To — Returns

Thirty-six

Here's Where Your Investing Returns Really Come From

When markets are good, advisers and portfolio managers get too much credit for investment returns. Clients are happy that their nest egg is growing and attribute their good fortune to their provider.

Conversely, when markets are bad, investment professionals take the heat. Whether it's fair or not, it happens a lot.

I've been thinking about this because we started our firm in 2007. I know, it wasn't great timing, but the good thing is that most of our clients joined us after 2008. They've had an uninterrupted string of positive returns since they joined and many have credited us with undue brilliance.

My point is, before you praise or criticize, it's useful to understand where your portfolio returns are coming from. Below, I'll lay out the basic sources of return in the order of importance.

Markets

How bonds and stocks are doing is the single most important determinant of how well you're doing. No matter if you have an indexed portfolio or are pursuing active strategies, the direction and magnitude of your returns will be driven by the markets. Your stocks and equity funds won't be up when the markets are down (and vice versa) except in rare and temporary circumstances. Similarly, your fixed-income holdings won't buck the trends in interest rates and credit spreads, no matter how unique your approach is.

Asset mix

You can't control the markets, but there are things you can control. The biggest lever you have for balancing return and risk is your asset mix. Your portfolio's blend of asset types — cash and GICs; bonds; stocks; and real estate — should fit your goals, time frame, risk tolerance and personality.

Cost

The cost of investing is always important. Research has repeatedly shown that the most consistent differentiator between investment approaches is cost, with low fees being the winner. In the 2 per cent interest rate world we find ourselves today, the impact of fees, commissions and administrative charges is magnified.

Security selection

Being an old stock analyst, it kills me to say this, but security selection, whether it's done by a professional manager or yourself, comes in a distant fourth on the list. The latest hot stock gets all the attention, but in the grand scheme of things, its impact is limited.

This lower placement assumes that the portfolio is reasonably diversified across geographies and industries. If, on the other hand, it's characterized by a limited number of large, thematic bets (i.e. precious metals; Canadian banks; REITs; technology; or cannabis), then the stock picks increase in importance, for better or worse.

The wildcard

At this stage, my nice, tidy list gets messier. That's because the fifth source of return can be slotted in anywhere. It depends on you. Your behaviour can be an important swing factor. If your actions show discipline, patience and courage (when needed), this item is at the bottom of the list. Your returns will come from markets, asset mix, cost and to a small extent, the securities you select.

Conversely, if you don't have a plan, are inclined to make frequent changes and ignore the cost side, your conduct moves to the top of the list, usually with negative implications. The size, frequency and timing of your moves could overwhelm the other factors.

I started by saying that investors give their investment professionals too much credit, both good and bad. That's true, although the industry has contributed greatly to the situation. We get too much credit because we take too much credit. You've heard it said many times, "Your good results are because of me. The bad ones? Oh, it was the market."

In assessing your provider, it's important to go beyond your initial reaction — Am I up or down this year? You must look at your results in relation to the market environment and your asset mix. Service and responsiveness should be factored in, as well as cost. And finally, the biggie — is your adviser or portfolio manager helping you to be a better investor — informed, disciplined, patient and courageous?

May 7, 2018

Thirty-seven

Beware the Love Affair With Short-term Results

"Tom, I'm going to be in Vancouver. Can I come in and discuss how we're managing low volatility equities? So far this year, the portfolio is up 14 per cent, and it's 5 per cent ahead of the composite over the last year."

This is an actual voice-mail message from a money manager who wants to manage a fund for us. Unfortunately, this individual couldn't have done a poorer job of piquing my interest. His teaser was guaranteed to turn me off.

It never ceases to amaze me how an industry filled with intelligent, well-trained people can spend so much time talking about short-term returns and market moves. Investment professionals do it even though when pressured they'll admit that what a security or portfolio does over a week, month or quarter is meaningless. It amounts to an inconsequential squiggle on a long-term chart.

It's one thing to report on how a fund or portfolio has done over the last quarter (it's expected), but quite another to present it as being important. Returns of less than one year can in no way be attributed to a brilliant or flawed strategy.

"Short-termitis" is not limited to those working with individual investors. In institutional presentations, I regularly see multiple pages of performance attribution, showing in detail which stocks and industry sectors contributed to the three-month return. The uselessness of these pages is regularly revealed when the stocks that led the way one quarter show up on the other side of the ledger the next quarter.

What makes short-termitis worse is when it's combined with "best number" syndrome — advisers and portfolio managers chronically emphasize the most favourable returns on the page. This means talking short-term when those numbers are good and long term when the short term is poor.

The best-number approach is intellectually dishonest, and more importantly, it distracts clients from what they should be focusing on — strategies and returns that match up with their objectives. Most clients, even those well into retirement, are long-term investors (money that has a time horizon of just a few quarters should be in a savings account at the bank, not invested in the stock market).

This best-number practice also hurts the adviser's credibility. Clients aren't always well informed, but they're not stupid. They pick up on it when their adviser or manager is jumping around from meeting to meeting.

Why is the investment industry so bad at this? (There are many exceptions of course.)

In the case of short-termism, it's partly because the clients take us there. In this instant gratification world we live in, clients want to know what we've done for them lately. "I was down last quarter. What's that all about?"

But there are other reasons. For one, we fall in love with our attribution software. With the push of a button, we can generate a wall of numbers. It's impressive, even if it's meaningless.

And of course, human nature points us toward the positive and away from the negative. We always want to put our best foot forward.

So if the wealth management industry can't help itself, what can you do to protect yourself from short-termitis and best-number syndrome?

In general, you need to stop letting your advisers and portfolio managers get away with it. That means taking a more active role at your review meetings.

"I see my return from the last year was quite good/bad. Am I on track to achieve my long-term objective?"

"How much of the return was from the market and how much was our execution? How would I have done if I'd had an index portfolio?"

"What is the long-term record of this strategy/fund?"

"What are the prospects for returns over the next five years based on my asset mix and your view of future market returns?"

It's going to take a while to find a cure to these afflictions, but I look forward to the day when I get the following message on my voice mail. "Tom, our short-term numbers suck, but I think you'll be impressed with how our philosophy and process has created wealth for our clients over the long run." A bit of a mouthful, but very effective.

May 27, 2015

Thirty-eight

Time to Ask Yourself Some Uncomfortable Questions About Your Portfolio

What a year 2013 was. Everybody's portfolio was up (or almost everybody), and most were up a lot.

It was an unusual year, but not only because of strong returns. For Canadian investors, a barbell shape may best describe the 2013 results. On one end, there's a large group who had balanced portfolios that were fully invested in the market and had a healthy allocation to foreign stocks. They did well – double digit returns for sure.

At the other end, there's a group who pursued less diversified strategies, many of which worked well in previous years, but were less fruitful in 2013. I'm referring to investors who had concerns about the macro-economic picture and kept lots of cash on the sidelines. And investors who, for comfort reasons, owned mostly (or solely) Canadian stocks, for which the results were mixed.

I can't draw the barbell definitively, but there's no doubt Canadian investors went into 2013 with too much cash and a strong home country bias. Monthly income funds, which are invested in Canadian securities only, are amongst the largest mutual funds in the country, and most portfolios holding individual stocks are heavily tilted towards Canada, with only a sprinkling of U.S.

The reality is, 2013 will be a just blip on your long-term growth chart five to ten years from now. The important question is: How has your portfolio done over the long term?

Normally, five years would be a reasonable period to assess this, but that's not the case today. Money managers will be trotting out some fancy five-year returns when they report to clients over the next few weeks, but unfortunately, these numbers represent only one side of the market cycle. Five-year results no longer include 2008.

To do a 'full cycle' assessment, you'll need to look at how your investments have done over a 7- to 10-year period, or longer. After all, it's the round trip that matters.

It's more difficult to get your hands on longer-term returns, but not impossible. If your investment manager or advisor doesn't show these numbers on their year-end statement, you should ask for a performance analysis. After all, they've been hired to help you achieve your long-term goals, which will involve lots of good and bad years. They must be able to show you how you're doing on that journey.

The most important part of your assessment, however, involves looking in the mirror and doing an honest, perhaps uncomfortable assessment of how you (the client) has done. You should be merciless in peppering yourself with questions.

Have I got an asset mix target and a strategy to implement it? Do I routinely assess my advisor or investment manager on service, fees and performance, and hold her accountable?

Did uncertainty around U.S. government finances shake me out of the market in 2010, 2011 or 2012? Did I avoid European stocks because of alarming headlines, or buy into the weakness?

After the 2008 crisis, did I max out on my RRSP contribution, or skip it that year? In a search of a quick fix, did I load up on bullion funds, dividends, Kevin O'Leary, covered calls, REITs or guaranteed income funds, or did I carefully assess each of these 'must have' trends to see how it fit into my overall portfolio?

And finally, the hard ones. Which did I spent more time analyzing — my portfolio or my cell phone plan? And if I'm really honest with myself, did my behavior help or hurt returns?

Since 2008, we've had a great ride. Unfortunately, not everyone got on the bus and of those that did, some got off a few stops too early. The last two years have highlighted the need to have a plan, and a strategy for implementing that plan in a disciplined and diversified way.

January 15, 2014

Thirty-nine

Don't Let a Juicy Yield Distract You From Overall Returns

You're getting ready to retire. For decades, you've been making contributions to your RRSP and TFSA with the purpose of building up a nest egg. Growth was the priority. Now, it's time to shift gears. You'll be drawing an income from your investments, so the focus will be on capital preservation and income.

But wait. Being a retired investor is even harder than that. You're hoping to live another 30 years, so you've also got to protect against inflation, and maybe even grow your capital. What is the priority? A steady flow of income or higher long-term returns?

For most retired investors, the answer is simple. It's all about yield. Holding bonds and structured products that have attractive payouts, and dividend stocks like banks, utilities and REITS.

But in my view, this unquenchable thirst for yield can go too far, resulting in undiversified portfolios and a lower total return (interest, dividends and price appreciation). I'm going to focus on the return aspect here because I see too many instances where people have chosen (or been sold) products that clearly sacrifice their long-term returns for the sake of a higher yield.

There's a great example of this in the ETF arena. BMO offers two almost identical ETFs – the BMO S&P/TSX Equal Weight Banks Index ETF (ZEB) and BMO Covered Call Canadian Banks ETF (ZWB). ZEB is super simple. It holds six Canadian banks in roughly equal proportions. ZWB owns the six banks, but also writes call options against them to generate a higher payout. Its yield is currently 5.2 per cent compared to 3.3 per cent for ZEB.

The extra yield sounds great, but there's a hitch. Over the five years ending Aug. 31, the covered call ZWB had an annualized return of 11.3 per cent (including distributions and price gains). Impressive, but the uncovered ZEB earned 13.2 per cent. Now, five years is a relatively short period and it doesn't include a bear market, when covered calls may lessen the downside, but it shows how a focus on current income can be detrimental to wealth generation.

BMO also has 'twin' ETFs that invest in utilities and the Dow Jones Industrial Average. They show the same pattern. The covered call versions offer higher yields but have produced lower returns. I'm not privy to the specific reasons for the shortfall, but I do know that there's no free lunch in the options market. It's dominated by sophisticated players who have yet to find a new, magical source of return. The reality is, in exchange for the premiums received for selling call options, there's a give up — the stocks' price appreciation is cut short.

For retirees, the hardest part of investing is generating a reasonable return with limited downside. Extracting income from a portfolio is the easy part. And yet, products designed to feature income, with elegant strategies like covered call writing and T-series funds that return capital tax-free, abound. It's revealing that in the case of BMO's twins, the covered call ETFs are all larger than the straight-ahead versions. But that's not where your focus should be. You're looking for more balance between your short and long-term needs.

On the investment side, that means holding a broadly diversified portfolio that has exposure to different types of securities from a range of geographies and industries. The asset mix should fit with your goals and risk tolerance. If you have a strong affinity to yield, your portfolio can be tilted toward higher yielding securities, but do so judiciously. Don't go overboard.

As for income, start by setting up your accounts so you're receiving cash from everything you're being taxed on. That means taking interest, dividends, fund distributions and RRIF payments in cash, rather than having them reinvested. If that's not enough to support your lifestyle, then set up an automatic monthly withdrawal to provide a top up.

Investing is all about tradeoffs. Risk versus reward. Short-term versus long. Your best interests versus your advisor's. When it comes to your portfolio, it's total return that counts, not just yield. Earning 5 per cent per year with irregular payments of 2 to 3 per cent is better than earning 3 per cent with a smooth, monthly income of 5 per cent.

September 25, 2017

Forty

Why You Shouldn't Let Recent Performance Dominate Your Investing Decisions

"Past performance is not indicative of future results."

This warning label is required for investment products, but like the ones on cigarette packages, it's rarely heeded. In fact, it's quite the opposite. Past performance, or more specifically, good recent returns, are like a magnet for investors. They overwhelm the other factors that should go into a purchase decision such as quality of the people and firm, investment approach and fee.

If the label is to be believed and the past doesn't predict the future, why does performance carry so much weight?

The main reason is that outstanding recent returns are hard to ignore. Fund managers who are riding high look smarter. Their words, body language and the suit they're wearing oozes it. The fear of missing out is overwhelming.

To fight FOMO, my partner, Salman Ahmed, and I select and monitor fund managers using an analytical framework called the 7 Ps. We look at People, Parent (organization and ownership), Philosophy, Process, Price, Performance (long term) and Passion. The last one refers to the fact that

I prefer to hire geeks who live and breathe the portfolio rather than portfolio managers who are more media-friendly and have extensive marketing duties.

It's important to remember that active managers go through cycles just like the stock market. An excellent 10-year record will include three to six subpar years. This makes it tricky to use short-term returns as a decision criterion. The Ps approach, in my view, is a better predictor of future results, although it's hardly foolproof.

In the institutional arena, pension and foundation committees use similar criteria, although if recent performance isn't near the top of the charts, the other 6 Ps don't usually win the day. Managers almost never get hired when they're going through the down part of their performance cycle.

The pattern is the same when it comes to managers being fired. The decision is overwhelmingly based on recent returns. Managers who are performing well are rarely let go, even if a key person leaves, the firm gets sold and changes direction, or the decision-making process changes. But a poor five-year return is often enough for a committee to fire a manager and hire another who has done better over that period.

But is five years long enough? Disappointingly, the answer is, it depends. A performance drought may feel like it's gone on forever, but what really matters is how the manager or fund has performed over a full cycle — i.e. good and bad markets.

Consider our current circumstance. We're in a 10-year bull market that's been fuelled by a few persistent themes. Interest rates have been low and/or declining. Debt markets have been strong. The U.S. stock market has consistently smoked the rest of the world. And growth stocks have had an extended period of superior performance compared to value stocks. It's hard to assess how a manager or fund will do through all seasons when there hasn't been a severe winter in a decade.

In my past life when I was working with pension clients, the best relationship I ever had was with a committee that selected our firm when we were going through a tough period. When I voiced surprise that we'd won the mandate, I was told they really liked the firm, the people and the long-term returns. They viewed the recent lull as a great opportunity to get in. By the time the paperwork was completed, and money invested, our performance was on an upswing and a lasting relationship had been established.

I'm not suggesting that you should avoid a manager or fund because the last few years have been good. Not at all. But you need to guard against the tendency to chase performance. Your odds of long-term success (all seasons) improve significantly if you have other good reasons for investing. Those other reasons will come in handy when the inevitable weak, 'not-so-smart' period hits.

April 22, 2019

Forty-one

The Key to Being a Successful Investor is Long-term Strategy

Gillian Tett, a columnist with the Financial Times of London, wrote a piece three years ago that I tucked in my "Reread" file. I dusted it off this week.

The article referenced the late Pierre Bourdieu, a French intellectual who was of the view that it's not just what we discuss in public that matters, but what we don't discuss that's really important in terms of reinforcing the status quo. He said, "Subtle cultural signals reproduce the position of the elite ..."

This is heavier stuff than I normally contemplate, but it relates well to my more mundane world of investment management. There are topics that keep repeating themselves — what Mr. Bourdieu calls the Universe of Discourse — that serve to entrench the industry's social and political hierarchies, but do little to enhance investor returns. Indeed, they likely hurt returns.

Our current Universe of Discourse is heavily reliant on economists and their predictions, with the ones who have been most accurate recently having the loudest voices. There is no differentiation between skill and luck, nor is there accountability for previous forecasts.

The Discourse places importance and urgency on short-term events and returns, most of which are forgotten weeks or months later. There's also a predisposition to provide simple explanations for complex events — a cause for every effect. The result is a pulsing desire to adjust our investments to what's going on in the world. To take action.

To be successful, however, investors need to think beyond the established Discourse and focus on what's important to them. The urgent news, short-term market moves and zigs and zags of the economy should be on the radar, but it's the undiscussed and undisputed that has a more profound impact on investment returns, and needs to be deeply understood.

In my view, the following concepts don't garner enough coverage.

Investing based on short-term strategies and forecasts is futile.

Outfoxing the market can work for a while, but doing it consistently is impossible. The world is complex and unpredictably interconnected, and too many variables are hidden in the shadows. And importantly, frequent trading doesn't cash in on the biggest advantage most investors have — a long time horizon.

Time and risk are at the core of investing.

Time is required to unleash the power of compounding — Albert Einstein's eighth wonder of the world. It allows investors to earn returns on their returns. At our firm, we often witness the wonder when long-standing clients are surprised by how much money they've made from earning high-single-digit annualized returns.

And time is inextricably linked to risk. For long-term investors who are well diversified, loss of capital is not an issue, nor is short-term volatility, although both feature prominently in today's discourse. An investor's true risk is the possibility of not achieving a reasonable long-term return.

Valuation is way more important than central bankers, politics and capital flows.

While investors watch the market's every move and hang on economists' every word, the best predictor of medium-term returns for bonds is the level of yields, and for stocks it's price-to-earnings multiples. Admittedly, valuation measures are just as useless at predicting short-term market moves as dissecting the Federal Reserve's meeting minutes or Donald Trump's utterings, but they're quite reliable when investors choose to look further out.

Rarely discussed is the fact that the interests of the wealth management industry are not the same as the clients.

Warren Buffett said it best: “Wall Street makes its money on activity. You make your money on inactivity.” Corporate growth strategies and compensation schedules are all about activity — new products, sales campaigns and strategy shifts. In the meantime, investors’ most effective option, most of the time, is ‘do nothing.’

And finally, emotion is the most consistent crippler of portfolio returns.

Yes, security selection and fees are important, but they pale in comparison to the impact that investor behaviour has. That’s because investing runs against human nature. We’re wired to buy high and sell low. As a result, changing direction at market extremes and/or abandoning the plan when it’s needed the most are all too common occurrences.

Investors need to develop a plan that takes an appropriate amount of risk, absorb the bumps along the way and take full advantage of a time horizon that is far beyond what the Universe of Discourse ever contemplates.

March 24, 2016

Tom Bradley is the Chairman, Chief Investment Officer and co-founder of Steadyhand Investment Funds, a low-fee money manager that serves individual Canadians. He holds an MBA from the Richard Ivey School of Business and has over 35 years experience in the investment industry. Tom has worn many hats throughout his career, working as an equity analyst, institutional portfolio manager, and CEO of one of the country's largest investment firms. Tom is an enthusiastic and unrestrained participant in the investment industry's dialogue through his blogs, articles in Canada's major newspapers and speeches to industry groups.

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