

- Client Information Summary -

Investment Planning Concerns and the Principles of Investment Management

Many people are apprehensive about the various issues that confront them when it comes to investment management. Due to lack of time, interest, or specialized knowledge, most people make investments that are *comfortable* rather than investments that are *appropriate*. Continuing this approach on a long-term basis will invariably lead to disappointing results.

Must Suit Personal Goals – Yes, comfort is important. You do need to be able to sleep at night. Thus, it's important to consider your sensitivity to risk before making any investment. Equally as important, investments need to be appropriate. They should be appropriate in terms of being compatible with an investor's personal goals, age, and investment time horizon.

Too often only the comfort factor is considered which can lead to an investor finding out too late in life that the investment made for 20 or 30 years, were not appropriate! In most cases, the solution is to start by developing a basic understanding of the many components of risk.

Understanding Risk - What is risk anyway? When an investor says, "I don't want to take any risks", what they usually mean is they want to be certain that they will get back their capital, as well as some return on their money. At first glance, this does not seem to be asking too much, does it? However, the truth is, *there is no such thing as a risk free investment*.

Risk, properly defined, is the degree of uncertainty of achieving an expected rate of return. Thus, as you would expect with all other factors being equal, there is normally a direct link between the degree of risk (uncertainty) perceived and the expected rate of return. As the perceived risk increases, one normally might expect to receive a correspondingly higher rate of return. Most of us would concur, however, often missed is the fact that risk has many components and can wear many disguises. Sometimes we are exposed to risks of which we are totally unaware.

Consider, for example, the risk involved in the most common form of investment for most Canadians—Guaranteed Investment Certificates (GICs). Where is the risk, assuming that it is CDIC insured? The exposure to risk is quite subtle, which is why most of us are not consciously aware of it. The risk in this case is what is referred to as *loss of purchasing power* caused by inflation.

To illustrate the point, let's suppose that you retired in 1980 with \$500,000 in capital—to supplement your government benefits and pension income. Let us further suppose that upon retirement you had to spend \$26,000 per year of your money to supplement your income. Due to inflation, each year you had to withdraw more of your money in order to maintain the same standard of living. What you may have found especially appalling was the fact that you had to withdraw so much extra each year to pay your taxes (assuming all your money was invested in GICs). How much capital would you have had left 20 years later? The bad news is you are broke. Your \$500,000 is gone. Even though you received an average return of 9.26% over this period of time on your investment, inflation has eaten your capital. The chart below details what happened to your \$500,000 over the years.

As you can see by studying the left side of this chart, when you buy only GICs once we subtract taxes and inflation, your money is actually shrinking.

Thus, we once again must come back to the fact that *there is no such thing as a risk free investment*. Every investment exposes the investor to one or more of the components of risk. In this case the risk was—*loss of purchasing power* by inflation.

There's No Such Thing as a Risk Free Investment

Year	GIC Investment			Withdrawal To Supplement Pension ⁽¹⁾	Equity Investment		
	Interest Earned ⁽²⁾	Withdrawal to Pay Taxes ⁽³⁾	Balance of Capital		TSE and S&P 500 ⁽⁴⁾	Withdrawal to Pay Taxes ⁽⁵⁾	Balance of Capital
			\$500,000				\$500,000
1980	\$61,800	\$38,267	497,533	\$26,000	\$159,525	\$74,083	559,442
1985	52,569	27,778	475,740	37,159	181,495	71,927	644,229
1990	44,516	21,470	375,671	46,261	(66,661)	(24,113)	542,748
1995	14,622	7,776	181,360	51,485	116,959	46,649	467,805
1996	9,286	4,938	133,193	52,515	119,992	47,859	487,424
1997	6,420	3,414	83,211	52,988	118,712	47,348	505,800
1998	4,577	2,243	31,550	53,994	57,953	21,293	488,452
1999	1,931	927	(22,898)	55,452	111,856	40,268	504,587

(1) Increased each year to match the historical increases in the CPI.

(2) Interest earned is based on historical GIC rates.

(3) Taxes based on historical top marginal tax bracket for the Province of Ontario.

(4) Illustrates the dollar value of increases or decreases based on 50% TSE 300 and 50% S&P 500.

(5) Estimated taxes based on historical marginal tax rates and 75% of the capital gains being taxable. Minuses based on credits for losses.

The component of risk that many investors fear the most, however, is the fluctuation in value of an investment referred to as *variability*. The paradox is that investments which are the most variable (like equities) have, over long periods of time, provided superior returns in comparison with those which are fixed in value. Before going further, let's consider why this is so.

When you invest your money in a GIC, you are really loaning your money to the financial institution. They pay you *rent* (interest) on the use of your money. (Incidentally, the financial institution re-loans your money to someone else for a higher rate of interest, and makes their profits on the spread between what they pay you and what they charge to someone else).

Buying a GIC is not a lot different than buying a government bond, in which case you are loaning your money to the government instead of the financial institution. In either case, there is a promise to pay your money back (plus interest) at maturity. GICs, bonds, and even mortgages are all referred to as *debt investments* simply because the promise to pay your money back is evidenced by a debt—the GIC, bond, or mortgage document.

While the value of these *debt investments* can vary prior to maturity, at maturity the value is fixed or guaranteed. Debt investments are also called fixed-income investments because, at maturity the amount of capital you receive back is *fixed*, plus any accrued interest.

Equity investments, on the other hand, are never fixed in value because they represent a share of ownership in something. For example, common shares represent ownership in a company. An *equity fund* (composed of common equity in many companies) represents a share of ownership in many companies. Over the long term, in a free economic system, the rewards of ownership (owning equity investments) historically have been greater than the rewards for loaning money.

That is why you hear "It's better to be an owner, than a loaner". Conversely, the risk (the uncertainty of achieving an expected rate of return) is also greater because the value of equity investments will fluctuate. The fluctuation in value is a component of risk known as *variability*. Is there also a risk of *loss of capital* with equity investments?

Certainly, if the company goes broke the shares become worthless and you are out in the cold. However, the same can happen with a debt investment; if the borrower goes broke your debt investment becomes worthless (unless there was some other form of security). Thus, assuming that we are dealing with equity investments in established companies (Bell Canada, Coca-Cola,

etc.) there is little risk of total *loss of capital* compared to investing your money in a GIC. The more relevant component of risk to consider in this case is variability, or fluctuation in value. The value of your equities will always go up and down.

Inflation is a Long-term Risk – What most investors fail to recognize is that variability is actually a short-term risk, and inflation is a long-term risk. To illustrate this point, let us now consider a similar example of someone who invested \$500,000 in a good quality equity fund in 1980, assuming their income requirements were the same as our person who invested in GICs, as inflation is the same for everyone. The withdrawals for tax would have been somewhat less, as historically; legislators recognize that there must be some incentive for owners (versus loaners). The benefit in this case is, less tax. Dividends and capital gains (the rewards of equity investment ownership) have always attracted less tax than interest income (the rewards of debt investment ownership). In fact, historical analysis shows that money loaned to a bank in the form of a term deposit would have achieved a better return if the investor instead had purchased shares in the bank, thus owning equity in the bank. This would be true measured either on a pre-tax or after-tax basis.

Real Rate of Return – You will note that unlike the GIC capital, which did not fluctuate in value but was simply a little less each year due to the regular withdrawals, the value of the equity investment fluctuated each year. The proper benchmark for measuring long-term investment results is real rate of return, calculated as the actual rate of return less the rate of inflation. Over the long run, the money invested in equities provides a much better real rate of return. In fact, as the previous chart shows, after 20 years we still have our original capital plus \$4,587.

Variability is a Short-term Risk – Have equities always provided a better real rate of return than fixed income investments? Looking at recent history, going back 49 calendar years (from 1950 to 1998) and examining all 469 10-year periods (i.e. 1950 to 1959; 1951 to 1960, etc.), equities have outperformed debt investments 78% of the time. Even when you examine the 577, 1-year periods over the same time horizon, equities did better than debt 66% of the time. (Source: '98 Andex Risk/Return for Canadian Investors) Thus, the conclusion is simple—variability is a short-term risk.

The degree of variability from the average historical return of any investment or class of assets is measured by a statistical measurement called volatility. An investment with a low volatility rating would have historically fluctuated to a lesser degree than an investment with a high volatility rating. Accordingly, two different investments may have the same average long-term return but different volatility ratings. The lower the volatility the less of a roller coaster effect on values.

Components of Risk –In addition to loss of purchasing power (inflation) and variability, there are many other components of risk. While we will not consider all of them here, it is important to at least be aware that they exist.

Many investors will discover at some point that investments with which they were most *comfortable*, were not really the most *appropriate* for their situation. In fact, most of us cannot accumulate enough wealth during our lifetime by simply relying on "setting aside savings" during our working career. Therefore, it is important for us to seek the greater long-term rates of return provided by quality equity investments to make our money last longer.

Conversely, those of us who have accumulated (or inherited) enough money to withstand the long-term impact of inflation would be foolish to let the purchasing power of our money get eroded through the years. It makes sense to "do something", if just for the sake of our beneficiaries.

Additional Components of Risk

- Risk of *loss of capital* (asset value permanently decreased)
- Risk of *variability* (increases and decreases in asset value)
- Risk by *industry* sector
- Risk of *currency fluctuation* (on international investments)
- Risk of *marketability* (lack a secondary market for trading)
- Risk of *poor results* (selection without research/advice)
- Risk of *loss of purchasing power* (inflation)
- Risk of *economic cycles* (growth in GDP/recession)
- Risk by *geographic or political regions*
- Risk of *liquidity* (ease to convert to cash)
- Risk of *reinvestment* (lost opportunities while invested and limited opportunities at maturity/disposition)

Once recognizing that there is no such thing as a risk-free investment and that each type of investment exposes us to one or more components of risk, it is important to *manage risk, and prosper by the process*.

Managing Risk and Prospering – Managing the risks of variability and loss of purchasing power is best accomplished by diversification, maintaining a fixed asset allocation and adherence to proper due diligence. Each of these factors in managing a portfolio will now be considered in more detail.

Diversification – Diversification simply means "not putting all of your eggs in one basket". Diversification can be applied in several ways. One example is diversification among various asset classes that allows an investor to hold assets that may fluctuate in value in opposite directions. An investor could allocate his investments among a variety of different assets classes, such as: cash, Canadian fixed-income, international fixed-income, Canadian equities, U.S. equities, international equities etc.

While an investor with limited investment assets may have trouble achieving adequate diversification through direct ownership of different asset classes, acquiring these assets through an asset management service or mutual fund makes diversification possible for even the smallest investor. For example, a portfolio for an investor with just \$50,000 might look as follows:

An Example of a \$50,000 Balanced Portfolio:

Amount:	Asset Class:	Holdings Within Fund:
\$ 5,000	Canadian Cash	T-bills
10,000	Canadian Bond Fund	High quality government and corporate bonds
5,000	International Bond Fund	High quality international bonds
12,500	Canadian Equity Fund	Shares in established Canadian companies
7,500	U.S. Equity Fund	Shares in quality companies in the U.S.
10,000	International Equity Fund	Shares in quality companies throughout the world.

The use of an asset management service or mutual funds also makes it possible to achieve *diversification within diversification*. For example, with only \$12,500 invested in Canadian equities, rather than all the money being invested in one or two stocks (as you would have to do if you structured your own portfolio), your \$12,500 would be invested through the asset management service or mutual fund in perhaps 40 or more quality companies.

Maintain a Target Asset Allocation – This approach involves maintaining a pre-determined portion of the portfolio in a variety of different asset classes. Balance is maintained in the portfolio by selling some of the investments from the asset classes that exceed their target percentage and, conversely, buying more investments in the asset classes that drop below their target percentage. This in effect forces the investor to buy low and sell high.

By looking at the historical rates of return for various asset classes over many decades, it's possible to project the potential return the portfolio will produce on a long-term basis. If the cash equivalent, Canadian fixed-income and international fixed-income components in the portfolio were increased, the potential return would be lower. Alternatively, by increasing the equity components (Canadian equities, U.S. equities and international equities), the potential return would increase. Increasing the equity component in a portfolio provides the patient investor with a potentially higher return (reward) for accepting the higher degree of fluctuation in value (variability).

It cannot be over emphasized that variability is a short-term risk. By maintaining a target asset allocation, the variability is continually moderated through diversification. This can result in a higher average return over the long-term, with only a moderate risk over the short-term. Ultimately, the key in developing a target allocation that will best meet an individual investor is the individual's personal goals and regard for their risk sensitivity.

Due Diligence – Rewards may be improved by the deliberate selection of quality assets within a specific asset class. That is, just to buy an equity fund because the market has dropped is not a good enough strategy to provide improved returns. It is important to have a well-defined process for selecting investments with intrinsic value.

For many investors, due diligence is the most difficult aspect of the whole investment process. This, of course, is not surprising in as much as there are so many investment options available. Thus, we would consider it foolish not to seek the help of professional investment advisors and money managers who devote their lives to the business of identifying superior opportunities and under-valued assets. For most of us it is much easier to pick one advisor than to continually pick good investments. It is also far less time consuming.

PRINCIPLES OF INVESTMENT MANAGEMENT

With a grasp of the various investment planning issues that face each of us, we can now establish some principles to guide our decision-making.

Principle # 1

Develop a Strategic Asset Allocation Strategy and Re-balance the Portfolio when it Deviates from Target – Optimal strategic asset allocation strategy should be based on investment objectives, risk tolerance and prioritized financial objectives. A diverse set of asset classes should be selected to minimize investment risk. The asset mix will determine the long-term risk and return characteristics of the portfolio as a whole.

Principle #2

Build an Investment Portfolio that Minimizes Risk using Diversification and Correlation – Build a well-diversified portfolio since this type of portfolio has the best potential for enhanced returns with less risk over the long term.

Principle #3

Customize your Portfolio to Optimize the Risk-return Trade-off . . . Efficient Frontier – Estimate and control both the type and amount of risk and return in a portfolio based on risk profile, investment objectives and financial objectives. For every risk level, there is an optimal combination of asset classes that have the potential to maximize returns. This is known as the efficient frontier.

Principle #4

Minimize the Risk of Not Achieving Financial Objectives (Shortfall Risk) – Focus not only on investment risks, but also on the financial risk of falling short in meeting financial objectives. In order to minimize this shortfall risk, investors must typically develop a more aggressive strategic asset allocation strategy, or modify objectives.

Principle #5

Recognize the Efficiency of the Financial Markets – It is unlikely that individual investors will succeed in consistently outperforming the market over the long term.

Principle #6

Adopt a Buy-and-hold Strategy and Invest with a Long-term Time Horizon—Do not use a Market-timing Strategy – Don't be tempted to change your asset allocation strategy and don't focus on analyzing and selecting individual securities in an attempt to outperform the market. Market timing and individual security selection is highly unlikely to consistently enhance long-term investment returns. Invest for the long term because it enables the long-term characteristics of the asset classes to come to the fore, since volatility of investment returns is reduced over time. Higher rates of return result when increasing the proportion of equities in a portfolio, but greater variability of returns will also result. (Equities offer the potential for higher long-term investment returns than fixed-income securities, but equities are also more volatile in their short-term performance).

Principle #7

Recognize that the Portfolio is More Important than the Individual Securities – The appropriate strategic asset allocation among different asset classes will have a far greater impact on the long-term portfolio results than the selection of individual securities.

Principle #8

Build a Tax-efficient Portfolio to Maximize Growth of Registered and Non-registered Assets – Recognize the tax treatment of different investments (after-tax returns) and the importance of building a tax-efficient portfolio to maximize the growth of registered and non-registered assets.

In Conclusion

Seeking top quality professional advice shouldn't cost anything. In fact it should pay. A good advisor should identify investments that best match your specific personal requirements.