

# STRONACH'S *Smart Money*

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## Who is Wagging the Tail of Your Investments?

In 2001 Andy Grove (CEO of Intel) submitted an article to Fortune magazine on prostate cancer suggesting that biases existed within the medical profession, making it difficult for those afflicted to clearly understand their treatment options.

He contrasted this confusion with how he felt when he first sought out investment advice. And in his concluding statement, he stressed that you should take matters into your own hands. He advised, "You should not take any one opinion as gospel. Rather, you should undertake the role of a generalist yourself because often the advisor, as well intentioned and competent as he might be, will favor his own financial instruments."

In many ways, I agree that you should take ownership in how your money is being managed. But I believe few investors truly understand:

- What to do with their money.
- What to expect from their investments.
- How to quantify the risk they're taking.

Over the past 3.5 years many inexperienced investors have relied heavily on their advisors to maneuver them through the minefield. Too often they uneasily watched their assets evaporate to a point where their retirement dates have now moved out a few more years.

Andy Grove suggests that conventional solutions to dealing with prostate cancer are the norm and any other treatment is deemed experimental. He states, "Combining the experimental solutions with conventional may prove to be more effective."

This seems to apply to investment management as well. (See Stronach's Smart Money, Fall 2002: Yale University Endowment Fund.) Stocks, bonds and debentures can be considered conventional investments while hedge funds, income trusts and

managed futures are considered experimental. Combining the two, results in lower volatility and potentially higher returns.

The experts claim that money management is effective, as long as you maintain a strict discipline. Venturing away from that discipline can be financially devastating.

Money managers have the advantage of not being emotionally attached to the money – as it is rarely their retirement on the line. And their access to research is not limited to that which the media continues to spew out. Although there is plenty of information available to the general public, much of the advice is either too general or too specific to be applied to most situations.

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***"You need to know your risk tolerance and what your options are before you'll ever be satisfied with your investments"***

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I regularly meet with people who are looking to find a "generalist" who does not sell financial instruments (we do not). But even as a generalist, it is difficult to advise on investment management solutions because you may have had less than satisfactory experiences in the past and/or you may have unrealistic expectations.

My role as an independent financial planner / advisor is to:

- a) Understand your financial situation completely.
- b) Listen to what you like and don't like.
- c) Clarify the realities of investment management and expectations.
- d) Direct you to an appropriate solution.

Often my role is to simply help you better understand your options so you can make well informed decisions.



*by Daniel F. Stronach  
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President*

## The Realities of Investment Management

Investment management is very different from other sciences, in that the returns are not predictable. If you have 2 identical portfolios and you elect to increase say, oil and gas in one, the difference in returns will not only depend on the returns of the entire market, but also on how the oil and gas sector fares relative to the entire market. And the results will not be replicated in the future – so theories are difficult to test.

However, although returns are not predictable, mathematics has enabled investment advisors to predict, with reasonable accuracy, how volatile a portfolio will be – relative to its benchmark (usually an index). In other words, you can control how far your portfolio will drift from the performance of the TSX. And although you cannot predict what the TSX is going to do next, historical data exists

to provide you with a reasonable understanding of how volatile the TSX is. So, ideally you want to design a portfolio which will be less volatile than the TSX without sacrificing significant performance over the long haul.

As an informed investor, you can control your volatility through asset mix allocation, broad diversification and management style.

### Asset Mix Allocation

Portfolio volatility is best managed by adding fixed income (see Stronach's Smart Money, Fall 1997. Why bother with fixed income investments?).

Adding fixed income is more of a mathematical exercise. The more fixed income you add, the more stable your portfolio will be. If you are 80% invested in equities and the market falls 20%, it is likely that your portfolio will fall 15%. With 40% in equities, a 20% decline would result in a portfolio decline of 5%.

Equity Allocation	STOCK MARKET RETURN						
	30%	20%	10%	0%	-10%	-20%	-30%
	PORTFOLIO RETURN						
0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
10%	7.5%	6.5%	5.5%	4.5%	3.5%	2.5%	1.5%
20%	10.0%	8.0%	6.0%	4.0%	2.0%	0.0%	-2.0%
30%	12.5%	9.5%	6.5%	3.5%	0.5%	-2.5%	-5.5%
40%	15.0%	11.0%	7.0%	3.0%	-1.0%	-5.0%	-9.0%
50%	17.5%	12.5%	7.5%	2.5%	-2.5%	-7.5%	-12.5%
60%	20.0%	14.0%	8.0%	2.0%	-4.0%	-10.0%	-16.0%
70%	22.5%	15.5%	8.5%	1.5%	-5.5%	-12.5%	-19.5%
80%	25.0%	17.0%	9.0%	1.0%	-7.0%	-15.0%	-23.0%
90%	27.5%	18.5%	9.5%	0.5%	-8.5%	-17.5%	-26.5%
100%	30.0%	20.0%	10.0%	0.0%	-10.0%	-20.0%	-30.0%

*Fixed income returns are assumed to be 5%.*

To test your risk tolerance, it is easiest to consider volatility in dollar terms. With

\$1,000,000 portfolio and 70% invested in equities, a 30% decline would result in a

loss of \$230,000 – leaving \$770,000 after the tumble. Now how would you feel?

### Diversification

The more stocks and debentures you have, the less volatile your portfolio will be – relative to your benchmarks. This is because certain sectors will perform well in some markets, while others will not.

The trick to diversification, is to find investment sectors and asset classes which

are either not perfectly correlated or are inversely correlated with others. The result will be less volatility.

Although more diversification does not necessarily increase expected returns, studies suggests that as you add asset classes, your risk will decrease without

adversely affecting your returns.

Some asset classes which are often not perfectly correlated with the market thus may reduce your total volatility include, small cap stocks, hedge funds, income trusts and precious metals.

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### Management Style

Some management styles are more aggressive than others. It makes sense that a value style (based on buying stocks inexpensively) will be less volatile than a momentum style (based on capitalizing on the investors excitement). Also, some managers prefer to hold a small number of stocks while others prefer to hold large numbers. The list of investment styles appear to be endless and it is common for investment managers to combine styles.

It is helpful for you to understand which management style best suits your temperament. And if you have a preferred style that suits you, it is important to stick with it. At some point in a market cycle, it is likely that your style will underperform another more-popular style. Right now it appears that dividend paying stocks and value stocks are in favour because they have performed much better than growth stocks. But 4 years ago, investors who chose dividend and value

styles, were anxious to throw in the towel for growth stocks.

Diversifying management styles can be counter-productive because it can transform your portfolio into a portfolio which looks a lot like the index. So, if your portfolio holds several mutual funds which have several different management styles, it would likely be less expensive and more efficient if you bought the index or exchange trade funds (ETF's).

## What is the Solution?

**I** believe the solution is knowing what you're comfortable with. Before you can create a portfolio structure, you need to:

- Understand how much risk you need to assume to meet your objectives. If you don't need to ride the roller coaster, why bother. A market like that we've just experienced can erode a considerable amount of your wealth in a very short time.
- Determine how much risk you're willing to accept. Naturally, the closer you are to retirement, the less risk you should assume.
- Determine what style best suits your temperament.

Once your structure is in motion, you should be able to leave it alone as the market swings.

For several years I have been working closely (but independently) with an investment counselor, TD Quantitative Capital (TDQC).

They appeal to me because they allow us to effectively combine several portfolio components into one structure (some conventional and some sophisticated).

I have written extensively about the Core Satellite Model (Stronach's Smart Money, Fall 1998 and Spring 2000) which is a framework that will allow you to utilize your favorite style while effectively diversifying asset classes.

TDQC is one of a few investment counselors who is flexible enough to implement such a structure. Using an investment counselor enables us to set it up properly (given TDQC's technical competence) and have it re-balanced regularly as the portfolio(s) adjust to the present conditions.

### What makes TD Quantitative Capital so attractive is:

- Their fees are half those of mutual funds.
- They have both active and passive (indexing) management.
- Several active growth models are managed externally – meaning that if their contracted managers don't achieve their expected results, they are replaced.
- They have several active management options (large cap, growth, value, dividend, blue chip, North American, Global).
- They have sophisticated products which can be imbedded in your portfolios, if they make sense (i.e., hedge funds, small cap funds, income trust funds, corporate bond funds, derivative funds for foreign content, real return bonds, index funds).
- The stocks and bonds are segregated. This way your assets are more portable and can be disposed of in a more tax effective fashion.
- They are able to provide tactical asset allocation (i.e., they can increase or decrease the amount of equity you hold in exchange for fixed income – depending on where the advisors believe the market is heading).

Andy Grove found that he could not rely on the experts to tell him what to do. If he had access to a generalist who could help him work through his options and could select a practitioner who was known to have success in that area of expertise, Andy's journey would have been less problematic. Stronach Financial Group is that generalist.

# WHO IS THE STRONACH FINANCIAL GROUP?

Stronach Financial Group has been advising wealthy individuals since 1983.

Our advice does not earn us commissions or finders fees, so this way you get what's best for you.

Rather than managing money ourselves we either work with your existing advisors or will recommend one that we feel will look after your needs and temperament.

We have established working relationships with many prominent financial professionals to ensure you get the best advice available.



FOR MORE INFORMATION VISIT THE STRONACH FINANCIAL WEB SITE: [WWW.stronach-financial.com](http://www.stronach-financial.com)

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