

# STRONACH'S *Smart Money*

Volume 7 Issue 1

Spring 2002

A STRONACH FINANCIAL GROUP PUBLICATION

## DIVERSIFICATION. Does it improve investment results?

From June 30, 1998 to December 31, 2001 (3.5 years) short bonds led the pack with an average return of 6.8% per year. Although Chart 1 (below) does not suggest that anything extraordinary happened during this period, the graph (Relative Performance of Indices) clearly reveals what the fuss was all about – the technology bubble. In comparison, the rest of the markets were seemingly docile during this period.

With annual returns like those shown in Chart 1, it is frustrating to say the least. Many investors can't help but question whether the strategies and advisors they've chosen and are really helping matters. Some have moved out of equities altogether, to curb their anxiety and preserve what they have accumulated.

Part of the problem is that it is very difficult to know whether you are doing well or doing poorly. Most of us only consider nominal returns, as our comparisons are often limited to using mutual fund surveys or GIC rates. But often, we're not comparing apples to apples and decisions can be clouded.

Given the lack of objective advice and the level of complexity in making wise investment

management decisions, your choices are limited to staying with your existing program, changing your investment manager or spreading your investment management solutions around.

changing your risk appetite without fully understanding the repercussions.

To diversify your investment management solutions, mutual funds make it easy. Often it starts with investing in the top performing funds, as it is not uncommon for investors to flock to the leading fund in expectation of continued rewards. But with experience, we soon realize that the best performing funds usually don't maintain their lead for long. So as investors, we either add new money to the funds we already own, or dilute our holdings by allocating to several managers with different management styles.

In the latter case, it is not uncommon to see large portfolios with 20 or 30 mutual funds. But realistically, this much diversification often results in "closet indexing" which means you are actually replicating the indexes (i.e., TSE 300, S&P 500).

If you are over-diversified with mutual funds, you might save yourself a considerable amount in fees by investing in EFT's (exchange traded funds) – or allocating a portion of your portfolio to EFT's.

*continued on page 3*

Chart 1		
Investment Returns		
June 30, 1998 to December 31, 2001 (3.5 years)		
	Total Return	Comp'd Return
Scotia Short Bond Index	25.8%	6.8%
Scotia Mid Bond Index	23.2%	6.2%
Scotia Bond Universe	23.1%	6.1%
91 Day T-Bills	18.6%	5.0%
IFC Emerging Markets	17.6%	4.7%
Solomon Brothers World Bond	17.2%	4.6%
S&P 500	14.9%	4.0%
Nasdaq	11.7%	3.2%
TSE 300	9.9%	2.7%
Morgan Stanley World	5.6%	1.6%
Morgan Stanley EAFE	-2.9%	-0.9%
Canadian Dollar	-8.5%	-2.4%
Trimark Fund	32.0%	8.3%
Trimark Canadian Fund	19.0%	5.1%
Altamira Equity Fund	15.5%	4.2%
Industrial Growth Fund	-7.7%	-2.3%

Changing investment managers may not always yield the best solution, especially if you are only hunting for better results. You may actually be

## Who is Managing your Money?

Viewing money management from our side of the fence has taught us that there is no such thing as the "right answer". In fact, we believe there are many right answers and no one can be certain which solution will be the best moving forward.

As financial advisors, we appreciate that our clients have different views about how they believe their money should be managed. So, rather than dictate our investment preferences, it makes good sense for us to listen to what our clients want and help them make sound investment management decisions. Since we do not sell investment products and services, we are able to shop around to find the best solution(s).

These investment management solutions are very similar in many ways. They all have a structure and are widely diversified. And in most cases the investment manager requires an investment policy statement - clearly defining the client's risk tolerance and limitations. It is assumed that each structure will harvest similar results over long periods of time, but there may be differences from year to year - as some managers may make better picks.

At Stronach Financial Group, not all our clients see money management in the same light as we see it. We tend to have more success with those who are looking to reduce their participation in the day-to-day investment decisions.

Most of our clients are successful people who do not feel their time should be spent mulling over their investments. They prefer having a money manager they can trust and the selected manager is expected to achieve the realistic targets they set. Stronach Financial Group in some cases keeps a watchful eye by providing our clients with objective performance measurement every quarter.

For most clients (with more than \$500,000 of investment assets), we often recommend that they use the services of an investment counselor. With less, we feel a full service broker is your best solution. But there are also hybrids.

*continued on page 2*



*by Daniel F. Stronach  
B.A., C.F.P., R.F.P.  
Personal Financial Planner*

## DIVERSIFICATION. Does it improve investment results? CONTINUED FROM PAGE 1

We prefer investment counselors because their styles are typically conservative, they employ academic portfolio structures and they do not earn commissions. They emphasize maintaining the portfolio structure no matter what the market is doing or going to do. Their management fees are often half of that which you would pay if you use only mutual funds. Their transaction fees are often only a fraction of those you would pay with a full service broker. Finally, with an investment counselor, the tax and administration are very complete – more thorough than with a full service broker or mutual fund.

In terms of investment management styles, investment counselors are not really different from mutual funds. When comparing one equity mutual fund to another, there are many differences. This is true with investment counselors as well.

The main differences between an investment counselor and equity mutual funds is that the fees are usually much higher with mutual funds and you need to invest much larger amounts to diversify investment styles using an investment counselor.

Investment counselors ideally create a "segregated" portfolio of stocks and bonds for each client (which means that you own individual stocks and bonds). Therefore, to adequately diversify and to be able to provide a certain level of service, most require a minimum investment of \$500,000 or more (see Chart 2). If you want to add another management style and prefer to keep your investments segregated, your minimum may increase to \$750,000. Otherwise you could use pooled funds or mutual funds.

Chart 2

INVESTMENT THRESHOLDS – DISCRETIONARY MANAGEMENT		
Type	Institution	Minimum Investment
Segregated Accounts	Investment Counselor	\$500,000 to \$5,000,000
Pooled Funds	Investment Counselor	\$300,000 to \$1,000,000
Wrap Accounts	Broker / Direct	\$150,000
Mutual Funds	Broker / Dealer / Direct	\$500

The advantages to having a fully segregated portfolio are that you have more flexibility with your investments and taxation and segregated portfolios are transferable. Pooled funds are not.

With a segregated portfolio, if you are not satisfied with your investment counselor, you merely transfer the securities over to your replacement counselor without having to sell them. Then you can keep the winners and clean up the losers without creating a tax hassle. Having Pooled funds is not as flexible as segregated securities because they are not transferable. If you wish to move to another institution, you have no choice but to sell everything and take your lumps.

If you are interested in an independent review of your portfolios, please fax or mail the response card on the back page.

## THE FOLLOWING ARE SOME INVESTMENT MANAGEMENT SOLUTIONS WE BELIEVE SUIT THE NEEDS AND TEMPERAMENT OF THE HIGH NET WORTH CLIENT.

### DR. JONES - A FULL SERVICE BROKER.

Dr. Jones likes to be in charge. He wants to be involved with all the buy and sell decisions. His portfolios have a variety of vehicles (i.e., North American stocks, mutual funds, stripped bonds, mortgage-backed securities and trust units).

He actively trades some of the stocks, while with others he has held them for many years. The long term holds have unrealized capital gains which make it difficult for him to sell without tax consequences. His mutual fund holdings are a result of acquisitions over a number of years.

He has worked with his broker for several years and is satisfied with his results. Most investments were suggested by the broker, but Dr. Jones has had the final say.

To keep Dr. Jones informed the broker sends him a monthly e-mail and usually follows up with a call

to discuss what needs to be done and some ideas to make the portfolios better. At year-end they meet to review the portfolios and performance.

Dr. Jones is not sure how much it costs to have his money managed, but feels his results, after expenses, are satisfactory.

### DR. BLACK - AN INVESTMENT COUNSELOR.

Dr. Black wants someone else to look after his money but wants to know what is happening. He has structured his portfolios using a "core satellite" strategy, which employs both an active and passive investment style (see Fall 1998 Stronach's Smart Money). 1/3 is invested in stock indices, 1/3 is invested in actively managed equities and 1/3 is invested in bonds. His investment counselor also provides "tactical asset allocation", so at any one point, he can have as little as 50% in equities or as high as 70% - depending on the manager's economic outlook.

His passive component is invested in pooled funds and his active components are invested in individually segregated stocks and bonds. Stronach Financial Group provides independent performance measurement each quarter. His management expense ratio is 1.0% (including GST).

### DR. SMITH - A HYBRID.

Most of Dr. Smith's assets are invested in mutual funds - at one mutual fund company. Because he has more than \$500,000 at this fund company, they have a special service to help him design an investment structure using their mutual funds. His advisor is like a private banker who is assigned to review Dr. Smith's portfolio annually and is available to look after his investing needs without being compensated by commissions.

Since the mutual fund manager offers several management styles, Dr. Smith's structure has specific weightings in 8 mutual funds (Money

## DIVERSIFICATION. Does it improve investment results? CONTINUED FROM PAGE 2

Market fund, Bond fund, Dividend fund, Canadian Equity fund, US Growth fund, Overseas Equity fund, Euro-Pacific fund and a Balanced fund). We estimate his management expense ratio to be about 1.2% annually (which is unusually low for mutual funds).

Dr. Smith also has an account with a mutual fund broker at another institution and holds a few specialty mutual funds (i.e., gold funds, technology funds, emerging markets funds, etc.). This portion represents no more than 10% of his total portfolio. His management expenses for these investments are much higher (i.e., 2% - 2.5%)

### DR. SCOTT - A HYBRID.

Dr. Scott's money is managed by an investment counselor who does not offer segregated portfolios unless you have more than \$2 million. They use Pooled funds. (Pooled funds are similar to mutual funds except there are no internal management fees. They are added on later, whereas mutual funds charge management fees against their portfolio assets.)

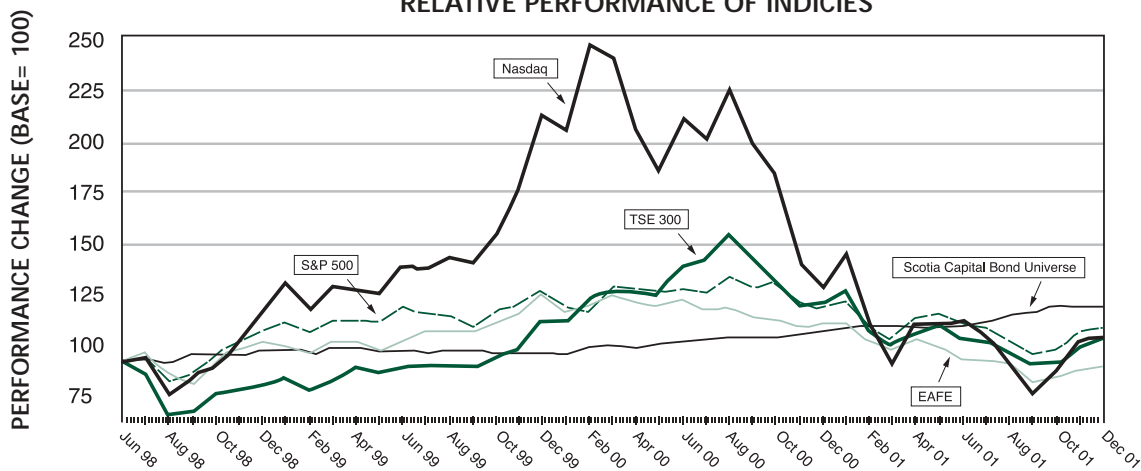
Dr. Scott has an advisor who helped him create the structure and now looks after his investment needs. This investment counselor subcontracts

various fund managers to manage the pools, so Dr. Scott has been able to create a, sort of, fund-of-funds – specific to his portfolio design.

Dr. Scott's structure has specific allocations in 7 pooled funds (Money Market fund, Global Growth fund, Canadian Growth fund, US RSP qualified equity fund, North American Small Cap fund, Dividend fund and a Bond fund). He also has tactical asset allocation on the growth and bond portions of his portfolio. Dr. Scott's advisor is compensated to look after his needs and for bringing in new money. His management expense ratio is 1.25% (including GST).

## Who is Managing Your Money? CONTINUED FROM PAGE 1

RELATIVE PERFORMANCE OF INDICIES



Mutual funds management fees, on average, cost between 2% - 2.5%, while EFT's cost as little as 1% for a comparable bundle of investments (assuming you are over-diversified). So, if you have a \$1,000,000 portfolio, your annual management fees could cost as much as \$25,000. Using EFT's your total management fees would decrease to as little as \$2,500 (90% less) – which means you save \$22,500 more each year (or an extra 2.5% in profits).

Many economists are predicting that conventional investments (i.e., stocks and bonds) will wallow in single digit returns for as long as 5 more years. It would follow that management fees are going to become a much bigger factor in future management decisions. If you are earning 8% and pay 2.5% in fees, you will net 5.5%. If your fees are 1%, you will net 7%.

To enhance your total returns, my advisors suggest the following actions:

- You might consider increasing your equity weighting. Fixed income returns are marginal and going forward it is expected that equities will out-perform fixed income returns.

For those who are more risk averse, it may make sense to add or increase your weight in dividend funds or high dividend paying stocks, as opposed to common stocks or equity funds. This way there is a certain expectation of income as well as the possibility of growth.

- Diversify more widely by adding asset classes. You might want to add Hedge Funds, Gold or Real Estate to your portfolio. Diversifying into asset classes that are not correlated with conventional investments (or are inversely correlated) will stabilize

your investment performance and may enhance your total returns. This is often referred to as "performance optimization".

But, before you make any changes, you should be clear about why you are making the change. Make sure you compare apples to apples. Make sure you don't stick your neck out to grasp for higher returns. Understand your risks. And take costs into consideration – especially if single digit returns are an accurate prediction.

You also need to consider how the changes could affect your long range picture. Will the change fit your investment philosophy or profile? Your proximity to retirement can be affected since liquidity may be a factor.

*If you would like to discuss ways to improve your investment structure, I would be glad to help you. Just return the card on the back page by mail or fax.*



## WHO IS THE STRONACH FINANCIAL GROUP?

Stronach Financial Group has been advising wealthy individuals about managing their money since 1993. I have been providing financial advice since 1983.

Our investment advice does not earn us commissions or finders fees, so this way you get what you want. Rather than managing money ourselves we can 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 investment advisors and counselors and often provide our clients with unbiased performance measurement. This way you will be well informed.



FAX THE CARD BELOW TO: 416-495-9034

### STRONACH FINANCIAL GROUP

15 MANORPARK CRT, WILLOWDALE, ON M2J 1A1 FAX: 416-495-9034



## SPECIAL OFFER

- Yes! Please call me immediately to schedule my FREE Financial Review & Check-Up (normally a \$500 value)
- Yes! I would like to receive future issue's of "Stronach's Smart Money"

Name: \_\_\_\_\_

Address: \_\_\_\_\_

City / Province: \_\_\_\_\_ Postal Code: \_\_\_\_\_

Please Check Preferred Phone Number:

Business: \_\_\_\_\_ Home: \_\_\_\_\_

Best time to call:

Day (MTWTF): \_\_\_\_\_ Time: \_\_\_\_\_

Day (MTWTF): \_\_\_\_\_ Time: \_\_\_\_\_