STANDUP Thoughts About Investment Policy Statements

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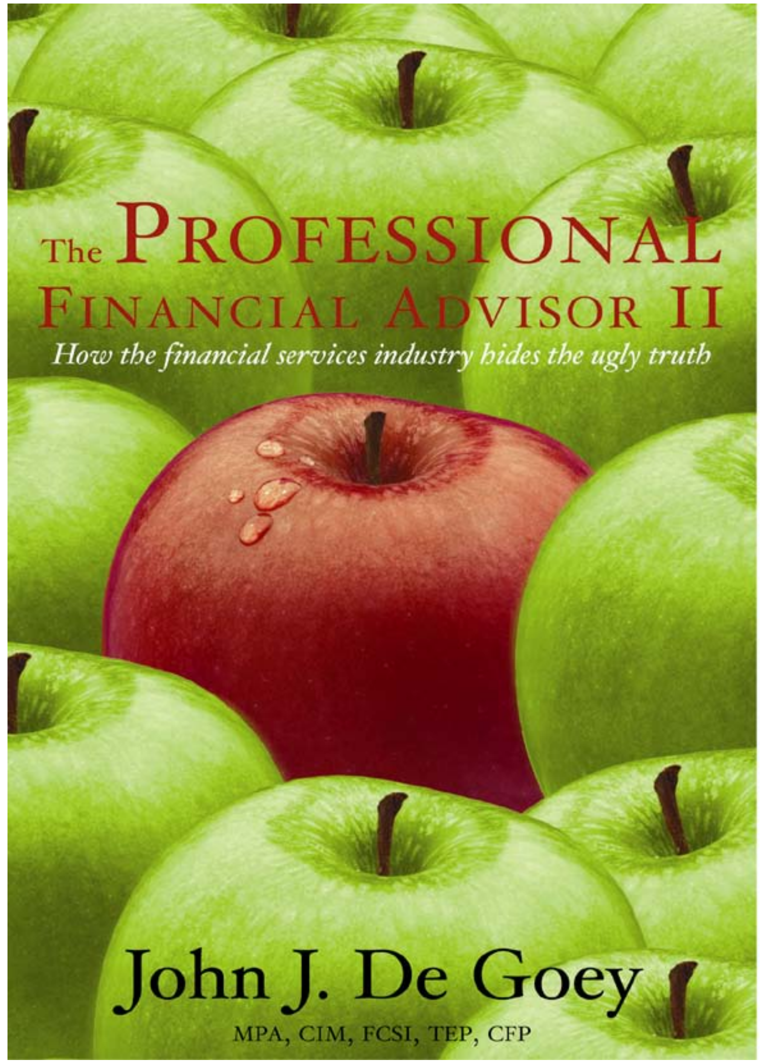
STANDUP for Professionalism

STANDUP

- Scientific
- Testing
- And
- Necessary
- Disclosure
- Underpin
- Professionalism



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For today…

- I'll offer my views on Investment Policy Statements (portfolio blueprints)
- Positioning (compare and contrast 'value propositions')
- Benefits
- Important Considerations

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Let’s Set the Stage…

“It is difficult to get a man to understand something when his income depends on his not understanding it”.

- Upton Sinclair

“It’s not what you don’t know that will hurt you. It’s what you do know… that just ain’t so”.- Will Rogers

“The most difficult subjects can be explained to the most slow-witted man if he has not formed any idea of them already; but the simplest thing cannot be made clear to the most intelligent man if he is firmly persuaded that he knows already… what is laid before him.”

- Leo Tolstoy

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Scientific Testing

- Many studies on the subject have shown that cost and performance are negatively correlated and that the impact is often ‘material’.

- Do advisors disclose that today? Will they in the future?

- How professional is it to willfully *not disclose* material facts that will assist clients in making an informed decision?

My Product Biases

- Cost Effective
- Pure
- Broadly-diversified
- Tax-effective

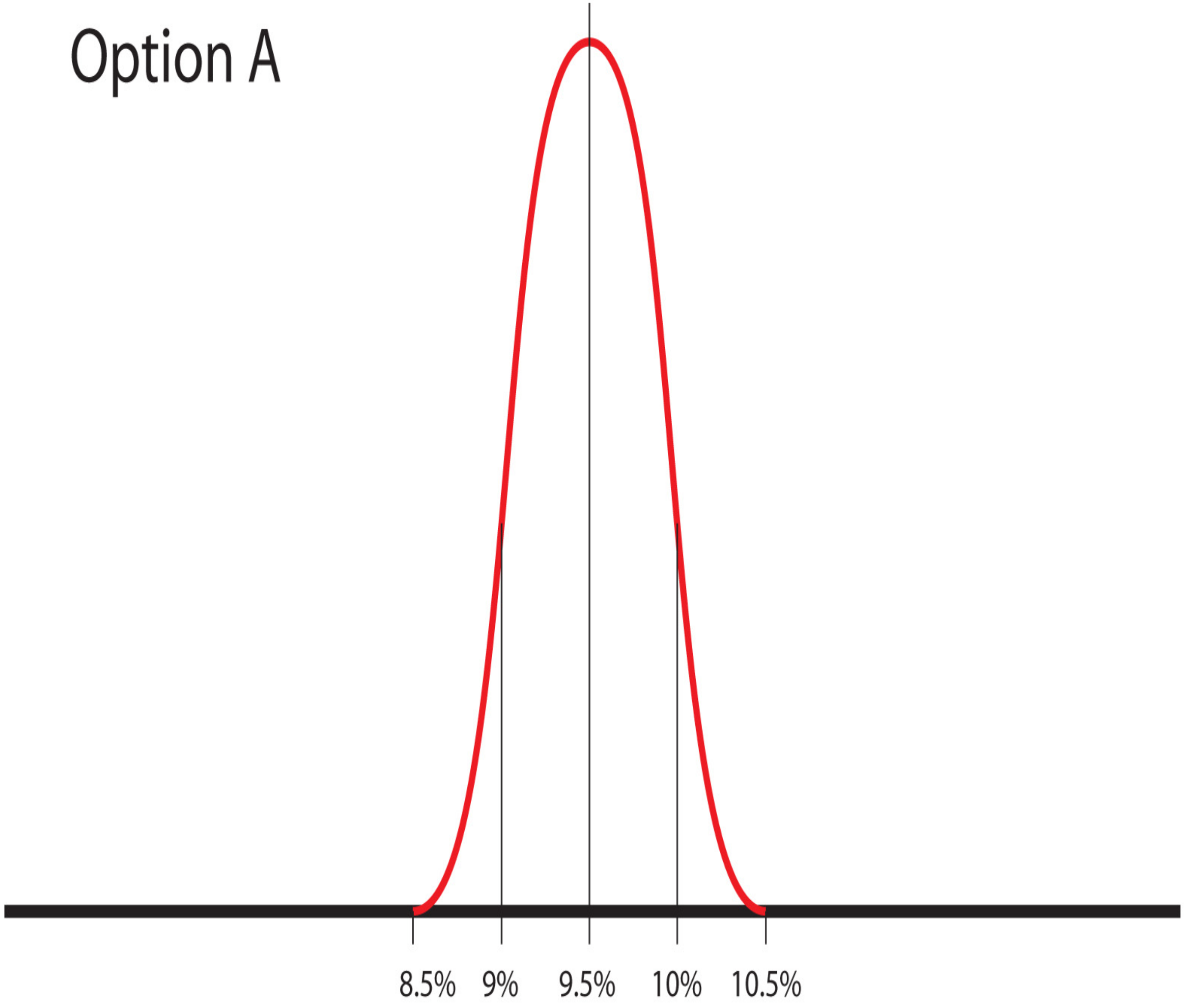
The ABCs of Investing

- A is for “Alpha” – the amount of ‘out performance’ that is attributable to security selection, market timing, etc.
- B is for “Beta” – the risk and return level of the market in general
- C is for “Costs” – all investment products have them and they impact performance numbers

What does William F. Sharpe say?

"Properly measured, the average actively managed dollar *must* under perform the average passively managed dollar, net of costs. Empirical analyses that appear to refute this principle are guilty of improper measurement."

William F. Sharpe, The Arithmetic of Active Management, FAJ, Volume 47, Number 1, January/ February 1991, pp.7-9- available on my web site



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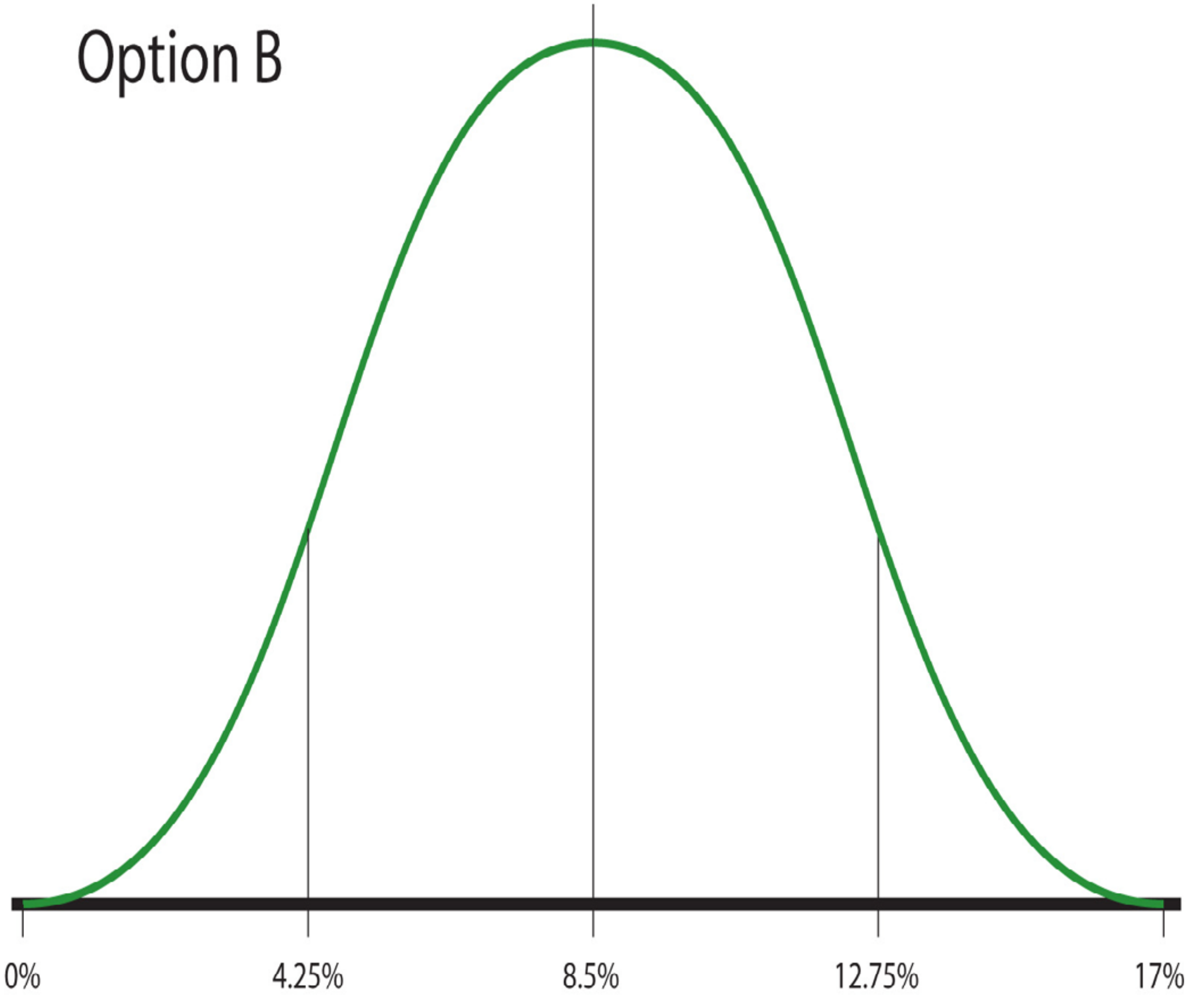

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Pros and Cons

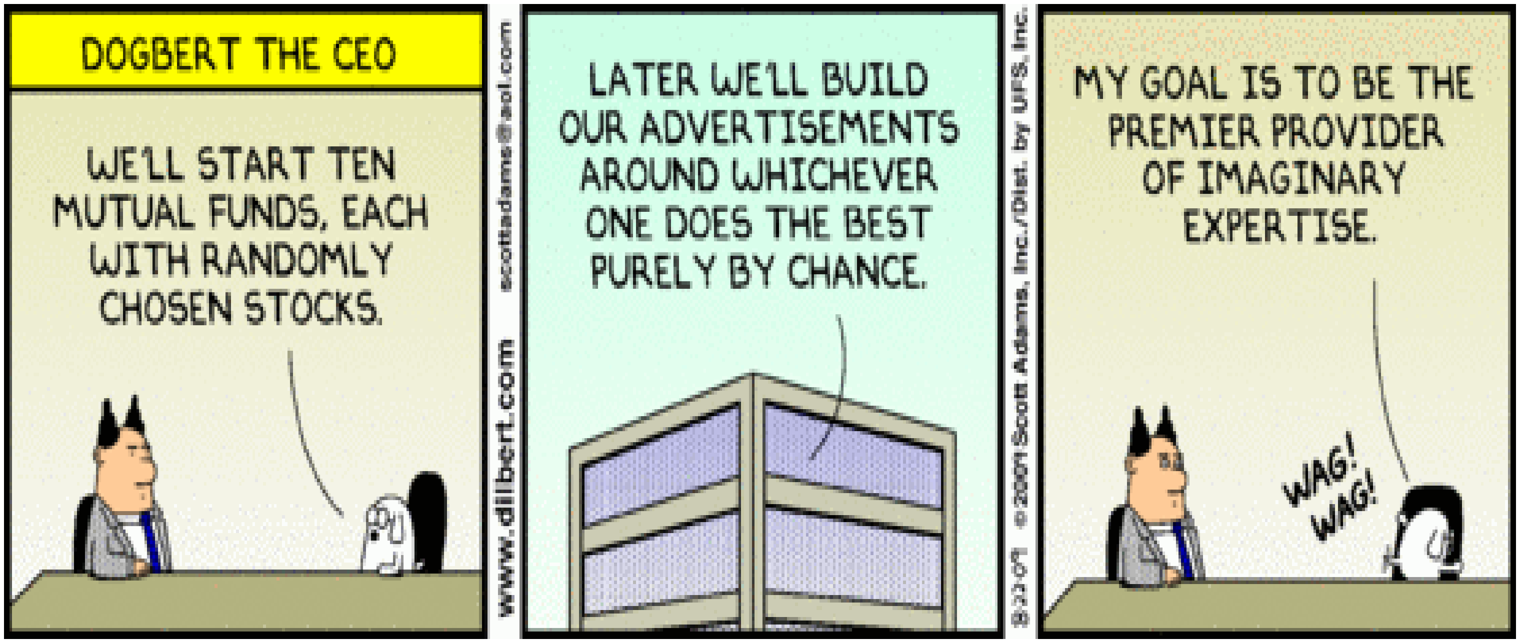
Option A:

Statistically stronger probability of return

Option B:

Pursuit of the positive outlier

What’s your preference?



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Standard and Poor's "SPIVA"

- For the five years ended on December 31, 2010, the following percentages of active managers beat their benchmarks:

- Canadian Equity: 2.53%
- U.S. Equity: 14.13%
- International Equity: 11.63%

Source: Standard and Poor's SPIVA, June, 2011

Mark Carhart's "On persistence in Mutual Fund Performance"…

Using a sample free of survivor bias, I demonstrate that common factors in stock returns and investment expenses almost completely explain persistence in equity mutual funds' mean and risk-adjusted returns. Hendricks, Patel and Zeckhauser's (1993) "hot hands" result is mostly driven by the one-year momentum effect of Jegadeesh and Titman (1993), but individual funds do not earn higher returns from following the momentum strategy in stocks. The only significant persistence not explained is concentrated in strong underperformance by the worst-return mutual funds. <u>The results do not support the existence of skilled or informed mutual fund portfolio managers.</u>

Carhart, Mark M., On Persistence in Mutual Fund Performance. J. OF FINANCE, Vol. 52 No. 1, March 1997. Available at SSRN: http://ssrn.com/abstract=8036

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A little test about Overconfidence

- Are you an above-average driver?
- Are you an above-average advisor?
- In over 17 years in the business, I have yet to meet a single mutual fund manager who admits to being “below average” … yet, by definition, about half of them are (before costs). After costs, the very large majority of them are “below average” (i.e. produce returns lower than their benchmark).

We can’t all be above average

- Only a small fraction (~10%?) of all actively-managed funds have a long term (10+ years) track record that beats the benchmark

- Those that end up in that minority group cannot be reliably identified in advance

- Think of Jeopardy!...

My Question to you…

Since the large majority of active managers lag their benchmark and since those who beat their benchmarks would likely have that outperformance attributed to luck rather than skill (i.e. the performance is not “persistent”), how professional is it (especially in the context of FPSC’s push to have CFPs recognized as ‘fiduciaries’) to actively encourage clients to pursue a strategy that has a negative investing experience as it’s most likely outcome… without AT LEAST advising them of the risks and limitations associated with that strategy?

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Disclaim and Disclose

All *major facts should be disclosed* so clients can make an informed decision.

All *personal opinions should be disclaimed* so that clients are sure to recognize them as opinions.

What if it is less than obvious whether or not the matter being questioned is a fact or an opinion? Take the debate between evolution and creation…. educators have chosen to teach both and advocate neither.

Disclaimer

The views expressed are those of John J. De Goey and are not necessarily shared by Burgeonvest Bick Securities Limited (BBSL). Debate regarding market efficiency, the usefulness of fundamental and technical analysis, active vs. passive management and the efficiency of fee payments is ongoing. To date, neither side of these debates has been able to claim unchallenged victory. BBSL as a policy, supports both active and passive approaches as well as fee based and commission based practices.

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Positioning, Branding and Value Propositions

- Determine Products (mix and match securities, funds, ETFs, PPNs, etc.)

- Determine fee structure/ business model (note: I take no position re: commissions, asset-based fees or fee-only models) – the presentation is designed to apply to all

- Determine value proposition (customized, pension-style management as opposed to clairvoyance)

- Clients want someone they can trust –
  and someone who understands them

The Enlightened CFP's Aim:

- Learn more about overconfidence, anchoring, negative loss aversion, compartmentalization

- Read books by: Belsky and Gilovich, Cadsby, Thaler, Statman, Shefrin, Taleb

- Constructive Behaviour Modification: Focus and Discipline that helps clients to buy low and sell high using pension-style tools that focus on risk as well as return

After all that preamble…

- Prescription before diagnosis is malpractice. Formulate a questionnaire that forces your client to consider trade-offs.
- Most similar wrap account questionnaires are awful - everyone wants high returns and no one wants risk!
- Get the client(s) to sign and date BOTH the questionnaire and the IPS… and then use both documents as a means of ensuring accountability when you meet.

Example #1

Risk and return are related. To get higher returns, one must accept a higher level of risk. Moving from low risk to high risk, which tradeoff are you most comfortable with if "most years" is 2 years out of every 3, so that one year in six will be higher than the high end and one year in six will be lower than the low end?

___ 3.5% above inflation (between +2% and +7% most years)
___ 4.0% above inflation (between 0% and +10% most years)
___ 4.5% above inflation (between -2% and +13% most years)
___ 5.0% above inflation (between -4% and +16% most years)
___ 5.5% above inflation (between -6% and +19% most years)

* Note how increased expected returns leads to increased expected variability.

Example #2

Most portfolios have combinations of asset classes with different risk/ return characteristics. Equities (e.g. stocks) are high risk/ high return; tangibles (e.g. real estate) are medium risk/ medium return; income (e.g. bonds) is low risk/ low return. Which combination do you prefer?

____ 30% equity; 20% tangible; 50% income

____ 40% equity; 20% tangible; 40% income

____ 60% equity; 15% tangible; 25% income

____ 70% equity; 15% tangible; 15% income

____ 80% equity; 10% tangible; 10% income

Years of Experience

- Began using IPSs about 15 years ago, but while using Wrap Accounts.
- I now do it on my own – similar value proposition
- I was leading edge, but also bleeding edge
- Q. Why do it at all? A. Focus and Discipline!

Professional or Salesperson?

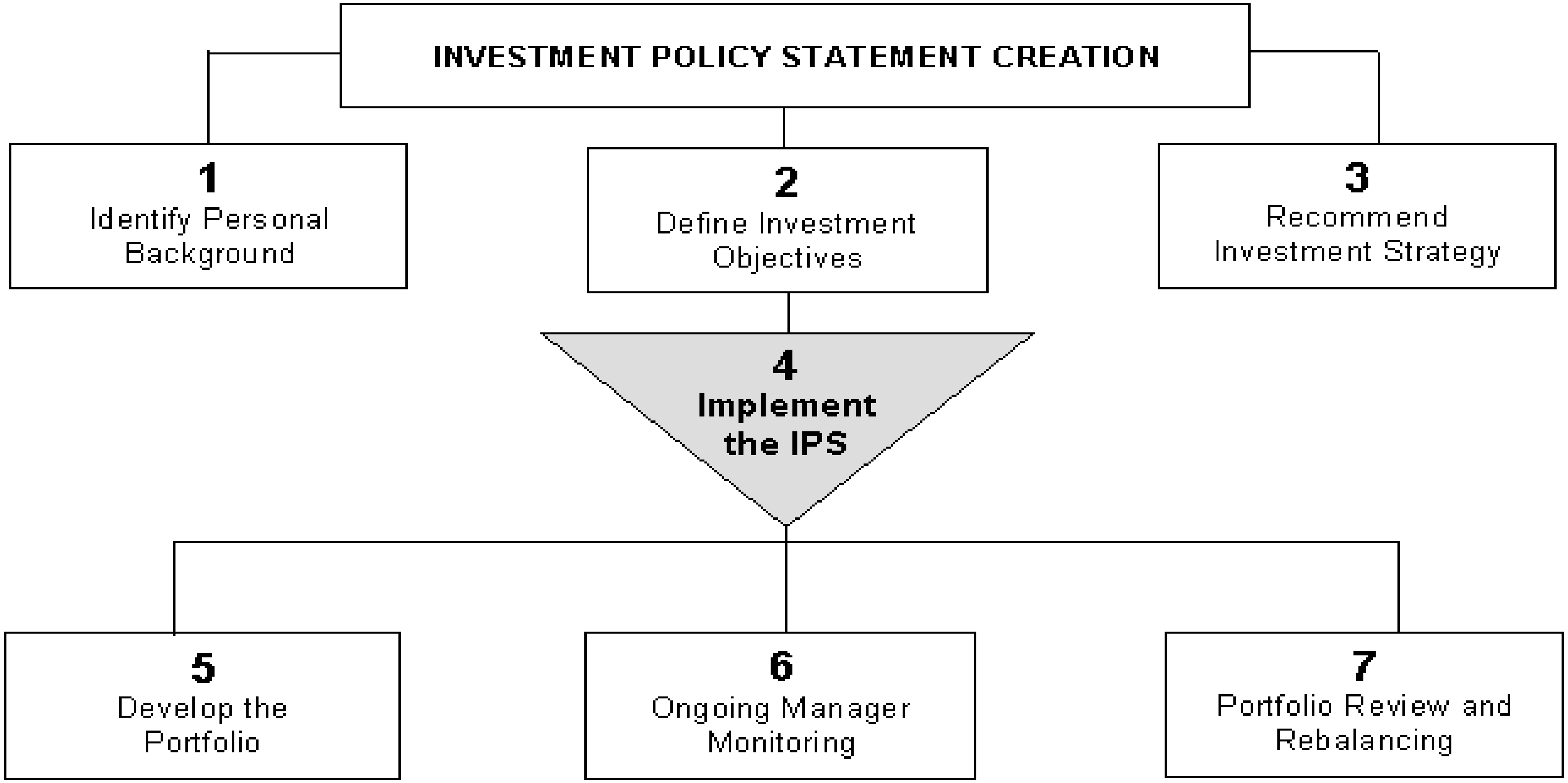
- Society has ‘top of the mind’ opinions of people. Doctors, accountants and lawyers are in the ‘professional’ category…but Financial Planners…

- Product orientation = a sales representative

- Advice and solutions orientation = a professional

The Gap: Investing or Planning?

- Planning: goals, savings, timelines, returns, integration, income needs, inflation
- Investing: setting and maintaining a suitable asset mix, focus and discipline, buy low; sell high
- Challenge is to integrate planning and investing so that they support each other



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Simple Steps

- Identify asset classes to be used
- Identify normal target weightings (ranges?)
- Choose the actual investments
- Re-balance back to bullet #2 on a consistent basis

Strategic Asset Allocation

The focus demonstrates that you're relatively unconcerned about how well product suppliers and / or research departments are performing (they can be fired if they're doing a bad job, anyway) and more concerned with optimizing your clients' returns (Brinson et .al. and Markowitz sorts of principles).

Stated only somewhat differently…

"I help people maximize their long-term, client-specific, risk-adjusted, after-tax, after-cost returns".

http://www.advisor.ca/my-practice/ips-your-ounce-of-prevention-41507

Be Clear Regarding Asset Classes

- There are a number of ways to define an “asset class”. I prefer broad strategic ‘baskets’ that allow for more granular and tactical plays as circumstances and client preferences warrant. You should decide for yourself… but be consistent with all clients once you have decided.

- My six: Income, Canadian Equity, International Equity, U.S. Equity, Emerging Equity and Tangibles

Consider a Simple 1/N Strategy

- This applies only to the equity baskets

- To me, the primary moderator of volatility is the inclusion of the less volatile ‘income’ asset class. The second-best moderator of volatility is to equalize exposure to the more volatile remaining (equity) asset classes

Basis is “How Inefficient is the 1/N Asset Allocation Strategy?”, De Miguel, Lorenzo Garlappi and Raman Uppal, December, 2004

Possible Problems

- Balanced Funds
- Tactical Asset Allocation funds
- ‘Impure’ Funds
- Funds allowed to go to cash
- 130/30 Funds
- Hedge Funds
- Market Timing Funds
- Illiquid products (PPNs, GICs, etc.)

Important Additional Considerations

- Loads, if any
- Tax Optimization
- Trading Costs (incl. capital gains/ losses)
- One off accounts (e.g. RESPs)

Be Sure to Include…

- Primary Objective (e.g. growth, income, etc.)
- Time Horizon
- Risk Tolerance (careful re: self-assessments)
- Liquidity
- Anything else that might assist with accountability and constructive behaviour modification
- Be sure to keep the length reasonable (5 – 10 pages)
- 2 copies – one for you; one for the client(s)

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A Sample Paragraph

“Trying to guess what's going to happen from day to day makes you jump in and out of the markets. Market timing - or buying investments when the markets are going up and selling when markets drop - is more likely to have a negative effect on your investment returns. This is the least effective way to build or manage a portfolio. It's easy to be swayed by the opinions of the media and all the other information that bombards you every day. Hold your ground and avoid letting your emotions guide your decisions. You'll be much more successful in reaching your goals if you stick to your strategy.”

The job is: buy low; sell high

- Get clients to re-read their IPS at least annually
- RRSP contributions always buy low
- RRIF withdrawals always sell high
- Prepare for one-off events (major purchases, inheritances, stock options, sale of a business)
- Prepare for volatility

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Re-Balancing: Just Do It!

- The jury is out re: annually, semi-annually, 10% contingent, 15% contingent, etc.

- No matter which method (including my favourite: ad hoc when the client shows up for a meeting or adds to the account), the important thing is that you do it

- General Outcome: Reduced risk and reduced return

- Trade off: risk, return and cost

How Clients Win

- Believe (with good reason) that their advisor understands them and is looking out for them
- Understand the process of portfolio management better (who says they strive for client education?)
- Genuinely less likely to be overcome by emotion- due to the focus and discipline you bring to the table
- Come to portfolio review meetings ready to re-balance rather than talk about the latest hot product/ fad/ asset class / stock
- More likely to stick with other parts of the plan

Focus on what you can control

- Take responsibility for my clients' portfolio costs, portfolio turnover and / or trading activity, asset allocation, tax integration and (to the extent that I have control) client behaviour.

- Do NOT take responsibility for picking stocks, picking funds or timing markets. I don't believe I can do it (reliably). With respect, I don't think you can, either.

- Less product; more process. STANDUP!