Chris Horan, Financial Advisor

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25 Years On

Saturday Hours

To make it easier for clients to come downtown, I will have office hours on selected Saturday mornings through the winter. Driving downtown on Saturday morning is a breeze, and the Eaton's Centre is open so you can do a little shopping too.

If this is of interest to you let me or Barb know and we'll set it up.

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September marks my anniversary of more than 25 years in the investment industry. It came up suddenly, so I've taken some time to reflect on what I've learned.

My career began as a sales trainee in the Vancouver office of Pitfield Mackay Ross, a blue chip investment broker, in September 1980. One of my first jobs was in the booming pandemonium of the Vancouver Stock Exchange floor where I worked the phones connecting the office trading desk with the floor traders.

It was the quintessential stock trading job: traders yelling, phones ringing off the hook, paper tickets flying. Those were the days of General Energy and Dome Petroleum. The head trader strutted cockily about, claiming that you should be personally making $1,000 per trade, per day (a month's pay back then). My first exposure to day trading.

I became Sales Assistant to one of the top brokers in the country. Velvet-voiced, ex-banker, he could sell anything to anybody. He was a king, and I was his assistant. In the euphoria of a bull market, people just wanted to buy what was going up the most, and he was happy to comply. Bank loans leveraged the certainty of riches to come.

In July of 1981 interest rates went to 20% and the markets headed south, big time. From July of 1981 to July of 1982 the Toronto Stock Exchange fell by 49%. Week after week, relentlessly, share prices would ratchet down, stagger up a little, then down again. My first bear market.

From my vantage point I got to see the gory details of wealth destruction. Up close. I recall taking a call from a physician client. A normal guy of maybe 50 who had postponed his savings and was trying to catch up. He had borrowed $40,000 to buy an oil stock, Texas International in New York, trading around $72. It was his only holding, and he was convinced it was going to the moon.

Except the day he called it had fallen by half, and he didn't know about it. "How's TI doing?" he asked. 'It's $36', I said. 'Oh did it split again?" he asked. (A stock split is where a company doubles the number of shares to keep the price affordable – it drops the price by half but the value of your holdings stays the same.)

Unfortunately Texas International had not split. It had fallen by half. I could only say, 'You better talk to the broker'. TI went to about $10, leaving the poor sot with a bank loan and no investment.

Returning to the office from lunch the day that General Energy went 'no bid' was a formative moment. General Energy was worshipped in the Vancouver office because it had gone from $2 to $20 in the bull market. Almost every broker had clients in it. Some had huge amounts of it. 'No bid' is trading lingo for 'no buyers'. Worthless. Nada. Brokers just stared blankly at their screens. I didn't know it then, but it was my first bubble burst.

And there I was, in the middle of it, watching brokers, who knew little, having flogged stock to people who had absolutely no idea what they were doing. No strategy, no philosophy, no plan, nothing. Just flail away, and hope it will go up. It made me want to throw up (still does, when I think about it). A very negative experience for me, or so I thought.

I could see that I needed to know a lot more about investing, so I did an MBA at Western, which eventually took me to Digital Equipment, the computer maker, as Treasury Manager for Canada, which is where I learned how the professionals manage money. At DEC I had the wonderful good fortune to chair the investment committee, which made me the 'point man' in moving the pension fund Trustees from the 'Old World' to the 'New World' of investment management.

In the 'Old World', the owner of the money (pension fund in this case) gives the money to a money manager, who takes it away, and everyone hopes for the best. The fund hopes the returns are good, and the manager hopes the trustees like the returns.

In the 'New World', the pension fund trustees engage a professional to draw up a detailed set of blueprints for the investment strategy. The plans consider all the variables of the pension plan members and the sponsoring company, and designs a portfolio based on the particular characteristics of the different asset classes that the fund could invest in (small company stocks, large company stocks, international stocks, bonds, etc.) and sets detailed parameters for the investment managers to follow.

The pension trustees then hire specialist managers for each segment of the portfolio, and measure the managers' performance against various benchmarks over time. In other words, the pension fund owner takes control of the strategy and delegates responsibility to specialists.

Most importantly, the DEC Trustees considered the risk/return tradeoff. In a nutshell, the tradeoff works like this: a portfolio with more equities is expected to grow more over time than a bond-oriented portfolio, because companies generate profits that grow over time while bonds only pay interest. This higher growth means that the pension plan sponsor needs to contribute less cash over the life of the pension fund. Lower costs are a good thing.

The drawback to an equity-heavy portfolio, as we all know, is that the market values fluctuate – sometimes a lot – year to year. So the fund trustees needed to be prepared for that, and we worked to understand downside risk.

Here's the thing that got my attention. The pension fund actuaries, who are the most conservative folks on the planet, were comfortable with the probability of long-term success from an equity-oriented portfolio. They liked the returns from stocks over 10 or 20 years. The actuaries were so comfortable with predicting long-term stock returns that they allowed the company to immediately reduce the accounting cost of the pension plan on the company's books.

So the Trustees adopted an 80% equity mix, and saved themselves a bunch of money. They were even okay and didn't lose their cool when the market crashed in October 1987. My first experience with a detailed strategy and setting client expectations. This was good!

This was very good, but working for someone else was not my cup of tea, so when 2 people in a period of about a month asked me to help their parents, who were fed up with using a broker to pick stocks and bonds, I saw the business opportunity right in front of me – bring professional portfolio management to individuals and smaller pension plans. I quit my job literally the next day, became a Financial Planner, and never looked back. Never worked so hard, but never looked back.

I have learned that there are a number of keys to investment success, but probably none more important than the idea that long term investment success is more a matter of investor behavior than achieving the highest return or even a 'good' return. It isn't about investment performance and it isn't about low fees.

The truth is that investment success or failure is determined by investor behavior. Behavior is driven by emotions, camouflaged by powerful illusions or psychological traps, which urge us to make The Big Mistake (see previous newsletter essays 'Investors Behaving Badly – Again', January 2006 or 'Investor Psychology', July 2000 on my website at www.chrishoran.ca).

My clients do understand this and that is why we get along so well. But I am always, after all these years, surprised at the number of people who really believe that high returns will lead to success. They spend their time and money chasing high returns. In fact, it is the *pursuit* of high investment returns that leads so frequently to disappointment.

And as fate would have it, the returns actually work out pretty well (see '2005 Mini-Review', May 2005, and 'Excellent Manager Project'. March 2004 from my newsletter at www.financialtailor.ca).

And so the most difficult part of the excellent advisor's job is not about designing a beautiful portfolio, tailored to the client's unique circumstances, and trimmed to suit the market conditions of the day. The most difficult part of the advisor's job is providing the discipline, *in a respectful and professional way*, to keep the client portfolio on course so that it can realize the gains that the markets eventually bring. I refer to this part of my job as The Emotional Counterweight™.

The best part of the last 25 years for me is that the best advice is although frequently the most difficult to deliver, has the greatest benefit to clients. As R W Emerson wrote in his essay '*On Compensation*' if you give the best advice you can, good clients will heed it, and they will prosper, and so will you. It is now very rewarding to look back with clients over the 5, 10 or 15 years that we have worked together, see their portfolios have performed very well through the ups and downs, and have the clients say that they 'have had good advice'.

Thank you. It is a pleasure to work with all of you.

Charitable Giving Fund

Now you can start your own Charitable Foundation. The Mackenzie Charitable Giving Fund allows you to make a tax-deductible donation and name your Fund. You can then specify which registered charity/ies you would like your Fund to donate its income to each year. The money is professionally managed by Mackenzie managers, so the capital and donations can grow over time. Plus, the tax people (CRA) have made it easier for people to donate existing investments without triggering tax.

If you have thought about leaving money to a charitable cause but would like some flexibility, this is a great idea.

This should also be of great interest to anyone who sits on a charity board, because it makes it so easy for people to donate, and it makes it easy to access professional management.

If you would like to know more, give me a call or email.

Hedge Fund Blows Up

Hedge funds have generated a lot of investor interest lately. Investors are pouring money into them, lured by the prospect of profits in down markets as well as up. Also because one of the largest personal residences in the US is owned by a hedge fund manager.

Hedge funds are a type of investment pool. They are named after the simple process that a farmer uses to sell his crop in advance of the harvest date – he hedges the price by selling some or all of the crop today, for delivery in say 3 months. A hedge fund is supposed to be able to hedge its bets by making an investment in one market, and offsetting or hedging the risk by say selling an investment in another. This is supposed to be investment Nirvana because a smart hedge fund manager can make money when a market is going up or down. (Obviously oversimplified – call me if you want to understand it better.)

Amaranth Advisors of Greenwich Connecticut, a hedge fund, began winding down operations after losing an estimated $6 billion on one set of trades – blowing up the fund. What happened was they made a big bet last year (2005) that natural gas prices would spike up in the autumn. A couple of hurricanes came along, boosted the price of gas, and the fund made something like $3 billion in gains; the head trader was reported to have netted a personal bonus of $100 million.

(Let me ask you a skill-testing question: is the head trader going to have a shred of doubt in his ability after a trade like that?)

So they tried the same trade this year. Unfortunately, there were zero hurricanes, the price of gas did not spike, and they blew the fund up.

If you think this is unusual, read the book 'When Genius Failed', by Roger Lowenstein, Random House, 2000. It is the story of another hedge fund, Long Term Capital Management, that blew up in 1998. The implosion of LTCM prompted Alan Greenspan, Chairman of the US Federal Reserve, to call an unprecedented Sunday meeting in New York of CEOs of the largest US banks so they could manage the bankruptcy and not damage the US banking system.

LTCM's managers included some of the smartest guys in US finance. They used a trading model to exploit small differences in securities prices from one market to another. Only problem was financial markets experience serious disruptions from time to time. Amazingly, LTCM's models did not go back far enough to include the disruptions of 1992 and 1987 – only 5 and 10 years before!

So let's see, they were totally undiversified, had borrowed gobs of money to make a trade that depended totally on the outcome of an event that they had no power to control, and were so smart they didn't consider the possibility that they were wrong! Makes you wonder.

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