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Good Advice Hard to Give

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Chris provides financial planning, investment planning and full implementation services to about 100 families.

We are pleased to welcome new clients.

For more information, please call (416) 216-6532 or email at choran@assante.com

What is Good Advice?

Thank you all once again for completing the Accretive Advisor surveys. I am pleased to be one of only about 50 advisors (out of the many thousands) in Canada that have met the Accretive Advisor Elite Status.

One of the most important and difficult qualification hurdles is the client survey. The minimum response rate is 30%; the average of successful candidates is 35%; your response rate was over 65%. The polling industry people tell you that when response rate is high, people feel strongly about something. Fortunately your responses were overwhelmingly positive. As one of the Accretive telephone interviewers said to me, 'You are the real deal'.

One comment on a number of surveys was the newsletter. Many of you appreciate the content and would like a more frequent newsletter. So I will write more frequently.

Define Value

Part of the Accretive exercise for me was to write a very concise summary of what I thought my value as an advisor is. I was reminded again of how extremely difficult it is for investors [and industry experts] to identify exactly what is good investment advice.

There are as many facets to financial advice as there are client questions, and each question is open to a range of strategies, so it is impossible to quantify or even define good advice[1] but for one facet, a story will have to do.

[1] Good advice is so difficult to define because every client is different, and the world is constantly changing, so the optimal strategy can vary over time, and it gets pretty complicated.

Background: One of the greatest dangers to investors is the tendency or temptation to buy too much of something that has gone up in price, and to sell out of something that has fallen. This destructive behavior is so perfectly instinctive to the human mind that it is extremely difficult to overcome[2]. I spend a good deal of my professional energy counseling against these twin devils.

Investing may be unique in that whatever the popular idea is, it almost certainly is wrong, or at least too late. The markets are very adept at making the largest number of people appear foolish. This is almost a mathematical truism, because if something (say, gold for example) seems to be a good idea, it is likely that other people think so too, so the price has probably already gone up.

A successful investor trains her mind to overcome these natural but dangerous inclinations, and looks for bargains in unpopular investment ideas, because only when an idea is unpopular can the price be low. The best money managers have the rare combination of ability to see a good idea at a low price, and the courage to 'pull the trigger' and actually buy the idea.

The Lunch

So, awhile ago I was at an investment industry lunch. Waiting for Mark Carney to take the podium, the table talk was about the financial meltdown in 2009, and how, although it was the mirror opposite of 1999, it was just as stressful.

In 09 the challenge was keeping clients invested as their portfolio values plummeted; while in 99 it was keeping them out of tech stocks that were going to the moon while value stocks seemed stuck in mud. The pressure in both instances was immense.

The person beside me, a successful (financially) broker at a well-known bank, startled me when she declared, 'I wouldn't do it that way'.

She continued, 'The problem with your approach is you risk losing the client. You are telling the client that what he wants to do is wrong. When you argue with the client you risk losing him. Or worse.'

She explained her approach: 'If the client has decided, because the market is going down, that his risk tolerance is now lower, my job is to help him accommodate that new risk tolerance. We are, as you know, legally required to keep the client within his risk tolerance. So I will reduce the risk in the portfolio'.

This sounded a lot like 'selling low' to me: 'And then, when things have gone back up, you'll buy back in?'

'Well', she said, 'when the client feels more comfortable with the risk, my job is to accommodate that in a sensible way'.

One point that this very nice broker completely misses, to the terrible detriment of her investors, is that the time to address the client's risk - and reward - profile is up front, in the financial planning and portfolio design stage.

Once the strategy is set, it should be changed as seldom as possible, and for heaven's sake not in the middle of a storm.

I couldn't believe what I was hearing. This person, well-dressed, educated, and articulate, was saying that her approach was to help the customer buy what he wants and sell what he wants. If that means buy high and sell low, and generating massive losses that will likely never be recovered, well, that's what happens.

[2] Many studies show that individual investors underperform even their own investments by a wide margin over say 5 and 10 year periods because individuals tend to buy high sell low, and trade too frequently, so they don't hold the investment long enough to get the return. Men tend to be worse. See 'Top Manager Study', www.chrishoran.ca. See also Terence Odean, American Economic Review, 1999; the Dalbar, 1994 study is one of the earliest, and has been replicated many times.

Wanting to buy tech stocks at the peak in 1999 or sell out in fear at the bottom in October 2011 are only two well-known examples. They may not have tempted you. But others might have, like the Y2K scare, real estate in 1989, tax shelter LPs, index-linked notes, or whatever your know-it-all neighbor was telling you to do. The common thread – and the most dangerous part of it - is the ideas seem to be so reasonable - at the time.

Ladies and gentlemen, I'm here to tell you that in the age of online investing, the client does not need me to sell her what she wants to buy. She can do that at any time at no cost with the click of a mouse.

Selling the customer what he wants is the key to success in many businesses, but it is almost NEVER good investing.

Back to the definition of value:

Of course I risk losing the client. Of course I argue passionately against buying tech stocks at 100x earnings. Of course I argue passionately against selling shares of great companies in 2009 after they've fallen 55% and you are terrified they might fall more. And of course I'm going to argue passionately against listening to some velvet-voiced salesman who woos your account during a tough time by saying *he* wouldn't have done what you've been doing.

I've had a client slap the table because he didn't have Nortel and his buddies did. Another had what she called 'a hissy fit' and fired me. (She went to a bank-owned broker, moved $1 million+ into tech stocks right at the top in February 2000 and 3 years later it was $250K, according to her lawyer).

Of course I do these things, of course – to me anyway. I do it because one of my strongest beliefs, based on 30 years watching people invest successfully while others blow themselves up (it's an industry expression[3]) is that panicking out at market bottoms, buying in at market tops, and buying popular ideas in between, is the surest way to destroy capital. Permanently.

Yes, my career objective is to have clients look back over ten years, and now 20 years, and say 'I have been well-advised'. (One of the best – if not the only – ways to recognize good advice is when you see how easy it would have been to have done something different …)

This career objective – delivering good advice over decades – necessarily means that I am coming head-on against the fears, the euphorias, and all the stupid ideas in between - that the world conjures up. If these emotional peaks and valleys are what makes investors want to commit *hari kiri* with their hard-earned lifetime savings, then yes yes and yes, I will most definitely be absolutely clear with my advice. If this means I lose clients because I argue with them from time to time, so be it. Good advice doesn't always sound like it at the time. That's why it's difficult.

In 2011 I lost clients totaling less than 1% of the assets in my practice. Many added significant amounts to their portfolios.

Thank you all for listening.

[3] The expression has unfortunate but real roots: a fellow in my parents' circle of friends in Vancouver bought a large amount of Bre-X (the gold stock) with his wife's money; tragically, he took his own life when Bre-X was exposed as a fraud and went to zero.

Q&A with Chris

This is the start of a regular section featuring questions from clients. Please call or email me at choran@assante.com. No question is too simple … or too difficult!

Q: Mutual funds seem to be getting a bad name. Some people say mutual funds have been doing poorly, and I should be buying individual stocks and bonds and things.

A: Poppycock. A mutual fund is simply a vehicle. It is a pool of money that is managed by a professional. The fund's performance precisely reflects the assets it is invested in, so that a US equity fund return is precisely the return from the stocks it holds[4]. A fund's characteristics have much more to do with the individual manager and the particular markets it is invested in, and nothing to do with it being a fund.

One of my top clients was being chastised by a couple of his buddies for using funds. They each had 2 brokers and felt important being on the phone all the time (even on holidays). The client asked another friend, who happens to be the retired major shareholder of a well-known investment firm, how he managed his money. The answer: "I keep half a million or so to play with in an online trading account, but my serious money is in funds'.

If that isn't enough endorsement to drive the question into the ground like a tomato stake, consider this: if you go to an investment counsel firm and have less than about $25 million, you are in their funds[5]. If you are a pension fund with less than about $50 million, you are using funds, especially for non-Canadian investments. Funds are by far the most efficient way to access professional money management.

Q: OK but what about the fees? Rob Carrick rips on endlessly about how mutual fund fees are so much higher than in the US, and says low fees are the solution.

A: Another good story, but only half the story. In Canada, mutual fund fees include both the investment management fee and the advisor's fee. The split is roughly 50/50. In the US, fund fees are reported *without* the advisor compensation (called 12.b.1 fees). So a Grade 3 could tell you US fees will be half those in Canada. Apples to apples there's no story.

But the main benefit of the advisor fee, by far, is that it can get you an experienced, knowledgeable and courageous advisor. And an ongoing fee is the best way, by far, to compensate a good advisor. Because the most difficult part of the good advisor's job, by far, is to keep the client strategy on track. And the thing that destroys most people's returns, by far, is an ill-advised change in investment strategy.

I love the quote from Red Adair, who famously charged fantastically high fees to put out oil well fires: "If you think a professional is expensive, hire an amateur first".

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[4] Less fees and expenses of course. The individual stocks in a fund will naturally reflect to a large degree the short term fluctuations of the market it is invested in, but longer term the manager has an important influence on the performance.
[5] Investment counselors and pension funds usually use 'pooled funds', which are identical to mutual funds except the fee is charged outside the fund. Many investment firms dress up their statements to look like you are holding individual securities, but you aren't.
Long term returns from Ibbotson, 1926-2010, and Towers Perrin *Economic Tables.*

1st Quarter Strong

The first 3 months of 2012 have started out well, with the US market up 10.5%, and the TSX up 4.4% in the quarter. Unless you switched to bonds in the October 2011 Euro mini-panic, because government bonds actually fell slightly (bonds go down as interest rise). Your portfolios have been positioned well for this, as we have been reducing government bonds to the absolute minimum, while increasing our US investments over the last year or so.

Investment Strategy Outlook

I continue to favor US companies as a good combination of excellent businesses, in excellent condition, with very good exposure to global growth, selling at very reasonable prices.

How can these companies prosper in a slow growth economy?

The answer is that the fortunes of a great many individual companies are quite disconnected from the overall economy, just the same way individual people's fortunes are. It is more the particular circumstances and behavior of the individual – competence, hard work, good customers, financial health, etc. – that determines their fortune.

A well-run company can easily produce 10%, 15%, or 25% on shareholders' equity, even with minimal growth in sales revenue. For instance, (from the holdings of the CI American Value Fund, which many of us hold), Microsoft has a 44% return on shareholder's equity, Exxon 26%, and Abbott Labs over 20%. These companies can continue to do very well in a slow-growth economy by expanding product lines, developing efficiencies for example.

So my view is that we'll see the overall market indexes progress modestly over the next few years. Interest rates will need to renormalize, and this will keep a damper on overall financial asset valuations.

However, within this moderate progress of the market indexes, certain individual companies and industry groups can and will likely do quite well. Ford Motor for instance, is more efficient than GM, has a very good product line, and its shareholders weren't massively diluted by government capital injections, so shareholders can do very well as profits recover. (Ford is a new top-10 holding in the Capital Appreciation Fund, managed by Dan Bubis).

The Ford Motor story is interesting: Ford has been run well by Alan Mulhally, the CEO, and was the only Big Three that didn't require government (taxpayer) assistance. As a result, Ford shareholders, including the Ford family, did not suffer the massive dilution of their holdings that the other firms did. It seems that having major shareholders that are deeply engaged in the company, and strongly focused on the long term interests of the firm, is actually very good for the company. Maybe we need more investors like the Fords.

The Euro

It is hard to believe that in only one short year the viability of the Euro has gone from unquestioned to centre stage. The drums are beating persistently with the prospect of an eventual breakup: George Soros [who knows a thing or two about currencies – his hedge fund made billions on the devaluation of the British Pound] writing in the Financial Times, a London newspaper, talks about how the Euro crisis is 'reorienting itself along national lines'.

The fundamental imbalances of the Euro countries have not been corrected, nor will they likely be. Much as we are constrained by political correctness to deny it, the different populations in the Euro have different economic characteristics that make sharing a common currency an implausible long-term prospect. The imbalances between economically competitive Germany and less-competitive Greece or Spain can be managed for a few years, says Soros, but the Euro is not viable long term.

With each passing month, more and more intelligent minds are wrapped around the complex issues involved with a Euro member leaving. More and more people realize that, with time, the details can be worked out. Taking apart the Euro may not be unscrambling an egg after all.

My guess remains that the weaker Euro members will be allowed to exit, where they can devalue their currencies as they wish. The exit(s) will be managed to protect the health of the banking system. Rather than a panic, world markets will likely sigh with relief. The Greeks' standard of living is being crushed anyway, and they will prefer to pursue their own destiny, rather than be bossed around by Germans.

How will this come about? Euro banknote serial numbers have a designation letter specifying which country printed them, for example 'X' for Germany, 'Y' for Greece, according to the Bundesbank. This means it would be easy for people to identify the issuing country.

Just as the bonds of Euro countries are taking on individual prices and interest rates to reflect each country's credit risk, it would also be straightforward to develop a street-level market recognition of the paper currency which would assign a different value according to which country the note is from. From this rough beginning of X Euros and Y Euros would evolve individual markets for Deutschmarks and Drachmas….

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