Assante WEALTH MANAGEMENT

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Chris has a BA in Economics from UBC, and a business degree from Western (now Ivey MBA). Before joining Assante in 1992 he was Treasury Manager for a Fortune 50 firm where one of his responsibilities was Chair of the Investment Committee of the $65 million pension fund.

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

We are pleased to welcome new clients. New clients should have $1 million or more of investable assets.

Proof in the Pudding 2016 returns

Value of Advice: Proof in the Pudding

My last newsletter discussed how having top-performing managers in your portfolio is not an indication of good advice: I make no claim that your money managers will ‘outperform’ any particular benchmark over any particular block of time. I said the same thing at a recent dinner party.

If you find yourself asking, as one of my friends did at a recent dinner, ‘With due respect, how can your goal be anything else but beating the index?’

I tried to channel Kung Fu: ‘Ahh, Grasshopper, if only it were so simple. What would beating a benchmark do for you?’

But instead I blurted out a good part of my investment philosophy: ‘Chasing performance leads invariably to buying high and selling low, and makes a Big Mistake more likely. Buying high and selling low costs the average investor 2 -14% per year, and Big Mistakes are fatal. My value is primarily in avoiding both those problems.’

I couldn’t just stop there: ‘Investment success is about time, not outperforming this or that. So it’s really a behaviour thing. Indexes tend to be more volatile than active managers, and occasionally they are disastrous, like with Nortel in 1999, or just bad, like resources in 2015, so they actually make the behaviour problem worse’.

‘But the mark of good advice is how you do, in total, over time. It has almost nothing to do with performance of this or that sector within the portfolio. All that is a tiny irrelevant detail. Nobody is poor because their fees are ½% higher, and nobody gets rich because their returns are 1% higher than their neighbor’s. They fail because they jump out of the plane. That’s the Big Mistake.’

‘And I’m happy, by the way, to have indexes in a client portfolio, because my fee is the same, so I am actually indifferent.’

Today, we'll look at how your portfolios have actually performed.

Not that your managers have done poorly: the last newsletter also showed how your Canadian equity managers just happened to have outperformed their index benchmarks over 5, 10, and 15 years (net of my 1% fee, and with the indexes carrying zero expense, which is biased to favor the indexes). And your Canadian Small Cap managers have hammered their index on the same basis by 2 to 8 full points over 3, 5, 10, and 15 years.

Your US managers did very well against the index, all beating the S&P500 in US$ terms over 3,5, and 10 years, although the picture is clouded by currency.

Much more importantly, critically in fact to the whole story, many of you have actually had those managers over those very long periods, so you've actually earned the returns.

So don't let anyone tell you your managers don't beat the index. Sometimes they do, and sometimes they don't. Financial journalism goes bananas when they don't, so I'm here to quietly remind you that they do.

Today we'll look at your total portfolio: how have you advanced towards your great long term goals, and, by the way, how might other people have fared?

Proof in the Pudding

Your advisor is one of the very few that has had the performance of a client account measured by an independent consulting firm over more than 15 years. It is a $3 million pension fund portfolio with a balanced investment mandate, like most of yours, and has followed my direction exclusively for those 15 years.

Below are the returns of the Fund, compared to various benchmarks. Note that since the pension fund and virtually all clients have balanced portfolios of equities (stocks) and fixed income (bonds), the appropriate comparison is to the peer group of managers with similar mandates; in this case Globefund balanced fund peers. The peer groups are professionally managed balanced funds: equity-oriented, fixed-income-oriented, and their global counterparts.

	1 Year	3 Year	5 Year	10 Year	15 Year
Pension Fund	7.9%	6.7%	10.2%	5.0%	6.5%
Global Peers					
Global Equity Balanced	4.6%	5.9%	8.7%	3.2%	3.9%
Global Fixed Income Balanced	4.1%	4.1%	4.9%	3.2%	4.1%
Canadian Peers					
Canadian Fixed Income Balanced	4.2%	4.3%	4.6%	3.4%	4.0%
Canadian Equity Balanced	10.2%	5.4%	6.5%	3.5%	5.0%

Source: GlobeFund

Now, with wealth management firms such as Assante and the bank-owned brokers required to publish the client rate of return on December account statements, and with Assante's bold and commendable decision to go back over 14 years (the limit of our data integrity, given systems changes), you can now see as much as 14 years of history on your own accounts.

You will notice that the 10-year balanced peer index returns are all in the 3% range, reflecting the impact of the 08-09 financial crisis. Most of you will also find on your December 2016 statements your own portfolio 10-year returns are in the 3 – 6% range, equal to or significantly better than the peer indexes over 10 years.

The longest period on your December statements is 14 years to 2002, so your inception number won't compare directly to the 15 year peer group and index data, but a difference of one year in fifteen has relatively little impact; you can see that your inception (2002) returns compare favourably as well.

Most of you will also see your 5-year returns from your December statements are in the 10% - 14% range, which far surpass the professionally-managed peers (doubling them in many cases).

The peer group indexes are professionally-managed portfolios, so they will not have been damaged by the Big Mistakes discussed in the last newsletter, such as the $800,000 account that went to $50,000 (I do not exaggerate).

Finally, I dare not claim to be happy with the performance, because the investment gods are very unkind to pride or hubris of any sort, so I will only make the humble observation that the performance has been satisfactory, particularly in the circumstances, for which I am deeply grateful.

The Value of Advice

Looking back over these returns, what has been the value of advice? Have these returns, superior to professional balanced portfolio managers, materialized out of your advisor's brilliant manoeuvrings and genius prognostications of the future?

Alas, not really.

My value proposition is: 'Working from a comprehensive long term financial plan, with a diversified investment portfolio built on the long-term characteristics of the major asset classes, and avoiding the great behavioural mistakes, you are highly likely to realize a significantly greater long-term return than the vast majority of your neighbors, or more particularly, what you would have done on your own'.

The value of advice over these long and very difficult years stems from several important things, each of which has zero to do with some segment of your portfolio outperforming some benchmark. And, I must point out, the value far exceeds the 1% fee, as should be obvious from your 10-year returns vs the professionally-managed balanced funds, never mind those poor souls decimated by Big Mistakes.

This value was proven several times over in the past 15 years (or 20, or however far back you care to look). Number one is that we managed to avoid the crash of the technology stocks in 1999, so that, 15 long years ago, in 2002, your capital was relatively undamaged, and you had a capital base to grow from. This alone saved many of your fortunes, and made my career.

Genius is just having a plan.

I'll take the credit, but in truth avoiding tech stocks was not much more than having a plan and sticking to it. Your financial plans in the 1990's didn't include technology stocks because nobody had heard of them yet. So when they burst onto the scene, as fads do, we avoided them primarily by sticking to the plan. That's why you have a plan.

Second, most clients, particularly those retired or nearing retirement, had significant exposure to bonds which stabilized the portfolios going into the crisis in 07. Incorporating bonds into a portfolio is nothing more than basic diversification – part of any investment plan.

A third important reason your returns compare so well to the professionally-managed peers is that you had the courage to maintain your investment strategy in 08 and 09, even as green water crashed over the decks. My value proposition includes the discipline to maintain the plan during those inevitable difficult times when courage wanes. Very simple, too simple in fact, in retrospect, as the memory of that great crisis begins to fade, but clients will recall how easy it would have been to 'duck out and sit in cash until things calmed down'; another fatal Big Mistake.

You seeing the pattern here? The importance of discipline in having a plan and adhering to it? Okay good. This next one changes it a bit. One of the things that makes investing endlessly fascinating to me is how the basic principles periodically need to be tailored to the current zeitgeist. Sometimes along the way, the sails might be trimmed in a slightly different way. As Templeton said, 'Always change a winning game'.

After all, it isn't as simple as rigid discipline. If it were, any twit could toss together an algorithm for investing success and be rich. The curse of investing is, as Templeton also said, 'This time is different'. So the trick, of course, is to judge what should be changed, and what should not.

One big difference in the 2000s was the emergence of China to become the world's second largest economy. It did this by adopting free-market principles, in the process bringing a billion people out of pathetic Maoist poverty, and now has 100 million people at Western middle-class living standards - a fantastically positive step in human progress.

The question was: 'Was China a fad? How should we adjust our investment strategy to participate?'

My view was that China would 'stay on the modernization track, not fall into the chaos that has consumed Russia', and that the best way to participate was indirectly, through Canadian resources and global companies. We were fortunate to have a significant weighting in Canadian equities and the attendant exposure to Canadian resources companies through the 2000s. (see China: Dragon Awakening, 11/04, www.chrishoran.ca)

Another example of trimming the sails: we did not rebalance portfolios as equities began to decline in 07 and 08. Recall that some money managers rebalance the asset mix each quarter by selling a portion of what's gone up and buying what's gone down, thereby keeping the asset mix fairly constant. This rebalancing is a nice theoretical idea, and is practiced by many investment people, including a few of the 'canned portfolio' management programs.

However, automated rebalancing appeals mostly to those with more textbook experience than actual hours of flying time. The problem is that automated rebalancing has the unfortunate effect of compounding losses in protracted bear market declines, (because you are buying more of what's still going down), and likewise also has the effect of truncating gains in a protracted rising bull market, (because you are selling what is continuing to go up).

The automatic rebalancing programs that sold down Canadian resource and value-style equities each quarter to buy US and International growth-style equities were licking serious wounds for years.

My preference, based on experience, is to 'let your winners run', and rebalance occasionally, more opportunistically, such as when things look like they're getting out of hand, or when things are so bad that bargains abound.

So we held our bond positions, did not rebalance, and let the equities decline as the storm brewed through 07 and 08. The result was our portfolios were better protected by the bond positions when the full ferocity of the storm hit with the Lehman bankruptcy in September 08.

An example of opportunistic rebalancing, and the final reason your returns compare so favorably to the equity indexes in the last 3 and especially 5 years is that since 2011/12 we have been weighted 30 – 50% or more to the US market; far more than the typical Canadian investor at about 5%. It took considerable courage on your part to rebalance portfolios and invest heavily in the US back then: the 10-year return in the US market (S&P500) was a sickening zero.

The point of all this.

The point is that investing success is not about having some segment of your portfolio at the top of the charts. In investing, as in life, success is a long and dangerous journey. There is no path. Not everyone is your friend, although many will seem to be. Most of the time, survival is success. And, as it turns out, your managers do very well against the indexes, and your portfolio does very well against professional peers, and probably your neighbours too.

Dangerous Market?

Financial media is bleating these days that the 'Trump Bump' has pushed the market to new highs, which must, by their very nature be dangerous. Of course they have a fact to back up their claim, which is that valuations are stretched: both the Post and the Globe carried Professor Robert Schiller's handsome visage last month (March 10th) with articles on how his Cyclically-Adjusted Price/Earnings (CAPE) Ratio is at similar levels to 1999. Since the markets fell almost 50% after 1999, another massive decline is surely around the corner. Should we be worried?

Short answer: no.

Longer answer: Since the markets are up about 25% from the lows of only February 2016 (S&P500), and since corrections of 10 – 14% happen virtually every year (see 'On Declines'www.chrishoran.ca March 2016) nobody should be the least bit surprised to see a bit of a pullback after this magnificent little run. Magnificent, not for its magnitude but for its defiance of the prevalent fear and skepticism.

As always, the importance of an observation depends on where you are. Schiller's CAPE ratio, adjusts, or smoothes out the Price/Earnings ratio by taking the 10-year average of earnings. Normally this would provide useful perspective, but today it doesn't.

The reason: the financial crisis of 08 and 09 resulted in losses which wiped out the US banking system and drove massive losses in other sectors as well. The effect today is to artifically lower the denomination which unnecessarily overstates the valuations.

Schiller actually discusses this limitation of the CAPE ratio in the most recent edition of his famous book, 'Stocks for the Long Run'; but you can't expect a journalist to know that.

A more useful indicator today, but one you won't read about in alarmist journalism, is the forward P/E ratio. Based on consensus 2017 estimates S&P500 earnings of $135, today's market level of 2385 works out to a P/E of about 16, a high-ish in straight history but not at all high in terms of inflation of 2% and 10 year bonds of 2%.

A P/E of 16 is the same as an earnings yield of 6.25% (it's the inverse). An earnings yield of 6.25% compares well to the 10-year bond yield of 2.5%, and inflation of 2%. So in today's low-inflation, low-interest world, the earnings from equities are 2½ times that of bonds; plus, earnings tend to grow over time, where bond yields are fixed for the life of the bond (that's why it's called fixed income).

US equity market returns are likely to be 'average' in the next few years, which is to say 5 - 10% per year, by any measure far superior to bonds and well ahead of inflation.

Today, the US economy continues to gather momentum, and China seems to be dealing with its growing pains. By far the greatest risk is a policy error from Washington. We can only hope that the saner heads in Congress will constrain the protectionist instincts of Mr. Trump.

A Note of Caution

The Trump administration continues to make anti-trade noises. Protectionism is well-established in history as a killer of economic progress. The Smoot-Hawley tariffs of the 1930's were one of the main causes of the Great Depression. Tariffs do nothing to protect saddlemakers, buggy-whip makers, or auto workers from progress, and they punish consumers, and drive international conflict to boot. Protectionism is a demonstration of economic ignorance, but it makes great sound bites for economically illiterate minds.

….If Congress allows significant damage to the world trade mechanism, all bets are off, and major portfolio revisions will be in order….