Assante WEALTH MANAGEMENT

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January 2017

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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.

Value of Advice: Not Performance 2016 Review

Value of Advice: Not Performance

Your January 2017 statements will include several changes, most notably the rate of return on the investment account and the dollar amount of fees paid to the advisor's firm (Assante). It is about time that regulators have stepped up to require improved transparency of fees and returns.

This improved transparency will be a non-issue to most of my clients since they have seen both their fees and returns on their Private Client Quarterly Performance Reports.

However, since financial media will be flailing away at 'fees and the value of advice', it seems like a good time to address the value of investment advice.

Good advice is the key to investment success. Its value is multiples of the fee. What's most interesting is that good advice is not what most people think it is.

Not Performance

Many people labour under the delusion that good financial advice is evidenced in the performance of their investments compared to some benchmark such as a market index. Financial media and most industry people are fixated on performance. They think that if your investments aren't producing returns greater than some market index, well, you should just buy the index ETF yourself, save the management fee and the advisor's fee, and live happily ever after.

The entire popular culture of investing is driven by the overriding assumption that investment performance is key to achieving one's financial goals.

Nothing could be further from the truth.

Equating value of advice with investment performance is a fundamental and often fatal blunder. It demonstrates a basic misunderstanding of how investment success is generated, and where investment losses come from.

The idea that 'outperformance' is achievable consistently through a lifetime by any financial advisor or anybody else for that matter, and the corresponding pursuit of outperformance, is the root of all the soul and portfolio-destroying mistakes investors make.

Pursuit of outperformance is a fool's game. It's where the expression 'pigs get slaughtered' comes from.

But even that graphic expression doesn't do the danger justice, because the danger is much more insidious and subtle than slaughtering a pig. Most investors aren't even aware that they are chasing performance. They naively think that the friendly salesman giving them a 'Second Opinion' is doing them a service.

A typical investor even looking at investment returns is unaware of the trap he is falling into. He thinks a good investment has 'performed well' in some recent block of time. It does not. He thinks outperformance will get him to his goals sooner. He's wrong. He thinks he's getting useful input from a 'Second Opinion' from his friendly banker. He isn't. He is likely being seduced by a sales pitch that preys on his worst and least controllable instincts.

My Claim

I make no claim that any of my clients' investments will consistently 'outperform' any other investment, benchmark, index, or group of peers, over any 1, 3, or 5 year block of time.

I do claim that, working from a comprehensive long term plan (summarized on the back-of-the-envelope 'Snapshot' that we review every meeting), and avoiding the great behavioral mistakes, my clients will realize a significantly greater total long-term return than the vast majority of their neighbors, or more particularly, the outcome the client would have otherwise experienced.

Once again: I claim no outperformance of investments. I do claim that the investor's long term outcome, the total return actually experienced by the investor, is highly likely to be significantly higher than the average investor, or what the investor would likely have realized on their own.

The distinction is crucial. Seeing that the performance of particular investments on one hand is very different from the actual returns experienced by the average investor on the other, is the key to understanding the value that I provide. It is also the beginning of investment wisdom.

How can investment success not result from investment outperformance? Surely top-performance will get you to the finish line sooner. How can you justify a fee and not produce superior investment returns?

Clients have read it many times in these pages, and I know I'm preaching to the converted, but suffer to read it again, because you cannot be inoculated too often: Most investors underperform the investments they hold, and by a significant margin.

By the way, if it sounds like I'm punching too hard at this, I'm not. My Dad's friend committed suicide after he lost all of his wife's fortune in Bre-X. Seemed like a good idea at the time, but turned out to be a total fraud.

Investor Underperformance

Tons of data consistently show that the average investor in an asset class, investment fund, ETF or what-have-you, underperforms the actual investment. They do not earn the return posted for the fund, or ETF in the performance rankings. And it's not because of fees.

The difference between the average investor in a fund and the performance of the actual fund is usually at least 2% per year and can be 12% or more per year. The classic Dalbar 1994 study found that a group of 219 equity funds generated an average return of 12% per year for 5 years, while the average investor in those same funds, actually lost 2.5% per year for the same 5 years. That's an underperformance of 14 points per year.

John Bogle, founder of the Vanguard index funds, was quoted in the Financial Times recently as saying his research showed that the average investor in the Vanguard index funds underperformed the actual fund by 1.6% per year.

The concept is not new: Peter Lynch, who managed the Fidelity Magellan Fund to a staggering 29% average annual return from 1977 to 1990 famously said many times that the average investor in Magellan actually lost money. Now just pause for a moment and think about that. How can you possibly lose money investing in a fund that has a 13-year average annual return of 29%?

Individual stocks are probably worse, (but the data isn't as good): Speaking to a corporate client's senior people years ago I pointed out that Dell Computer was the only major stock to have tripled in price two years in a row, but, I claimed, most people would probably lose money on it. An attendee put up his hand and stunned his peers (and me) by saying, 'I've invested in Dell the last two years and I've lost money on it'. I kid you not.

Of course, if you own an investment for say 5 years, and it generates a 10% - or 29% - return per year, then your return will be exactly 10% or 29% per year for those 5 years. The problem is that hardly anyone holds anything for the 5 years. So they don't get the 10% per year, they get something else.

What do they get? Most people notice a fund after it has had a return of say 29% per year for 5 years. Certainly the broker doing a 'Second Opinion' on you will bring the performance to your attention. People naturally want that return, because (they think) it would make them rich, so they sell the 'underperformer' in their portfolio, say the fund that's had 5 years of zero, and invest in the new 'performing' fund.

Naïve Extrapolation

This naive extrapolation of investment returns runs head-on into the natural cyclicality of investment markets. It's so compelling it's difficult for anybody except battle-hardened veterans to resist. It's also called buying high and selling low, or 'driving by the rearview mirror', and it is just as fatal to investment results as it is driving a car.

As the Dell guy explained, 'Dell may have tripled twice but it wasn't a straight line. It would go up 30% and I'd buy it, just in time for it to go down 25%. I'd get scared and sell, just in time for it to go back up 30%. I'd get my confidence back, and buy again, just in time for it to fall …'. You can't ask for a better example of how investors fail miserably, even as markets go up ten-fold. (Yes, he became a client.)

Naïve extrapolation of returns, known in psychology circles as 'recency bias', is just one of the great perception errors or biases that lead to Big Mistakes.

(Strictly speaking, equity market returns are neither random nor cyclical; they exhibit *negative serial correlation*, which means a string of high or above-average returns tends to be followed by below-average returns. People also say returns revert to the mean. Mean reversion isn't quite the same as cyclicality, but the main concept is bad times follow good times, and vice versa.)

Investor underperformance is a behavioral issue: it results directly from the overwhelmingly powerful tendency, hard-wired into the human brain, encouraged by virtually all financial media and much of the financial industry, for investors to put more money into something that has gone up or 'outperformed' in the most recent block of time, and to withdraw money from or avoid whatever has gone down or 'underperformed' in the last block of time.

Naïve extrapolation of investment returns is as dumb as thinking that because it's been cold for 14 weeks in the middle of February, it's going to be cold for another 14 weeks. It's actually worse – it's like thinking that because it's been -10C for 14 weeks, it's different this time, and it's going to stay cold for a whole year.

This type of performance-chasing happens on a massive scale: data compiled by Cambridge Investment Advisors[1] shows that from 2008 to 2012, even as the equity markets doubled off the 09 lows, investors in the US sold billions of dollars in equity funds every month – thereby locking in losses – and ploughed a trillion dollars into bonds and cash, even as the yield on those bonds approached zero – thereby precluding any hope of earning a return!

For more on the psychology behind this imperceptible yet irresistible process see 'The Science of News' www.chrishoran.ca April, 2013.

Note that the behavioral sword is two-edged: not only do we instinctively want more of what's gone up, we avoid what has not done well in the last block of time. Good advice provides the nudge to overcome the instinctive reluctance and capture the opportunity.

For example, clients will recall when we rebalanced into US equities in 2011 and 2012. The looks on many clients' faces confirmed the trepidation in your questions: "Really? The US?" And with good reason: US equities had just experienced an awful 10 years of zero return.

A surprising thing about Big Mistakes is the almost total lack of public recognition of the issue. The widespread failure to manage investor behavior is not even recognized by much of the industry or the regulators as a problem that they could or should do anything about: the predominant view is that the job of the financial services industry is to cater to the client. Even if the client wants to change his risk tolerance abruptly at an inopportune moment. (see 'Good Advice Hard to Give, www.chrishoran.ca April 2012)

1 Cambridge Advisors, Fund flows stocks vs bonds, 2007 - 2012

Note that I'm tarring most of the financial industry with this brush. As an experienced industry executive said to me at a recent conference, 'It is not possible to convince people (even advisors!) to invest in a 1 or 2-star fund. People will only buy 4 or 5 star funds'. (The primary criteria for awarding stars is performance, so a 4 or 5-star fund has 'performed well' in the recent past.) That means the only thing people like to buy is what has recently done well.

Good Advice

The reason for the industry's failure to confront the behavioral problem? It's worthy of a book, but suffice to say that dealing successfully with the problem requires the good advisor be willing to have a potentially difficult conversation with the client. Facts and figures aren't enough: true advice requires the advisor, at those infrequent but critical moments, to respectfully but firmly push back against the client's erroneous instincts.

Advice to capture an opportunity or avoid a Big Mistake, as the case may be, requires an advisor to have a rare blend of the wisdom to know what to do, and the courage to be honest and say what needs to be said.

Since many industry people are by nature deferential to the client (and many clients like the deference), it can be difficult to guide the client against his instinct or wishes. Equally prevalent are financial salespeople with short-term goals such as keeping their jobs by meeting sales targets.

(I'm happy to say that virtually all of my colleagues at Assante, having been on the client money management side of the industry for many years, are in the forefront of managing client expectations and behavior.)

The Value of Good Advice

Avoiding a Big Mistake is probably the most important, as well as difficult, thing an advisor can do. It is also sometimes the most difficult thing for a client to perceive, since something that didn't happen is difficult to appreciate.

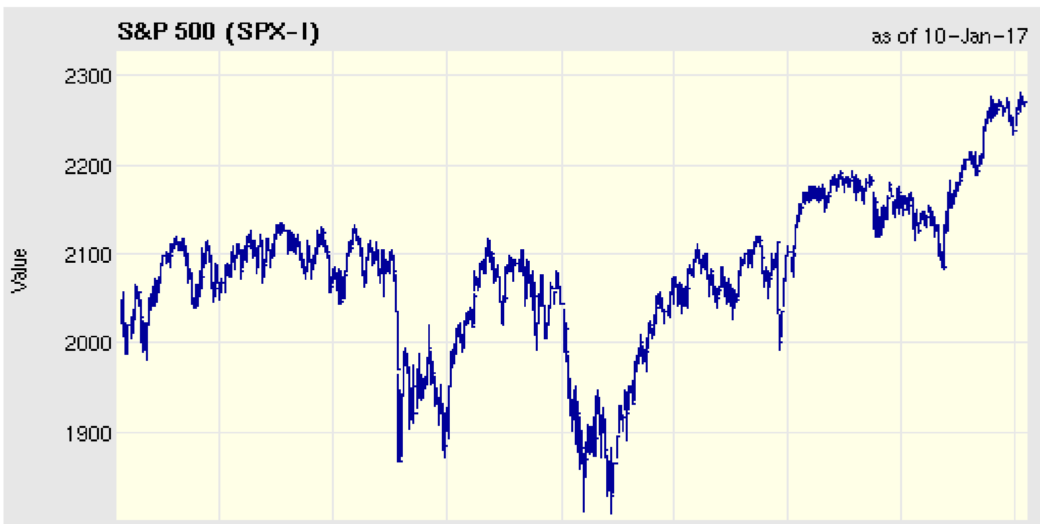
Since the cost of the behavioral errors in the examples above are between about 1.6% and 29% per year, a good advisor's fee at 1% is a bargain.

2016 Review

Speaking of performance, let's look at 2016 and see how we did.

It helps to make sense of 2016 by looking at the picture for the last two years, as in the chart for the US market below. The obvious feature is the two corrections, the first of a little over 10% between August and October 2015, followed by the second in January – February 2016 of about 12% .

US Equity Market



2 years

Source: GlobeAdvisor

They were both sharp, prompted by deflationary pulses out of China as commodity prices, notably oil, fell below $30 in response to a slowdown in demand growth and increased supply. Financial media gleefully reported that the first two weeks of January 2016 was the worst start to any year since 1929.

Financial journalism fanned the flames of fear when the research analyst at UBS, a Scottish bank (whose 'sell' recommendation on the eve of the financial crisis in 2008 made him famous), was quoted around the world at the bottom of the correction in February 2016 when he forecast a 'cataclysmic year' in 2016 and recommended investors 'Sell everything except high-quality government bonds'.[1]

How did that advice work out? The US and Canadian equity markets both turned around immediately to finish up 9.5% and 21% for the year, while the bond market peaked in June (meaning interest rates began to rise and bond prices to fall) handing government bond investors a loss of 10% for the balance of the year[2].

1 Andrew Roberts, head of European strategy at UBS, Daily Telegraph, January 11, 2016

2 US Long Treasury Index return June-Dec -10.5%: Bloomberg

So the first major point for 2016 is that we optimists who stayed invested through the two little corrections did not crystallize losses and miss the subsequent 9 and 21% rise. Even better, the clients referred to in an earlier newsletter who sent in 6-figure chunks captured the entire 25% rise from the bottom in the US (35% in Canada).

Canadian Market

The Canadian market was quite different, with the two corrections running together into one 20% correction from early 2015 to February 2016 taking the index down about 20% - the verge of bear market territory. Since the Canadian market is dominated by the energy, mines and gold sectors, the deflationary impulse from China and fears of slowing world growth hit the Canadian market hard, as you can see.

Canadian Equity (TSX)

2 years

Source: GlobeAdvisor

So the TSX's strong-looking 2016 return of 17% (21% with dividends) is really a rebound from 2015's decline of 11%; Canada's 2-year return is about zero, where the US is up about 10% over the 2 years. The US performance reflects that economy's underlying strength with unemployment at only 4.5%, as well as the market's much greater breadth of exposure to economic sectors. (Canada's unemployment currently at 6.9%)

How did your managers do in 2016?

Great question. As the charts below show, there is substantial variation in the manager returns vs the indexes, but some important messages are sprinkled in the numbers.

Canadian Equity

	1 Year	3 Year	5 Year	10 Year	15 Year
Managers					
CI Cdn. Investment	13.0%	5.0%	9.3%	3.8%	7.1%
CI Cdn. Small/Mid Cap	16.0%	5.5%	8.6%	5.0%	7.0%
Mackenzie Cdn. Growth	9.2%	15.0%	15.3%	6.8%	7.2%
Mackenzie Cdn. Small Cap Value	7.2%	4.3%	9.9%	2.0%	5.3%
Index					
TSX TR	21.1%	7.1%	8.2%	4.7%	7.4%
TSX Small	35.2%	2.6%	1.4%	-1.0%	2.4%

Source: GlobeAdvisor

First, the TSX Index and its small cap counterpart did very well in 2016, handily outpacing your managers. Ha!, the critics claim, I heard managers can't 'outperform' the index! So why am I paying fees?

The Canadian indexes did well in 2016, particularly the small cap at +35%. But 2016 was a rebound, as resource companies recovered from the crushing in 2015, including the 75% decline in mining stocks over the 5 years to 2015. The longer term numbers tell the story: the small cap index return is only 1.4% for 5 years, and -1% for 10 years - both handily out paced by your managers.

The 5 and 10 year numbers show your small-cap managers totally dominated the small-cap index. Because the managers were able to minimize their exposure to gold, energy, and mines as those sectors were hammered, they handily outperformed the index. Not that outperformance is a goal, but…

The large-cap story isn't as clear, but the managers hold their own very well against the supposedly vaunted index. Keep in mind that the managers' returns are after their management fees and Assante's advisory fee. The two fees total around 2%, where the index numbers are purely theoretical with zero management fees, expenses, or advisory fees at all. Even if you grant the index ¼% for fees and expenses, and my advisory fee at around 1%, the managers perform very well against the index in 5, 10 and 15 years.

Not only do the managers do quite well against the indexes, they do it with a much smoother ride: in 2015 (not shown) the TSX was down 11% and the Small Cap Index was down almost 16%. The worst of the managers above was down 4% in 2015, and Dina DeGeer's Canadian Growth was up 13.8%.

So the message is investment managers not only do quite well against an index longer term on a comparable fee basis, they give you a much smoother ride.

US Equity

	1 Year	3 Year	5 Year	10 Year	15 Year
Managers					
Cundill US	14.5%	11.4%	17.0%	5.6%	-
Mackenzie Mid Cap Growth	12.4%	13.2%	18.0%	11.7%	-
Mackenzie Mid Cap Growth (C$)	14.7%	4.3%	11.6%	8.5%	-
CI US Equity Plus	8.9%	11.1%	15.7%	4.9%	-
CI American Value	4.4%	12.6%	16.5%	6.1%	4.9%
CI American Small Companies	10.6%	13.0%	17.9%	7.4%	4.3%
Index					
S&P 500 TR	9.5%	6.6%	12.2%	4.7%	4.6%
S&P 500 (C$)	8.6%	17.7%	21.2%	8.5%	5.5%
S&P Mid 400	20.7%	9.0%	6.3%	4.8%	6.8%

Source: GlobeAdvisor

US Picture

The US picture is more interesting because the exchange rate plays a big role in the last 3 and 5 years. Looking at the Index numbers, the upper line (S&P500) is the return of the US index in US$ terms; immediately below it is the same return translated into Canadian dollars, i.e. from the perspective of a Canadian investor holding US equities. This is because a decline in the Loonie makes US investments more valuable, so it boosts the return to a Canadian investor; a rise in the C$ reduces the return on US investments.

Over the last 3 years for example, the US market return was 6.6% per year, however, because of the decline of the C$ over that time, the return to a Canadian investor was 17.7% per year. Similarly over 5 years the US market return to a 'local' in US$ was 12.2% per year, but in C$ it was 21.2% per year.

The impact on managers' returns gets a little fuzzy because some managers hedge their portfolios to the C$, which takes currency fluctuations – and in this case the benefit - away. The effect of hedging can be seen in the difference between the two US Mid-Cap funds: the funds are identical except that one is hedged and the other is not hedged at all. So the hedged version (C$) return is much lower over 3 and 5 years because the beneficial effect of the depreciating C$ is lost or 'hedged away'.

(Clients will be happy to recall that for the period 2012 – 2015 we were in the unhedged version, so captured the additional gain from the falling Loonie)

The instructive point here is that in US$ terms, your US managers did very well against the index. In Canadian dollar terms their returns are lower because they were partially hedged, so they only received part of the benefit of the falling Loonie. Cundill US for instance, 3 year and 5 year returns in C$ at 11.4% and 17% respectively, lag the index in C$ at 17.7% and 21.2% respectively because the manager was partially hedged, so he captured only part of the benefit of the decline in the C$.

Note that currencies are notoriously fickle and volatile. I do not expect managers, and I do not want them to try to play the currency 'right'. I am happy to have managers hedge selectively as they see fit, which means I expect their returns to be somewhere in between the pure US$ and the fully hedged C$ returns.

So don't let anyone tell you that managers can't beat the index. Some managers do, some don't, but much depends on the time period, and in any case they aren't far off. And much more importantly, nobody fails to meet their investment goals because their returns were 7.4% instead of 8.4%. They fail because of a Big Mistake.

RSP Reminder

The deadline for 2016 RSP contributions is Wednesday, March 1st, 2017. The maximum limit is $25,370 for the 2016 tax year and for 2017 it rises to $26,010. Your personal limit is on your Notice of Assessment from your 2015 Tax Return. If you're having trouble understanding the calculations, please give us a call.

If you currently do your banking online, you can send your Assante contributions via internet banking. (Please call Barb McKenzie to find out how!)

2017 TFSA Limit

CRA announced that the TFSA limit for 2017 will remain unchanged at $5,500. If you don't have a TFSA and would like to open one or if you would like to transfer an existing TFSA held elsewhere, please contact Barb.

2016 Tax Information

Fund companies are beginning to mail out December 31st statements. For non-registered accounts, these statements contain important tax information on capital gains/losses incurred and in some cases, fees paid during 2016. The statement may also contain the T3 or T5. Please keep the information and pass it on to your accountant.