Rapport

Go Figure

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As the current bull market runs its course there will be many winners, but also a host of losers for, as mariners know full well, a rising tide does not necessarily float all ships! Over time, not all investors nor every portfolio manager, is treated equally. Some are the beneficiaries of sound advice, while others are given an almost impossible task to perform. *Go Figure* is an assessment of the many factors involved, and recommends ways for investors to maximize their longer-term investment returns.

FOR BETTER OR WORSE

Since I came to make my living on and about Bay Street the mutual fund business has changed a great deal. Back in 1965 it was a tiny industry; today it is a behemoth multi-trillion-dollar titan, offering a dizzying choice of investment policies and strategies. Unfortunately, it no longer exists to serve the interests of the investor, but rather those of the managers and distributors. In the good old days its focus was stewardship. Today it is all about salesmanship, asset gathering being the primary driving force.

Whereas 90 percent of industry assets were once represented by stock and stock-oriented balanced funds, they comprise less than 60 percent today. Though index funds were only introduced in 1975, they currently account for fully one-seventh of equity fund assets and are growing rapidly. Bond funds are 20 percent of the total, and money market funds about 25 percent. Funds held in RRSP and profit sharing savings plans are estimated to be 40 percent of total fund assets.

Way back when, an investor had three chances out of four of picking a mutual fund whose return was likely to closely match the performance of the major stock market benchmarks. Today the odds are seven to one! Rather than be guided by an investment committee, collective wisdom has been replaced by the perceived brilliance of individual portfolio managers. Unfortunately most of the aggressive performance fund types have proved to be comets, illuminating the firmament for just a brief moment before flaming out. Even so, the portfolio manager system remains largely intact, the continuity provided by the historic investment committee format all but a distant memory.

PORTFOLIO TURNOVER RATES ARE OUT OF HAND

A dramatic increase in turnover rates has come with the change over in portfolio management style and the greater emphasis on short-term performance. At just 17 percent forty years ago, most funds held the majority of their holdings for about six years. Today's

average is 110 percent, reflecting an average retention rate of but eleven months. All of which suggests that today's mutual fund managers are not investors per se. They are nothing much more than a bunch of giddy speculators whose portfolios own nearly 25 percent of the stocks listed on the TSX, yet account for up to 50 percent of the trading. As few hold an investment position long enough to receive a corporation or income trust's next annual report, it is little wonder they have a long time record of passivity and lassitude about corporate governance issues. Then again, perhaps it is because so many of their ilk have been such bad actors in their own right!

REDEMPTION RATES ARE RISING

Given today's "I want it and I want it now" lifestyle, it is not surprising the rate of redemptions has also increased over time. It has gone from six percent of assets in the 1960s, equating to an average retention of sixteen years, to a high of 41 percent in 2002 at the height of the market timing craze, to about 25 percent these days, resulting in an average holding period of just four years. As the old buy-and-hold mantra turned to pick and choose, freedom of choice became the industry watchword, and fund supermarkets with their open architecture the norm for the larger mutual fund management companies. Departing from the industry's time-honoured tenet of "we sell what we make," and jumping on the "we make what will sell" bandwagon, that is, creating funds to match the stock market fads of the moment. As such, the managers must assume much of the responsibility for the volatile nature of today's mutual fund investors.

Although picking tomorrow's winners based on yesterday's performance may seem attractive in theory, there is, unfortunately, no data to support that the strategy works in practise. Nor do top-performing portfolio managers ever seem to match their previous record of success when lured away to work for another firm. Quite the contrary.

OPERATING EXPENSES ARE EXORBITANT

Mutual funds tend to appeal to unsophisticated investors who often pour their hard-earned money into yesteryear's winners at just the wrong time, and suffer major losses in the subsequent downturn in the stock market. The most recent industry trend is to merge these fallen angels into better performing funds within the same family. As if this was not enough punishment, total management fees and operating expenses as a percentage of fund assets have risen over the past half century from 0.76 to fully 1.56 percent. Quite obviously, mutual fund investors have yet to share in the very substantial economies of scale! As more and more of the fund companies became public, the managers inevitably put their own interests ahead of those of the fund investors, which eventually led some to engage in unsavoury practises. The recent scandals and fines proof that salesmanship has triumphed over stewardship.

OVERALL PERFORMANCE IS DETERIORATING

The increase in costs has had a deleterious impact on the returns to mutual fund investors. In the U.S., in the 1945–1965 period, the average fund delivered 89 percent of the stock market's annual return. In the 1983–2003 period, the equivalent return was only 79 percent.

As to the future, hopefully the mutual fund industry will return to its roots, managing in the interests of the investors, rather than those of the managers and distributors.

Reducing portfolio turnover rates would be a very good first step. Lowering management fees and sales commissions, coupled with a cut in operating and marketing costs would also help, as there is no reason to believe that the gurus will suddenly find the ability to provide market-superior returns. Investors could, however, get a leg up if the mutual fund managers were to once again focus on broad diversification, with sound investment objectives, prudent policies and longer-term strategies.

The need for change is obvious, so too are the steps that must be taken. Unfortunately, many of the management companies are doing quite the opposite in promoting an array of still more costly hedge funds to meet the latest investor fad. Pray tell, if these folks could not get it right by going long, what makes them think they can do so by going short?

For the uninitiated, short selling is somewhat of a black art performed by shadowy figures rooting for stocks to tank. Then again, without whistle-blowing short sellers, fraudulent companies can coast more easily, raising additional capital at undeserved prices, forcing honest ones out of business. Whatever the case, recent performance has not been impressive. According to CSFB/Tremont, dedicated short funds lost 32.6 percent in 2003, as compared to the S&P500 which gained 28.7 percent including dividends. In 2004 they lost 7.7 percent as total stock market returns rose 10.9 percent. For the first quarter of 2005 they are up about 10 percent, whereas the primary benchmark is up just 2.7 percent. The good news as far as the managers are concerned is the pricey 2.0 percent fee and the 20 percent of the gains achieved above and beyond the statutory 8.0 percent annual gain in the value of the total portfolio. All of which amounts to nothing more than highway robbery as far as I am concerned!

MUTUAL FUND GROWTH AS A CONTRARY INDICATOR

In fairness to the beleaguered mutual fund managers, they do have a strike or two against them before they ever step into the batter's box hoping to hit a home run on behalf of their vast multitude of investors. Whereas investment advisors dealing with individual investors may be challenged by the finite amount of money they have to invest, pension managers and insurance executives have an inherent advantage in knowing well in advance how much in the way of new money they will receive on a more or less month-to-month or quarter-to-quarter basis. Unfortunately, apart from guessing the size of the next RRSP season contributions, mutual fund managers are left to cope with the vagaries of the stock market. In their case, the money inflows tend to increase as the stock market rises, the greatest gobs coming at or near the top of the bull market, when volatility is high and liquidity is robust. Similarly, once the bear market takes hold the redemptions begin to rise, climaxing at or near the bottom of the correction in stock prices, when volatility is modest and liquidity has all but dried up. As such they seldom have much in the way of elbow room when they need it most.

Rather than be in a position to buy early and sell early on in a rising stock market as the most successful of investors are wont to do, mutual fund managers, through no fault of their own, are forced to buy late in the bull and sell late in the bear market cycles. In effect they are selling to those with a more-or-less steady cash flow to invest and buying from investors who have already realized substantial gains and are trimming back portfolio positions knowing, as they do, that when mutual funds are swamped with new money to invest the stock market is about to peak! Conversely, when redemptions are running at a

record pace, it is always a great time to be buying. Though the high-beta stocks that have taken the greatest beating will tend to lead the way off the bottom, the well-financed, dividend-paying growth stocks will ultimately prove to be the better buy in the intermediate to longer term. Such is always the case!

THE SECRET OF SUCCESS

Despite the advantage of a steady flow of new cash to help alleviate the pain of past mistakes, one has got to wonder why so many pension fund and insurance company investors continue to have such a devilishly difficult time trying to match, let alone exceed, the performance of the major stock exchange indexes. Particularly so when the many individual investors who do, do so without direct access to CEOs, research analysts and hot new issue offerings.

As I see it, we only have a limited amount of money to play with. We regard cash as a valid investment alternative. We may even keep our powder dry for months on end until we find the right kind of investment opportunity at the right price. We are not under pressure, as many institutional investors are, to be fully invested at any point in time. We refuse to take a lot of chances when it comes to investing our hard-earned savings. We stay away from troubled companies and never want to get in over our heads. We are prepared to admit to having made a mistake, and will immediately sell at a loss if need be. We see nothing wrong in booking a profit. By the time the major investment dealers finally get around to covering many of the stocks we own, usually halfway to the bull market top, we know from past experience that the time is fast approaching when we should begin to cash in our chips.

Wall and Bay Streeters hate to tell investors to sell for fear it could have a negative impact on their lucrative investment banking business. As such, they tend to avoid doing so until after something untoward has occurred and the price of the stock or trust unit has fallen substantially. Furthermore, once a goodly number of their competitors eventually follow suit, history tells us that a rebound in the price is more than likely to occur. This trend has become even more pronounced since the research analyst transgressions of the recent past came to light and hefty fines were imposed. Despite the subsequent groundswell in sincerity – if you can call it that – those issuers with the highest percentage of sell reports continue to do better than the many without a one. So, CEOs should not be overcome by a rash of these sort of dastardly recommendations as, more often than not, it is the first sign of better times to come!

Individual investors are not the dummies many of the so-called professional members of the investment community try to make us out to be in their concerted effort to sell us on buying a fancy, new financial product. Sorry, but we would much prefer to keep it simple, stupid! The only way the portfolio managers are ever likely to get it right is to put their own money on the line. If they were to do so they would soon know to reduce the turnover rate and risk exposure, and spend more time assessing the merits of each and every investment on the books, discounted new issues and secondary offerings included. They might also come to realize that a money manager's record of performance is often 70 percent due to the firm they work for, and only 30 percent to their own prowess! Which helps to explain why a portfolio manager's track record seldom follows them when they switch firms.

IN SUMMARY

Managing money is no easy task. Very few of the portfolio managers, be they employed by a mutual, pension or insurance fund, ever do as well as the stock market benchmarks. As the battle for supremacy heats up, more and more are becoming indexers rather than stock pickers, charging lower fees, and reducing trading in order to minimize costs and potential tax burdens. As they do, it will become easier for the better informed individual investors to make money as inevitably the professionals will be caught up in other matters and not have their eye on the stocks and trust units with the greatest upside potential.

Go figure, but if I was the chief executive officer of a publicly traded enterprise, I would never lose sight of my individual investors who collectively own 55 percent of all the securities listed for trading on the TSX. When kept in the know, they are quite willing to step up to the plate when the going gets tough, and the CEO needs the tough to get going!