

MORNINGSTAR REPORT

JUNE 11, 2008; MORNINGSTAR CONFERENCE AT THE CARLU IN TORONTO

Buy and Hold

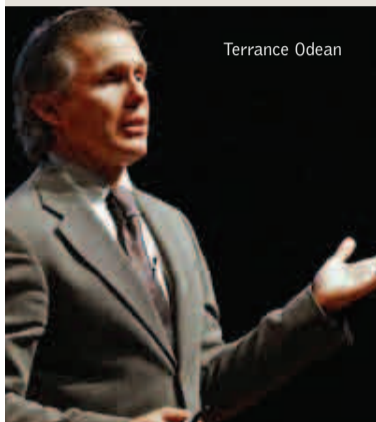
Active trading costs clients' wealth

BY KANUPRIYA VASHISHT

Have you dealt with clients who, riddled with bullish bravado, forced you to buy when the market spikes, and sell when the bear turns on them? Terrance Odean, professor of banking and finance at the University of California at Berkeley, told delegates at the June Morningstar conference that the best way to deal with such fidgety clients is to use insights from behavioural finance to both understand and guide them.

As a leading U.S. investor-behavioural expert, Odean is a prolific researcher of trading habits. His raw data consists of the actual trading records of thousands of individual-investor brokerage accounts from the '90s. As a result Odean, and his collaborators, have plumbed through this unique database to catalogue the many ways small investors undermine their own results.

Some investors get overwhelmed and make unwise decisions.



Terrance Odean

In an initial research project, Odean divided the small-investor records into five groups, based on frequency of trading. The most active group trailed the most passive by an average of 7% each year. On a \$10,000 investment, that adds up to a deficit of roughly \$8,000 over six years.

Through this research, Odean has come to believe that while confidence is a factor in trading, over-confidence is far more problematic. Another pervasive problem is an investor's inability to predict market timing. Small investors habitually overestimate their ability to predict the future, and fitfully trade in and out of stocks.

Based on the trades of 10,000 investors at a large discount trading firm, Odean observed that those who traded stocks that were in the news, when maximum attention was focused on them, enjoyed no benefits. In fact, Odean found that excluding transaction costs, newly acquired stocks actually underperformed the stocks that were sold.

Curious as to how much of an impact dreadful market timing had on these investors, Odean looked at the performance of stocks after the trades took place. On average, the stocks these investors bought underperformed the stocks they sold by 3.2% over the next year, and 3.6% after a two-year period. This was before deducting com-

missions. To make matters worse, rather than admitting their mistake, investors held on to the losers for far too long.

That's not all. Odean found that over-confidence also led to another seminal mistake: under diversification. Based on his research, Odean found that employees who invest one-fourth of their assets in company stock sacrifice 42% of the stock's market value relative to holding a well-diversified portfolio. "While an over diversified portfolio will never make you as rich as Bill Gates, it will also never lose all your money," says Odean. "Look at what happened to the 62% of Enron employees who only invested in company stock."

Not surprisingly, Odean's research also showed significant differences between the trading habits of men and women. In a 2001 study, men claimed to have greater investment ability than women. However, the data indicated that the performance of single men was 1.4% lower than the trading performance of single women.

Unfortunately, combatting a client's perception of market confidence is far more difficult for advisors in today's world of technological advancements. Now, many clients and investors have access to a lot of online data and this tends to feed investor over-confidence. But access to more knowledge isn't necessarily an advantage, says Odean. "You assume you'll make more [money] if you know more, but some investors get overwhelmed and make unwise decisions."

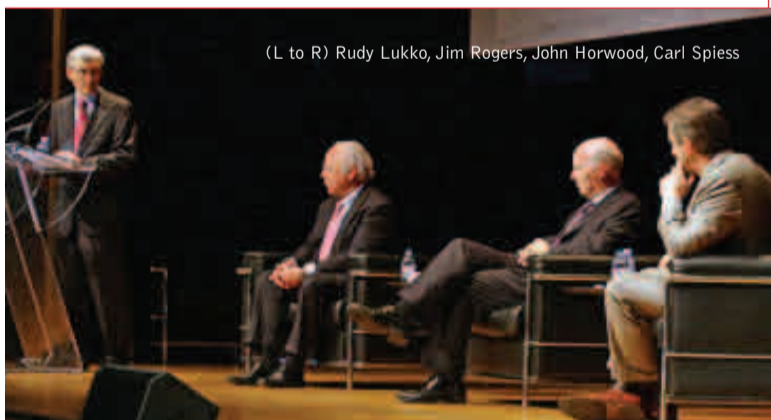
Odean noted, in a 1999 report, that before going online, investors outperformed the market by 1.9%. This outperformance disappeared when these investors moved to online trading, underperforming the market by an average of 3.6%.

"Individual investors who wake up at 2 a.m. and are tempted to trade online should go back to bed," recommends Odean. "When you get up in the morning, if you're still hot on the stock, do diligent research or speak to an experienced advisor if you want to protect your wealth." **AER**

Quest for Income

Advisors evaluate the options

BY STEVEN LAMB



(L to R) Rudy Lukko, Jim Rogers, John Horwood, Carl Spiess

There is no lack of innovation in the financial services sector, with revolutionary products being brought to market at a dizzying pace. The question remains, however, are they needed?

At the 2008 Morningstar Investment Conference, the theme may have been *Taming the Market Cycles*, but for three top advisors speaking at the event, that's the easy part; staying on top of product development takes a little extra effort.

"So much of our time now is spent learning new products and there's a new one every few weeks," said Carl Spiess, director, wealth management, ScotiaMcLeod.

Segregated funds with a guaranteed minimum withdrawal benefit rider were singled out as particularly time-consuming, in terms of due diligence.

"I know how long it's taken for me and my colleagues to understand at least 90% of how the thing works," said Spiess. "I cannot believe that the clients who are buying it understand how it works, let alone that the majority of advisors can explain every potential possibility and outcome."

GMWB products have helped insurance companies capture a significant piece of the retirement funding pie, largely because of the downside protection they offer.

"They are a product that is a marketing marvel, in my judgment," said Jim Rogers, chairman of Rogers Group Financial. "They recognize the psychology of the retiree better than any other single product that I've seen in a long time."

He said guaranteeing a minimum income flow for the rest of the client's life addressed the fact that the loss of a dollar is worth twice as much psychologically than the gain of a dollar.

"The question is 'can you emulate the performance with a well-diversified portfolio?' The answer is, yes you can," Rogers said. "Can everybody do it? No, and I think that's why they are being sold to the extent they are."

He suggested that GMWB products are being sold primarily by advisors who lack a licence to assemble a portfolio of individual securities.

He explains that a carefully constructed portfolio, balancing individual equities and bonds, helps to smooth out the rough patches.

"I think everybody who is focused on retirement would be well served if they looked at what major pension plans invest in," said Rogers. "Typically, they're bal-

A carefully constructed portfolio... helps to smooth out the rough patches.

anced portfolios. Presumably, the money managers know what they are doing, so perhaps this is the sort of portfolio you should be looking at."

While bonds remain the favoured method of stabilizing a portfolio, there is some debate as to how they are best employed. Many investors would assume that a balanced fund with a smattering of bond holdings should suffice, but Spiess suggested another tactic for clients whose retirement is imminent.

Rather than balancing the overall portfolio, he splits the fixed income portion off and constructs a ladder of guaranteed investment certificates – the investment workhorse of the 1980s. The GIC ladder is best built within a registered retirement income plan, to mitigate the tax hit of interest-based income.

With a hefty GIC due to mature each year for the first five years of retirement, he says he "can look the client in the eye across the kitchen table and say 'we have enough income guaranteed for the next five years.'"

He considers this approach "much better than a bond fund, or a balanced portfolio" because the concept is easy for the client to understand, and they know how much they will receive on maturity. With a balanced fund, "we know there are bonds in there, but since the whole thing is going up and down, the client doesn't have the same comfort level."

Wealthier clients may require more exotic products.

"We're seeing a lot more interest in hedge funds, and for long-term growth, private equity. There are a lot of ways to control volatility in the portfolio other than using bonds," says John Horwood, first vice-president and investment advisor, Richardson Partners Financial.

"For many of these people, they already have more than enough cash flow to fund their retirement and the two biggest challenges that we face as advisors are taxation and inflation, and bonds don't solve either of those long-term problems."

Hedge funds and portfolios of individual securities may be more fashionable, but Spiess defends the traditional mutual fund, pointing out that for the mass market of investors, it still fits the bill. **AER**

Reward Beyond the Risk

Hedge funds can trim volatility

BY SCOT BLYTHE

Hedge funds have certainly attracted their fair share of opprobrium, between some of the rather more spectacular blowups, concerns about market distortions, and their high fees.

Indeed, hedge funds are sometimes characterized as fee-collection schemes masquerading as investments, notes Jim McGovern, managing director and CEO of Arrow Hedge Partners and past president of the Canadian chapter of the Alternative Investment Management Association.

The probability of a 22% loss on the Dow in 1987 was once every 8.5 million years.

WHAT IS A HEDGE FUND?

On the one hand, a hedge fund has fewer regulations to follow; a hedge fund is also able to take long and short positions and invest in futures and other financial instruments that are generally denied to conventional mutual funds. The aim is an absolute return, a positive return, year in and year out, with manager skill devoted to smoothing volatility and thus offering better risk-adjusted returns than a passive investment in a benchmark.

But not every hedge fund succeeds. They have to be treated as a small business — just like an individual stock is a business, with managers, balance-sheet reporting obligations, a regular tallying of profits and losses as well as sturdy back-office operations. Hedge funds that produce profits, and produce them transparently, succeed; those that fail, just like a public stock, go out of business, McGovern says.

“As a business, hedge fund

managers must make money,” he notes. And McGovern welcomes that: “It shows the system is working; when people don’t perform, they’re out of business.”

That’s much more difficult to stomach for the investor. Except that 87% of the companies once listed on the Standard & Poor’s 500 have also disappeared, he points out.

EVALUATE THE NUMBERS

So to evaluate a hedge fund manager like a stock, there are three types of due diligence criteria involved.

The first set of criteria bear on qualitatively evaluating the managers and their pedigree as well as their fee structure.

The second set focuses on the investment objectives and their quantitative measures, such as their correlation to long-only markets, the length of their drawdowns — the time it takes to recover from a loss — and their volatility.

Finally, there are risk considerations, such as leverage, portfolio concentration, liquidity, and not least, tail risk: whether an ostensibly low-risk play is subject to sudden shocks in the market.

This is not to be gainsaid, although it is hard to predict. For example McGovern cites the 22% loss on the Dow in 1987. That was a probability that should occur once every 8.5 million years. Yet, it happened. And that’s what counts, it’s the outliers that matter to clients, the extreme situations. Yet, these same outliers may create structural opportunities for skilled managers to exploit. What’s the difference? “Really, truly understanding what you’re doing,” says McGovern.

ESSENTIAL DUE DILIGENCE

Nevertheless, he admits that due

diligence is “really hard work.” For instance, Bayou Management, whose founder was recently in the news for faking a suicide, pitched Arrow Hedge Partners about a year before it blew up in a haze of false accounting. It had created its own accounting firm and brokerage to disguise its trades.

That was upfront due diligence. But there’s also a need for continuing due diligence.



Jim McGovern,
managing director
and CEO,
Arrow Hedge
Partners

Amaranth Advisors, which went down in the fall of 2006, morphed from a multi-strategy fund to a directional bet on energy prices. Moreover, the size of the bet was too large for its capital base; in effect, Amaranth became the market. Apart from that, penalties for redemptions should have been regarded as a red flag.

OTHER CONSIDERATIONS

Fee structures reveal whether a hedge fund manager’s incentives are aligned with those of the investor. Leverage, too, is a concern: “Leverage combined with hubris will usually bring down a hedge fund,” McGovern says.

Then there’s the size question. As more assets are accrued, often there are fewer opportunities to exploit, but nevertheless, the manager is “clipping a management fee” just on the assets, not their performance.

Hedge funds, when they work, have a return profile somewhere between bonds and equities. As such, they can have a useful role in portfolio diversification.

Yet, there is not enough data, McGovern admits, to warrant large exposure. Indeed, classical portfolio optimization would suggest a 100% weighting in hedge funds. McGovern suggests a 10% to 20% exposure. There’s another aspect to risk management: client expectations. Risk aversion is not the same as loss aversion; drawdowns do matter. It’s for that reason McGovern recommends a hedge fund of funds. The advantages are diversification and active management across styles, thus mitigating the idiosyncratic risk of a manager meltdown. But again, as Portus Alternative Asset Management and Norshield Financial Group demonstrate, funds of funds require due diligence too.

Measuring the Manager

Analysis can yield insight

BY SCOT BLYTHE

Can a fund manager beat an index? If so, is it luck or skill? How do you demonstrate that, or at least put it within the context of a balance of probabilities?

With a complex set of criteria, says Brian O’Neill, Morningstar Canada’s senior fund analyst. The first set of criteria concern the fund’s management, including the length of time a manager has directed a fund, proven ability to sidestep big losses and a deep team to back the manager. Then there’s the fund manager’s strategy, essentially, are they guiding a mandate in which they have some experience, is what they are doing readily understandable, and finally, is the investment process repeatable.

That’s on the portfolio manager side. On the fund company side, key questions involve fees compared to low-cost passive options, the charging of performance fees based on beating a relevant benchmark, and declining management fees as assets ramp up.

Is the distribution sustainable?

Looking back: 6.4% annualized nine-year return

Looking forward, what can we expect to return

How does this work in practice? O’Neill offers three examples.

50% Canadian Equity	8.0%
40% Canadian Bonds	4.0%
10% Cash	3.5%
Expected Return	6.0%

Kim Shannon, currently manager of the Brandes Sionna Canadian Equity Fund, but before that the guiding mind behind the CI Canadian Investment Fund, is the first example. While a third-quartile performer in 1999, she bumped into the first quartile soon after that. A major reason is because she resisted buying Nortel. Using rolling returns, O’Neill suggests this wasn’t simply a lucky call. Subtracting the period of Nortel’s spectacular rise and decline, Shannon was in the top two quartiles 70% of the time. And that’s with lower price-to-earnings and price-book ratios than the index, but with a higher return on equity.

Conclusion, says O’Neill: a good stock-picker with potential to perform on the downside.

Now take a fund with quite a bit less renown: Trimark Europlus. It’s quite volatile, O’Neill observes, down 17% against an index that is down 11%. Or, as he puts it, “from hero to zero and back again.” But does the volatility matter over something more than a one-year period? As a high-beta fund the volatility hardly seems worth the risk.

But that’s not the whole story. First, beta is measurably sensitive to the end points, to what happens at the end of the period measured, not during. And even those betas may not be representative of what the fund is trying to do, so the benchmark that defines beta may well be inappropriate. Finally, volatility, defined as standard deviation, makes no distinction between gains and losses, only the variance up and down around a mean.

In O’Neill’s analysis, Europlus has suffered from higher and more concentrated positions in small and mid-cap stocks than the index. For all that, much of the time it has actually beat the MSCI Europe index thanks to upside volatility. But how? By owning good-quality but unloved consumer and financial stocks, and by eschewing resource names. On a cumulative 10-year basis, that strategy has outperformed both the index and the median European equity fund.

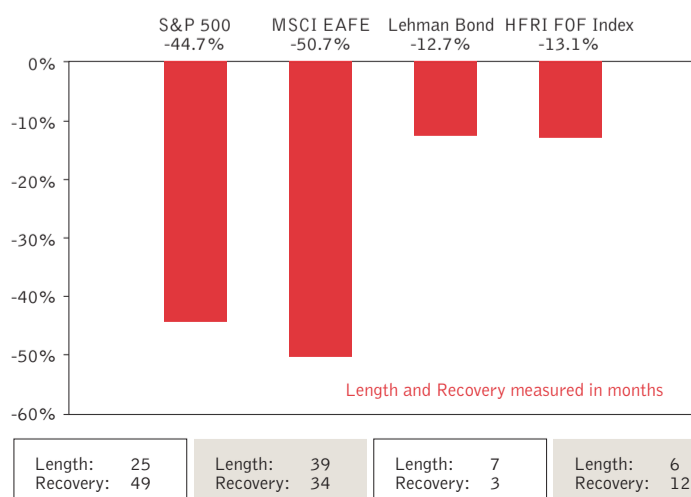
So, says O’Neill, the stats don’t necessarily represent what the fund is actually doing. At the same time, to reap the benefits of the fund’s investment strategy, investors must have a long-term position.

Luck and long binoculars. What’s next? Likely sustainability. Despite a well-regarded management team, BMO Monthly Income, Morningstar data suggests, may not be able to maintain the promise. The fund offers a 7.2% annual tax-efficient distribution. The fund has achieved an annualized return over the past nine years of 6.4%. But a look at the 2007 distribution shows that 64% of it was return of capital. Tax-efficient yes. Sustainable, probably not, not against an expected return for the portfolio of 6% versus a distribution of 7.2%.

Even if an annualized return of 7.23% were to occur, O’Neill notes, there is still the sequence in which they happen to consider, argues O’Neill.

AER

HISTORICAL DRAWDOWNS



Oil Flares Debate

Currency & commodities at the fore

BY BRYAN BORZYKOWSKI

If there's any topic that can spark a heated debate, it's the rising price of oil. Where the cost of the expensive commodity will go was the main topic of discussion during the Morningstar Investment Conference panel in June, with one forecaster saying we'll see a barrel of crude hit \$140, while another speaker said prices will drop to \$85.

"An awful lot of people are surprised at just how high oil prices have gone," says Patricia Mohr, vice-president, industry and commodity research, at Scotia Economics. "I wouldn't be surprised to see oil move higher in the second half of the year to the \$140 mark."

Well, it didn't take long for that mark to be surpassed.

Mohr says the expected rise in prices is partly due to Russia's dwindling oil supply. Production in the former Soviet Union dropped last year, and high export taxes on crude are making the country's supplies less attractive to foreigners. "It looks as though the drilling activity has really stagnated," she adds. "All the major

Russian oil producers are posting year-over-year declines."

Other reasons for the climbing oil costs have to do with demand in emerging markets, a slower U.S. economy and the inability of non-OPEC countries to meet global demand.

Dennis Gartman, the Virginia-based publisher of the Gartman Letter, an investments-focused newsletter, disagrees with Mohr's assessment. The vocal American says that he is bothered by people who say that the crude oil supply is tight. "If that's true, why are West Texas Intermediate and Brent Futures at contango? This last \$40 in crude oil is absolutely absurd and will disappear very quickly."

He thinks oil should fall to the \$85 mark a year from now.

Mohr counters Gartman's ar-

This last \$40 in crude oil is absolutely absurd and will disappear very quickly.

gument, saying "the idea that things have to fall back is not always the case." She points out that a few years ago everyone was upset over \$40 oil. That eventually moved up to \$60, and then to \$80. "It could move down again as we move into the next decade," she says, "but the level will remain much higher than where we started this decade."

Emerging markets will also keep oil prices high, Mohr thinks. In China, demand for SUVs remains strong, although the vehicle isn't yet common there. She predicts the Chinese will eventually start buying bigger cars.

But Gartman points out that even though Chinese salaries are increasing, there's no way they'll be able to afford \$4 a gallon for gas, so prices will have to stay low.

Eric Bushell, CIO at Signature Global Advisors, says while the Chinese market might be able to handle rising costs, other emerging markets won't be so lucky. He said inflation is set to skyrocket to 13% or more. If that happens, he thinks, no one will be buying houses or cars, and growth will stall.

"We bought a bit too much into this seductive emerging markets growth story."

Besides oil, the panel had a spirited debate around the Canadian

dollar. Gartman proclaims that he is getting "violently bullish" on the loonie again.

That prompted John Embry, chief investment strategist at Sprott Asset Management, to point out that "in one breath, you just said the oil price is going to get crushed, and if the oil price gets crushed, the Canadian dollar is going with it."

Gartman points out that Canada has other commodities – copper, corn, canola – that will keep the Canadian dollar high. "You've got all kinds of crap to sell," he told Embry, "not just crude oil."

"I can't agree with you," said Embry. "The shutting of the [GM] car plant? The dollar went down."

The issues surrounding the credit crisis also came up in the panel's discussion. Gartman says he thinks we're "through the seventh and a half inning of a nine inning game," adding that "we'll get through this."

He expects hundreds more banks to file for bankruptcy – only two have so far – but it won't spell the end of the financial industry. Em-



From top to bottom:
Eric Bushell,
Dennis Gartman,
John Embry.
Not pictured:
Patricia Mohr.

bry "totally disagrees." He says North America has "never been in a position like this" and that it's impossible to predict what's going to happen. "We could be in the second inning," he adds. "We haven't necessarily seen the worst."

Mohr explains that the U.S. slowdown will continue but that it will be a prolonged downturn, rather than a sharp decline. "We will remain very soft in the U.S. for some time," she says. "Housing is going to be very slow to recover."

Despite all the back and forth between panellists, everyone agreed that poorer economic conditions in the U.S. can only help Canadian banks. Bushell explains that Canadian financial institutions are well capitalized and are much more profitable than their U.S. counterparts. "Canadian banks will exit this episode to become bigger."

Adds Gartman, "Canadian banks are going to be in the driver's seat for the next decade. They're going to come around and buy everything in the U.S." **AER**

An Extra Layer of Diligence

Environmental, social and governance values at work in a client's portfolio

BY ROMANA KING

The biggest perceived problem with socially responsible investing is that a premium must be paid for being socially responsible – a premium that diminishes investment returns and limits market opportunities.

This is a myth, explains Michael Jantzi, Canada's leading advisor on socially responsible investing (SRI).

At the June Morningstar conference, Jantzi tackled the zero-sum myth that has plagued SRI since its inception in the invest-

ment realm more than 20 years ago. He also offered an alternative perspective: that adherence to environmental, social and governance (ESG) values adds an extra layer of due diligence.

Considering market volatility, the lack of knowledge for complex investment vehicles and dropping consumer confidence, a little extra due diligence might be exactly what advisors need to offer their clients, and investors know this, says Jantzi.

According to his company's

proprietary research, European retail and institutional SRI assets total more than \$2 trillion euros (about \$3.2 trillion CAD). In Canada, SRI assets under management topped \$503 billion in 2006, an increase from \$65 billion since 2004.

This increase is in line with reports from the Social Investment Forum (SIF), a national U.S.-based association whose members include various financial professionals and institutions.

According to SIF, SRI assets increased 18% between 2005 and 2007; in the broader universe of professionally managed assets the increase in assets was less than 3%, during the same time frame. Globally, SIF reports that ESG investment assets increased from \$639 billion in 1995 to \$2.71 trillion in 2007 – an increase of more than 324%.

"You can't maintain a company's bottom line without examining these environment, social and governance issues," explains Jantzi.

To illustrate his point, Jantzi offers a comparison of the Jantzi Social Index (JSI) – a basket of 60 Canadian companies selected on the basis of environmental, social and governance performance – and

You can't maintain a company's bottom line without examining these ESG issues.

the S&P/TSX Composite Index and the S&P/TSX 60. Since the inception of the JSI, on January 1, 2000, the index has outperformed both the S&P/TSX Composite Index and the S&P/TSX 60.

Jantzi believes this is because "investors are starting to understand that their investments can make a difference." On the flipside, "companies who are proactive in terms of environment, social and corporate governance issues will not only be considered good businesses, but by addressing these concerns [they see] it is good for the bottom line," explains Jantzi, who has more than 20 years of experience in the ESG/SRI field.

He continued by offering some compelling reasons why the zero-sum equation – social values and investment returns cannot coexist – is a myth and why SRI investing is being thrust into the mainstream. These reasons included (but were not limited to): heightened concern over climate change, the increased awareness of the

carbon disclosure project and the growing body of research highlighting the link between superior sustainability performance and enhanced share value.

Investors want downside protection, not just upside gains, explains Jantzi. When an advisor adds in the due diligence that is inherent to the ESG investments, it makes this investment style even more appealing in a volatile and uncertain market. And not to be dismissed as one of the converted, Jantzi openly posed the question that many advisors in the audience were probably asking themselves: Can you be an SRI investor and still make money?

"The answer is quite honestly something we're not going to be able to answer definitively," says Jantzi.

"But I'm perfectly comfortable saying to you that this myth – that SRI is at one end of the spectrum and making money is at the other end – is a misconception.

"Think about how you can begin to integrate this into the conversation with your clients," Jantzi says, "how this might be a prospecting tool and how it might differentiate you in an increasingly crowded market." **AER**



Michael Jantzi,
founder and president of
Jantzi Research.