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PUR Investing Inc. is a Toronto-based software development firm registered as a portfolio manager with the OSC that engineers disruptive investment and pension strategies for Gen X/Gen Y/ Gen F, and mass affluent investors by combining and leveraging new technologies with innovative investment products and ideas.

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ARTICLES

CREATE SUSTAINABLE PORTFOLIOS
January 2013

A MATTER OF TRUST
February 2013

EXAMINING PE AND INFRASTRUCTURE ALTERNATIVES
March 2013

TAKE ADVANTAGE OF REIT ETFS
April 2013

SOCIALLY RESPONSIBLE ETF INVESTING
May 2013

INVESTOR KNOWLEDGE CONTINUES TO LAG
June 2013

WHAT UNBUNDLING COULD MEAN FOR THE FUTURE OF ADVICE
September 2013

REGULATORS DON'T UNDERSTAND DIVERSIFICATION
October 2013

HOW TO MANAGE A BOND PORTFOLIO
November 2013

WHY OUTCOMES ARE THE NEW ALPHA
December 2013

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Create Sustainable Portfolios

January 2013

When I chaired the investment committee for an endowment fund some years ago, I faced a conundrum that many investors struggle with today: dwindling yield.

The fund, responsible for providing scholarships and bursaries, saw its purchasing power eroding because the portfolio was invested almost entirely in fixed-income securities.

Faced with falling interest rates, the spending policy couldn't adapt, even with modest capital gains. The headmaster wanted to expand the bursary program and something radical had to be done.

I connected with J. Peter Williamson, then a professor at the Amos Tuck School of Business at Dartmouth College and a consultant to the Commonfund, an organization created by a grant from the Ford Foundation that invests for endowment and not-for-profit organizations in North America and the U.K.

Professor Williamson, a Toronto native, introduced me to the Yale formula and emerging trends in endowment investing that, like pension plans, have long time horizons, but unlike pension plans, need to provide stable annual income. If your clients are in or approaching retirement, learn from endowment fund strategies that allow for more stable drawdowns and focus on risk in a way that's different than pension and mutual funds.

The Yale Formula

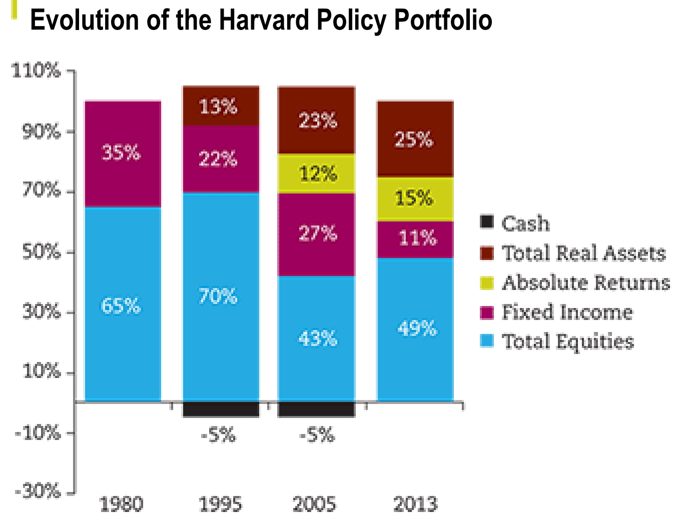
The Yale formula allows endowments to smooth spending. Starting with last year's expenditure as the base, a 24-to-36-month moving average of returns is used to establish spending for future periods. Notably, the formula permits both income and capital gains to support funding requirements.

This contrasts with the more common practice of spending only interest and dividend income or a flat 4%-to-5% of the portfolio's value. A modified version of this formula allowed the endowment with which I was involved to double funds available to worthy students by building in a growth component.

Having accommodated capital gains in spending models, the Commonfund and major North American endowment funds like Yale and Harvard began to pursue broad portfolio diversification that moved away from the traditional pension fund asset mix of 60% equities, 40% bonds.

In examining the chart at the right, the fund made three important changes:

1. It grew total real assets;
2. It introduced absolute-return assets; and
3. It reduced its fixed-income assets.



What Can We Learn?

Endowments have dramatically reduced fixed-income weights to about 11% currently. That means domestic bond exposure is down 4% from 15% in 1995. Pension funds, by contrast, should theoretically be invested 100% in bonds because fixed-income instruments provide the best offset to their liabilities. As interest rates rise, both their assets and liabilities decline and vice versa. But since most defined-benefit plans are in deficit to funded projections, this strategy would only lock in shortfalls today — not a good idea.

Harvard's low bond weight is worthy of note. A 1.61% yield from 10-year U.S. Treasury Bonds has a five-year average volatility (standard deviation) of 9.9%. That's plenty of risk for not very much return.

Ten-year Government of Canada bonds yield 1.71% with 5%-to-6% volatility. High-yield and corporate bonds offer equity-like risk and return characteristics. Although corporate cash flows and balance sheets are improving, bonds are riskier than many investors appreciate right now.

Alternative sources of yield like dividend ETFs can substitute not only for bonds but also alternative equity with a stable stream of cash flow. Absolute return and private equity strategies, including infrastructure ETFs, are scarce, unproven and usually expensive. We will explore these ETFs in coming months.

A sustainable income policy combines more focus on growth with a spending policy to accommodate capital gains. Advisors should consider an endowment model for their income clients. If you want to use fixed-income securities, remember they're riskier than they appear.

High-Yield ETFs Trading In Canada

High-Yield ETFs	Expenses	Index Risk (SD)	Duration	Weighted Avg. YTM
BMO High Yield Corporate Bond Hedged to CAD (ZHY)	0.55%	17.6	4.26 yrs	5.82%
iShares US High Yield Bond Index Fund (XHY)	0.60%	16.6	3.98 yrs	5.51%
Horizon Active High Yield Bond (HYI)	0.60%	NA	5.7 yrs	6.67%
PowerShares Fundamental High Yield Corporate Bond (PFH)	0.65%	NA	3.69 yrs	5.09%
iShares Advantaged US High Yield Bond + forward structure costs (CHB)	0.55%+	17.6	4.27 yrs	5.59%

Final Note

Professor Williamson passed away last summer, but his counsel and direction continue to help many students access better education. Thank you Professor!.●

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A Matter of Trust

February 2013

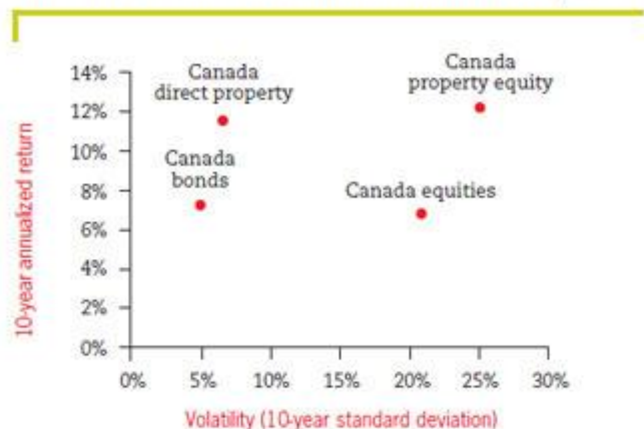
Real estate investment trusts (REITs) pose risks that can extend beyond typical investment concerns.

Leverage, external management and potential conflicts of interest, like related-party transactions, are part of navigating risks for the largely retail-oriented Canadian REIT marketplace, according to a Raymond James whitepaper published in 2012. Given these caveats, using and diversifying with REIT ETFs seems like a good idea.

Real Estate Portfolios

Canadian insurance companies and pension funds eagerly added real estate to portfolios 30 years ago to participate in strong commercial property markets, and diversify traditional portfolios of bond, stock and mortgage holdings. Real estate funds evaluated only one-third of their portfolios annually based on transactions, so a lag in timing and subjectivity smoothed returns, making valuations stable.

In risk-adjusted terms, lower volatility — a result more of the valuation cycle rather than portfolio management expertise — helped managers look good. The chart "10-year total return and volatility," this page, shows directly held property had low volatility — close to bonds — but returns similar to publicly traded property equity.



Cohen & Steers, a global investment manager, believes direct real estate holdings' volatility is understated when compared with publicly traded holdings.

Still, real estate can anchor an income portfolio. But when income is the primary investing goal, yields can be deceptive when property markets overheat. Investors may face the risk of falling values.

The S&P/TSX Capped REIT Index (iShares; XRE) and the FTSE Canadian Capped REIT (Vanguard; VRE) are largely weighted by capitalization based upon 15 securities (XRE) and 19 securities (VRE) respectively.

Dow Jones Canada Select Equal Weight REIT Index (BMO; ZRE) is different with 20 securities each accounting for about 5% of the fund. Cohen & Steers Global Realty Majors Index (iShares; CGR), the only global real estate ETF trading in Canada, has 75 holdings.

TSX-Listed Real Estate ETFs	Symbol	Expenses	Yield
Vanguard FTSE Canadian Capped REIT	VRE	0.35%	na
BMO Equal Weight REIT	ZRE	0.55%	5.45%
iShares S&P/TSX Capped REIT	XRE	0.55%	4.74%
iShares Global Real Estate	CGR	0.63%	2.71%

Largest U.S.-Listed Real Estate ETFs	Symbol	Expenses	Yield
Vanguard REIT	VNQ	0.10%	3.49%
iShares Dow Jones U.S. Real Estate Index Fund	IYR	0.48%	3.60%
SPDR DJ Wilshire International Real Estate	RWX	0.59%	6.60%
iShares Cohen & Steers Realty Major	ICF	0.35%	2.97%
SPDR DJ Wilshire REIT	RWR	0.25%	2.99%
iShares FTSE EPRA/NAREIT Global RE ex U.S.	IFGL	0.48%	5.75%

U.S.-listed ETFs offer more variety with similar expenses. Notable exceptions include: iShares CGR 0.63% (Canada) and ICF 0.35% (U.S.), based on the same index, and Vanguard REIT's expense of 0.10%, which is very low. International REITs feature higher yields but with more country and currency risk exposure.

In a move harkening back to the Canadian income-trust craze, U.S. companies, ranging from private prisons, billboards, and cell phone tower companies, are interested in converting to REITs. Although 75% of REIT income in the U.S. must be derived from rent income, definitions are blurring.

For instance, Iron Mountain, the document management, storage and shredding specialist is moving toward REIT conversion based on the rental of document storage space. Together with master limited partnerships, the income-generating market is developing rapidly, and tax considerations for Canadian residents notwithstanding, will be entertaining to follow.

Institutions hold 86% of U.S. REITs, but small size and lack of liquidity, among other factors, have led to limited institutional interest in Canada, according to Andrew Kavouras of Canadian-based public real estate specialist Presima, a part of National Australia Bank Group. Accordingly, retail investors own 70% of Canadian REITs. Appropriately, small- and mid-cap REITs represent 60% of the U.S. market versus 80% in Canada. As ETF sponsors look to global markets for product, research from Presima is instructive. REITs with lower leverage and better interest coverage outperform more leveraged instruments. This may seem counterintuitive, but the REIT structure itself suggests that access to capital to take advantage of attractive opportunities relies on a strong balance sheet and flexible sources of funding — things the American REIT market does well. With reduced leverage and stronger financials, REITs and REIT-based ETFs seem poised to offer investors continuing success. ●

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Examining PE and Infrastructure Alternatives

March 2013

Private equity, private debt and infrastructure investing are popular with institutional investors because payoffs complement the publicly traded parts of portfolios.

Private equity and debt describe securities not traded on public exchanges and negotiated between the investor and the company receiving funds. Including leveraged buyouts, these allow investors to structure terms and conditions tailored to their needs.

Consider an insurance company looking to offset long-dated liabilities. Private-equity investors occasionally negotiate spots on the company's board, and can help make ideas successful.

In 2012, North American private equity buy-out deal flow was $152.3 billion, a post-Lehman high according to Preqin, an alternative assets data provider. Retail investors can access private equity and debt via a handful of U.S. companies, and public and private closed or open-ended funds.

There are two exchange-traded notes (ETNs) in the U.S. offering exposure to business development companies. ETNs, like ETFs, offer exposure to an index (Wells Fargo Business Development Company Index in Table 1).

However, unlike ETFs, they're structured as debt obligations that bear credit risk (UBS's credit risk in the case of the examples in Table 1). A redemption fee may also be levied. Note the leveraged version seeks to replicate the return of the underlying index on a monthly basis, rather than daily. Also, both ETNs have the same expense ratio (0.85%). The yields reflect the impact of leverage: BDCS's dividend yield is 6.98% and BDCL's is 12.87%.

Stable Demand

Infrastructure investing is a form of equity or debt financing for businesses involved in permanent assets that relate to rudimentary components of an economy, such as transportation, energy, and utilities. Some businesses have monopoly-like characteristics and are regulated (e.g., hydroelectric plants), but generally the common feature is stable demand.

The idea is to translate stable demand into cash flow that investors need to offset a particular liability, such as a pension. There are three infrastructure ETFs trading in Canada (see Table 2) and seven in the U.S. (see Table 3).

Infrastructure ETFs may include shares of companies involved in infrastructure projects. Engineering and construction companies that perform infrastructure work, such as Chicago Bridge & Iron Co. NV, Fluor Corp. and SNC-Lavalin Group, are included in these ETFs, although the return profile is that of an industrial firm subject to the capital spending cycle.

Energy and pipeline companies such as Enbridge, Kinder Morgan, TransCanada Corp. and Duke Energy Corp. may also be included. These ETFs are exposed to the infrastructure cycle, but don't necessarily have the risk characteristics institutions seek in private deals.

Some investors focus on the yield possibilities of these instruments, but the risk characteristics are more important to portfolio building. Table 4 shows the five-year volatility of various infrastructure indices compared with the S&P 500 and MSCI World indices. This includes one- and five-year returns, which struggled following the financial crisis. However, infrastructure indices have had lower volatility than broad equity indices in the global and U.S. regions.

Should You Invest?

Private equity and infrastructure investing will continue to be popular with institutional investors. Although more expensive, U.S.-traded business development company index ETNs are closer to institutional infrastructure vehicles than other exchange-traded products in the capital spending cycle. Lower volatility make these vehicles interesting.

Thanks to Mark Weisdorf, managing director, CEO of J.P. Morgan Asset Management's Infrastructure Investments Group in New York and R. Waghela of J.P. Morgan in London for providing statistics.

Table 1. U.S.-Traded Private Equity ETNs

U.S.-traded Private Equity ETNs	Symbol	Div Yield	Expenses
UBS E-TRACS Wells Fargo Business Development Company Index	BDCS	6.98%	0.85%
UBS E-TRACS 2XLeveraged Long Wells Fargo Business Development Company Index	BDCL	12.87%	0.85%

Table 2. Canadian-Traded Infrastructure ETFs

Canadian-traded Infrastructure ETFs	Symbol	Div Yld	Expenses
BMO Global Infrastructure	ZGI	3.11%	0.55%
iShares S&P Global Water	CWW	2.31%	0.60%
iShares Global Infrastructure	CIF	2.82%	0.65%

Table 3. U.S.-Traded Infrastructure ETFs

U.S.-traded Infrastructure ETFs	Symbol	Div Yld	Expenses
iShares S&P Global Infrastructure	IGF	4.02%	0.48%
SPDR FTSE/Macquarie Global Infrastructure 100	GII	3.19%	0.59%
iShares S&P Emerging Markets Infrastructure	EMIF	2.87%	0.75%
Powershares Emerging Markets Infrastructure	PXR	1.56%	0.75%
Emerging Global Shares INDXX Brazil Infrastructure	BRXX	5.62%	0.85%
India Infrastructure	INXX	1.22%	0.85%
Emerging Global Shares INDXX China Infrastructure	CHXX	2.45%	0.85%

Table 4. Broad Market and Infrastructure Index Volatility

	1-Year Return 2012	5-Year Annualized Return	5-Year Index Volatility
S&P 500 (USD)	13.4%	-0.6%	24.2%
MSCI World Index (USD)	13.2%	-3.4%	26.6%
MSCI USA Infrastructure Index	9.3%	1.9%	18.7%
MSCI World Infrastructure Index	6.1%	-2.3%	16.7%
Macquarie U.S.A. Infrastructure Index	-1.0%	-1.9%	19.4%
Macquarie Global Infrastructure Index	1.2%	-7.1%	16.8%

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Take Advantage of REIT ETFs

April 2013

What is the appropriate weight for REITs in a portfolio? The capital value of REITs has been about as volatile as stocks, but REIT distributions are expected to remain within a stable range — 4.5% to 7%.

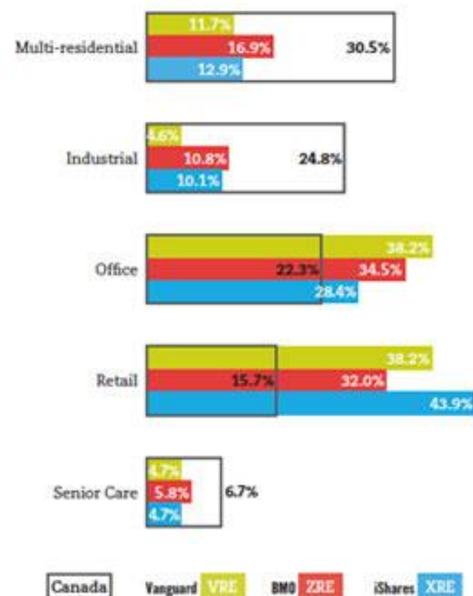
Long-term Balanced Portfolio

An average RRSP account has 60% equities, 40% bonds and a time horizon of more than 15 years. It will often include real estate the same way some pension funds do (for a list of the policy real estate weights for the largest funds, see table at the end of this article).

Most institutions are at or slightly over their policy weights. The current interest rate environment, viewed by most as artificially low because of central bank intervention, may force institutions to consider alternatives to long bond positions. Real estate is a logical choice, so allocations may rise.

Most institutions get real estate exposure through direct property holdings, not REITs. Direct property has different risk characteristics than their public-market cousins, including lower volatility and restricted liquidity.

The chart at the right shows the difference between actual commercial real estate distribution and the sector exposures of the three REIT ETFs that trade here.



The underweight to multi-residential is good news for Canadian REIT ETF investors. Overvaluation talk is primarily associated with the residential sector. However, multi-residential rental cash flow is considered stable compared to other sectors. As a result, it has a current capitalization ratio — the ratio of operating income to property value — of about only 5.2%.

Senior care is another source of stable income and also underweight among ETFs. Both of these sectors involve higher leverage, partly because of government subsidies either in financing, operating expenses, or both.

The debt-to-total-capitalization ratio is 45% for multi-residential and 56% for senior care. This compares with 34% and 33%, respectively, for comparable REIT sectors in the U.S.

The overweight to retail and office real estate is also evident, so Canadian REIT ETF holders need to be particularly aware of the outlook for those sectors.

Income Portfolios

Including REIT ETFs in an income portfolio makes sense because they provide stability. Given the myriad risks involved, the diversification is also a boon. We looked at the dividend growth for REITs and the S&P/TSX Composite and found them to be virtually identical.

A J.P. Morgan study of U.S. REITs established they behave like common stock in the short term and real estate in the long term. This suggests income seekers willing to overlook short-term market fluctuations should reap the diversification benefits real estate offers.

Traders

Advisors with shorter-term orientations should know higher interest rates may make financing future acquisitions more expensive and access to capital more difficult, given already-leveraged balance sheets.

Canadian REITs have smaller capitalizations and higher debt-to-capitalization ratios than their American counterparts. And here at home, retail investors primarily own REITs, unlike institutional investors in the U.S. Since capitalization ratios are near historical lows, we should expect more volatility here.

The outperformance of Canadian real estate recently, compared with the U.S., is largely due to appreciation of relative property values. This is more likely to favour the U.S. over the next few years.

After any big run, investors want to know if there is room left to benefit. So, just be sure you use these instruments for what they can do in the future, not what they have done in the past.

Canada: Largest Pension Fund Policy Real Estate Weights

Pension Fund (Foreign and Domestic)	Real Estate Portfolio Weight	Real Estate Policy Weight
Caisse de dépôt et placement du Quebec	11.45%	10.1%
CPP Investment Board	9.50%	10.0%
Ontario Teachers' Pension Plan Board	17.06%	12.0%
British Columbia Investment Management Corporation	13.46% [1]	15.0%
Alberta Investment Management Corp.	10.04% [2]	9.0%
Public Sector Pension Investment Board	9.14% [1]	10.0%
Ontario Municipal Employees Retirement System (OMERS)	13.18%	12.5%
Healthcare of Ontario Pension Plan (HOOPP)	11.00%	12.5%
Ontario Pension Board	13.50%	13.0%
Canada Post	4.10%	3.5%

[1] March 31, 2011

[2] March 31, 2012

Source: Bentall Kennedy

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Socially Responsible ETF Investing

May 2013

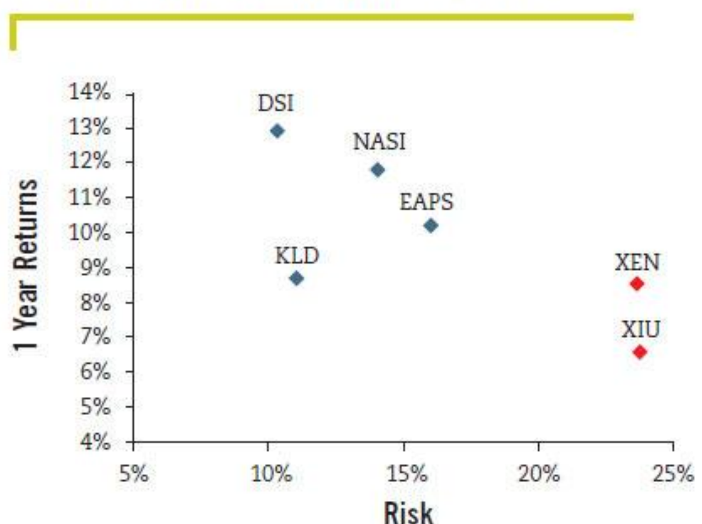
Chef Martin Picard's Au Pied de Cochon is my favourite Montreal restaurant. When I visited his maple sugar harvest event, it was a carnivore's paradise — four meaty appetizers and three mains. But he also offered a vegetarian dish.

I tell you this because investment professionals tend to be carnivorous. Any investment with the scent of upside is fair game. But some investors don't embrace traditional corporate values, and instead have social and environmental objectives. Today's advisor should develop strategies to address those needs.

Socially responsible investing (SRI) used to mean "no tobacco, alcohol, gambling, weapons and no apartheid." But sustainable environmental, social and corporate governance (ESG) activity has also become important. Some investors will exclude offending companies from their portfolios, while others prefer broader criteria, such as investing in best-in-class companies. So advisors will need to address these views.

The best way to construct a portfolio that meets a client's social and investment needs is to build it from individual securities. A diversified solution may require more capital than is available, so a little imagination is required. Consider buying a broadly diversified ETF and shorting the objectionable holdings individually or collectively. One positive consequence is that you may reduce risk without impeding returns.

There are now ETFs that reflect the growing demand for responsible investments. There are five U.S. choices and one Canadian in the broad ESG category and several ecologically specific choices (see table "Socially Responsible ETFs in North America," last page). Unique among these is the AdvisorShare Global Echo ETF that, in addition to seeking companies focused on sustainability in energy, technology and the environment, gives 0.40% per annum to Philippe Cousteau Jr.'s Global Echo Foundation.



The iShares Jantzi Social Index (XEN) excludes nuclear, tobacco and weapons manufacturers and holds 60 stocks that have been ranked for their environmental, social and governance criteria.

As of March 31, 2013, XEN had outperformed iShares S&P/TSX 60 Index Fund (XIU) for all periods with similar risk (see the chart “Socially responsible ETF vs. broad equity indices” previous page). But this is a broad index that may not satisfy every investor interested in SRI, so you need to be creative.

XEN holds shares of Suncor, Imperial Oil, Cenovus Energy and Canadian Oil Sands — all oil sands participants. And yet consider the controversy over the Keystone XL pipeline. Critics are concerned about the potential for oil spills and the expansion of oil sands production. This is partly because average greenhouse gas emissions for oil sands extraction and upgrading are estimated to be between 3.2 to 4.5 times as intensive per barrel as for conventional oil produced in Canada or the U.S., according to the Pembina Institute.

To avoid holding those companies, one strategy is to buy XEN and short the iShares Oil Sands Index (CLO) in proportion to the approximate energy exposure (20%). In this way, you achieve broad ESG participation less oil sands exposure. The returns of this strategy are shown in the table below, “Tactic To Establish A Canadian Non-Oil Sands SRI ETF Portfolio”.

Another tailored strategy is shorting the stock of an undesirable company while owning a SRI ETF that includes that stock. Some clients may be against a certain mining stock or object to a company operating in a war zone.

For instance, several public companies operate in the Sudan region, which is under sanctions for human rights violations. Such companies include Petrochina Company, the largest oil producer in China. PTR’s parent, China National Petroleum Corporation, helps the Sudanese explore and develop energy reserves.

Tactic To Establish A Canadian Non-Oil Sands SRI ETF Portfolio

	Jantzi (XEN) Short (CLO) 20%	Jantzi Social Index (XEN)	iShares Oil Sands (CLO)	S&P/TSX 60 (XIU)
3 month	5.06%	3.70%	-6.94%	3.21%
1 year	11.55%	8.54%	-15.70%	6.56%
3 year	4.95%	4.10%	-7.28%	3.85%
5 year	2.62%	1.80%	-9.39%	1.32%
Risk	16.87%	23.65%	36.07%	23.74%

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Socially Responsible ETFs in North America

Socially Responsible ETF	Symbol	MER	Location
iShares Jantzi Social Index	XEN	0.55%	Canada
iShares KLD 400 Social Index	DSI	0.50%	U.S.
iShares KLD Social Select Index	KLD	0.50%	U.S.
PAX MSCI EAFE ESG	EAPS	0.55%	U.S.
PAX MSCI North America	NASI	0.50%	U.S.
Huntington Ecological Strategy	HECO	0.95%	U.S.
Guggenheim Solar	TAN	0.65%	U.S.
Powershares Cleantech	PZD	0.67%	U.S.
Powershares WilderHill Clean Energy	PBW	0.70%	U.S.
Powershares WilderHill Progressive Clean Energy	PUW	0.71%	U.S.
AdvisorShare Global Echo	GIVE	1.70%	U.S.

Glossary of ETF terms

Underlying securities: Certain types of securities issued by corporations.

Net asset value (NAV): In mutual funds, the market value of a fund share; synonymous with bid price. NAV is calculated after the close of exchanges each day by taking the closing market value of all securities owned plus all other assets like cash, subtracting all liabilities, and then dividing the result by the number of shares outstanding — this last number can vary, depending on purchases and redemptions. This definition is specific to mutual funds.

Market price: Last reported price at which a fund was sold on the market. For any inactively traded security, evaluators have to determine a market price if needed. For ETFs, market makers look at the last prices and the depth of all securities in the basket of the fund to calculate its price.

Intraday value: Stocks can reach high or low prices, and then change value again, within the trading day. An ETF’s intraday value is its estimated fair value based on the most recent highest and lowest same-day price of its underlying assets. It is used to gauge the fund’s current market price against an intraday NAV estimate.

Bid-offer spread: The difference between a fund’s bid and offer prices. The two prices together comprise a quotation. For instance, if an ETF is trading at $15.30, market makers will set the spread at $15.29-to-$15.31 to show its highest bid and lowest offer. This is also known as the bid-ask spread.

Sources: Barron’s Dictionary of Finance and Investment Terms, Fifth edition; ProShares.com. ●

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Investor Knowledge Continues To Lag

June 2013

My daughter was born with hip dysplasia. My wife, a physiotherapist, has helped bridge the information gap between us and the medical world. Information is power and having a skilled interpreter is invaluable.

The same is true for investment management. The internet and securities regulators make investment information readily accessible, but investor knowledge continues to lag.

Investment and financial advisors are meant to bridge this gap. Unfortunately, most advisors' compensation structures don't reward this important function.

The CSA mutual fund fee discussion paper provides comprehensive research into investor perceptions and industry practice. The paper establishes that mutual funds are primarily sold through advisors, whom seven of 10 investors incorrectly believe have a legal duty to place client interests first.

Because of sales incentives, suitable funds may not be selected. Market transparency suffers, consumers remain uninformed and price discovery between mutual funds ceases. This helps explain why fund fees are so high in Canada: advisors make buy decisions, and price competition among mutual funds is impeded.

An unintended consequence is that mutual fund manufacturers are best served by designing products primarily for advisors based on compensation, and not for investors based on risk and return. The discussion paper confirms that:

- trailing commissions as a percentage of total advisor compensation rose from 27% to 64% between 1996 and 2011;
- self-regulatory organizations (SROs) do not require advisors to tell mutual fund investors about trailing commissions, CRM II notwithstanding.

Growing advisor dependence on undisclosed trailing commissions, which can be increased without unitholder consent, can lead to concealed fees that are subject to manipulation.

Regulatory efforts to improve disclosure, like the CSA Point of Sale Project, Fund Facts and CRM, overlook the fact that investors rely on advisors to read all relevant material on their behalf. Virtually all investment fund and fund wrap assets under administration, excluding ETFs, are distributed by channels overseen by SROs and involve trailing commissions. More disclosure is always good, but what if the intended audience—the investor—doesn't read it?

As registered portfolio managers, my team and I treat clients' money as if it were our own. We have a fiduciary responsibility to them. I mention this for two reasons: firstly, as disclosure for the comments that will follow, and secondly, because responsibility to clients is at the heart of the debate over mutual fund fees in Canada.

There are three main remedies to the problem.

1. Unbundle Fees

The fund industry argues embedded commissions give small investors access to financial services that would be unaffordable if priced separately. Fee-only planners should charge hourly rates for actual work done. Larger fees at set-up reflect information gathering and risk profiling needed early in the process.

If investors can't get the advice they need, the industry will provide default choices with diversification and risk controls suitable for long-term investing. The defined contribution pension industry has done so with more than 80% of new plan participants in default options that include target-date and balanced funds.

2. Eliminate Trailing Commissions

The Canadian fund industry argues that fee comparisons with other jurisdictions are unfair because marketing costs are excluded. It misses the point.

Assume a $10,000 portfolio growing at 7% annually with a 2% fee (no taxes or transaction costs). Every year, 2% of the investor's portfolio moves to the advisor's "bucket", compounding at 7%. After ten years, the investor's bucket has grown to $16,073 and the advisor's bucket to $3,598; about 17% of the total return for the period. After 50 years, the investor has $107,274 and the advisor $187,297.

Sixty-one percent of the total return goes to the advisor. Apply a 2.5% annual fee—slightly lower than the median Canadian equity balanced fund—and 69% of the total return goes to the advisor.

3. Descriptive Advisor Labeling

Commissioned mutual fund salesperson; commissioned securities salesperson; salaried mutual fund salesperson. Regulators insist on clear product labels, so why not for advisors? Advisors using ETFs to bring client expenses down are on the right path. The financial services industry must lower gross costs before investors and regulators do the math. ●

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What Unbundling Could Mean For The Future of Advice

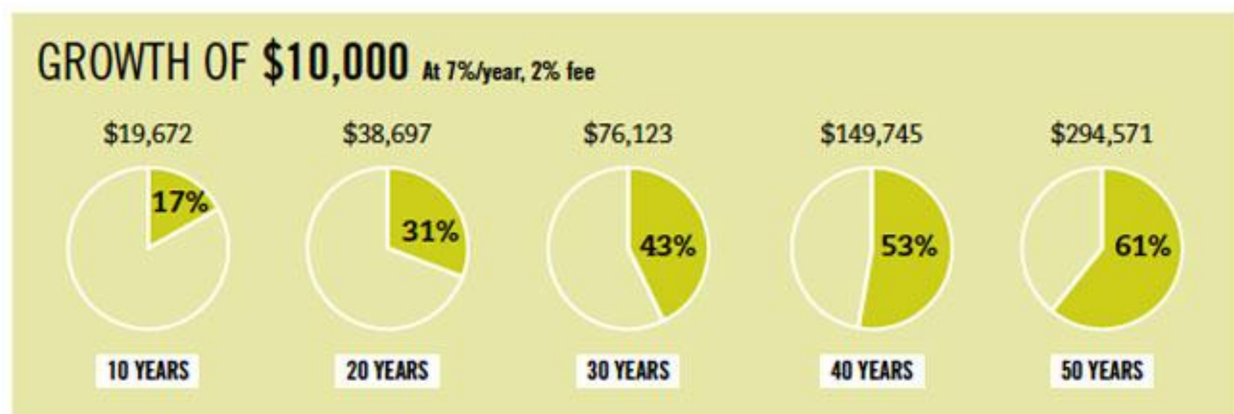
September 2013

The impact of compounding fees struck a chord with readers (see previous article, “Investor Knowledge Continues to Lag,” June 2013). Several wrote with concerns. Some couldn’t believe the math. Others objected to the term “advisor’s fee.” Here are the calculations.

We described a $10,000 investment compounding at 7% with a 2% annual fee that left the investor with only 39% of the accumulated capital after 50 years. We tested two approaches.

1. We created two buckets: one for the investor and one for the advisor. We moved 2% of the value of the investor’s bucket at the end of each year (representing the fee) to the advisor’s bucket, both compounding at 7%.
2. We compounded the initial investment at 5% and 7%, with the difference approximating the advisor’s fee. This was John Bogle’s approach from The Pension Gamble, shown on PBS in 2013.

The slight difference between methods is attributable to timing fee calculations at the end, rather than the beginning of the period (see the spreadsheet at purinvesting.com/web/pur_advisor/home).



Advisor’s fee

Sadly, too many investors don’t know what they pay in fees. Investors put up 100% of the capital, take 100% of the risk and, as our calculations show, end up with less than 40% of their own money. For this to be palatable, we need an extended period of strong returns; otherwise, we face ongoing fee pressure. There are solutions. Some funds, like Steadyhand’s, taper fees and offer rebates for long-standing clients. This makes sense, as do fee-only financial planners.

Transparency

CSA Discussion Paper 81-107, Mutual Fund Fees says, “This trend away from transaction-based sales commissions has resulted in advisors today being compensated largely through trailing commissions in connection with the distribution of mutual funds.” As a result, distribution costs are more hidden from consumers.

The automatic conversion of DSC funds to front-end load is described in 81-107 as a “conversion that yields a 100% increase in trailing commission compensation to the advisor without any consent from or disclosure to the client at the time of the conversion.”

Investors may not pay more, as the letter points out, but these arrangements “appear to display an alignment of interests between the mutual fund manufacturer and the advisor that could be detrimental to mutual fund investors,” says 81-107. Who is to blame for poor transparency? You and me.

Asset-weighted mutual fund fees (MERs, front and no-load) increased for equity, fixed income and balanced funds between 2006 and 2011, according to 81-107. DSC charges weren’t mentioned, but their present values are certainly higher thanks to lower interest rates.

Unbundling: A new world of advice

Product costs are different from fees for advice, noted another reader. Investors can’t avoid product costs, but they can become self-directed.

Product costs are unavoidable, but there is choice. Canadian equity index mutual funds have MERs between 0.72% and 1.01%. ETF equivalents charge 0.08% to 0.25% before commissions.

The Canadian wealth management industry’s revenue model is evolving. Capital market growth alone won’t expand advisors’ books. To grow, firms need more clients and assets. Here are some changes you can make:

- Move to a fee-based model and use lower-cost products that offer demonstrable value to investors.
- Move to a discretionary license to eliminate time-consuming order approvals.
- Use portfolio construction services to reduce time spent managing investments.

This will leave you more time for asset gathering.

U.S. model portfolio assets among registered investment advisors are growing 50% annually, prompting unified management account (UMA) firms to model ETF wrap programs. The next generation will be mass-customized portfolios: personalized, with automatic monitoring, rebalancing and reporting. Automation improves portfolio fit and lowers cost. Current UMA expenses of 1.3% to 3% could drop under 1%, including product fees.

About 15% of Canadian advisors are discretionary and fee-based, a positive trend. Having clients pay directly for advice aligns everyone’s interests, focuses on lower-cost options, and can reduce compliance burdens, things upon which we can all agree. Advisors who don’t seek better solutions risk losing to those actively exploiting the new reality. ●

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Regulators Don't Understand Diversification

October 2013

In all professional sports, managers take a disproportionate share of criticism when things don't work out—and with good reason. They're responsible for assembling players with the expectation of winning games.

Clients have similar expectations of investment advisors, who are supposed to assemble products into winning portfolios. But rules and misguided interpretations sometimes get in their way.

The suitability standard is one example. Advisors must assess suitability pursuant to NI 31-103. The key principles are to know clients' needs and objectives and other factors relating to a purchase or sale (KYC), as well as each product's attributes and associated risks (KYP). Trading off higher returns for more protection is the challenge for advisors, just as building a balance between offence and defence is for hockey coaches.

In fact, hockey has many parallels to the investment world. Forwards take risks to penetrate the offensive zone, and are exposed to bruising body checks at the blue line. Riskier investments like technology, small cap or emerging equities perform these roles in portfolios.

Meanwhile, size, checking ability and aggressiveness are qualities of suitable defencemen. In the investment world, dividend-paying utilities, banks or preferred shares fall into this category because they provide relatively predictable re- turns. Net coverage and the ability to anchor a defence make for suitable goaltenders, just like fixed-income instruments that offer stable if unspectacular returns with predictable risk.

Six Goaltenders

As a coach, would you put six goaltenders on the ice at the same time? Securities regulators would. According to them, an advisor should only recommend conservative investments to conservative investors. So investing 100% in Canada Savings Bonds would be suitable for these investors.

However, investors usually combine several securities, funds or ETFs. Portfolios deliver risk and return for investors, just as combinations of players provide the balance between offence and defence for a team. Some products with higher risks—limited liquidity, leverage or complexity—offer higher compensation, demanding intervention in the absence of a fiduciary standard. But suitability obligations, while laudable for considering conflicts of interest, lack insight beyond a single transaction.

An important goal of suitability is to protect investors from risk. The key to combating risk and volatility is diversification. As a result, pension plans, endowments, and larger institutional accounts have expanded the number

of asset classes they use. For instance, the Harvard Endowment once had a simple domestic stock, bond and cash portfolio. Today, its policy portfolio includes 13 asset classes.

What asset allocation and how much diversification is suitable? CSA Staff Notice 33-315—Suitability Obligation and Know Your Product, IIROC Notice 09-0087 and Best Practices for Product Due Diligence do not discuss diversification.

Consider that managed futures provide almost a perfect hedge for long-only portfolios. Since futures are used, this strategy is limited to aggressive retail investors. Regulators have not addressed that different assets and risks combine to provide superior risk dampening and return possibilities. Investors suffer as a result: Imagine not being able to put a superstar centre on the ice with a defensive winger, even if they play well together.

No Special Teams

Investment dealers have their own asset allocation standards.

A moderate portfolio may have a 60% equity and 40% bond weight, while a conservative one may have 40% equities and 60% bonds.

Again, it doesn't seem as if regulators understand diversification. If an investor is assessed as having a moderate 60/40 profile and has RRSP, taxable, TSFA and RESP accounts, common sense suggests highly taxed assets, like bonds, should be placed in the RRSP. Loading a TSFA with riskier holdings takes advantage of that structure, yet each account must now have a 60/40 mix.

How suitable is the suitability obligation? If the Toronto Maple Leafs had to comply with securities regulations, they could only play six goalies, six defensemen or six forwards at the same time, and have no power plays or penalty-killing specialty lines. Regulations are about fairness and controlling abuse, but not about winning. That's crazy—even for the Leafs. ●

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How To Manage A Bond Portfolio

November 2013

When I started in the investment business, equity portfolio managers had shinier shoes than bond managers. Analyzing financial statements and calculating interest coverage ratios partly explained the personalities of these people in rumpled suits.

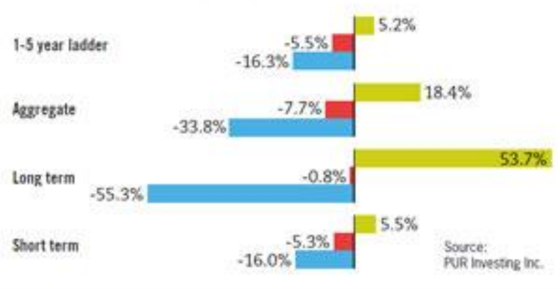
The persistent bear market in bonds since the end of World War II had beaten participants into an attitude of resignation. Then something changed. Double-digit interest rates and inflation in the early 1980s crushed the value of bond portfolios, rendering many financial institutions technically insolvent. An asset, taken for granted as ballast on balance sheets, was suddenly in focus.

CHART 1 GOVERNMENT OF CANADA BONDS

Impact of interest rates to 0%, 30-year average, and 50% of 30-year average

CHART 2 POPULAR STRATEGIES

Impact of interest rates to 0%, 30-year average, and 50% of 30-year average



Only people older than 50 remember this transition. Bonds have since enjoyed a 32-year bull market, with only occasional interruption. Bond managers could do little wrong, and were now dressing as sharply as their counterparts in the equity space. But few believe the next 30 years will be the same as the last. Extending duration, leveraging sector spreads and lowering quality to pick up yield will not be enough. Welcome to the "new" old bond market.

Whether rates increase immediately or not, the risk/reward for bonds looks troubling. Chart 1 shows three possibilities:

- an upside if interest rates fall to zero (a depression);
- a downside using the average yield over thirty years;
- a downside of moving to half the average yield over thirty years.

Bonds are not necessarily the low-risk asset class portrayed in textbooks, and capital markets seem to have anticipated some of this back up. Chart 2 shows the same scenarios applied to popular strategies with ETFs in each category shown in Table 1. Long-term bonds already appear to be at half their 30-year average yields.

Traditional benchmarks are increasingly useless to investors. Who cares how a manager does against the DEX universe? Only preserving capital and generating income matter. For a 60% equity 40% bond portfolio, it's unclear which will be the riskier asset class over the next few years.

Preserving Capital

In rising-rate environments, keeping duration short mitigates losses. ETFs offer two approaches: floating-rate notes, available in both an active (HFR) and passive (XFR) version; and senior loans, also available in active (FSL) and passive (BKL). The duration of each of these instruments is less than one year.

Alternative sources of yield for consideration include emerging markets debt, high yield, real return, REITs, preferred shares and structured solutions like private debt, and infrastructure. Many of these strategies are represented by ETFs. Breaking down the component parts of the fixed-income equation and returning to the trading approach of an earlier era may prove useful to bond managers in the future.

Thirty years ago, the focus was on continuously improving the quality, term and yield of a bond portfolio. If interest rates are heading higher, taking the best the market will mean abandoning benchmarks and being actively opportunistic. Buy and hold may not be good enough anymore.

Table 1 Selected Bond ETFs Category Listings by AUM

	Symbol	MER	Duration	YTM
1 to 5 YEAR LADDER				
iShares 1-5 Year Laddered Corporate Bond Index Fund	CBO	0.28%	3.00	2.40%
iShares 1-5 Year Laddered Government Bond Index Fund	CLF	0.17%	2.98	1.74%
PowerShares 1-5 Year Laddered Corporate Bond Index	PSB	0.25%	2.98	2.50%
LONG TERM				
Powershares Long Term Government Bond	PGL	0.25%	13.90	3.66%
iShares DEX Long Term Bond	XLB	0.35%	13.29	4.04%
AGGREGATE				
iShares DEX Universe Bond Index	XBB	0.33%	6.63	2.77%
BMO Aggregate Bond Index	ZAG	0.23%	6.65	2.71%
Vanguard Aggregate Bond	VAB	0.26%	6.90	2.70%
Horizon Active Canadian Bond	HAD	0.42%	6.78	3.09%
SHORT TERM				
iShares DEX Short Term Bond	XSB	0.28%	2.73	1.83%
BMO Short Corporate Bond Index	ZCS	0.30%	2.77	2.30%
BMO Short Federal Bond Index	ZFS	0.20%	2.59	1.43%
Vanguard Canadian Short-term Bond Index	VSB	0.19%	2.70	1.80%
Vanguard Short-term Corporate Bond Index	VSC	0.18%	2.80	2.40%

Table 2 Defensive Bond Strategies Category Listings by AUM

	Symbol	MER	Duration	YTM
FLOATING RATE				
Horizon Active Floating Rate Bond	HFR	0.40%	0.53	2.48%
iShares DEX Floating Rate Note	XFR	0.22%	0.15	1.24%
SENIOR LOANS				
Powershares Senior Loan (CAD Hedged)	BKL	0.80%	0.25	5.35%
First Trust Senior Loan (CAD Hedged)	FSL	0.85%	0.41	5.64%

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Why Outcomes Are The New Alpha

December 2013

In its recent report, The Investment Management Industry: Outcomes Are the New Alpha, McKinsey & Company attributes the industry's slow growth prospects to demographics, recent memories of volatility and a decade of flat equity returns. Three key areas, however, hold promise for growth over the next several years:

- passive investing
- alternatives
- outcome-oriented solutions

Low returns are forcing more investors to look beyond relative return strategies like actively managed equity and bond funds, and money market vehicles. Chart 1 (this page) shows U.S. asset flows from 2008 to June 2013.

Passive Investing

The trend toward passive investing (including indexing, index mutual funds and ETFs) is a logical development, given that active management has not consistently added value to passive benchmarks and lower-cost products are now more widely available. The shift toward fee-based advice, encouraged by the elimination of trailing commissions in the U.K. and Australia, also promotes flows into index products.

In Canada, regulators recognize part of the problem is many advisors' increasing dependence upon trailing commissions (CSA Discussion Paper 81-407 Mutual Fund Fees). It's encouraging that about 15% of advisors have moved to a fee-based model, aligning their interests with clients rather than product providers. It's a big trend in the U.S., where advisors are driving the fee-based movement and are using ETFs.

Alternatives

This category encompasses a broad

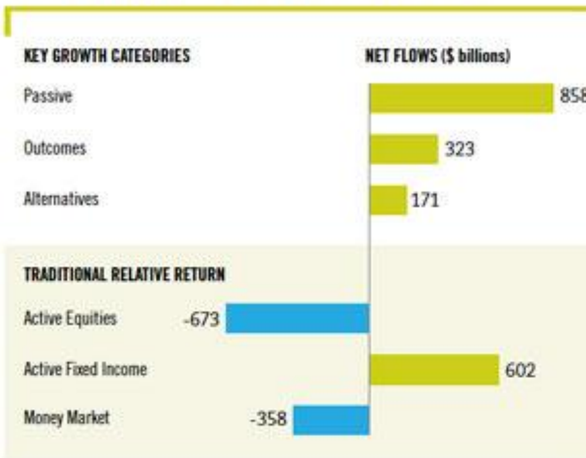
array of products, including real estate, private equity and the full range of hedge fund strategies. Despite an inconsistent track re-cord during major market collapses—when fear makes everything decline—broad diversification has been an effective way to deal with volatility. ETFs representing alternative approaches allow more investors to access these specialized asset classes that otherwise come with obstacles, such as minimum investment, illiquidity and layered fees.

Outcome-Oriented Solutions

The McKinsey report notes a key concern for investors is outliving retirement savings. Defined contribution (DC) pension plan members need to accumulate sufficient capital to provide replacement income in retirement, but they lack the expertise to manage their portfolios. Target date funds, which automatically adjust the asset mix of a balanced portfolio to become more conservative as retirement approaches, are a common but unsophisticated solution. The new trend in benchmarks is outcomes.

Pension Outcomes

In a 2011 paper for the Rotman International Journal of Pension Management, my colleague Ioulia Tretiakova and I described a risk-based glide path that increases or reduces portfolio risk based on how an investor is progressing towards her capital accumulation goal. If she falls behind (see “A” and “C” in Chart 2, below), risk is modestly increased. If she’s ahead (see “B”), it’s reduced.



After adopting this approach, one of the first things a $45-billion Australian superannuation plan did was remove itself from league tables: it no longer publicly compares its portfolio’s performance to a benchmark of indexes or to other superannuation plans. The only benchmark that matters is progress towards target capital for plan members. This is a good example of the shift to outcomes.

The table (see “Annual net flows,” below) shows estimated growth or decline for selected asset classes from 2012 to 2016. Growth for ETFs, alternatives and multi-asset solutions are highlighted in green. (DC plans aren’t included; they would add $400 billion to multi-asset class solutions if recent history is any guide.) Advisors can still use relative return strategies to win assets from other advisors, but providing an outcome-based solution is a far more powerful value proposition.

McKinsey states that, within five years, 70% of investable assets will be in the hands of retirees or those close to retirement. Next month we'll review a post-retirement investment approach that aims to minimize the risk of running out of money.

Annual Net Flows 2012-2016

	ETFS	Domestic Equities	International Equities	Fixed Income	Alternative	Multi-Asset Class	Total (billions)
Total (billions)	$410	- $357	$413	$56	$429	$224	$1,173
AUM 2011 (trillions)	$0.5	$3.7	$1.5	$3.8	$0.5	$0.4	$10.5
Growth/2011	82%	- 9.6%	27.5%	1.4%	85.8%	56%	11.2%