1 Products & Product Fundamentals October 2006

Products exist because of one of two problems

- Most advisors do not possess the expertise to construct, plan and manage portfolios themselves.
- The industry does not have the ability to distribute personalised wealth management solutions from the basic portfolio building blocks of cash, fixed interest and equities.

Products are packaged solutions to the problem of distributing investments and to the problem of constructing, planning and managing portfolios of investments.

- A share is not a product, cash is not a product, a government of Canada bond is not a product.
- A mutual or pooled fund, a wrap account, a principal protected note, a hedge fund, a segregated fund, a GIC are all products.

The difference between a product and an asset is that products do one of the following.

- Combine a number of different or similar investments together within a managed structure.
- Change the risk/return relationship of the investments held.
- Change the normal investment time frame of the investments held or the ability to buy and sell the investments held.

While many products are genuinely needed and have a valid investment rationale, many more are not and, many of those that are valid, are either far too expensive or incorrectly applied.

1.1 Basic rules & basic problems

In order to understand products we must first of all understand some basic rules. Furthermore, in order to understand why products are sold we need to understand some basic problems. For further information see rules and problems on the side menu.

1.1.1 Basic Rules

Rule number 1 – the elements, the building blocks

All investment return and all investment risk comes from the return on and the risk arising from capital invested in the economy. The return on capital as far as the investor is concerned is broken down into 3 components

- The return on cash
- The additional return on fixed interest
- The marginal return on equity investment.

Rule number 2 – the uniqueness rule

We know that the risk and the return on each of the above varies and, varies over time. How much you need of every asset depends on your financial needs, your risk preferences and the current risks of investment (stock market and economic risk).

In truth, because everybody is different, everyone should have a unique combination of these investments and because everybody's needs change over time, this combination will change and will need to be managed.

Rule number 3 – The no free lunch rule

If you want the return on equities, you have to take the risk of equities. If you want to invest in equities while avoiding the risk of equities you will need to pay someone for taking the risk for you. Invariably this will rob you of the extra return on equities and at best, over the longer term, leave you no better off than if you had invested in low risk assets.

Rule number 4 – the marginal return rule

Transaction and management costs act as a drag on the return of each asset class, increasing the risk of investment and, in certain circumstances, possibly invalidating the rationale for long term investment in anything other than low risk/low cost cash.

Rule number 5 – the distribution rule

The ability to personalise the structure of assets, the planning of assets and the management of assets takes a certain amount of resources, asset management expertise, systems and the necessary business and services processes to do the job properly.

Rule number 6 – the allocation rule

For those who do not possess the requisite systems, the business or the service processes, the resources or the expertise to manage a specific component (US smaller companies, Canadian large caps, Asian stocks, government or corporate fixed interest etc) or the whole (the portfolio) you will use a product to access that component or to deliver a wealth management solution.

Rule number 7 – the efficiency rule

There are good products and there are bad products, there are products that solve problems and products that cause problems and a good advisor will know when and when not to use them. A product should always represent a more efficient way of gaining access to an asset class or a cheaper and more efficient way of gaining access to wealth management expertise.

Rule number 8 – the integration rule

A product should always be capable of being integrated within a portfolio without upsetting the management of risk and return or the management of liabilities or financial needs. Because of this the use of products requires portfolio construction, planning and management expertise, to some degree.

Rule number 9 – the accountability rule

All product recommendations must be justified against a lower cost and more direct method of accessing the investment.

1.1.2 Problems

Problem number 1

Investors are understandably and largely ignorant of the basics of investment and, in their ignorance are swayed by many a product claim.

Most individuals are therefore ignorant of rules 1, 2, 3 and 4. Even those who are normally wary of offers of something for nothing will accept a pitch from what they consider to be a registered and regulated professional.

Problem number 2

There is insufficient expertise and resources for each individual advisor to personally manage each individual's portfolio. This means that there is not enough resources to allow every individual's portfolio to be built bottom up from the basic investment elements (rule 1).

Indeed, an individual with a global portfolio is going to have to access a managed investment vehicle for some of that exposure, unless they are extremely wealthy and have access to asset managers that are able to research, select and manage direct equities in all markets and all market components.

Further information on this topic can be found in the valuation, allocation and management technical document, in the news and technical section of the website.

Problem number 3

The industry is resistant to integrating the management of assets with the management of financial needs for a number of reasons. Further information is provided in the portfolio problem section of the website.

Such integration would allow very high levels of personalisation (satisfying rule 2) and automation (satisfying rule 5) of the portfolio construction process. All portfolios would be built from the basic elements (satisfying rule 1), all portfolios would be unique (satisfying rule 2), reducing costs (satisfying rule 4) and allowing more flexible, lower cost wealth management solutions (satisfying rules 6 and 7).

Problem number 4

If investors are ignorant of the realities and basic elements of investment, if advisors do not possess the expertise, or the systems, or the resources, or the knowledge to personalise portfolio structure to financial needs and risk preferences, you have an impasse.

This impasse is the product.

1.2 Products can solve fundamental "problems"

A mutual/pooled/exchange traded fund solves the problem of insufficient expertise and manpower in the financial services industry to personally manage portfolios of direct shares for individuals.

A mutual fund is a way in which one manager can manage thousands of portfolios or, a way in which investors can diversify into areas that they do not have the time and resources to personally manage. There is nothing wrong in delegating the management of your Japanese small caps, or your Canadian small caps, or your emerging market exposure to a competitively priced firm with the resources and the expertise to do the job properly.

Indeed, mutual funds (if we ignore the costs, the sales practises and the way they are often used to build portfolios) represent one of the most important product developments in investment history.

Most portfolio managers will need to access a pooled fund of some sort to gain exposure to areas they do not possess the expertise or the resources to personally research and manage direct stocks and, their are a number of very good managers who find it more efficient to delegate all the stock selection to experts in a particular area.

1.3 Products can solve the wrong problems!

Understand this, in a transaction driven industry remuneration is primarily by commission. The company that produces the product and the salesman that sells the product only earn a return when a sale is made. The interest of the product provider and the salesmen are intertwined.

There is no problem in selling products as long as the client does not think they are being provided with a wealth management solution.

The problem for the salesman is in making sure that "your" capital goes from an asset that does not earn a transaction return or a management return (cash) to one that does.

Naturally many investors are cautious over the risks of stock market investment and may limit their exposure to such assets. If an institution can develop a product that will be attractive to lower risk individuals they will be able to earn either a transaction or a management return on their capital, or both.

These types of products are often typified by their so called ability to earn "stock market returns" while avoiding stock market risks. Unfortunately, in most instances, the negative aspects of the investments are not discussed and the broad marketing claims made are unlikely to be met.

In order to understand why products are not often effective solutions to problems investors need to understand both the basic rules of product use and the difference between portfolio structure and products.

Investors must also understand that the industry is in transition and, that products represent a halfway house in this transition. At some point in the future the industry will finally accept the need to integrate the management of both financial needs and financial assets. The ability to do this will take away the need, the imperative, the rationale and the distribution network for the vast majority of products we see today.

1.4 Products create problems

There are many problems with products

- More often than not they represent one off solutions which means they lack a genuine investment rational and are difficult to integrate within your overall portfolio and get in the way of effective portfolio management.

- Investors risk ending up with a collection of products/one off solutions, that have bear little or no relationship to each other or the individual’s financial needs.

- Those who rely on products to solve every asset allocation or investment dilemma are not likely to possess the necessary expertise needed to construct plan and manage portfolios.

- Products are expensive not just because they require incentives to be provided to the seller but also because of the various layers involved in developing and managing them. A large part of the investment industry today exists purely for the return it provides to the companies that produce the products.

Individuals whose portfolio is largely comprised of products face higher costs, lower returns and higher risks.

As discussed in the TAMRIS March 2006 review, higher costs can often take away most if not all of the benefit of a product's underlying investments. At times individuals may be better off with a no cost cash based investment.

1.5 A well constructed portfolio should meet all needs and risk preferences

In truth, a well constructed portfolio of cash, fixed interest investments and equities/cost effective mutual funds/ETFs should be more than capable of meeting all your needs and your risk preferences.

If you are lucky to have the amount of capital that can warrant proper portfolio management then you would best avoid most one-off product solutions.

At all times, when being sold a product remember that the person who is selling it may receive a commission for its sale and, if commissions are the only means by which the advisor is remunerated, then beware.

All that most products represents is a costly, complex and awkward combination of investments compared to a portfolio comprised of the basic investment assets.

Note a product is developed without knowledge of your risk preferences, without knowledge of your financial needs, without knowledge of all your investments and without knowledge of the risks and returns of the current market and economic cycle.

1.6 The risks are often not pointed out

If a salesman is selling a solution to a problem, it is often counterproductive to point out the negatives. While much of the detail an investor needs to be aware of is provided in the small print of the prospectuses provided, much of the rationale for or against a purchase is not.

Failure to point out the negatives is a misrepresentation of the facts. Yet, misrepresentation is a common practise in the financial services industry.

In reality, in an industry where most earn their return from the sale of products and transactions, there is little or no incentive to draw up arguments against a sale. Why cut your own throat?

A professional advisor on the other hand should not use one sided arguments to induce you into any investment, but should give you a well balanced and clear explanation of the risks and rewards of the investment as it relates to your financial needs, risk preferences, your other investments and the current risks in the market and economy.

2 Structure versus products - One Size Does Not Fit All

How much you have in cash, how much you have in fixed interest investments (including how much you have in individual fixed interest investments and when they mature), how much you have in equities (in each market and within each market the yield, the risk and the market cap) are all determined by the size and timing of your financial needs over time, your risk preferences and the current risks in the market place.

If the structure of your portfolio, the planning of your portfolio and the management of your portfolio is so specific then how can a product which is a one size fits all investment possibly meet your needs?

The answer is simple, one size does not fit all!

Most products cannot be effectively integrated with other assets to form a portfolio. It is because of the fact that a portfolio should be personal, that a portfolio should be built as much as possible from the basic investment elements. Only where a basic element can be accessed more efficiently by a product, should a product be used.

In reality, if products are being used, your advisors should know the required structure of your portfolio and the required asset allocation before any specific products are selected.

All products should be used for is to allocate to each component of the portfolio at the lowest cost, as close as possible to the underlying asset while retaining all the natural characteristics of the asset they are allocating to.

This directive runs counter to most product sales.

- Many products represent ***fixed combinations of investments*** which may not match your financial needs. They may also represent a more expensive way of meeting your needs or may indeed expose you to risks they should not.

- Many products are sold as ***stand alone transactions*** where the advisor may not pay attention to the structure that you would need to reflect your financial needs.

Because every product that is sold will affect the shape and structure of your portfolio, merely stating that a product reduces risk and increases diversification is not enough.

In fact, while it may increase diversification if it does not match your needs and it cannot be managed it may end up increasing risk and reducing return, irrespective of its diversification benefits.

Putting a stand alone product in a portfolio that cannot be integrated into the structure is like adding an obstruction in the road. You end up having to drive around it.

Your advisors should not start off with the product, they should start off with the structure and asset allocation of the portfolio and then look to products where necessary.

This means your advisor needs to possess portfolio construction, planning and management expertise. Otherwise it will be difficult for your advisor to be able to assess the effect of the inclusion of a product on the structure of your portfolio and its ability to manage current and future financial needs.

But, then, we get back to the basic problems in the investment industry.

There is insufficient expertise and resources to personally construct, plan and manage assets to meet financial needs over time.

Perversely, the industry possesses all the expertise and resources needed to design systems that could solve the problem, but this would mean dismantling the transaction based industry that the institutions rely on for their earnings.

2.1 Important characteristics of assets

An asset class needs to be as easily and as directly accessible as it is within its natural state, needs to be as liquid as it is within its natural state (can be sold easily and without additional cost or penalty) and needs to be purchased and managed efficiently and cost effectively so as to retain as much as possible of the differential return. An asset class also needs to be as close as possible to its natural risk/return relationship.

Any product that combines assets, prevents individual asset classes or components from being sold, or restricts sales to specific time frames is a problem to the portfolio. Also any product that effectively increases the risk profile of an investment would also be included.

It is important to note that the important characteristics of assets and asset classes can be maintained within a properly constructed, planned and managed portfolio of assets. Indeed, the systems and services of the future will not need to use most of today's products to solve the portfolio problem.

Products will in the main be the relic of a passing and bygone age. From the horse and cart to the internal combustion engine, from the witch doctor to modern medicine, from the product to the properly constructed, planned and managed portfolio

3 Suitability

It is well understood that we live in a transaction driven industry. The problem for the investor is that the securities regulations that govern investment advice, instead of mandating that securities recommendations be suitable for the individual, protect the right of the industry to sell products without fully addressing the suitability of an investment.

There are five rules that should determine the suitability of an investment.

- An investment that is recommended must relate to a) the actual size and timing of financial needs over time and b) the relationship between financial needs and total assets over time (both current and future disposition of capital) .
- After relating the allocation to a given investment or set of investments based on financial demands on the portfolio over time, the investment must then be able to relate to attitudes to risk and investment preferences.
- The recommendation must relate to all existing investments and the relationship that exists between these investments and financial needs at a point in time and over time.
- The recommendation made must make sense given the price of the investment at the time and the risks the investment is exposed to over time.
- Suitability can only be fully assessed with client interaction in the decision making process. This also means that education and communication regarding the basics of investment, the risks of investment, the manager's investment style and how portfolios are constructed, planned and managed to meet financial needs over time are key to agreeing suitability of transactions, products and recommendations.

In fact, the minimum industry standards (the know your client form) that govern the suitability of a transaction do not require compliance with any of the above.

This means products can be sold as one off solutions and invariably investors will end up with a collection of securities and products that make little or no sense. These products are expensive not just because they require incentives to be provided to the seller but also because of the various layers involved in developing and managing them.

In a transaction driven industry where products can be sold as stand alone entities the consumer is at risk of inappropriate products masquerading as appropriate product solutions.

It is an awkward situation that the only one responsible for making sure that they are getting good advice is the consumer and, the consumer is the least able to understand whether or not they are getting good advice.

4 Advisor responsibility

This document does not relate to situations where individuals are managing their own portfolios and relying on product and transaction recommendations from their brokers. There is little or no responsibility here on behalf of the broker to make sure the product is appropriate within a portfolio construct.

4.1 Is your advisor taking the weight or shifting the responsibility?

If you are depending on your advisor to make a product/transaction recommendation within a portfolio designed by the advisor to meet your financial needs over time, irrespective of whether it is an advisory (before the fact) or discretionary (after the fact) relationship, your advisor needs to justify every product recommendation as well as every asset allocation and all changes to security selection, asset allocation and strategy.

Indeed, while the individual may not fully understand the following questions, there is nothing to stop them from asking their advisor.

- Does the product complement the roles of all other assets without having to force the sale or purchase of another investment?
    - Essentially, does the investment disrupt the balance of the portfolio?
- Does the addition of the asset positively affect the ability of the portfolio to meet financial needs at any point in time and at all points in time?
    - Is there a fundamental rationale for it?
- Is the advisor able to model the interaction of the new asset within the portfolio and its ability to meet financial needs over time?
    - Will it affect the ability of your advisor to manage all the portfolio relationships?
- Does it provide better management of liquidity?
    - Why buy a principal protected note if you are going to need the money before the maturity date?
- Is it cheaper and, is it a more efficient method of allocating to an asset class?
    - For example, why buy an actively managed mutual fund that mirrors the index when you can buy an indexed investment at a lower cost, or a bond fund when all you need is a place to park your cash for a year?
- Does it provide the opportunity for better performance, better management of risk or lower costs?
    - Who actually benefits from the recommendation?
- If it is a complex product, why is better than a combination of cheaper basic elements; cash, fixed interest and equities?
- How much does the advisor earn from the recommendation and how much will they continue to be paid if the product does not require any management?

Your advisor needs to show you the effects of the additional charges on your return, how much return the product would provide under different conditions relative to other options available in the market place or, within your portfolio if investments are being sold to finance the purchase.

It is a fact that many advisors solve problems with products when a simpler cheaper and more appropriate solution is available. While one can understand that is how many advisors are remunerated, the logic of many a recommendation has little or no foundation.

The detailed mechanics, the pros and the cons, of the product need to be provided in summary form and in plain English.

While a prospectus is also necessary, the investor should not have to rely on it to find the salient details. Indeed, if your advisor relies solely on the prospectuses for the risk disclosure it is highly likely that the product is unnecessary and it is possible that your advisor does not fully understand the product.

Why?

Because the prospectus cannot possibly relate to your financial needs, risk preferences or the current risks in the market place. It was not designed with this purpose in mind

TAMRIS draws no distinction between an advisory relationship and a discretionary relationship when it comes to accountability and the need for an advisor to justify their transactions, their strategy or their performance.

While an advisory relationship requires a justification prior to the client's acceptance, a discretionary relationship requires justification after the fact, at the client's review. A discretionary relationship should not replace or obviate the need for accountability. Organisations structured to deliver a wealth management solutions should not find this a problem because they will be organised to provide this information.

5 Costs - Let us go back to basics!

The whole point about many products is to provide a managed vehicle that provides us access to lower and higher risk asset classes.

- But what if the return that we were looking to get by buying the product was reduced by the product itself?
- Would this reduce the benefit of the product and defeat the objective?
- If it were to defeat the objective what is the point of the product?

The additional return on stock market investments over and above the return you get on cash is the return you get for taking the risk of equity investment.

The only point you take the risk is for the return. If charges eat up part or even all of the return, you are still left with the full risk.

It is a fact that today's transaction and management charges eat up a substantial element of the additional return you get on stock market investments.

There wrap accounts with annual management charges of 3% or more, there are mutual funds with annual management expenses of 2.5% or more, their are balanced funds which charge 2% or more for managing the cash and fixed interest portion of the portfolio, there are bond funds which take away the additional return on fixed interest. Also, do not forget to factor in the initial transaction costs.

Over very long period of times stock market investments outperform lower risk assets, but the differential between the two is not as great as many would think.

According to the London Business School's "The Millenium Book", a study into historical asset class returns (2000), Canadian equities produced an annual real return of 4.6% above the return on bonds over the period 1900 to 2000.

Most mutual fund charges would at least halve this return and many wrap accounts would eat into 2/3rs of the return before we even look at transaction costs. Also, this is historical return. Today's markets are much more highly valued than they were for most of the last century and it is expected that future returns on investment from this point on will be lower.

For individuals looking to draw down on capital over time, the combination of high transaction and high annual management expenses effectively invalidate the rationale for having a managed equity component as well as managed fixed and cash components.

Today's product offerings and today's financial services industry are failing the investor and ignoring the realities of risk and return and proper portfolio construction planning and management.

Most products are notoriously expensive because they are more complex, they need to be sold and there are far more individuals involved in the overall process. Products really, invariably, make money for the industry and the risk for the future is that the financial services industry will be the only party to the transaction that will on average make a return from investment products.

Managing portfolios does cost money, but it should not cost anywhere near the amount it currently costs private investors. It may be tempting for individual investors to ignore the issues and seek comfort in the illusion that their advisor needs to earn a return too.

It is therefore important that investors ask for information on all transaction and management costs associated with the management of their assets. It is important that an advisor justifies their chosen asset allocation vehicles and it is important that advisors provide regular performance analysis so that the individual investor can assess whether or not they are getting value for their money.

6 Industry structure

The wealth management industry exists because the economy needs capital for investment and because the individual needs a return on their capital.

Today's financial services industry has grown up around these two mutually dependent needs.

The problem that exists is how to distribute products and investments to the consumer and how to manage the capital invested.

As discussed throughout this site, the problem of distributing products and investments and of managing products and investments is not managed efficiently by the industry. There is insufficient expertise and resources to manage wealth effectively under traditional asset management techniques.

While the industry has developed tools to deliver portfolios and wealth management solutions, these tend to be very expensive, do not relate to financial needs, cannot effectively manage risk or return and are primarily concerned with product distribution.

At the present moment in time the product providers and product managers and the sellers of wealth management products and solutions are too closely related. ***While the industry does not efficiently manage wealth for the average individual, it does quite nicely for itself***. Indeed, financial services in most developed economies is either the single biggest or one of the biggest components of the economy.

Think of the financial service's industry as an old water pipe, leaking water and in need of repair. The water company is not losing any money because it is charging you for the privilege, but you are!

Many say that the industry is in a transition from a transaction led services industry to an advice led financial services industry. This is not really the case. While the development of advice based solutions may be happening at the margin, the product and transaction structure of the industry remains firmly intact, protected by statute, minimum standards and regulation that limits competition and, by the limited application of the technological advances of our age.

Most of the software developed in the financial services industry to date has been focused on how to sell more products and transactions, in other words, how to sell more of the same.

All that has happened to date, for the vast majority of individuals, is that the name of the game has changed, but the game remains the same.

The image of the industry and the sophistication of its product offerings may be in transition, but the fundamentals underlying the industry itself are not.

The transition when it finally happens will not be a transition but a revolution and will therefore not be without problems. This very fact underlines clarifies the problems experienced by the Ontario Securities Commission in trying to push its fair dealing model between 2002 and 2005. No vested interest is going to voluntarily change the rules of the game.

6.1 Why will it be a revolution?

The next stage of the development of the financial services industry will be the integration of the management of financial assets and financial needs.

These systems would be capable of delivering portfolio constructs built from the basic investment elements, without the need for complex, awkward, expensive products and without the need for a labour intensive work force. More importantly these centralised services structures can be run by much lower labour input, will source the cheapest and the best quality asset management, and wealth management products, separating the relationship between the consumer and the transaction.

An entire way of life, product sales and transaction remuneration, would be removed in a very short space of time and there will be considerable upheaval when this happens. Product sales will be relegated to selling to central investment services companies and while individuals will be able to buy products on their own, they will be from virtual financial services supermarkets.

In Canada the structure of the industry and the regulation of the industry places further barriers preventing the necessary transition.

Insurance, mutual funds, stock selection and management and product transactions are treated as four separate wealth management functions and are separately regulated. The current status quo favours the product sellers and not the consumers.

The industry of the future will be different. As discussed in the TAMRIS March 2006 Report on magic numbers and safe withdrawal rates, technology will allow highly personalized advanced wealth management solutions to be delivered at a fraction of the current costs of wealth management.

7 Past performance

Relying on past performance is as effective as closing the barn door after the horse has bolted! The past performance of an investment should never be taken as a guide to the type of returns you could expect in the future. At times, even the historical returns that are quoted as being available from the different asset classes should not in truth be taken as guidance for the future.

Inflation, economic cycles, market valuations, yields and risks "today" are all different.

More importantly, it is short term performance from here on in, that is performance over the next 5, 10 and 15 years, that has the greatest bearing on financial security for those that depend on their assets to meet financial needs. In this context long term historical returns can actually be irrelevant.

The only way your advisor can assess future returns and the risks to these returns is by being able to value the present, a skill which most in the industry do not possess.

The basic fact is this; the average investment, fixed interest or stock market, only has a limited capacity to produce return over time. Simply put, above average increases in the price of stock market investments are more likely than not to be followed by below average rises in price, or even falls.

Think of it as someone running a marathon. If you run too fast over part of the race you are going to slow down over another section. You only have so much energy to expend over the course of the race.

7.1 General rules

- The further an investment has risen in price the less likely it will be able to repeat that performance and the more likely that future returns will be lower. There is no rule that says “buy high sell low”?
    - By buying a highly valued investment all you are doing is providing the opportunity for someone else to sell at a profit.
- If anything, you should really be buying when returns have been poor and an investment is undervalued. Hence one of the primary investment rules, buy low sell high.
    - As such, if you are looking at a transaction, strong positive past share price performance is not necessarily the best guide to future performance.
- Individuals that sell a product based on past performance are more likely to be product salesman than professional advisors.
    - Why would a professional advisor pander to your weaker, baser and irrational instinct to buy high?
- Most mutual fund and product marketing focuses on performance periods which put the investment being sold in the best light.
    - Without advice, most investors would avoid under performing assets and it only takes a little push to get individuals to buy the current high flyers.

Are you a dedicated follower of fashion?

If you are being sold a product on the back of strong past performance, discount this figure immediately in making your decision and ask your advisor why the investment is likely to produce this performance from this point on.

- Whenever you are shown past performance as an incitement to invest, ask the advisor how the starting period of the comparison compares to the current point in time. If the start of the period was a recession and the bottom of the stock market and the end was a boom and a market peak, then you have problems.

- Ask them the type of returns that have historically been achieved from current valuations and the current point of the economic cycle or the business cycle of the specific investment. Indeed, whenever you are being quoted a specific achievable return or a past performance, ask this question.

If the advisor cannot answer these questions, then you be cannot be assured that this is a good investment for you.

Indeed, many products are introduced on the basis of past performance and it is one of the more obvious conflicts of interest within the industry. Advisors who are remunerated by commission are more likely to push flavour of the month products where the performance is in the price while disciplined managers are more than likely to avoid them.

A professional firm that has valuation expertise and the ability to properly construct, plan and manage portfolios will pay attention to the underlying fundamentals of the investment (valuation) as opposed to the past performance.

7.2 Reasons why past performance has become so important.

- It takes little or no expertise to plug past performance and expectations of gain make the transaction more appealing to the investor.

- Most products and mutual funds require a reasonable amount of investment expertise to select, to allocate and to manage. Performance can be easily illustrated and requires little expertise to work out which has produced the best performance.

7.3 Performance information is helpful though.

Performance is helpful in that it provides a basis for comparing like investments with like investments and it is also helpful in assessing inconsistencies between a manager's stated investment style and that of the fund or portfolio. But this type of analysis requires expertise which only the most diligent of advisors would possess.

It is also useful in providing an assessment of the risk of the manager’s strategy relative to other similar managers and the effectiveness of their discipline in their stated area of expertise.

But, the bottom line, and the most important step in selecting any investment, is first and foremost valuation which, assess both the potential for return and the risks to return. Only once you know the valuation of an investment can you decide how much you want to invest in it and this has nothing to do with past performance.

Indeed, if your advisors is a disciplined asset allocator, as managers, including those who use mutual funds and ETFs should be, he or she should first of all identify the the areas of the market/world markets they want to be in via a fundamental valuation analysis. This analysis would tell them what they want to buy and how much. This is what is called a valuation, allocation and management framework.

They would then select the managers based on whether or not their style and the composition of their funds matched the valuation and allocation parameters you wanted within their portfolios.

Performance would be only one of a number of ways of differentiating managers.

Professionals who allocate to investment vehicles by this method would not have to trawl through the 1,000s of funds available. A disciplined process would only need to focus on a handful of funds for each component of the portfolio. For the amateur asset allocator, the only way to differentiate between the thousands of funds available is by a analysing performance.

Selecting funds based on performance alone is wholly impractical.

7.4 Portfolio performance analysis

The other time when performance is important is for reporting on the performance of a portfolio. It is a moot point that the industry is quick to point out past performance to smooth a sale but digs in its heels when it comes to mandatory justification of the performance of investments recommended for a client. Ask your advisor about this if you do not get a performance analysis.

One of the hallmarks of a professional is that they will resist the temptation to sell their services through the development of false expectations. Indeed it will be impossible for them to do their job by relying solely on performance. This makes the initial job harder.

Relying on past performance figures to generate client acceptance of a recommendation is the hallmark of a transaction driven sales process as opposed to a service driven advice process.

If indeed your advisor is properly constructing, planning and managing your portfolio they will have a specific asset allocation that they consider matches your needs and risk preferences given the risks and returns available in the market place.

They will select investments based on their own valuation and risk analysis and when discussing the rationale for their inclusion will focus mainly on the valuation rationale as well as the benefits to the portfolio as a whole.

Steer clear of those whose main rationale is performance and not valuation of risk and return.

8 Conclusion

You may think that every product simplifies the investment process. It does not. A product more often than not simplifies the sales process but complicates the construction, planning and management of assets to meet financial needs over time.

Most products represent the trappings of a transaction led industry and are far too expensive to represent efficient components of a portfolio in their own right.

While many products do have a rationale, most do not and there is a direct and inverse relationship between product use and investment expertise, product use and financial advice, product use and portfolio returns and product use and financial security.

Given the weaknesses of products in terms of costs and structure, the emphasis on past performance as a strong component in the sales process is of no surprise.

In the present environment it is the individual investor’s responsibility to stand up and to make sure that the advice they are receiving is in their interests and, that they are indeed receiving advice as opposed to a product sale. Only then, will the industry be forced to change.

Demand leads innovation and those who remain happy to pay through the nose for the "advice" they receive will unwittingly reinforce the current status quo.

Products are a sign of an industry in transition and those who principally sell products and their benefits are the servants of an industry that does not have the client’s interests at heart.

Buyer, beware!