TAMRIS Global Blog Comments Compendium

The document holds a broad selection of commentary made by Andrew Teasdale on a number of global financial blogs from 25 April 2007.

It is important to note that blog commentaries are about specific issues, have a narrow focus and are made outside of a wider context that would normally be addressed in a detailed analysis. Nevertheless the document provides comments on a wide range of issues.

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Buy and hold – 1 April 2009

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2009/04/01/buy-and-hold-portfolios-do-better-no-april-fool.aspx

The buy and hold mantra is an over simplification of investment risks and returns:

But let us not confuse buy and hold with the active versus passive debate: while they can be one and the same, at times they are completely different: you can have a buy and hold allocation to an actively managed mutual fund.

One of the fundamental tenets of buy and hold is the implication (expressly stated or tacitly implied) that over the long term, you will achieve a return close to the long term average rate of return irrespective of the ups and downs in between. The lesson of the last 10 years (and more) is that this is not the case, and since the latter 1990s, anyone taking a buy and hold stance (especially where this has been accompanied by high costs) has been severely impacted financially.

The integrity of buy and hold over the short term (we all live in the short term to paraphrase Keynes) has been clearly degraded by events.

An investment prescription should be capable of managing the risks (as well as communicating realism over these risks) to the ability of assets to meet financial needs over time. If this prescription tells people that they can ignore short term market movements and economic cycles without risk to their financial security, and this turns out not to be the case, then we need another methodology that can allow us to take the risk of equity investment without being exposed to the often significant to extreme market and economic risks.

If we are buying risky assets we cannot ignore economic and market valuations, and the often significant to extreme market and economic risks, when managing assets to meet financial needs.

We need to pay attention to valuations and valuation risks.

At the same time, the alternative to buy and hold is not necessarily market timing, which is confusing, because it is also impossible for the market as a whole to time markets. All we can do is to adjust portfolio structure to take account of the time frame of the liabilities of a portfolio to the time frame of the risk of the investment (or the sum of investments), which means adjusting allocations to risky assets in accordance with the size and timing of financial demands and market and economic valuations. If we adjusted allocation structures in this context we would find that market movements to the extreme would be constrained.

Buy and hold has been a useful mantra for a retail based industry that very rarely looks at valuations and valuation risks (and that lacks the strength in depth needed to do so) when providing portfolio solutions.

Of course, modern portfolio theory, with its belief that markets are efficiently priced, and that historical risk/return distributions are reflective of future expected returns, has also aided and abetted a reliance on this oversimplification of the truth. If market and economic relationships were never significantly out of balance, if market and economic growth were always ultimately upward, save the impact of the occasional and brief recession, then buy and hold as a mantra would have more or less stood the test of time.

The ultimate risks of oversimplification are clear: many a retail investor no longer trusts what their advisors tell them.

The active versus passive debate, while similar, is on an altogether different plane and relates to the inability of most investment strategies to outperform the market for reasons of cost and mathematical constraints.

Only a small minority of managers can outperform (they need to move against and not with the market and will often suffer periods of under performance while moving against the market), and to do so they need to take significantly different positions relative to the market to stand a chance of doing so.

The allocation stance of most managers means they will never be able to cover the costs of management. Active versus passive in this context means that most equity allocations should be best held in indexed funds, but this does not mean that you can safely buy and hold, irrespective.

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Can I add one thing. Siegel overlooks the very important fact that the rule only works if a very small percentage of the market sells at that specific point: if everybody tried to take advantage the rule would disappear. It is therefore not a rule, but an exception to the main rule, which is that it is not possible for the market as a whole to time en masse.

This also applies to mean variance optimisers that recommend an increased allocation to an asset class because of past risk/return profile - if everybody changes the allocation the risk return profile going forward reverses, becoming low return high risk. It also only applies to the particular, not the general.

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Sequence of returns – 30 March 2009

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2009/03/30/two-thirds-fixed-income-panacea-for-retirement-security.aspx

Before I go insane:

The current market downturn is not a sequence of return risk - sequence of return risk is risk associated with what many perceive to be the randomness of market returns - but a systematic risk associated with severe financial and economic imbalances.

Sequence of return risk is only a risk if you expose equity positions to short term market and economic risk.

You are exposed to this risk if you take systematic withdrawals from equity positions at all points in time in the market and economic cycle.

If you have a structured approach with a dedicated low risk asset allocation where the maturity structure matches the size and timing of income and capital liabilities and where the equity allocation consumption can be deferred for a time frame capable of dealing with significant market and economic risk (8 years or more) and a modelling approach that stress tests to determine a safe structure and withdrawal rate, you are not exposed to sequence of return risk.

Most analysis of sequence of return risks ignore the impact of asset management costs: high cost systematic withdrawal mutual fund solutions (even with a balanced asset allocation) pose a higher risk of depletion than a naïve 100% allocation to a low cost 100% equity ETF.

Just do the modelling!

But in a market moving towards zero, everything turns on its head: instead of eating up your bonds you should be consuming your equities.

Why oh why do we persist in calling the problem a sequence of returns issue when sequence of returns is not in fact a problem if a portfolio is properly structured? Presumably because it would appear to be a easily communicated risk against which to sell the solution you have to hand!

This is the same old trap Michelangelo considered when he said something to the effect that; "The greater danger for most of us lies not in setting our aim too high and falling short, but in setting our aim too low, and achieving our mark."

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Why institutions miss-diagnosed the extent of the crisis – 30 March 2009

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2009/03/30/two-thirds-fixed-income-panacea-for-retirement-security.aspx

Just a short point with regard to Coxe's document.

It would seem that the industry's excuse for not working out in advance the risks was that a) they trusted the Wall Street banks to be smart enough to manage the risks and b) that Obama's policies have not worked out as well as expected.

This is absolute £$"%"%, the risks to the financial, market and economic infrastructure were clear to anyone who cared to dig into structural domestic and global economic imbalances and the fundamental risks of unregulated and unfettered growth of the global OTC derivatives market place and broad money supply growth.

This was a disaster that should have been clear to the very, very many seasoned economists that are employed in the industry.

Obama is a sideshow and an easy target to deflect criticism. I would not say that the financial services industry was wholly to blame (Central banks pumped far too much liquidity in the system and regulators completely ignored the enveloping storm), but the industry went to the same party and drank from the same cup and chose not to leave when things started to get out of hand.

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Advisors inability to risk manage – 10 March 2009

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2009/03/09/poll-finds-investment-pros-lack-knowledge-to-properly-manage-portfolio-risk.aspx#comments

This is an old report, 2003 and many of the risk procedures that appeared to work in the last bear market have fallen apart in the current.

That said, I am in agreement over many of the criticisms and concerns made. I have for the last 19 years consistently proposed a more sophisticated systemised approach for the management of risk and return over time. I am still watching and waiting for the world to catch up.

It is not that we do not have the technology and expertise to develop and implement better structures and systems, but that a) "we" appear totally uninterested in the concept of properly managing portfolios to meet financial needs over time irrespective of risk, and b) that "we" can only cope with so much information at once, and the solutions we require to properly manage portfolios are complex.

Most people cannot see all the angles and cannot integrate them into their own processes. They therefore cannot see the need or understand the consequences. In order to accept change, most need a fait accompli.

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Market bottoms and investor emotions – 27 February 2009

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2009/02/27/the-cycle-of-market-emotions-revisited.aspx#comments

Please note the following taken from an earlier blog post.

In order to have a market bottom we need a stable financial and economic system, otherwise relationships that define the variables will keep braking down.

As a global economy we are desperately trying to find, what I would term, an equilibrium point, a point beyond which demand and supply will no longer fall below and from which both will recover and grow. We have not yet got to that point. While markets always tend to recover prior to end of the recession, this is largely due to that natural support (equilibrium point) and the monetary relationships that define that support. Demand for and supply of financial assets reaches equilibrium before the demand for and the supply of goods and services, largely because of the sensitivity of assets prices to small changes in monetary demand for them.

But, I would to restate that we are not in a recession, we are not in a normal downturn and the place where we came from should not have existed in the first place: the global economy should have turned down in late 1997/1998, but the excess kept on going for far too long.

I have no doubt that things will eventually stabilise, but since we are still in the process of unwinding the excess and have yet to really overshoot beyond that, I have little faith in the short term that markets will recover sufficiently to meet the needs of the messages of many advisors.

From Europe, to Eastern Europe, to Asia, Australasia, to Latin and North America, we are in crisis. This is unparalleled.

As to market valuations, I do believe that current valuations represent good long term value relative to prospective cash returns and that cash and fixed interest investments represent higher risks than real assets; but, this is a long term view of 10 years plus.

If we are to recover we must take risks and the world authorities will make sure that investors will be forced to take risks by lowering interest rates to absurd levels and by fostering conditions where it becomes risky to hold too high a level of cash.

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A few points with respect to some of the points discussed.

Please note that selling from hedge funds represents to a large extent excessive gearing that was and still is being unwound: this gearing was part of the excess that led us to where we are and for that we must remember the very large percentage take of trading on the world's major exchanges hedge funds had at the top of the market. We cannot blame hedge funds for the fact the market has fallen if the leverage they employed was excessive and added demand to the market on the way up.

We must not forget the importance of monetary demand for asset prices, the stock of broad money supply and money supply growth: holdings of risky assets as a % of total investor assets was at historical highs in 2006/2007. Investor cash holdings as a % of total assets has been much higher for much longer during periods of stress and could therefore continue to expand and stay high for some time: add in deleveraging and reduced money supply growth, a declining global economy and the medium term demand equation for equity based investments does not look good.

The chart showing the cycle of investor emotions is assumed to have a relationship with market movements. Unfortunately this chart ignores the fact that we are breaking through economic equilibrium points, meaning that the traditional relationship between investor sentiment and the size and timing of market recovery no longer holds.

"Job losses are pervasive right now but investors shouldn't worry too much about rising unemployment because it's a lagging indicator." Again, this assumes we are in a normal economic cycle: I may be wrong (though worryingly I have not been to date), but I do not believe we are in a normal economic cycle and that therefore we cannot be blasé about any of the economic data currently being released. Consumers entered the current downturn with historically high levels of debt; now the asset prices that helped many to consume and the income (for those who are unemployed) that allowed them to finance the debt have collapsed; declining employment levels add further stress to the system, meaning that unemployment has leading implications. The debt still exists, needs to be written down, this impacts the banking system and monetary demand for assets and output.

In a typical recession demand for and supply of financial assets and goods and services can be righted by interest rate policy and, if need be countercyclical fiscal stimulus. At the peak of a cycle, typically money supply grows too fast, monetary demand exceeds real supply, government raises interest rates to curb rising inflation, demand falls, output falls, unemployment rises. At some point the excess demand is considered to have been taken out of the economy, interest rates are raised and demand recovers. This cycle is considered necessary to ensure that over time demand grows in line with the ability for production to meet demand without excess inflationary consequences. Time frames for monetary policy to impact demand are based on this type of stable economic relationship: recessions are not bad things at all in this context. But this is not the current scenario.

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I do not get emotional about markets: people who get emotional do not understand what is happening, quite often for very valid reasons. If I did not understand what was happening and why, I would be fearful, bordering on desperation.

However, that said, I am extremely concerned about the global economy and the potential human consequences as things unfold.

Personally, I think the average investor is somewhere between fear and desperation, but closer to fear than desperation: panic, capitulation and despondency have yet to be reached. Note that capitulation is always relative to the context and the context today is huge.

As for myself, cash holdings outweigh equity overall, although the equity holdings I currently hold, I have held throughout.

As to cash holdings, I believe that those who are pre retirement currently need to hold much larger cash balances: the usual rule of thumb is enough to cover a six month period, but I think the rule to cover the current period is much longer and probably closer to the cash level you would need if you were wholly dependent on assets to fund expenditure; obviously most will not be able to hold such cash levels.

I also think that those who are going to be hit the most will be those who are pre retirement, who do not have the asset cushion (even a depleted asset cushion), who may be in debt and who may soon lose their jobs.

Retired investors should really have had a structure that could cope with a period of significant market and economic risk, irrespective, and risk/return assumptions that could cope with a significant risk event. As such, if a portfolio is properly structured, conservative risk/return assumptions used, a retired investor should not be immediately impacted; any impact should be gradual.

What would have been a realistic equity risk/return assumption for an equity market at the top of an economic cycle with significant debt levels? If you were looking to cover the significant risk of a normal market and economic cycle, you would probably be looking at a long term return total real return assumption of around 3% before management expenses and transaction costs, and a potential negative return over a short 5 to 10 year time frame with a structure capable of managing this risk. If you were looking to cover a higher level of risk, then your risk/return assumptions would need to have been lower.

As such, what may have a more important impact on the market going forward may be those who would be saving from between the ages of 40 and 60, that may now be looking to hold higher levels of cash than those who are retired and currently invested who are depleting their asset base.

There is no doubt, that if the capitalist system holds together that those who invest in equities over the next few years will be rewarded for taking the not inconsiderable short term risk, but that the time frame for the market to recover previous valuation relationships is much more complex.

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It is not necessarily the tool but the message.

The message assumes that emotions oscillate around a stable economic/financial market relationship, meaning that investors should ignore their emotions and focus on the reality of the relationship.

If we believe that this relationship is stable over time, then we can ignore both our emotions and any need to explore reality (economics/valuations) and still end up where we need to go. In this case, both advisors and investors can ignore reality and perform their economic functions of allocating, investing, saving and consuming capital.

If on the other hand we do not assume that this relationship is stable, we have to interpret the message to mean that we need to focus on the reality as opposed to our emotions. In this case advisors and/or investors should be focussing not on their emotions, but on the reality of the moment and should not be accepting standard retail mantras which assume otherwise.

I am not sure that this is a reality many wish to accept, or would know how to deal with. Unfortunately, attention to the reality of the moment should have been addressed a long time ago to have averted the crisis we are in. All we can do is to stabilise the system (protect the banking system, lower interest rates, provide heavy fiscal stimulus) to allow the excess to work itself out of the system. Heavy fiscal stimulus and banking system support is transferring the risk to the future, meaning that the normality of the past will for a time into the future be only a shadow of its former self.

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Fee only and fee basis

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2009/02/12/where-to-find-a-fee-only-planner.aspx#comments

There should be a fundamental difference between a % of assets fee and an hourly rate type of fee.

Broadly it should revolve around the amount of replication / automation / uniformity in the process.

Most of the costs of stock selection, investment strategy and portfolio structuring are fixed; personalisation of portfolios to risk aversion and financial needs can incur additional costs, but since even this process can largely be automated (systemized), then a fee based on a percentage of assets under management is the most appropriate format.

The more unique each piece of advice is, and the greater the time spent is dependent on the circumstances of the client, the less able you are to base your charging structure on average costs, and hence an hourly rate is the appropriate course of action.

But whatever approach, the hourly rate or the % of funds under management, all are based on a rate return required for the service.

You could have a great process which adds tremendous value, but which requires little time to implement. Should a labour intensive process that adds less value but which takes more time to create have a higher fee? As such non hourly fee based approach allows you to charge for components which add value (have taken up capital) but which take up little time in the process. To assume that % of assets under management is inferior to a fee only approach ignores a lot.

If the advice is unique and specific and the time spent on providing that advice cannot be reused on other clients, then an hourly rate more accurately reflects the costs of the work involved. But even with hourly rate advice, much is driven from experience and templates developed over time and hourly rates reflect the accumulated expertise and costs of doing business, much the same as fee based rates should.

What clouds the issue are the relatively high costs of fee based services and this is down to competition in the market place, and not to a fundamental weakness in fee based costing.

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FYI - Everyone should look at what the UK is doing...

www.fsa.gov.uk/.../0116_dw.shtml

> "I*n June, we will consult on rules that require adviser firms to set their own charges. To be entirely clear, these rules will bring to an end the current practice in the UK of product providers offering adviser firms amounts of commission for selling their products. We will consult on rules that, by the end of 2012, will stop adviser firms from being able to sell investments that reward them with commissions. And by adviser firms I mean all firms giving investment advice - be they stock brokers, wealth managers, multi-tied advisers or indeed IFAs. This change is important because, in the longer term, we do not believe that consumer trust and confidence in investment advisers can be built up while the potential for commission to bias advice continues to exist.*
>
> *For insurers, fund managers and other product providers, the practical implications of the change need to be understood. In the retail market, the proposals mean that all investment products would, by default, need to be priced to pay no adviser commission. Some product providers may want to offer consumers facilities for deducting adviser charges from investments, and may need to make changes to their systems to do this. But all product providers will need to keep in mind that the changes we are consulting on involve each adviser firm setting its own charges: product providers will not be able to offer rewards in return for product sales from adviser firms. The way that they compete for business will – and should – change, focusing more clearly on what their products deliver for the end consumer.*
>
> *Those product providers that are based off shore, and not subject to FSA regulation, will still be affected, as we propose to ban UK adviser firms from selling products that bear commission set by providers from the end of 2012. Equally, overseas adviser firms that set up branches in the UK under the MiFID passport will be subject to the new rules. And whilst adviser firms that operate cross-border will not be regulated by us, the preference of UK consumers for getting investment advice face-to-face suggests it is unlikely that adviser firms would migrate to other Member States simply to avoid making the changes we are proposing.*
>
> *Coming back to the basic principle of adviser firms setting their own charges can help adviser firms to think through the practical implications of our proposals. If adviser firms are going to be genuinely in the driving seat – and their remuneration not influenced by product providers – they will need to decide on, and explain to customers, their own charging tariffs.* "

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ETFs gain at mutual fund expense

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2009/01/20/etf-makers-continued-to-gain-assets-at-mutual-fund-industry-s-expense-in-2008.aspx#comments

Before you can discern anything from the data you need to know where the money came from: if the money came from institutional investors then this says nothing about investor attitudes or investment decisions.

What is more important is the fact that mutual funds are not selling: if you do not sell you cannot support your cost infrastructure; you will need to cut costs and make your product more attractive. Mutual fund prices will have to come down and price falls will be led by those that want to survive and be perceived as a leading value proposition for investors and advisors.

Transaction based systems are going to have trouble surviving whereas a lower cost process based system is the better animal for the current environment: cost structure is not dependent on transaction returns and can continue to operate on tigher margins and lower revenue.

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Hedge funds inefficient – 13 Jan 2009

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2009/01/12/fidelity-unit-targets-mass-affluent-canadians.aspx#comments

Re Hedge funds

"***Hedge funds had become key allocators of capital, with a willingness to take risks in deciding which companies, industries and countries to back. Apart from helping companies raise cash, they provide liquidity to the markets and make those markets more efficient by arbitraging away price differences."***

I would question the assertion that hedge funds made markets more efficient given that prices and supply supported by these funds ignored the economic, market and financial structural im balances. In truth they were a product of excess and not an optimising agent.

Just goes to show how little many who still write on the subject know about it.

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Asset Dedication

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/12/29/asset-dedication-vs-asset-allocation.aspx#comments

FYI: I first developed asset dedication in the UK in the very early 1990s, an approach which was put into software and used in the UK financial advisor market from as early as 1993.

Asset dedication has to be properly managed and I have seen many a flawed asset dedication approach. We are only a year or so into the current crisis: an asset dedicated portfolio cannot prove its worth until we have passed much longer milestones.

Asset dedication is not new, yet a 1990s bull market, the rise of MPT (which does not have a liability input) and numerous flawed risk management products have in my view thwarted the acceptance of a critical portfolio construction methodology.

I have a couple of documents on asset dedication and these are available at my website.

The Fundamentals of Asset Allocation, Weaknesses of M.P.T. & A Fundamental Framework for the Management of Assets and Liabilities

moneymanagedproperly.com/.../Fundamentals%20of%20Asset%20Allocation,%20Weaknesses%20of%20MPT%20and%20a%20Fundamenrtal%20Portfolio%20Foundation.pdf

Magic Numbers & Safe Withdrawal rates

moneymanagedproperly.com/.../TAMRIS%20Review%20-%20March%202006.pdf

Andrew Teasdale

Valuations not as good value as historic benchmarks might suggest – 25 Nov 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/11/25/the-crash-already-happened-so-stock-market-risk-is-now-low.aspx#comments

Price does not necessarily equal value: the only way we could be sure about value is to know precisely the growth rate of future earnings; since we do not know this rate, we can never be totally sure about value. One thing we do know is that the lower the price relative to current earnings, the higher the risk to current earnings we can take and the less dependent we are on future earnings growth.

Markets are currently pricing a significant drop in earnings and a long period beyond that of poor earnings growth. Whether current pricing is rationale or not, such a scenario is not is not out of the question.

A deep and prolonged global depression could be the type of scenario that would lead to such an outcome.

Levels of consumer demand in a number of major economies were based on excessively high levels of money supply growth/consumer debt. This excessive consumer demand was backed up by both an increased supply of assets and a rise in asset prices. The higher price and supply of assets were above the ability of these economies to produce the output growth necessary to provide the income to fund the debt and to support the future consumption implied by the supply and price of assets.

If consumer demand collapsed back to where it would be without the debt and where it would need to be to bring demand and supply into balance, then earnings would continue to decline. The only thing that could prevent such a collapse in economic output would have been a rise in demand in those economies that were not so exposed to excessive domestic demand growth and that were part of the global economic imbalance that further aggravated domestic structural imbalances in these economies: in other words we needed global economic decoupling; decoupling is not happening.

The only other option is to reflate domestic demand to allow inflation to make the necessary economic adjustments. The end result is the same, asset prices move back to the ability of the economy to produce real output growth. Reflation, would however turn the current crisis on its head, risking nominal assets such as cash and bonds.

This does not mean that current valuations are not good long term value, just that they may not be as valuable as historic point in time comparisons might suggest. For example: we are at the end of a long, strong, global economic expansion and the last time we had p/e, price to book and dividend yields globally at such low levels was at the end of a period of low economic growth.

Andrew Teasdale

The TAMRIS Consultancy

Bear market and financial security – 20 Nov 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/11/20/market-crash-has-over-40s-rethinking-retirement.aspx#comments

The market crash itself, up till now, should have had little or no impact on the time frame and duration of retirement income planning.

Let me explain.....

In the industrial world we were at the end of a very long economic expansion: forward looking models of market return should have been building in a significant amount of market and economic risk.

For example, in June 1997 my long term market and economic valuation models for the US put the S&P 500 at 800 in 2002 and 900 in 2008 with a dividend yield of 3% and a P/E ratio of 14. The higher markets moved up post 1997 and the longer the economic cycle pushed out the lower my projected return figures became.

If your risk/return modelling have been conservative all that should currently be happening is that future returns on equities are now higher and current capital values lower. There should be no immediate impact on the ability of your assets to meet your future financial needs: if the ability of your assets to meet your financial needs have immediately dropped by a significant amount then it is likely that your planning has not been focussed sufficiently on the short and long term risks of markets and economies.

Secondly

This may seem strange, but when you consider that a portfolio should be constructed to manage a significant economic and market risk event at all points in time, no investor should be exposed to stock market risk over a period sufficient to cover this significant risk. When I used to manage money, this was a period of 8 years (I used the 1970s crisis as a significant risk benchmark, neither a depression, nor a mild recession): this eight year period would be pushed out for more conservative investors and extended at market and economic peaks for all investor profiles.

Leaving the detail and structural issues aside, no investor should be exposed to current market and economic risks.

If we are entering a depression then it is likely that the duration of the economic and market risk event will exceed significant risk parameters, but even here good modelling should build in a number of compensating assumptions: if you have a strong inflation risk assumption within your modelling, then a period of deflation will further expand the security provided by a well structured portfolio, further enhancing the time frame over which equities should not need to be realised. Adjustments that may need to be made over time to planned withdrawals are therefore likely to be minimal.

I believe that the risk event we are facing is well outside a normal risk event, but that well structured portfolios with conservative risk/return modelling should see less impact on both income and capital security in the current market and economic crisis.

It is time the retail financial services industry paid attention to the fact that we do not live in efficient markets, that investment planning assumptions should reflect market and economic risk and that portfolios should be structured to mitigate the often significant market and economic risks of the capitalist system. That and of course, costs need to come down.

Someone invested in an indexed ETF with an MER of 0.25% for 25 years could have accepted a decline of 50%on the index and still be left above the total return of a mutual fund with an MER of 3% without such a decline (whose return before charges equalled the index return) – this calculation assumes no taxation of return and all dividends reinvested.

One of the reasons I stepped outside the industry was its failure to seriously address the management of liability risks and to ignore the importance of structure and sensible risk/return modelling in favour of static portfolios, limited integration of liability management and absurdly high long term equity risk premiums at market and economic peaks. The ascendancy of modern portfolio theory in the 1990s has I feel helped to perpetuate an ignorance and an avoidance of these issues and has contributed much to the current state of affairs.

I feel that the retail financial services industry can no longer ignore these issues: its historical business model is at risk if it continues along the current path.

Andrew Teasdale

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ETF Portfolios – 18 Nov 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/11/18/etf-maker-barclays-unveils-quot-portfolio-builder-funds-quot.aspx#comments

These low cost portfolio options provide a value benchmark against which the higher cost mutual and segregated fund industry will need to be judged. You can only charge a higher cost if the higher cost adds value.

However, I am unclear as to which market place these new funds are directed: are they to be purchased direct by investors or are they to be purchased by advisors for clients? If they are to be purchased by advisors then another layers of fees will be added.

The limited asset allocation spectrum might impact use by advisors as would the limited information about the proprietary multi factor models used to determine asset allocations: I presume information on this is available somewhere.

I wonder also if the models underpinning these funds might need to be tweaked if we end up with a pre 60s paradigm of equities yielding more than bonds: factor return models depend more or less on long term linear relationships holding.

Andrew Teasdale

The TAMRIS Consultancy

PS - I appreciate that equities currently yield more than bonds: what is important is whether this relationship will hold for long enough to materially impact multi factor model assumptions.

Andrew/TAMRIS

I asked the question as to who these products are directed at because they are not as simple as they might appear to be at first glance. Incorporating satellite funds into a strategy is not a trivial exercise and the way in which asset allocations are going to be managed in all funds is not immediately clear: how stable is the multi factor model, what are the minimum and max allocations, what is the risk/return profile of the portfolio components: in short what could one expect from these investments over time relative to a number of simple benchmarks.

If they are going to buy on their own, investors have to be able to understand what to expect from an investment so as to be able to continue to hold it through different market and economic conditions.

Perhaps I am over complicating the issue and it is a case of the more you know the more you ask. Good advisors provide stability and discipline and if investments are to be sold direct this stability and discipline needs to be part of the process.

I would like to refer to a comment from the on line brochure

ca.ishares.com/.../2min_pbfunds_en.pdf

"It's amazing what a single trade can bring to your portfolio".

The word trade means to me that the product is communicating to the more sophisticated investor.

Andrew/TAMRIS

Mutual fund performance and economic commentary – 6 Nov 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/11/06/canadians-dumping-mutual-funds-but-buying-etfs.aspx#comments

In the CI document they reference the performance of markets from 1978 to September 2008 and use this as an example of what equities can provide irrespective of market downturns.

1978 could well be defined as a low point in global equity market valuations: we were at a high point in terms of interest rates, inflation, leverage and a number of other important factors.

Equities are not guaranteed to rise irrespective of market and economic risks. If economies and markets are way out of equilibrium the impact can be significant and sustained.

I would rather that we saw realism under pinning the need to remain invested at current levels with a sober assessment of the immense economic risks we are currently witnessing. The current crisis eclipses by a wide margin any of the risk reference points in the chart shown.

Andrew Teasdale

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I also looked at the Invesco Trimark commentary which ommited to mention many of the significant structural economic imbalances that lie behind the crisis and that are more than likely to continue to develop.

Please also note an amendment to a prior comment -

"1978 could well be defined as a low point in global equity market valuations: in 2007 we were at a high point in terms of interest rates, inflation, leverage and a number of other important factors.."

Andrew Teasdale

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Randomness – 29 Oct 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/10/29/the-world-is-curved.aspx#comments

I usually agree with much of what Fred says.

However, I would disagree that the current crisis is a random event for the simple reason that the cause and consequence are the direct result of accumulated actions on which the current crisis is dependent.

Randomness is related to movement from a point of equilibrium and is an independent action.

In fact, mathematicians are at the heart of the current crisis, in that it was their very probability based models on which much of the so called diversification of risk has been based.

The probability of an outlying event increases the further away from equilibrium you move.

Andrew Teasdale

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Market timing – 20 Oct 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/10/20/reader-response-to-quot-why-did-we-not-act-quot.aspx#comments

It should be clear by now that the current market and economic situation lies outside the boundaries of natural market and economic risk.

Portfolio theory (modern or otherwise) is not structured to deal with the current risk event, nor is the modern capitalist system.

However, I can guarantee that if everyone were to attempt to exit the market en masse, the world would go up in smoke: it is a physical impossibility for everybody to get out of the market place at once, to do so (or to recommend so) would cause irreparable damage to an already fragile system; we are all to varying degrees hostage to the current situation. It is a closed system.

Market timing (in my opinion) has always been a marginal activity conducted by the few with varying degrees of success and to my mind was itself never intended to be a general prescription for all capital. I still hold to this view.

That being said, I do feel that asset allocation structures should take into consideration the impact of significant cyclical market and economic risks on investors' short term financial security (risks that can impact security for 5, 10 years or more).

What needs to be challenged is the presumption that markets are efficient and that by virtue of this so must security prices be correctly pricing risk and return at all times. I have never believed this to be the case, preferring to believe that we go through periods of excess on either side and that asset allocation structures should reflect liability profiles with adjustment for mature market and economic cycles – this is not market timing, merely the management of the saving and consumption of capital, itself central to investment and production components of the economic equation. I believe that the development of market and economic portfolio theory is still in its infancy.

Given the above and much much more, I do not feel that the vast majority of advisors can be held responsible for not taking their clients out of the market. The situation is clearly well outside their brief and knowledge base.

I do however feel that many of those who were in a position to have known better (central banks, institutional research departments, regulators, chief economists and academics with the time and resources to do the job properly) were intellectually negligent for ignoring the magnitude of the buid up of structural risks and their potential impact even during the later stages of the current crisis.

We live in a time without precedent!

Andrew Teasdale

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Heart of the matter – 18 Oct 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/10/17/ten-reasons-for-optimism.aspx#comments

The heart of the matter is not that the near collapse of the financial system has caused markets to fall and economies to slow, but that the excess debt and vast structural imbalances built up over the last 10 years led to the collapse in the financial system in the first place.

These structural imbalances and vast levels of consumer debt (compounded now by declining economic growth and falling asset prices) are still a significant threat to economic growth and market valuations: the excess in the system is still being worked out and sustainable economic growth is unlikely to resume until this process is complete.

Stocks are very attractively priced, but these prices must be judged in the context of the very real economic headwinds we still face and which are unlikely to be assuaged by the mere recapitalization of the banking system.

All the positive points made are indeed positive points but they need to be balanced by the negative issues that remain to arrive at a balanced perspective of the current market and economic situation.

Andrew Teasdale

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Point of maximum pessimism? – 16 October 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/10/14/was-friday-the-moment-of-maximum-pessimism.aspx#comments

At 870 S&P and 3840 FTSE I think it best if we avoid talking about market bottoms and look closer at valuation and time frames.

Many of the world's stock markets are at P/E levels now that could withstand 30 to 40% declines in profitability and still look reasonable on a long term historical perspective.

Corporate profitability prior to the crisis was at historically high levels and P/Es were not reflecting the risk to a return to lower levels of corporate profitability. This has now been pounded out of the market.

On a long term basis current market valuations are discounting a significant amount of risk and for long term investors (conservative or otherwise) one's only decision now should be whether or not to buy.

That said, I think it likely that the market will continue to decline; the economic headwinds are strong and GDP growth is likely to come in much much lower than many are currently forecasting; we are still in the process of deleveraging and investors the world over are likely to be holding a lower allocation to less risky assets for some time.

That said, the real decision for investors on a long term basis (10 to 15 years plus) is "are equities able to provide a return comfortably in excess of lower risk returns from current levels even if the situation deteriorates further in the short term?". I feel that current levels can accomodate a fair amount of additional market and economic risk and that investors should now be focussing on long term value, not on short term price movements.

Whenever you buy, your investment should be able to accomodate significant risk and still provide long term value.

Should investors be committing short term capital (0 to 5 years) to the market? No! Market valuations could remain depressed for years and they could fall further.

Where I still have concern lies in the 5 to 10 year time frame and if I had been running portfolios in the lead up to the crisis this would have been covered, irrespective.

Andrew Teasdale

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Competitive capitalism is dead! – 9 Oct 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/10/09/bad-markets-often-followed-by-violent-recovery.aspx#comments

I wonder if anyone has realised that the market and economic system in which we are living is no longer one of competitive capitalism.

Markets are no longer determining the efficient allocation of capital, but central banks and governments who are looking to bolster the financial system and the assets within the system that are causing problems.

If we are no longer in a true competitive capitalist system, then what are markets and securities valuing?

I do not think we can look at past scenarios to determine the value and risk of the present. There is quite frankly no comparison.

The reason why we need to stay with a well structured balanced portfolio is because we need to hedge our bets with respect to the potential outcome of the current crisis.

Andrew Teasdale

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This is much more than a financial crisis! – 4 Oct 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/10/03/grandpa-at-the-casino-s-one-advisor-s-take-the-financial-crisis.aspx#comments

I very much sympathize with advisors like Smith who are responsible for instilling discipline in the face of heavy fire. Without such, what we have seen in the markets would have been much worse. And, of course, such discipline will continue to be needed.

While my prescriptions for the necessary long term portfolio discipline and risk management may not differ, my views on the deep structural issues with the US and global economy are still at odds with the consensus. The consensus view, at the moment, is that what we are seeing is principally a global panic in response to natural market and economic risks, as if the problems were restricted to the financial system and the lack of confidence in it.

The crisis is much more than a lack of confidence in the financial system. Economic and financial stability depends on a balanced relationship between consumption, saving, investment and production.

Over the last ten years (and in reality the last 30 years) we have seen too much consumption and too great an increase in money supply growth that has allowed for a monstrous increase in debt and the supply and price of assets that have supported that consumption increase.

Not only are consumers over indebted, but the supply of debt and the value of assets used to support that debt have become out of balance with the ability of the economy to produce the real output growth needed to justify the price and value of assets.

In other words, we needed inflation or a fall in asset prices to bring consumption, saving, investment and production relationships back into balance. What we are seeing is a fall in asset prices, followed by debt defaults, followed by a fall in consumption, production, saving and investment.

What makes the above worse is that the structural imbalances in the global economy are themselves imbalanced; excessive consumption as a percentage of GDP in the US and excessive production as a % of GDP in Asia.

What makes the above worse is the way in which the financial system has itself taken risks with respect to these imbalances. When AIG went down it went down with some $500bn plus of credit default swaps; these swaps allowed banks to reduce the reserves they needed to hold against their more risky assets. By some estimates, there is currently some $60 trillion dollars of credit derivatives in the market place today.

What makes the above worse is that globally the allocation to risky assets was at historically high levels, and the allocation to cash at historically low levels. You only need a small marginal reallocation towards cash to precipitate a substantial decline in asset prices. With the world deleveraging, not only are people looking to increase their cash balances but the amount of broad money supply available is also now declining.

The capitalist system is a monetary system. Actual cash (notes and coins) represent only a small component of money supply. Most money supply is comprised of debt, which is supported by asset values. Over the last ten years the monetary system has become corrupted and exposed. As I have stated a number of times, we are all hostage to the system and the crisis: we cannot all sell and head to the hills, the physics and maths are against it; most of us will get killed in the stampede.

Andrew Teasdale

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Advisors need to get real – 29 Sept 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/09/29/gut-check-time.aspx#comments

I think it important that advisors are aware of the very real physical structural issues in the economic and financial market place and should not be passing these moments off as pure emotionally driven market price movements.

We have not arrived at this point in time because investors have panicked but because of very real financial, market and economic excesses that are trying to work themselves out of the system.

Too much debt was accumulated over the last 10 years; too much of this debt was related to either excess supply or excess asset prices, and too much of this was both held above the banking system and insured numerous times over by the financial system.

The crisis is centred in the financial system, but it is directly related to an over debt burdened global consumer and the real economic adjustments have yet to be felt.

This is not an emotionally inspired event. This is real and emotions have until now lagged reality. This looks to be changing and emotion may well start to take over as the main driver of price movement.

What makes the current crisis so complex is that we know economic relationships are still well out of equilibrium and have a long way to go, and because of this there is little or no certainty with respect to how much further debt and asset values will continue to contract and impact the banking system.

We have never, ever before been in such a crisis, and it is a crisis whose impact will likely last decades and not months or years.

Andrew Teasdale

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Just one point regarding Swedroe's comment about the risk we are experiencing always being in the system: the risks we are experiencing are the result of the corruption and abuse of the capitalist system and are not natural market and economic risks.

This crisis cannot be compared to any crisis of the last 30 years. The current crisis is a risk to the financial market and economic paradigm and not a risk of the system itself.

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There is one subtle point that i think needs explaining from my perspective.

If you believe in the strong form of modern portfolio theory, its central tenets are that the market is efficient at pricing risk, that the market and economy are at equilibrium at any one point in time, that future information affecting equilibrium relationships is unknown, and as soon as this information arrives it is adjusted for by the market as it moves to a new equilibrium point. No one can profit by trying to time the market or by trying to predict the nature of future information.

This is contrary to my belief of the market and economic system. Price movements are not independent from period to period because the market and economic framework is not at equilibrium.

The two perspectives are vastly different and investors and advisors need to be clear as to the differences.

The economy (comprised of debt and assets that reflect consumption, production, savings and investment relationships) has been well out of equilibrium for some time and this information has been in the system. Price movements are therefore dependent on the excesses and the risks posed by these excesses.

If markets and economies were truly in equilibrium prior to July 2007, then, the size of the problem and the magnitude of the reaction to the problem would have been different. This new information did not come out of nowhere.

Andrew Teasdale

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Structural imbalances – 22 Sept 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/09/22/tinkering-with-portfolio-mix.aspx#comments

As the global recession bites earnings will fall: this means the short term risks to equities will rise resulting in the risk of further market declines.

Declining economic demand will not just impact earnings but also asset prices. There is still a lot of bank balance sheet and off balance sheet securitised debt that would be impacted by deterioration in asset prices and declines in their values would also impact the OTC derivative markets which would further impact the financial system.

The economic imbalances (excess consumer debt and excess consumer expenditure) have yet to shake out and hence the prospects for economic and market declines remain high.

What we do not know, is how the money supply situation is likely to develop. In order to prevent a melt down in the financial system asset prices need to stabilise and this is likely to be engineered via fiscal/central bank and hence and monetary stimulus.

A period of inflation would impact cash and bond returns because interest rates would need to be kept low to allow economic, market and financial imbalances to right themselves. perversely, moving out of equities could put investors at greater long term market and economic risks.

Essentially, when you have excess it either has to be accomodated by the system (inflation) or shaken out of the system (asset price declines, debt defaults and money supply contraction).

The difference between current and previous episodes is the magnitude of the excess and the complex frameworks in which this excess was harboured.

E = MCsquared. The energy held in the accumulated excess is equal to the energy to be transferred within the ultimate outcome.

Andrew Teasdale

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Questioning Swedroe – 18 September 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/09/18/swedroe-on-the-financial-crisis.aspx#comments

"Everything above is already known by the market and should already be built into prices. It is important, therefore, not to confuse this information with information you can exploit. You can only profit from information that no one else has."

I would disagree with this comment: we knew everything we needed to know about this crisis well over a year ago when markets were at much higher levels; what we now know are some of the consequences of what is effectively a third wave of reaction to the structural financial, market and economic excesses built up over the last 10 years.

While I do agree that you cannot time markets, I would disagree that markets know how to price risk. I think the market has clearly failed in its ability to price real risks by ignoring the relationship between the long term productive potential of an economy and the supply and price of assets and debt supporting those assets.

The debt built up, and the assets supported by this debt exceeded the ability of economic output to sustain their implied future demand; the market failed to notice this, and instead built up a vast web of securitized debt and derivatives around this excess, an excess and a web that is now threatening the viability of the world financial and economic system.

Prices stood where they were because of excess asset focused money supply growth and because prices refused to incorporate the risks of such excess. Markets were not being efficient, instead they were being motivated and driven by self interest and greed.

The exchange traded market place did not correctly price the supply of assets and debt because it ignored the vast over the counter derivatives and securitized debt market places.

It is more than likely that the short term consequences of the unwinding of the excess have yet to be fully priced into the market.

I do however agree with the statement "Make sure your investment plan incorporates really bad crises so that you don’t take more risk than you have the ability, willingness or need to take", although I doubt whether many a sensible investment plan would incorporate events that are likely to continue to unfold.

My reasons for the need for calm and the retention of sensible long term asset allocations are based on the needs of the capitalist system - we will all be better served by investors retaining appropriate long term asset allocations than heading for the hills.

Nevertheless, investors should have been holding more defensively structured portfolios as the market and economic cycle matured to protect their ability to support their short term consumption needs, just as they need to retain long term asset allocations to equities to allow both themselves and the economy to provide for future production and consumption.

Larry also missed a number of significant risks in the system: notably the very high levels of consumer debt, the impact of declining asset prices on debt and consumption and the very high level of personal consumer expenditure as a percentage of GDP in the US and other countries. The risks are not confined to the financial system, they mirror the very real risks to consumer demand and hence production etc.

Andrew Teasdale

Real adjustment still to work way through economy – 16 Sept 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/09/16/groping-for-the-bottom.aspx#comments

The problems we are currently seeing are the direct result of high levels of securitised debt creation and the way in which this debt is related to the operation of the financial system.

The deteriorating quality of the assets supporting the debt has resulted in significant losses for the world's banks as a result of this relationship, but it has also brought into the picture the excess supply of debt and assets supporting that debt relative to the ability of the real economy to generate the real growth in incomes and output to support that debt over time.

As such, the real adjustment in the wider economy is still to fully work its way through with further consequences for asset prices supporting excess debt levels; asset price reactions tend to precede developments in the real economy.

The current crisis is not one of investor overeaction (a decline in demand for real assets) but a fundamental and far reaching strucutral physical reaction to a period of excess that has been building for at least the last 10 years.

In other words the current crisis is supply driven as opposed to demand driven; excess money supply growth has built up an excess supply of debt and assets purchased by that debt. This is why the heavy price movement started in the credit markets and in 2007.

Unfortunately, it is not a question of selling assets to mitigate the risks of a falling market, since the capitalist system is dependent on economic and market particiants continuing to hold to long term consumption, production, savings and investment decisions.

If we all bale, so does the system We are a hostage to the system we live in and the crisis that risks it.

The best investors can do is to hold to long term asset allocation structures, providing their portfolios are structured to cope with a significant period of market and economic risk; no-one can manage an outcome that lies outside these parameters and attempts to do so will worsen the outcome.

This is not as easy or as obvious as it seems and investment advisors will need to think clearly as to how their structural processes and planning can help investors live through the crisis.

We will have to accept the new market and economic environment and adjust to its realities.

Andrew Teasdale

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Interconnected – 20 May 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/05/20/maxed-out-vs-thrift.aspx#comments

It is amazing how interconnected economics and markets are.

High levels of debt have been important in maintaining domestic demand growth: asset prices depend on domestic demand growth for their value.

A steep and sustained fall in consumer demand implied by high debt levels would also see a large fall in returns on assets - both spenders and savers alike are impacted by the same excess.

It is also worth noting that higher levels of consumer debt have also been accompagnied by lower earnings growth and greater income inequality.

All components of capitalism are joined at the hip. Note Newton's third law of motion, "For every action there is an equal and opposite reaction."

Andrew Teasdale

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ABCP not too complex to comprehend! – 29 April 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/04/25/lessons-from-the-abcp-fiasco.aspx#comments

I agree that the machinations behind the construction of the Collateralised Debt Obligations etc that under pinned many of the ABCP were complex but disagree that the risk of the products were too complex to comprehend at the retail financial institution and hence advisor level.

ABCP was a short term loan based on longer term higher risk assets. The paper was only liquid as long as there were willing buyers. No one in their right mind should have recommended these assets as cash substitutes. Non Bank ABCP were especially risky.

But then again there are many more products that fall into the riskier than portrayed category; income trusts, hedge funds etc.

There is an all pervasive ignorance and a corruption that promotes the supporting environment.

In short the risks of ABCP were not too difficult to comprehend and if you wanted to understand the nature of the products all you needed to do was to spend a little time thinking and reading up about them.

Andrew Teasdale

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Capitalism In Crisis – 17 April 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/04/16/recession-roadmap.aspx#comments

One of the reasons I have titled a number of recent reports "Capitalism in Crisis" is because the current market and economic system depends on investors remaining more or less fully invested.

Even a small market wide shift in cash allocations can cause a catastrophic collapse in asset prices.

Capitalism is in crisis because the system that was meant to efficiently match demand and supply has become corrupted.

We are all ultimately bound, dependent on and essentially captive to the modern capitalist system. Investors on average cannot time the market and should only be adjusting their allocation to risky assets based on their own consumption profiles; the market portfolio should represent the sum of all consumption, saving, investment and production decisions within an economy and hence asset allocation profiles need to represent an individual's own relationship with the market portfolio.

Properly constructed portfolios should be able to cope with significant market and economic risk and should not need to time the market beyond small marginal adjustments to manage liability risks.

Risk events beyond those considered natural market and economic risks cannot be managed nor can they be pre-empted in a monetary based system. It is a physical problem and we are all in a sense captive to the rules of the problem.

This does not of course prevent the marginal investor from attempting to profit from the errors and ommissions of the market, but it should not be a general prescription.

I am presently completing a third piece dealing with the fundamental physical problems of money supply and market timing and their relationship with the portfolio.

Andrew Teasdale

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The split depends on the liability profile of the investor; that is how much are the assets likely to be depleted over time under a conservative set of risk/return assumptions.

Depending on the profile and risk preferences any split between 0 and 100 could be appropriate.

The one problem with fixed allocations is that they are exposed to significant market and economic and risk events. You are having to sell under valued equities on an annual basis, or bonds that have fallen in price to meet withdrawals.

A portfolio structured so that capital depletion is taken from cash and maturing bonds and relatively and absolutely over valued equity components (if any) during risk events would cover the points made by many market timers.

If you do not have to sell or access a volatile asset during a significant risk event then there is no point in having to time the exit and entry for risk reduction.

Integrating the liability profile of an investor into the portfolio structure and management is not efficiently managed even though the overall market portfolio and economic relationships demand such.

There are other problems with the typical balanced mutual fund. One is that it is far too expensive and therefore even less efficient at managing liability risks let alone risk/return relationships.

Current portfolio theory and practise is stuck in dealing with the two dimensional risk/return relationship and is incapable of dealing with liabilities efficiently. It may state that it manages this component but in reality it only fudges it.

A balanced asset allocation without liabilities is very efficient at managing risk and return at a point in time as demand moves from one asset class to another but does not efficiently manage liabilities.

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PS - I go into the errors and ommissions of modern portfolio theory and the management of liability risk in the complex document noted below.

www.moneymanagedproperly.com/.../Fundamentals%20of%20Asset%20Allocation,%20Weaknesses%20of%20MPT%20and%20a%20Fundamenrtal%20Portfolio%20Foundation

Mutual funds – 12 April 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/04/08/fund-fees-redux-hallett-vs-tufano.aspx#comments

Three points

Number 1, regarding Dan's comments.

Where the comparison made is active mutual funds versus the index Dan is right to point out the total service costs for those who apply indexed fee versus active commission based service costs.

Advisors who use passive indexed allocations need to be able to justify their fee based service costs. After all, many of these services offer fixed long term asset allocations with simple rebalancing. There are advisors who offer substantive investment planning services and administrative support as well as the necessary understanding, management and support to their disciplines. All services (financial or otherwise) have a cost/benefit relationship.

A number of academic studies have shown that individuals who use index funds are also likely to succumb to market timing thereby negating some of the benefits of indexed investment approaches. Thus the average investor who would benefit from an indexed approach is also likely to be an individual that lacks the understanding and discipline to manage even a simple asset allocation stance in the absence of professional help.

I would still suggest that an average 3% total service cost for active Canadian equity mutual funds is "way too high" and "indefensible" against any benchmark. Costs are an absolute and I note that Canada is only second to Denmark once we include bond and money market funds.

Over a 50 year time frame an index investment with a 1% total service cost will return 64% of the index, with a 1.5% cost a corresponding 51% and with a 3% total service cost an index investment would only return 25% of the index. A fund that produces 90% of the index return before fees (say 9% versus 10% per annum) with total annual costs of 3% would only return 12% of the total index return.

As I think I pointed out in an earlier comment the costs of active mutual fund management in most instances invalidates their reason for being; managers with balanced "index like" allocations would need to be able to generate extreme out performance on their active component to justify the fees.

Second point, regarding Danielle's comments.

I am not sure whether she is countenancing that all managers should be operating on a market timing/sell equities into cash basis or decrying the futility of active management relative to a more passive indexed approach. Market timing can only ever be a marginal activity.

If we assume for the sake of assumption that the market portfolio were to be 10% cash, 30% bonds and 60% equities, an attempt to increase the cash holding to 11% by selling equities would see a decline in the equity market of 15%, an attempt to increase cash to 20%, a decline of 83% in the market and so on.

At any one point in time money supply is fixed and the only way the market can increase cash balances as a percentage of the portfolio is to lower the value of other assets, in this case equities.

The percentage of cash that individuals and institutions wish to hold is influenced by risk preferences, interest rates and money supply growth as well as financial innovation (structures that allow investors to increase exposure to risky assets). Any thing which either risks a reduction in money supply or investors' risk and liquidity preferences would negatively impact all risky asset prices. Nevertheless a rush for the exits would create catastrophe and is impractical for the market as a whole.

Third point

Disciplined non indexed (not necessarily "active") management can only out perform if the number of disciplined managers and the number of similarly disciplined investors are in the minority. Value is created by differences in relative demand for risk and return. IF all managers were disciplined we would have a truly competitive market place where the role of such managers would be limited to setting prices and all investors would hold the index or risk adjusted components of the index.

Andrew Teasdale

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Market timing – 9 April 2008

Juggling dynamite, Where is the value?

Danielle

I was wondering what would be your prescription for the market as a whole with respect to market timing given that a) the money supply is fixed at any one point in time and the market as an average cannot increase the amount of cash it holds and b) that given (a) it it only takes small marginal changes in preferred percentage cash holdings to move markets.

For example with a "market portfolio" of 10% cash, 30% bonds and 60% equities an attempt by the market to increase cash holdings to 20% by selling equities would cause an equity market decline of 83%.

If everybody were to move out of equities completely we would have the proverbial stampede for the exits.

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Active versus Index - 1 April 2008

WealthyBoomer.ca - Barclays campaign will target Canada's high fund MERs

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/03/28/barclays-campaign-will-target-canada-s-high-fund-mers.aspx?CommentPosted=true#commentmessage

Total service costs (management, administrative and sales costs) and transaction costs are the major reason why the average mutual fund does not match or beat their appropriate benchmark and why more mutual funds do not beat these benchmarks.

This does not mean that a non indexed approach is not appropriate and that valuation based methodologies cannot add value. Indeed, sufficiently diversified, low cost, low turnover, value biased investment approaches are capable of adding value especially when we add the back the costs of portfolio management and financial advice; note those who offer index services will have annual management expenses and an apples to apples comparison only be made when assessing the total costs of the advice and management medium.

Stocks with low price to book, low P/E, high dividend yield, low price to cash flow and sales have been shown to outperform the market place significantly in numerous studies and is the centre piece for strategies followed by the likes of DFA.

The difference between DFA and disciplined valuation driven investors, in my opinion, is the reason for the pricing differential; one believes it is due to efficient markets pricing higher risk stocks effectively, the other believes it is due to investor psychology and the impact of relative demand on pricing differentials.

While I do believe that a situation where all investors are in indexed funds would be bad for market pricing and would ultimately build risk into the indexes (note an index is price driven while valuation disciplines are earnings and cash flow driven meaning that one buys the price movement the other the fundamental value) the actual level of indexing in the market place is much higher than many believe. Most mutual and institutional funds are more or less index weighted with small deviations from the index used to attempt to enhance returns or reduce risk. Indeed, the capital allocated on an index weighted basis (more or less) to the index is no doubt very, very high.

Over a long period of time it is virtually impossible for a high cost active mutual fund to out perform its benchmark. If we look at an MER of 2.75% and annual transaction costs of 1% a mutual fund would need to deviate 75% from the index (via sector, stock and/or market cap) and obtain a return of 50% more than the market each year on this component just to equal the benchmark index return. If we look at an MER of 2% and annual transaction costs of 0.6% we would need a 50% deviation from the index with a return on the deviation of 50% more than the index to break even. Indeed, a fund with a 20% deviation would need to earn a return of 273% on the 20% deviation (a 2.75% total service cost and 1% transaction cost) and by 220% on the 20% deviation (for an MER of 2% and a 0.6% transaction cost).

Given the above most investors would be better off moving from their active funds to an index, a move which may have only marginal consequences for efficient pricing.

But the index itself is the sum of all consumption, investment, production and savings decisions within an economic and market entity. This means that the time frame and composition of the index is an average of the time frame and saving/consumption decisions of the individual. A broad market index fund is not a total portfolio solution for all, but neither is the high cost jumbled logic of the mutual fund industry. Indeed, many of those advisors that use index funds take a higher risk/higher yield fixed interest allocation or an additional domestic market high yield stock allocation to beef up the yield.

But MERs and transaction costs are not the only portfolio risk/return costs. Inappropriate management of portfolio structure and the size and timing of financial demands can also add additional costs.

I would also agree with Barclay's assessment of Canadian investment advice standards, although Canadian investors in general appear oblivious to the fact, and these clearly need to be dramatically improved.

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Follow up 2 April 2008

One important point of reference, I was basing the above analysis on average total market returns on the US market from 1963 to the end of 2007 of about 10.8% per annum.

Costs reduce return per unit of risk thereby increasing risk and lowering return. This should be obvious to all and sundry by now. Excessive costs reallocate capital away from personal expenditure decisions and important capital projects towards a much larger less productive retail financial services industry.

High cost financial services industries do not operate in the interests of the public (which is the ultimate interest) and because of this do not operate in the interests of efficient long term capital allocation within the economy.

The Khorana, Servaes and Tufano study into worldwide mutual fund costs cited a number of reasons as to why mutual fund costs tended to be higher in certain countries.

If Mr Flaherty is reading these comments he would do well to read this study and to instruct his economists to give him a lesson in the importance of competition, productivity and the efficient allocation of capital for long term economic growth and overall living standards.

I make these comments with respect to the current review of the financial services industry in Canada.

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Follow up 2 April 2008

Re Outroupistache's comment.

The funny thing is that the people who OK the structure and ultimately develop, push and protect the structure are highly intelligent, well respected and very well qualified.

Canadian financial services standards come right from the top.

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DIY versus Mutual funds and fees – 1 April 2008

WealthyBoomer.ca - Online Investors: Do the Slow Die First?

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/03/31/online-investors-do-the-slow-die-first.aspx

Tipping points

In "Mutual fund fees around the world" Khorana, Servaes and Tufano looked at total service costs for Canadian mutual funds of 3% per annum. This is before I presume transaction costs. Papers and other research into transaction costs place (commission and bid/offer spread) these average transaction costs for active mutual funds at between 0.5% and 1%.

This actually makes Canadian mutual funds on average worse than the average DIY trader noted above.

Additionally, if we add the fact that most mutual fund investors get less than the average mutual fund return because of the tendency to buy high and sell low we arrive at an even more perverse conclusion for the mutual fund industry.

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papers.ssrn.com/.../papers.cfm

Follow up 2 April 2008

One additional point.

It should be clear that the current retail financial services model does not work. If the costs of getting DIY wrong are no worse than advice from the industry then something is clearly wrong.

Online distribution of financial solutions is the way forward. I have said on numerous occasions that annual management/advice costs via online distribution of retail financial solutions will dramatically reduce costs and enhance the quality and personalization of those same wealth management solutions.

All we currently really have is online distribution of the transaction medium.

The industry or rather the interests that drive and depend on the current structure would suffer. It would need to rationalize, restructure, reduce costs, shed manpower and capital.

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Systematic risks and financial crisis – 25 March 2008

FtAlphaville

http://ftalphaville.ft.com/blog/2008/03/25/11789/calling-the-bottom-in-pictures/

This is merely the end of the beginning, not the beginning of the end. We have yet to feel the full impact of a soon to be significant decline in US consumer expenditure, a decline which will further impact the build up of excessive financial leverage and place further strains on the myriad of OTC derivatives and off balance sheet securitized debt.

Marginal liquidity that had moved to the sidelines or into commodities and other safe haven assets has moved back into the market in the belief that the systematic risks to the financial system have abated and low interest rates will now be able to work through to the economy. You only need a small marginal reallocation of cash and other assets to see the price recovery we have seen.

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Passive versus active, 21 March 2008

Financial Times – I'm not motivated by my work

http://blogs.ft.com/dearlucy/2008/03/im-not-motivated-with-my-work/#comment-1708

I agree with many of the comments.

The only economic rationale for active management is efficient market pricing at the margin which would mean significant deviations (allocation, returns) from the index in a less than efficient market and moderate deviations in a fully efficient market place.

In an efficient market place for market price setters the return from such activity would of course need to provide returns over the long term that beat the index. We do not have an efficient market place for a number of reasons; too many participants in the "price setting role" zone with shorter term horizons that conflict with price setting targets; an infrastructure set up to incite and profit from excess active market pricing participation and asymmetric information over the realities of investment and price setting.

There is too much money being made from not making money efficiently to prevent the industry from pursuing a more efficient route and too little end consumer awareness to force a more competitive market place. But hell, why not stop at the stock market, excess returns to suppliers are not restricted to the financial services industry.

I do however disagree that everyone should hold the broad market index.

The major market index represents the sum of economic consumption, saving and investment needs and decisions and each individual investor has a different time frame, risk preference and liability profile. This means that component driven strategies (higher yield, lower short term risk, higher long term return greater short term risk etc) are viable differential investment strategies. Also, given that liability/consumption profiles should impact asset allocation and risk management, timing decisions related to the management of liability risks and asset allocation are also important. Therefore many of the characteristics which we use to define active management actually have a place in a structured passive investment structure.

Institutional money however has a broad mix of time frames and profiles within its mandate (note pension funds) making an index composition and hence an index strategy more appropriate.

There is of course money to be made for the providers of risk capital (and not just the managers) in efficient market pricing but this can only ever be a marginal activity and the market for this activity is not transparent or efficient.

Long term asset class returns – 21 March 2008

WealthyBoomer.ca, 21 March 2008 – Long Term Asset Allocation

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/03/20/the-empowered-investor.aspx#comments

I would strongly agree with all 8 points.

One comment re expected returns.

Expected returns relate to long term historical average returns. They are asset class returns typically associated with an asset class and are not guarantees.

Over shorter time horizons returns can be significantly different (both above and below). Note investors in US large caps as of 1999 as evinced by the S&P 500 are now into their tenth year of zero nominal capital gains even before we factor in management and transaction costs.

In the absence of asset price bubbles/significant economic demand supply imbalance and if markets were efficiently valued at all points in time (and rational pricing did indeed accord higher returns to high price to book and smaller cap stocks) then these historical returns expectations (or risk premiums) could more or less be relied upon over shorter time frames.

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US economic risks, 18 March 2008

Naked Capitalism, commodities big fall is coming

http://www.nakedcapitalism.com/2008/03/commodities-big-fall-is-coming.html

I think the risks of stagflation are much higher than you would think from the direction of interest rates alone.

Interest rates are low because monetary policy is much less effective given the nature of the problems in the banking sector.

Also, given the weight of the over the counter derivatives market place and a still large overhang of securitized debt above the banking system the Federal Reserve cannot afford to let the economy move into a severe recession. Insolvency would become an even more pronounced factor and interest rate policy even less effective.

Unless the financial system is stabilized, the probability of a depression and deflation are nevertheless very high.

On the other hand if moves to stabilize the financial system are successful, part of this success will be through maintaining a large broad money supply base. There will therefore be an abundance of money supply.

If we cannot let economic conditions deteriorate even though the fundamentals strongly suggest weakness, the other side if we reach it is indeed stagflation.

Prior to the crisis the relationship between money supply growth and the productive potential of the US (and other) economy was well out of alignment. That much of this misalignment was concentrated in property and other securitized debt products held indirectly via the banking system is a major reason why we are seeing the initial reversion in the banking system.

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Markets and the credit crunch, 17 March

WealthyBoomer.ca, Black Swans and Falling Chainsaws,

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/03/17/falling-chainsaws.aspx#comments

A slightly amended copy of my e mail to Jon.

In a normal economic and market cycle the allocation to cash, bonds and equities are usually only affected by reallocation of demand between the asset classes. This can be caused by a rise or fall in interest rates and/or a rise and or fall in return expectations for any one asset class due to changes in economic outlooks (growth and inflation).

Post war market and economic cycles have mostly been dominated by long term economic growth and an accompanying increase in money supply growth interspersed with the usual boom/bust or slowdown/recovery.

It is important to note that the most important determinant of asset prices is the overall growth in money supply and the demand for money within a portfolio. Note that money supply is fixed (at a point in time) and investors as a whole cannot hold more money and less securities; all they can do when reallocating is to cause the prices of other assets to fall so that the percentage of cash held within portfolios increases; individual entities can obviously hold more cash in absolute terms but the "market" as a whole cannot.

If we were in one of these normal cycles all that would currently be happening is that the demand for money would be increasing and cash or lower risk assets as a % of a portfolio would be increasing and equities would be falling. Sooner or later once economic and market conditions stabilize people would demand less money and other lower risk assets within their portfolio and would start to increase their equity holdings.

This is why it is usually dangerous to attempt market timing, because sooner or later demand for money would fall and liquidity would move back into markets (or rather snap back at market lows). In this case market downturns of the size and scope we have currently seen would provide good long term investment opportunities; it is important to note that valuations are nowhere the near the peaks seen in most global markets from 1997 to 2001 or in Japan in the late 1980s and early 1990s.

What is happening now is different. The ultra low interest rates that were originally lowered to offset the severe market and economic risks of the late 1990s have initiated an excessive surge in asset focused money supply growth. This low interest rate policy and money supply growth had not only helped fuel strong consumer US demand growth (by raising asset prices in particular property) but had also been behind the development of a vast securitized debt and over the counter derivatives market place. Much of this new market place had been placed firmly above the financial system and it is now struggling to get out the way it came, that is back through the banking system. The stress of this event is what we are calling the credit crunch, but it is essentially a solvency issue since leverage to asset ratios are rising and the ability to meet liabilities falling.

The current crisis was precipitated by the collapsing US housing market and was initially concentrated in sub prime securitized debt instruments. It has since spread to higher grade mortgage backed securities and corporate debt. This has impacted the whole derivatives market place including the banks' (deposit and non deposit taking investment banks) relationships with leveraged non financial entities (hedge funds and private equity vehicles).

While market participants have increased their preference for cash so have the institutions. This has led to fall in securitized debt and stock market prices, although the fall in securitized debt prices has till now been far more severe.

Declining asset values and banks write offs reduce banks assets, thereby impacting their ability to lend and ultimately the money supply. Declining bank asset values also risk bank failures and a collapse in the money supply and hence demand for assets.

If the current event were only limited to a panic about securitized debt and their impact on bank earnings I would say buy, buy, buy at current levels. The trouble is we have yet to see the true economic impact of the current risk event. While many consumers in many economies are highly leveraged it is the US consumer that is of the greatest concern.

US consumer demand could possibly fall from the current 70% of GDP to 62% of GDP; it is some 2% to 4% above where it should be and in a deep recession could slide further as a percentage of GDP. For a more involved discussion of the risks please note my second capitalism in crisis report.

A collapse in US consumer demand would see much greater strain on banks and leveraged (non financial, i.e. hedge funds and private equity firms) entities further reinforcing the potential for a decline in money supply growth.

It is the structural economic weaknesses that lead me to believe that the current crisis has much further to run. In such a scenario as hedge funds and banks reduce leverage, demand for all types of assets will eventually be impacted.

As such the usual long term investing rules may not apply in the current situation. Money supply and money supply growth risk contraction further reinforcing the demand for money and aversion to higher risk asset classes.

What happens from here on in pretty much depends on the ability to stabilize the financial system which will ultimately depend on much greater government and central bank intervention. That is the bad debts/assets will need to be taken out of the financial system, interest rates will need to be kept low and higher inflation will be needed to avoid a deflationary spiral.

Andrew Teasdale

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Hedge fund performance - 18 March 2008

WealthyBoomer.ca, Black Swans and Falling Chainsaws,

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/03/17/falling-chainsaws.aspx#comments

According to HFRI the average hedge fund is down -.48% year to end February.

The best performing average was the macro systematic diversified up 9.94% year to date . A large number of sectors are showing losses.

Of course the hedge fund indexes do not include the impact of funds that have collapsed and where investors have lost capital; HFRI includes past performance of defunct funds but only up to their voluntary last reporting date which tends to exclude the losses that led to their extinction. As such they are not a true reflection of the risk/return characteristics of this genre.

The returns quoted above could have been achieved by investing a number of individual stocks (Goldcorp for example was up 33% year to 17 March). Given the complexity of choosing the right fund and the right strategy, individual hedge fund selection may be just as difficult as individual stock selection.

I am sure that those holders of Bear, Focus, Peleton and Carlyle Capital (and others) may not share the same view. The losses of these investments will not be included in the hedge fund performance tables.

Needless to say there will be a number of funds that have provided exceptional performance, but to state that these are the rule and not the exception is disingenuous.

Please also note the following excerpt from a report on hedge fund performance by Malkiel and Saha.

"although the rewards from selecting the top-performing hedge funds are very high, so is the risk of selecting a dismal performer.

Most hedge fund attrition rates are three or four times greater than the mutual fund rates, and the differences are highly significant.

We showed that the practice of voluntary reporting and the backfilling of only favorable past results can cause returns calculated from hedge fund databases to be biased upward. Moreover, the considerable attrition that characterizes the hedge fund industry results in substantial survivorship bias in the returns of indices composed of only currently existing funds……. The cross-sectional variation and the range of individual hedge fund returns are far greater than they are for traditional asset classes. Investors in hedge funds take on a substantial risk of selecting a dismally performing fund or, worse, a failing one."

www.analysisgroup.com/.../HedgeFunds_Risks_and_Returns.pdf

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Guaranteed Minimum Withdrawal Benefits and market falls - 18 March 2008

WealthyBoomer.ca, Black Swans and Falling Chainsaws,

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/03/17/falling-chainsaws.aspx#comments

Those who hold Manulife investments will have potentially seen a far greater fall in the value of their investments during a time frame when a balanced portfolio would have been well able to meet financial needs without having to access equity capital.

I state a higher potential loss because

a) many will have sold existing investments and suffered transaction costs on the sale of existing assets and the purchase of the new,

b) the higher management expenses will exaggerate the market declines and will continue to do so,

c) deferred service charges will force a higher loss if they need to get out or to access capital above the max withdrawal and many products reset the guarantee once an excess withdrawal has been made,

d) many will have shifted from a cash or lower risk investment into what has been sold as a lower risk investment and will therefore have taken on the differential risk 9and costs) between the performance of a lower risk asset and an equity portfolio,

e) many may have accepted higher risk equity strategies because of the supposed risk benefits of the product and reduced their lower risk allocation thereby exposing themselves to the higher risk of equity markets and the higher costs of the product, something they would not have been otherwise exposed to,

f) a good number of those who are pre retirement have been sold leveraged GMWB investments and these individuals will be firmly between a rock and a hard place, and many others...

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Market timing - 18 March 2008

WealthyBoomer.ca, Black Swans and Falling Chainsaws,

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/03/17/falling-chainsaws.aspx#comments

One other important, but not so obvious point with regard to market timing in the current downturn.

I believe on the whole that a passive long term asset allocation approach is the more socially responsible approach.

Markets and economies are better served by individuals holding to their long term investment and consumption goals as represented by their portfolio structure providing the structure and its management reflects the size and timing of financial needs.

But this depends on efficient markets. In efficient markets, central banks would look to control money supply growth to prevent asset price bubbles and market participants would price with respect to long term risk/return relationships as opposed to short term risk relationships.

But markets have been far from efficient and honest. As it is we have a) a financial services framework and mentality that encourages, because it profits from, short term time horizons and active trading, b) central banks that have allowed a large surge in asset focused money supply growth and c) financial institutions that have developed and sold vast numbers of high risk securitized debt, derivatives and other products without attention to risk, to costs, to consequences and time frames.

We have a system and a structure focused on the short term that is working against investors focused on the long term.

The market and economic order has stood by while an asset price bubble of historic proportions has been allowed to build, a bubble that is now placing the long term financial security of individual investors at risk.

Many have profited from this excess, and in a sense you could call this opportunism a type of blatant, self interested market timing by those in the know.

Yet, the financial services industry is asking the individual investor to hold tight, to accept the consequences while the professionals and institutions bale.

Why should the individual investor be left holding the hot potato?

Financial institutions and central banks need to be held accountable for a version of capitalism that has clearly lost its direction.

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Systematic financial and economic risks – 18 March 2008

Naked Capitalism, Commodities: "The big fall is coming"

http://www.nakedcapitalism.com/2008/03/commodities-big-fall-is-coming.html

I think the risks of stagflation are much higher than you would think from the direction of interest rates alone.

Interest rates are low because monetary policy is much less effective given the nature of the problems in the banking sector.

Also, given the weight of the over the counter derivatives market place and a still large overhang of securitized debt above the banking system the Federal Reserve cannot afford to let the economy move into a severe recession. Insolvency would become an even more pronounced factor and interest rate policy even less effective.

Unless the financial system is stabilized, the probability of a depression and deflation are nevertheless very high.

On the other hand if moves to stabilize the financial system are successful, part of this success will be through maintaining a large broad money supply base. There will therefore be an abundance of money supply.

If we cannot let economic conditions deteriorate even though the fundamentals strongly suggest weakness, the other side if we reach it is indeed stagflation.

Prior to the crisis the relationship between money supply growth and the productive potential of the US (and other) economy was well out of alignment. That much of this misalignment was concentrated in property and other securitized debt products held indirectly via the banking system is a major reason why we are seeing the initial reversion in the banking system.

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Systematic financial and economic risks – 16 March 2008

Naked Capitalism, "We may just have started to feel the pain"

http://www.nakedcapitalism.com/2008/03/we-may-just-have-started-to-feel-pain.html

What makes the current crisis so much different from any we have known is the confluence of systematic and structural risks; a) a vast and imploding OTC derivatives market place, b) excessive asset focused money supply growth, c) an imbalanced global economy dependent on wildly over burdened consumers dependent on asset prices dependent on excessive financial leverage now falling back through the banking system.

US consumer demand as a % of GDP is probably 2% to 4% points above where it should be. In a recession, we could see an overshoot (consumer demand could decline to 62% to 64% of GDP) given the current debt load and declining asset prices; but this declining PCE will also be accompanied by a declining GDP.

We are not yet on the ground and, if we hit the ground expect no mercy.

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Systematic Financial and Economic Risks – 11 March 2008

Ftalphaville

http://ftalphaville.ft.com/blog/2008/03/11/11506/concerted-central-bank-action/

The trouble is this does not flush the proverbial out of the system. Ultimately the Central Banks may be forced to buy the real crap from the banks and then sell this onto an open market exchange (as opposed to over the counter). Once this happens central banks will be better able to influence economic activity through interest rate policy and raise rates if need be.

We will still be left with the large issue of structural economic imbalances but we will no longer have the intense systematic financial risks which the makes the current crisis one to be feared.

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Active versus index – 7 March 2008

WealthyBoomer.ca Active mutual funds still lagged index funds in 2007,

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/03/07/active-mutual-funds-still-lagged-index-funds-in-2007.aspx

Mutual funds have a lot going against them.

Many of them are closet indexers with excessive costs; many are run by young managers with little experience who are more likely to get swayed by the crowd; many are driven by marketing and short term business objectives where short term under performance is not tolerated and many are launched in response to the flavour of the month/year.

Mutual funds in general are products whose main objective is to earn returns for financial intermediaries and financial institutions and in many respects pander to the short term whims of the general investing public and the financial community at large.

Sadly the mutual fund industry (as a whole) could be considered more of a game with the odds stacked against the investor than a serious attempt to deliver value and discipline.

Where does most of the under performance go? It goes in transaction and management expenses to the exchanges, the brokerages, the intermediaries, the financial institutions and to the sellers (who sell high) and to the buyers (who buy low). The return is not lost or illusory, it is merely transferred.

Mutual funds as a genus are more a reflection of the human condition than investment discipline and an attempt to deliver long term value for money.

But to use mutual fund performance as a rule that states investment discipline cannot be used to provide a superior risk/return outcome to the market is incorrect.

The conclusion that can be drawn though is that consumers cannot in general trust the financial services industry to deliver the necessary discipline and value through mutual funds and must therefore logically, in the absence of such discipline, go to index funds where the costs and the odds are lower.

A collective investment vehicle as a construct should be a superior method of delivering discipline and value for money and for a number of disciplined, cost conscious managers this is precisely what they do.

Canada however is one of the worst offenders when it comes to the value for money mutual funds offer the investor. When will Canadian investors as a whole start to realize that the odds, based on the current status quo, are more often than not stacked against them? Perhaps the current regulatory review instituted by Minister Flaherty will address wider issues of competition in the financial services market place, but then again, perhaps not.

Andrew Teasdale

The TAMRIS Consultancy

Active versus index – 7 March 2008

WealthyBoomer.ca Active mutual funds still lagged index funds in 2007,

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/03/07/active-mutual-funds-still-lagged-index-funds-in-2007.aspx

Just to provide a bit of perspective.....

It is also worthwhile noting that some of the quasi index funds have under performed.

Note

a) the DFA Core Canadian Core Equity (A class) which has also underperformed since launch and closely tracked Morningstar's Canadian Equity mutual fund benchmark.

b) the DFA Canada Core US Equity (A class units) which has under performed both the index and the average mutual fund.

c) the DFA Canada International Core equity (A class units) which has underperformed its index since launch to date and only marginally out performed the average mutual fund in the sector.

Andrew Teasdale

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Active versus index – 7 March 2008

Active mutual funds still lagged index funds in 2007, Wealthy Boomer

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/03/07/active-mutual-funds-still-lagged-index-funds-in-2007.aspx

Unfortunately the objective of my point was not driven by data mining or indeed to defend mutual funds.

My objective was too highlight the fact that comparing the returns of funds with an embedded management component cost against those without but to which ultimately a cost would be added is incorrect.

A better comparison would be to compare the f class mutual fund average against the f class quasi index and low cost etfs.

Of course there are other issues here (mutual fund churning and market timing via mutual funds) but these are outside the immediate environs of a like for like performance comparison.

Andrew Teasdale

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Hedge Funds – 4 march 2008

FtAlphaville

http://ftalphaville.ft.com/blog/2008/03/04/11341/another-hedge-collapse-in-focus/

You have to wonder about the risks of contagion. Not only the funds who are having to close because of margin calls but those who have holdings in these funds whose assets will also now be devalued and who may likewise be exposed to margin calls.

This is how it starts, counterparties collapsing. All we need now is a run on hedge funds (investors demanding capital back). Forced sales mean that the asset values that hold one side of the hedge will no longer support the strategy validating the leverage. In today's markets, leverage is much more than the sword above their heads.

Andrew Teasdale

The TAMRIS Consultancy

Tax Free Savings Accounts – 27 February 2008

WealthyBoomer.ca, Tax Free Savings Accounts -- It's about time!

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/02/27/tax-free-savings-accounts-it-s-about-time.aspx#comments

In one fell swoop Flaherty has set the stage for a much simpler tax system and a much more advantageous investment environment for income orientated Canadian investors.

If we assume that investment returns and costs are the same within the new plans and an RRSP and the individual's tax rates are the same at both the contribution point and the point of withdrawal, there is no difference between a TFSA and an RRSP. The net return would be the same for both plans, irrespective of rates of return and withdrawal rates.

The tax benefits of a number of investments would disappear, for example the income return differential due to tax treatment between a bond and a preference share. It would initially alter the balance between equity and fixed interest returns towards fixed interest returns at the short end of the portfolio. This is because capital gains on equities which are uncertain are a large component of equity returns. The certain return component of a fixed interest investment will rise relative to the dividend return on equities.

It should also simplify the tax system because the administrative changes required to implement the new plans may also require a more simplified tax structure for traditional taxable investments. Otherwise we might find that the administrative costs of the new plans may mitigate the benefits. So watch this space!

Some investors may undoubtedly already have been caught out by the change. Recent investors into GMWB plans and annuities may find that it is not possible to transfer their investments into the new more tax efficient vehicles. This will therefore leave many developers of products with a major headache and those investors locked long term into less tax efficient investments at an even greater disadvantage.

There is no reason why most investors should not be able to avoid tax completely on non RRSP holdings. Effectively, the only benefit offered by RRSPs now is that offered by the tax differential between the tax benefit at the time of investment and the rate of tax paid at withdrawal.

It is worthwhile noting that the UK has had similar plans available for the last twenty years. The inspiration for the TFSA may well have come from across the pond just as Flaherty has invited FSA alumni to advise on changes to the Canadian regulatory system.

Andrew Teasdale

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Tax Free Savings Accounts – 27 February 2008

WealthyBoomer.ca, Tax Free Savings Accounts -- It's about time!

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/02/27/tax-free-savings-accounts-it-s-about-time.aspx#comments

MM80sband

Personal tax payable on investment returns.

Over time a couple can invest 10k (in addition to RRSPs) a year (indexed) and make up for any unused contributions. This type of contribution rate over time should allow most individuals to shelter more or less all their non RRSP investments.

If we looked at a real return of 4% per annum after costs and 10k per annum for a couple (in real terms) compounded over 30 years (age 35 to 65) then we have a total real capital value of $583,000 in 30 years time.

At 6% real annual compound returns we have $838,000 in real terms. At 3% inflation and 9% nominal return this equates to a nominal capital value of 1.97m.

Note a) even after individuals have stopped saving out of earnings (once at retirement) they will still have leeway to transfer non TFSA investments into TFSAs and b) RRSP and residential real estate investments would be on top.

Obviously the very high net worth investor would still likely have taxable investments, but most investors are not of the very high net worth variety.

The reference to tax does not include tax on earned income or corporation tax on corporate earnings....

Andrew

Canadian Financial Services Market Place – 25 February 2008

WealthyBoomer.ca, Royal PH&N

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/02/25/royal-ph-amp-n.aspx#comments

It is a shame, I have to admit.

One thing should be clear, Canada does not need more of the same old institutional approach but new business models looking to take a lower cost/value added client centric approach.

What it could say is that PH&N can see little or no further growth for their business model as is and the only way to grow is to link into RBC's bigger distribution model.

I somehow do not think that this is the main reason however. The real reason may well be that the price offered exceeded the return PHN expected to be able to receive from their current business model by a wide margin.

There is of another possible reason.

RBC may indeed be looking to change its direction in the market place and PHN is part of this strategy. In this case there is a cost to developing a PHN type of model and RBC decided to pay this up front and be first to market.

Andrew Teasdale

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Canadian Financial Services Market Place – 20 February 2008

WealthyBoomer.ca EdgePoint: even the name sounds like Trimark, 20 February 2008

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/02/20/edgepoint-sounds-like-trimark.aspx#comments

It certainly sounds intriguing.

I am not so sure that Canada needs another mutual fund company. Canada does need a more competitive, service orientated, client centric investment/wealth management firm capable of delivering sophisticated wealth management solutions at a much lower cost to the market place.

After all it is the distribution mechanism for wealth management services that is in need of change.

One such carefully organized organization could have a significant impact on the Canadian financial services landscape. I am sure that this is a growth market while the market for mutual funds may well be a very tough one over the next few years.

Interestingly his views on the current risks also closely mirror my own.

Andrew Teasdale

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Global Decoupling, Economic Crisis – 18 February 2008

Steadyhand, 'Decoupling' Theory Plays Down our Integrated and Leveraged World

http://blog.steadyhand.com/default.asp?item=765811

Posted By: Andrew Teasdale (18/02/2008 4:16:01 PM)

Comment: Whether Asia is decoupled from the US is relevant within the context of extensive US structural economic imbalances. If the US is merely going to have a mild recession the degree to which Asia, US and European demand/supply relationships are correlated is not of significance. The issue of decoupling is important in the context of the risk of a steep fall in US consumer demand. That the potential sources of such a decline are more varied and of greater significance than has been the case since the 1930s naturally places the risks of a deep and prolonged decline in US economic growth at the forefront of any discussion of decoupling. For those who are interested, the following document discusses these issues in greater depth.

http://www.moneymanagedproperly.com/newsletters/TAMRIS%20Perspectives%20On%20Capitalism%20In%20Crisis%202.pdf

Securitization reform – 15 February 2008

Naked Capitalism, Securitization Reform: Don't Hold Your Breath

http://www.nakedcapitalism.com/2008/02/securitization-reform-dont-hold-your.html

It makes for sense for the true nature of an assets risk and return profile to be reflected in the price. It also makes sense for a security to be liquid and tradeable on an open market place. Just shove the securitization process to an open market and let the market decide the risk and the price. We would probably find that a market can more easily diversify risk and price it, obviating the need for monolines, SIVs etc.

Andrew Teasdale

The TAMRIS Consultancy

Systematic risks and financial crisis

Financial Armageddon, No longer an impending crisis,

http://www.financialarmageddon.com/2008/02/no-longer-an-im.html

I wrote a report into the risks of derivatives in June 2006 and came up with a very similar conclusion. As you say, until the risk event came it was very difficult to sound credible against the world's esteemed central banks.

"But the real argument for the risks that derivatives pose has not been properly enunciated. Derivatives increase the risk in the financial system by transferring financial activity from the established financial exchanges, where the counterparties are indeed diversified, to an illiquid over the counter market lacking a true equilibrating mechanism where counterparties are also concentrated. Worse, the counterparties to which both risk and the clearing mechanism have been transferred are the gateway to the world's financial stability."

http://www.moneymanagedproperly.com/technical%20docs/TAMRIS%20Derivatives,%20the%20risk%20they%20pose%20&%20consumer%20fundamentals.pdf

Andrew Teasdale

The TAMRIS Consultancy

Posted by: Andrew Teasdale | February 17, 2008 at 02:33 PM

Manager Search & Selection, 12 February 2008

Wealthy Boomer.ca, Teasdale Capitalism In Crisis

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/02/11/teasdale-capitalism-in-crisis.aspx#comments

I would like to point out that there are some good, well disciplined wealth managers in Canada. As such there are many investors who are not totally at the mercy of either volatile and uncertain markets or poor financial advice.

A project that I currently have underway is developing educational profiles for a number of these managers.

These managers will be amongst those whom I consider to operate a disciplined and structured process that pays attention to integrating the management of financial needs with the management of financial assets that are transparent with respect to performance and total costs and that pay attention to providing value for money.

These managers will be drawn from a range of disciplines and styles.

These profiles will comprise material to be made available to individual investors to help them cut through the complexity of the wealth manager selection process as well as the costs of such a process.

It should also help provide perspective for those who are not currently receiving the benefit of good financial advice and asset management.

Andrew Teasdale

The TAMRIS Consultancy

Canadian Financial Services Standards, 12 February 2008

Wealthy Boomer.ca, Teasdale Capitalism In Crisis

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/02/11/teasdale-capitalism-in-crisis.aspx#comments

For those want to reference some of my comments with respect to financial service standards in Canada I have 4 documents dealing with this issue.

The first deals with suitability, fiduciary responsibility and minimum standards in the Canadian financial services industry, the second provides an analysis of the objections to the FDM model by the registration reform project, the third is an analysis of the Joint Forum of Regulators point of sale documentation and the fourth an analysis of the current IDA complaint proposals and amendments to OBSI's Terms of

Reference within the context of minimum industry standards. The links to these documents are provided below.

www.moneymanagedproperly.com/.../Suitability,%20Minimum%20Standards%20&%20Fiduciary%20duty.pdf

www.moneymanagedproperly.com/.../TAMRIS%20Commentary%20on%20Registration%20Reform%20Project's%20Working%20Group%20Reports.pdf

www.moneymanagedproperly.com/.../Comments%20on%20Point%20of%20Sale%20Proposals.pdf

www.moneymanagedproperly.com/.../TAMRIS%20Consultancy%20-%20Suitability,%20IDA%20Complaints%20and%20OBSI%20Terms%20of%20Reference%20comments.pdf

Also I have two documents on key issues with respect to the current financial crisis. My points with respect to the risks of a depression are I feel valid given the context of large structural economic imbalances and systematic risks to the financial system.

However, this does not mean that a depression is the likely result. With central banks cutting interest rates and governments providing fiscal stimulus this would probably be avoided. In this instance, however, the risks of stagflation are much higher. Globally we already had excess money supply and significant structural economic imbalances. All we will have dealt with by bringing interest rates down is to avert a systematic collapse of the banking system. The other problems remain.

Indeed while we could see interest rates continue to fall for a while, rising inflation will sooner or later force central banks to raise interest rates. In other words the excess that has built up in the global economy is only being accommodated, it still has to work its way through the system and this could take a long time.

www.moneymanagedproperly.com/.../TAMRIS%20Perspectives%20On%20Capitalism%20In%20Crisis.pdf

www.moneymanagedproperly.com/.../TAMRIS%20Perspectives%20On%20Capitalism%20In%20Crisis%202.pdf

Andrew Teasdale

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Buffett and US Economic Risks, 7 February 2008

WealthyBoomer.ca, Buffett "huge bull on the U.S. economy"

http://network.nationalpost.com/np/blogs/wealthyboomer/default.aspx?PageIndex=3

Buffet is a valuation driven investor and he has not been averse to holding cash when he can find no viable purchase. This would be classed as market timing by many but is in truth nothing of the sort.

His Berkshire fund is also a very long term investor, with a far longer timeframe than most individual investors. If we look at the date quoted in the main article, 1790, this encompassed the long recession from 1873 to 1879, the late 1920s and the depression era and the long period of poor real market returns (ex dividends) from the late 1960s to the early 1990s.

We are now in the 9th year of the current decade, a 9th year in which the real value of the S&P 500 is still significantly below its 2000 peak; since most investors fail to even earn the average return many will be in a far worse situation. Valuations and time frames matter and Buffet knows this.

He has successfully managed the risks of the market and the economy through his focus on valuation, by taking on specific stock risks which he feel offers value and by avoiding the market and economic risks of the index. This does not mean that he does not focus on the economics, since the micro factors impacting a stock's earnings are indeed the firm's economics.

He does not possess a blind indifference to what is happening, but he is blindly indifferent to what others are feeling or doing in terms of their own stock selection and buying and selling decisions. This is what he is saying when he says "turn off the stock market". He is not saying "ignore valuations" or price movements. He is supremely focused on the price of a stock because this is directly related to the intrinsic value of a stock, so whatever the market as a whole does to the value of a stock he holds or wants to buy, he is interested.

I would disagree with Warren about comparisons to 1982. He said that interest rates were at 21%. But price earnings ratios were much lower and earnings yields much higher; the S&P 500 had an earnings yield of 12% and a P/E of 8 in the early 1980s (with depressed earnings because of a 16 month recession starting in July 1981 and ending in November 1982) and a market yield of 5.5%. This was a screaming buying opportunity where all the risk was in the price.

July 1981 to November 1982 was a recession in the US, following on from a small 6 months recession in 1981. Since the end of the 1982 recession we have seen the longest and strongest economic expansion in the US since records began; the 1990/1991 recession only lasted 8 months as did the 2001/2002 recession,. In fact, 1982 marked the start of a consumer led economic expansion with personal consumer expenditure as a percentage of GDP (adjusted for changes in disposable personal income) at a post war low.

Today's US economy was imploding with interest rates at 5.25%. 1982 was as close as you could get to a multi decade low for market and economic valuations and represented a low point of a long bear market and the starting point of one the longest and strongest bull markets in US history. The current S&P 500 P/E ratio as of the end of January 2007 was 17.54 times earnings and the yield was 2.09%. This gives an earnings yield of 5.7%, half that available as of the start of 1982 with dividend yields on average 37% of 1982 levels and this is based on peak cyclical earnings (less the recent adjustments to banking stocks earnings, which admittedly represent earnings that should not have existed in the first place).

If we are at the start of a period of lower growth and higher inflation, earnings growth rates will fall, P/E multiples will decline and market returns will be below average.

Consumer debt as a percentage of GDP in 1982 was 48%. As of 2006 it stood at 98%.

In 1982 personal consumer expenditure (PCE) as a percentage of disposable personal income was 86%, today it is 96%..

Just for the sake of analysis, if we take Warren Buffet's 21% interest rate figure for 1982, this is 4 times 2007's peak of 5.25%. If we adjust interest rates for personal debt levels (personal debt in 2007 was 2 times 1982's level) we find the effective interest rate multiple is only 2 times – that is 4 divided by 2.

If we then adjust for the fact that disposable personal income less personal consumer expenditure in 2007 was 27% of the figure in 1982, we find that effective interest rates for individuals with an average personal debt level are now twice the level they were in 1982 (27% times 2 = 50%); based on the relationship analyzed.

1982 was the end of a long period of below average market and economic returns, 2007 could well represent the peak of a period of above average market and economic returns. Over the very long term, this may well be of marginal significance, but for those living in the here and now it could be of immense significance.

Additionally, I would not be so sanguine over a) the amount of credit available in markets nor b) the fact that credit is no longer available to many of the previous buyers. Much of the growth in money supply and hence debt has been focused on assets and off balance sheet assets in the case of banks. As credit becomes less available, the price of many of these assets will fall impacting on so many other relationships. In the end Buffet is correct; this is just a demand/supply imbalance, albeit with significant short term implications.

Buffet states that he is a huge bull on the American economy by referencing a period 1790 to 2007, a period over which the returns from economic growth eclipse any short term economic risks. He may well be correct in terms of this type of time frame. I am bullish on long term real economic growth but am expressing considerable concern over short term problems. Over time the economic demand/supply imbalances will work out, but this does not mean that there will not be pain in the interim.

It is also worthwhile remembering that not everyone holds a Buffet portfolio and not everyone has the luxury of a 220 year investment horizon. If I was a long term investor with no financial liabilities arising over the next 15 years equities would be my preferred asset class relative to cash and bonds, but I would be mindful of valuations in determining where I put my money.

Buffet may also hold emotions at bay, but he can only do this because he thoroughly understands his own valuation paradigm. He does not care whether a share rises or falls, what he cares about are the earnings a company can deliver and a share price in the context of the price of those earnings. His asset allocation stance is sensitive to a different set of indicators than most who are in the market but this does not mean that he is blind to what goes on around him.

It is also worthwhile noting that Buffet is also at odds with strict academic interpretation of modern portfolio theory, which, has a much more dogmatic rationale for avoiding market timing and holding prescribed long term asset allocations. In this context, you can indeed be blind to what goes around since markets are efficiently valuing return and risks to return; unfortunately MPT and efficient market theory are not entirely representative of the real world.

In the end Buffet entered the current market downturn with a long term portfolio he felt held value. As prices fall, the investment universe becomes cheaper and less risky on a long term view, but only if you entered the downturn with an appropriate portfolio of assets, a disciplined valuation framework and a long term perspective.

Perhaps the better perspective would be what would Buffet do with many of the portfolios currently held by private individuals?

I am not concerned about investors with well managed portfolios held together by disciplined processes and, I am certainly not concerned about Buffet and his portfolio of assets, this as far as much of the retail financial services market place is not the issue.

Andrew Teasdale

The TAMRIS Consultancy

Index versus Active, 4 February 2008

WealthyBoomer.ca, The mutual fund 'they' don't want you to know about,

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/02/01/the-mutual-fund-they-don-t-want-you-to-know-about.aspx#comments

It would seem a reasonable passive portfolio investment for fee based financial advisors to recommend to their clients. Let us say 0.25% on the capital for the planning and personalized advice and, if we are being generous a further 0.25% per annum on assets for ongoing planning and advice. In many circles this portfolio solution would be appropriate for both high and low net worth investors.

I do feel that many financial advisors risk pricing themselves out of the market as technology allows for mass low cost customization of effective portfolio solutions.

Once higher volumes have been reached, I would suspect that ING can compete at much lower cost levels and fees on these products will fall further as competition enters the market.

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Asset allocation and Monte Carlo, 29 January 2008

WealthyBoomerRRSPs (The Book) and the Future of Mutual Funds,

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/01/29/rrsps-the-book.aspx#comments

Just a couple of points.

The first is regarding asset allocation and return.

The belief that asset allocation is responsible for some 90% of return is often due to a misunderstanding of the results of the 1986 Brinson, Hood Beebower study into pension fund returns.

The study compared the returns that would have been derived from the strategic or policy allocations to the actual returns achieved by the pension funds. The study analyzed how much of the variability of the returns of the actual performance could be accounted for by the variability of returns of the strategic policy allocation. They found that, on average, 93% (R squared) of the variability of the actual returns were explained by the variability of returns of the policy allocations.

The results of the Brinson study did not mean that asset allocation was responsible for 93% of return. All it meant was that the average asset allocation of all the pension funds over the time period in question could well have been pretty close to the average policy allocation of the funds.

If your asset allocation is similar to a comparable benchmark then the amount of return you could have achieved and the variability of the return would have been very similar to the comparable benchmark. Take a significantly different position to an index and your potential returns and the variability of your returns will likely differ substantially from the index.

Secondly, Monte Carlo simulations are not predictive.

They cannot tell you what is going to happen, nor is the probability distribution of returns they provide from the simulations a realistic opportunity set of the range of probable outcomes.

That is unless, of course, you believe that the world is permanently in a state of equilibrium and that the movement of economies and their asset prices from one equilibrium point to the next is random, unpredictable and immediate and that the sensitivity of asset prices to change are constant; then the

Monte Carlo distribution of outcomes may well provide a realistic assessment of the probable range of outcomes.

Otherwise, because standard deviations, returns and the relative position of assets prices and economic relationships from equilibrium are changing, the probability distribution of outcomes of a monte carlo simulation will by no means be predictive or accurate of the range of outcomes.

Where a monte carlo simulation has use is where conservative risk and return assumptions are used to model the impact of portfolios with withdrawals over time. But even here care needs to be taken with regard to interpretation of the results. The lower bounds of the distribution may well imply economic ruin, a position which no portfolio structure could ever realistically manage. Likewise the upper bounds would represent a perpetually high rate of return unlikely to ever be achieved.

For those use who statistical analysis alone to manage risk we need only look at the drubbing value at risk measures have recently been subjected to. The reason is that the probability distribution of outcomes shifts, meaning that at certain times the probability of a low probability event is extremely high and that with a high probability significantly lower. This is due entirely to the difference between equilibrium models and real world economic and market relationships.

Andrew Teasdale

The TAMRIS Consultancy

Systematic financial and economic risks, 21 January 2008

WealthyBoomer.ca, Global Stock Market Rout – babies tossed with bathwater

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/01/21/global-stock-market-rout-babies-being-tossed-with-the-bath-water.aspx

I have felt for some time now that we are in an extremely complex financial, market and economic situation, the likes of which we have probably never seen before.

Since 2000 asset focused leverage and the over counter derivatives market have exploded. These developments alone, given the significant risks they posed to the financial system, would have caused concern.

Unfortunately we have also had global consumers leveraged to the hilt (in particular the US). These consumers have been dependent on the rise in asset prices driven by the low interest rates and the rise in asset focused financial leverage.

That the financial system has come under stress from a declining US housing market while the world economy was still growing and growing strongly was to me a great concern. If the US is entering recession then we are likely to see greater systematic financial risks from here on in and this is what markets are concerned about.

The trouble is we do not know the full extent of the impact that these risks will have on economic growth and overall financial stability and, for how long. What we do know is that the potential risks are indeed monumentally significant.

If you have a properly constructed portfolio and planning has taken into consideration significant cyclical economic and market risks to return then you should be covered against all of which has already happened and a good deal of what may be about to come.

Should you be selling right now? It all comes down to the risks you are looking to manage within a portfolio. If the current risks are greater than your portfolio is structured to manage then you will obviously need to make changes.

However, we are in an unfolding market and economic crisis. It is more than likely that the world central banks are going to cut interest rates aggressively, possibly tomorrow morning and if the crisis worsens we will see governments around the world providing fiscal stimulus. In this environment markets are likely to rebound. In this environment discipline and expertise is critical.

My view is that we have structural problems that have developed over the last two economic cycles and that these structural problems will take some time to work out. We are likely to see higher inflation and lower growth in the meantime. How this impacts the valuations of financial assets is difficult to gauge. A disciplined investment process that is able to take account of market and economic risks and their duration is critical. A disciplined approach will not necessarily spare you from falling markets but it will have a much stronger probability of getting you through in much better shape.

Canadians have witnessed strong market returns over the last few years. It is easy to forget that UK (FTSE 100 Spring of 1998), US (S&P 500 Spring of 1999) and European (DAX and CAC 40 late 1999) investors who held market positions towards the end of the last bull market are today at similar nominal index values, let alone real. Japanese investors saw their major market index close in on 40,000 in 1990; the current level is 13,000.

Excess has a price and a duration. Understanding the excess and the probable size and duration of the risk is important. This is where a disciplined investment process comes in and why investors need sound financial advice and asset management.

As to what investors should do, this is something their advisors are responsible for. Every approach and discipline is different and the appropriate response is dependent on the specifics of each discipline and process.

Andrew Teasdale

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Fidelity Income Replacement Portfolios

WealthyBoomer.ca, Fidelity targets boomers with new Income Replacement portfolios

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/01/10/fidelity-targets-boomers-with-new-income-replacement-portfolios.aspx

Briefly, I have a number of issues with this current product, some of which may be resolved over time, some of which may not.

The first is that Fidelity does not currently provide MERs for these portfolios. I have been told that MERs will not be available until perhaps 3 to 6 months or even the first year anniversary which is strange considering the portfolios are comprised of Fidelity funds with MER records. The second is that I cannot get a hold of the actual mutual fund asset allocation of these portfolios. I presume these exist.

It is a concern that private investors may not have independent access to this information. Hopefully advisors will be providing this information.

Thirdly, these portfolios redeem units to provide the income stream. For one this means realizing equity based units as well as fixed income units; in a bear market this does not make sense and exacerbates normal market and economic risk, something which retirees need to be shielded from. The level of equity risk obviously depends on the portfolio selected, but for longer term investors this could be significant.

Also, realizing units of fixed interest funds on a point in time basis can also be risky. How risky this is depends on the maturity structure of the underlying fixed interest components. Over short periods of time fixed interest investments can be subject to high levels of risk, especially during a period of rising interest rates and changing inflation expectations. As such, realizing fixed interest units during periods of risk can be detrimental to financial security.

Andrew Teasdale

The TAMRIS Consultancy

The costs and risks of financial innovation

ftalphaville

http://ftalphaville.ft.com/blog/2008/01/07/9947/the-dubious-worth-of-financial-innovation/

One of the fundamental issues with a product is that it adds another layer of cost, or rather enhances return for the issuing party. This lowers return, increasing risk to the purchaser.

But cost and complexity are not the major problems; investors have been buying high cost complex vehicles for a long time. Rather it is the enormity of the leverage associated with the purchase of these investments and the over the counter nature of modern financial innovation that has raised a very large stake to the heart of the financial system. This stake is now being hammered in and still has some way to go.

Andrew Teasdale

The TAMRIS Consultancy

Bad and good financial advice – 5 January 2008

WealthyBoomer.ca, How financial advisors provide value

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2008/01/04/how-financial-advisors-provide-value.aspx#comments

I certainly agree with Dan that most individuals lack the time, the expertise and the motivation to properly manage their own money. Most individuals would be better off with a good financial advisor, this is irrefutable.

I am not so sure however that the court cases (involving either fraud or bad advice) that we see are the proverbial “straws in the wind”.

While I cannot speak for all instances of advice, I only get too see a small sub sample myself, those cases that I do see smack of an institutionalized process that protects low standards and encourages the abuse of those low standards.

If this was not the case the institutions involved would have settled those instances of bad advice immediately. Instead they seek to vigorously defend them.

Most cases of bad advice also never get to trial; if you have ever seen the trials and tribulations that an individual with a complaint has to endure then you would understand why.

Let us not forget the mutual fund market timing abuses, the wholesale industry involvement in the sale and promotion of many dubious business income trusts, the (institutionalized) high management expense ratios of mutual funds and other investment products and of course the dead end that the Fair Dealing Model disappeared into.

The industry is predominantly sales focused and remunerated by the transaction. This is not conducive to the provision of good financial advice. Every institution has within its power the ability to raise standards, enhance accountability and to stamp out inappropriate behaviour, yet low standards, synonymous with bad advice, are allowed to prosper. You need only look at the marketing literature for many an investment product and the arguments used by many to sell their products to realize that the industry's interest is first and foremost.

There are of course good advisors and good firms out there and these companies need to be more vocal in their support of higher industry standards and their promotion of their own services.

Investors should generally avoid those advisors remunerated by commission and should seek those with demonstrable and disciplined investment/financial planning processes. They should also avoid those companies that have been shown to vigorously defend bad advice at the expense of the interests of its clients.

Advisors should be clear about all fees and charges and should provide a comparative performance analysis of assets under their management. Advisors need to be able to provide good advice and to be accountable for the value it creates.

How many clients in the industry actually receive an account statement that allows them to assess the value added by their advisor? Without such accountability it is difficult to discern the actual number of straws in the wind.

Andrew Teasdale

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Mutual funds general – 20 December 2007

WealthyBoomer.ca Am I going to be OK?

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/12/20/am-i-going-to-be-ok.aspx#comments

I just wanted to make a comment about a remark made with regard to mutual funds. Mutual funds are part of a class of what I term collective investment vehicles, which include pooled and exchange traded funds.

I do not believe in the argument that collective investment vehicles are for the small investor alone and, that large investors should go the direct equity route. It is rather more complex than that.

The viability of a direct equity or a collective investment vehicle portfolio is partly dependent on the expertise and discipline of the manager of either option. Getting access to a good direct equity manager is not always as easy as you may think.

Providing a collective investment vehicle (or portfolio of such) has a cost that reflects the value added, then there is no reason to conclude that it is not an effective vehicle. Both solutions should represent the sum of security selection, valuation, allocation and management.

If there is room for weakness in either option, it would be in the discipline and the process and not the medium. Warren Buffet's Berkshire vehicle is after all a collective investment vehicle.

Even within a well managed direct equity portfolio there will be components that the manager will not be able to manage him or herself and will therefore need to access a collective investment vehicle.

Many investment vehicles exclusive to high net worth investors are also managed vehicles, notably hedge and private equity funds.

That collective investment vehicles are sometimes seen to be the preserve of the smaller investor, with insufficient capital needed to access direct equities, is more to do with the failings of the financial services and mutual fund industry in the use and application of these vehicles than any real weakness of the construct itself. Note the high costs of the vehicles and the vast armies of advisors who do not understand how to value and allocate, yet are allowed to act as if they did.

After all, there is no reason why a skilled manager able to focus on a small number of vehicles in his or her own area of expertise should add less value than he or she could if they had focused on scores if not hundreds of personal accounts.

A well disciplined investment process that uses direct equities to allocate for private clients should more or less replicate the processes a disciplined collective investment vehicle would follow.

Incorrect use of direct equities and/or collective investment vehicles will both end in an inferior solution.

The issues are of course more involved than implied by the comments made above. The issue of personalization comes to mind; but even this should not be an impediment to the effective use of collectives.

Andrew Teasdale

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Market timing, 13 December 2007

WealthyBoomer.ca, Plunge Protection

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/12/12/plunge-protection.aspx#comments

If you are a fundamental valuation driven investor then of course you should always ignore short term share price movements and focus on the fundamentals.

If you are a passive diversified indexed investor, then again you are better off ignoring market movements and just accept the fact that markets and economies move up and down over time.

For many investors price declines of 3% are just too small to even worry about avoiding. Transaction and opportunity costs will more or less cover these small dips. If you are a mutual fund investor taking the full hit on the load, then you are probably looking at the risk of a 10% fall in markets before you should even start to consider sweating.

Most investors should therefore be able to take corrections, and in reality a bear market, in their stride providing their portfolios are well structured.

But what when fundamentals change markedly for the value investor and what when liquidity conditions (underpinning the passive indexed rationale) in a market are undergoing a fundamental shift?

The issue of market timing is an interesting one in the current context. If you are always reacting to risk by selling your assets and buying once things have settled down, you will most definitely get stuffed in the long run. It just does not pay over the long term, even though on the odd occasion you may come out on top. This is of course the gambler's dilemma.

Are we currently in such a dilemma? This is a good question.

Andrew Teasdale

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7 December 2007

DIY Consumers, 7 December 2007

WealthyBoomer.ca, An industry outsider takes on Bay Street

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/12/07/an-industry-outsider-takes-on-bay-street.aspx#comments

The industry better watch out just in case any more investors start standing on their own two feet.

People like Gail serve a very important market function, namely that of giving the costly and inefficient intermediation of capital markets a much needed reality check, or if you prefer, kick up the backside.

It is time the consumer started to be more demanding and to initiate greater competition in the market place.

Perhaps one day the industry will be able to deliver the low cost sophisticated solutions it is capable of and will certainly need to provide if it wants to keep the Gail Bebees from the door.

But it will need to close down the feeding troughs first.

Well done with respect to her caution over products. I have not read the book, but at some point I would certainly need to.

Andrew Teasdale

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Canadian Financial Services Industry and bad Advice

WealthyBoomer.ca, Chasing performance hurts load mutual fund investors, study finds

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/12/06/chasing-performance-hurts-load-mutual-fund-investors-study-finds.aspx#comments

While I have not had the benefit of completing a large study into this area I have studied, reviewed and researched many such instances.

Bad advisors do buy hot funds/stocks (often long after they have achieved their performance) and sell under performing investments (often long after they have under performed).

In many instances the portfolios they (advisors) recommend are the victims of circumstance in that their very structure is to a large extent a lagged response to past performance.

While markets are going up, much of the risks, costs and consequences are hidden from view. Your performance can appear to be acceptable even though you have accepted a far higher level of risk and achieved a lower level of return than you should have for the risk you took.

I feel that this problem is more pervasive than some might think for a number of reasons.

A) The Canadian financial services industry is primarily a transaction distribution model.

B) With remuneration tied to transactions, there is a natural incentive for those without discipline to trade; with investments rising and falling regularly, there is enough reason and opportunity to justify such in the short term.

C) The absence of qualitative benchmarks and processes governing portfolio construction and management; advisors are generally free to determine their own asset allocation and security selection.

D) Many advisors are tied to organizations whose primary return is derived from product sales and/or transactions. This is a conflict of interest given that these organizations use their sales forces to push new products and funds and to sell based on past performance.

E) Many advisors do not possess the expertise and knowledge needed to manage active portfolios yet act, without sufficient organizational constraint, as if they do.

Organizations should not allow their sales forces/investment advisors to determine asset allocation or security selection but should instead determine centrally the asset allocation and security selection parameters for investor portfolios.

Good advice is worth paying for, as to whether the current cost if appropriate is another matter entirely.

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Look at your standard portfolio statement. It will lack a statement of the recommended allocation and deviation from it, it will often lack information on portfolio and security yield, it will lack almost always a comparison of the portfolio's performance to relevant benchmarks, will rarely if ever show a style or comparative risk analysis.

Without a comparative analysis you are forced trudge through the minutiae to find the asset allocation, the strategy or lack thereof and ultimately the relative value.

Andrew Teasdale

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Systematic financial and economic risks US, 29 November 2007

WealthyBoomer.ca, Rumors of Uncle Sam's death greatly exaggerated? 29 Nov 2007

I believe that the systematic risks are far greater than McKeough believes and that the US and world economy is in a far more delicate state that it has been for decades.

In the scheme of things I am not as concerned over the Canadian ABCP markets as I am over the global securitized debt and derivatives markets and the global economic imbalances that are presently unwinding. This is not to say that it (Canadian ABCP) is not serious, just that it is not the main game.

Nevertheless, this is not the time to lose your head and disciplined attention to valuation, allocation and structure is warranted more than ever, which appears to be what McKeogh is also saying.

I have prepared two reports on the current crisis for anyone who might want to read up on some of the fundamental issues; please see the attached links.

www.moneymanagedproperly.com/.../TAMRIS%20Perspectives%20On%20Capitalism%20In%20Crisis%202.pdf

www.moneymanagedproperly.com/.../TAMRIS%20Perspectives%20On%20Capitalism%20In%20Crisis.pdf

I expect to be dealing with further perspectives on the subject in December (market valuations) and January (systematic risks).

I have to admit this is one of the most complex periods I have ever encountered. I would not be so sanguine.

Andrew Teasdale

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Benefits of Diversification – 16 November 2007

WealthyBoomer.ca, Fidelity rediscovers Canada

Is it the exception that proves the rule, or the exception that forces you to prove the rule?

If you consider that a retired individual will be drawing 4% to 6% from their portfolio on an annual basis and that we are talking about a 20 to 30 year time frame in retirement, a period of 3 to 6 years of out performance of a market and a currency probably represents no more than 10% to 20% of a portfolio at most and less if returns are high and costs low.

Diversification allows us to take advantage of the relative out performance of other markets and economies throughout the lifetime of a portfolio. While out performance of a market at a point in time may lead us to wish we had all our money in that market, we know that we cannot possibly consume all the capital (or point in time excess return) we hold during that relatively short time frame of out performance. We need access to excess return throughout the lifetime of the portfolio which means allocation to different markets and different market components or at least a domestic market strategy which allows for a similar risk/return management outcome.

The object of a portfolio and the management of return is to avoid the vicissitudes of feast and famine. The relevance and importance of global asset allocation to the management of market risk and return, the management of economic risk and the management of liability risks over the lifetime of the portfolio remains the same.

Nevertheless, the allocation to the domestic market will depend on risk aversion, on the size and timing of liabilities, the relative valuation of the domestic market and currency and the structural precepts of the portfolio. While 3% provides an analysis of the economic risks of a Canadian allocation, a 3% allocation to a domestic market for an individual with financial demands is too low an allocation for a number of reasons I do not have the space or the context to go into.

Andrew Teasdale

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Financial Crisis and Inflation

WealthyBoomer.ca, Hedging against inflation

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/11/14/hedging-against-inflation.aspx#comments

Back in 1993/1994 I was speaking to a journalist from the Times of London about inflation. I felt that the next inflationary cycle would start sometime in 2003. There were a number of valid reasons why inflation would stay low at the time for some time. This is no longer the case and has not been for a number of years.

Now however we are indeed in a much more complex financial scenario than even i could have imagined back in the 1990s. It is not just a question of high money supply growth (I discuss high money supply growth in my October missive) but global economic imbalances, high debt levels and systematic financial risks.

http://www.moneymanagedproperly.com/newsletters/TAMRIS%20Perspectives%20On%20Capitalism%20In%20Crisis.pdf

I have felt for some time that a period of higher inflation would be unavoidable given high money supply growth and high debt levels tied to asset prices. I think higher inflation is a risk that we may have to live with for some time as the excesses and imbalances of the last 10 years work themselves out of the system.

We have seen over the last six months that we cannot use interest rate policy to curb demand pressures to the extent that is probably required and that this will force central banks to effectively relax their inflation targets if they want to avoid a severe downturn in economic activity.

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Financial Crisis and Inflation – 15 November 2007

WealthyBoomer.ca, Hedging against inflation

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/11/14/hedging-against-inflation.aspx#comments

Re Jon's question.

A portfolio should naturally be hedged against short and long term risks, inflation being of the key risks a portfolio should always be structured to manage (at least for portfolios structured to meet financial needs).

On a theoretical level any asset whose price is determined by demand and supply has a natural element of inflation protection, providing the demand for that asset will remain stable as a % of overall demand during the inflationary period. The trouble is human tastes change as does the supply of goods and services. In order to manage inflationary risk you need a diversified portfolio of real assets better able to capture the impact of changing liquidity (demand) in the market place. However, inflation will not protect a real asset class if that asset class is overvalued relative to other asset classes. If property is overvalued then inflation is only one of many adjustments that will be moving through the market place.

The normal rules of structure relative to the size and timing of financial demands and diversification that pays attention to valuation and economic risks still apply. Inflation does mess up the risk premiums between low risk assets and equities and longer term fixed interest investment becomes a much higher risk proposition. As such, inflation expectations/risk are part of the low risk valuation and allocation process and portfolios really should be stress tested for inflation risk.

Inflation risk also impacts consumption, saving, portfolio allocation and investment decisions within the economy. During the elevated inflationary risk period relative valuations of asset classes can become stretched providing opportunities for investment in assets other than the immediately obvious classes such as gold.

If you are going to buy or increase an allocation to any asset class you need to understand the fundamental demand/supply relationships. One of the reasons why gold might do well is not because it is a natural inflation hedge but because everyone might be buying it and you can bet that a large number of individuals will be buying at some point at far too high a price.

Inflation complicates what is already a fairly complex area. If we get a period of stagflation then it is possible that even real assets will see a fall in their real value since stagflation and depression are very similar economic phenomenon.

As always, do not get drawn into the herd.

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Gold and the credit crisis – 9 November 2007

WealthyBoomer.ca, Loon - acy!, Gold and the Greenback 9 November 2007

One of the problems with a credit crisis is that certainty and correlations (inverse or otherwise) tend to fly out of the window. Outside of a credit crisis we know that marginal liquidity tends to move from one asset class to another as it is reallocated. In a credit crunch, amidst marginal reallocation of demand, liquidity is also being withdrawn and not reallocated. Quant models cannot deal with this scenario. It is therefore not a question of whether you think gold is going to fly but of whether you are so uncertain of traditional asset classes that gold is one of the few you want to increase your allocation to. One of the benefits of gold, aside from any leverage used to purchase it, is that there is no debt component; gold does not disappear as debt/credit is withdrawn from the financial system. In a credit crunch assets with significant debt components become much more risky.

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With respect to John's comments please note the following excerpt and link to the Cleveland Federal Reserve's 1996 report "Where Is All the US Currency Hiding?"

"Researchers at the Federal Reserve Board have examined this issue in depth. A preliminary study conducted in 1993 estimated that more than 70 percent of all U.S. currency is held outside our borders, with most of the outflows occurring since 1970. Recently, a broader examination set that figure at between 50 and 70 percent, with about 80 percent of all currency growth since 1980 tied to increased foreign demand."

http://www.clevelandfed.org/Research/Commentary/1996/041596.htm

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Guaranteed Minimum Withdrawal Benefit Plans, 6 November 2007

WealthyBoomer.ca, Income Plus vs. Desjardins Helios

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/11/06/finsurance-has-room-to-improve-income-plus-vs-desjardins-helios.aspx#comments

I have no problems with individuals buying an investment after being presented the actual pros and cons. However, I think if you look at the product literature you will find the pros and cons have not been properly presented. In fact the claims are disingenuous to the extreme; please see my previous comments on this blog re Chevreau's last article on this subject.

The full text of my comments to Jon is noted below. I would also like to thank Jon for keeping this issue in the limelight and for reporting both sides of the story.

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A GMWB is a portfolio product promoted to its highest level of incompetence. It does not provide a guaranteed income; it provides a guaranteed nominal return of capital. While Manulife now guarantees to provide a guaranteed withdrawal for 30 years, at 3% inflation the value of the total guarantee is still a hair's breadth away from the real value of the initial capital.

At an annual rate of inflation of 3% the real value of the 5% guaranteed withdrawal is worth 3.7% in year 10, 2.76% in year 20 and under the Manulife 30 year guarantee, 2% in year 30.

The annual costs of these products are close to the equity risk premium for the Canadian stock market from 1900 to 2000 of 4%. This should mean something to anyone with a fundamental understanding of risk and return. Because the underlying risks of the assets remain the same even within the product, the impact of lowering return through high annual costs means that you are more likely to need the guarantee because of the costs of the product than the risks of the underlying assets themselves.

Manulife's total fee is close to 3.5%, Sun Life's close to 3.85% and Desjardin's for the fully invested equity component is close to 3.5%. All three reserve the right to increase the cost of insuring the guarantee which brings the potential annual cost closer to 4% (and possibly higher). The above fees tend to cover the cost of the basic guarantees and 75% maturity and death benefits. Additional riders and insurance cost extra.

The period of risk often noted as the "retirement risk zone" can be better managed through a portfolio construct that uses dedicated/cash matched low risk assets to guarantee financial needs in the event of significant market and economic risk. With the cost of the product more or less equaling the long term average equity risk premium this should be axiomatic.

The only reason these products have appeal is because standards within the industry are low and the costs of wealth management high so that the additional annual cost of the segregated fund and its withdrawal guarantee makes them appear attractive.

The arguments concerning the risk management, the structure and the benefits of the product are flawed. However, this does not mean that individuals are not exposed to the risks of running out of capital within their lifetimes with inappropriate planning, structure, management and excessive costs. They quite definitely are, but there are far cheaper, more flexible and more sensible options available. In all the GMWB is the right problem but the wrong solution. All the GMWBs are doing is padding the wallets of the status quo.

To go back to incompetence; these products have taken the financial services industry to a tipping point where it is conceivably better for an investor to avoid financial advice completely and DIY a simple portfolio construct through low cost equity ETFs and direct or ETF purchases of short to medium dated government bonds. This is a sad indictment; the chasm between value and cost has never been wider. And in case anyone thinks that just because a product has been developed by bright minds in ivory towers it must be good, just take a look at collateralized debt instruments and asset backed commercial paper.

We must not forget the very important issue which lies at the heart of the GMWB arguments. Moshe Milevksy calls this issue the retirement risk zone and I call it the period of significant market and economic risk. We have different ways of managing this risk and different beliefs about the nature of the risk but we both identify it as a significant risk that must be managed.

While there are many more issues involved in managing the ability of assets to meet financial needs over time, it is critical for those who are managing this requirement that they have a clear and structured approach to managing the risk and the time frame of the risk. The insurance companies' GMWBs have excessive costs which invalidate, in my opinion, their ability to add the necessary value. These products are also unclear as to how the insurance companies are managing the risk, to what extent they are bearing the liability and what type of risk events their planning is looking to manage.

Long term average return differentials (arithmetical or geometrical) between lower risk fixed interest and higher risk equities obscure the impact of significant (and periodic) and often prolonged risk events on portfolios dependent on capital depletion to meet financial needs. I believe that anybody managing this issue needs to be clear about how their structure manages this risk.

My GMWB report does not specifically detail my particular approach but it does state that a simple low cost low risk/equity portfolio with the low risk allocation acting as the portfolio buffer during a risk event would be a more efficient and much cheaper option. It also models the relative risk of an absurd 100% equity allocation against a GWMB over multiple historical time frames with 5% withdrawals to illustrate the impact of GMWB costs on the viability of the product.

If individuals want a simple introduction to my views regarding the management of capital depletion please see the following links.

http://www.moneymanagedproperly.com/newsletters/TAMRIS%20Review%20-%20March%202006.pdf http://www.moneymanagedproperly.com/New_Folder/Education/Total%20Asset%20LCWM.htm

If individuals want to be clear about my own methodology with regard to portfolio structure and the management of assets and liabilities over time then please see the following link. This is a very complex and very detailed document.

http://www.moneymanagedproperly.com/technical%20docs/Fundamentals%20of%20Asset%20Allocation,%20Weaknesses%20of%20MPT%20and%20a%20Fundamenrtal%20Portfolio%20Foundation.pdf

Full access to analysis of the GMWB products and issues can be purchased from me, but an intro is provided on my website.

http://www.moneymanagedproperly.com/technical%20docs/GMWB%20Compendium%20Sample.pdf

I am fully open to discussing this issue and to broadening and opening up the debate. I am interested from a professional point of view in finding out Asher's differences with my analysis and approach since it may be worthwhile clarifying or developing the resulting issues.

Andrew Teasdale

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Value at risk – 2 November

Ftalphaville

http://ftalphaville.ft.com/blog/2007/11/02/8591/another-fine-var-mess/

VAR really is a dumb measure for managing extreme event risk. It is not a question of the weakness of the normal distribution or even the fatness of the tail. It is the fact that the probability distribution of future outcomes depends on how far from and on which side of the equilibrium point you are. The probability of an extreme event shifts. Modern financial theory on which VAR rests depends on an equilibrium state, or as little deviation from such a state as possible.

Andrew Teasdale

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Financial Abuse - 2 November 2007

WealthyBoomer.ca, Abused investors: full Markarian ruling now in English

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/11/02/markarian-case-now-in-english.aspx#comments

I see a number of cases where I ask myself, "why does the financial institution not just admit culpability and settle and, why do the regulatory organizations not come down hard on the individuals and the companies?"

The transgressions are so obvious and shameful that it begs belief that individuals are often forced to go through years of regulatory and legal process to get redress, that is providing they can survive the financial and emotional tole.

I can only surmise that financial abuse is an accepted part of Canadian Financial Services culture and that the regulatory system merely reinforces and supports this culture. I can see no other reason. Markarian is a very good case in point.

Andrew Teasdale

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Fee based financial services models

WealthyBoomer.ca, Millionaires, Penta-Millionaires and Deca-Millionaires

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/10/15/millionaires-penta-millionaires-and-deca-millionaires.aspx#comments

What are we talking about, a way for advisors to earn more money or a way for clients to get better financial advice or both?

Merely providing advice on top of a transaction based service model will only increase costs and take up additional time thereby reducing the amount of time allocated to the transaction based remunerative component. Advice in a transaction led environment is also all too often self serving and of little objective value. In this instance both the client and the financial entity are operating in an even less efficient environment.

The quote in the article states that a fourfold increase in revenue equates to a 60% increase in profits. I am sorry but this translates into a lower profit margin and therefore a less productive state.

The whole point about a fee based model for the client should be that there should be no remuneration incentive from the transaction recommendation. This means that what might be the best solution under a transaction based service is not that which would necessarily be recommended under a fee based service. The provision of products is not an advice led, fee based service process solution but the same transaction game with a different name.

I see no reason why a fee based approach should be a way to generate more revenue but I see plenty of reasons why a fee based approach could lead to higher margins and better value for the client.

A fee based approach without a well defined and efficient service process is time consuming and inefficient. A fee based service should be focused on automating as much of the processes underpinning advice as possible. A properly defined service process is more likely to provide a better quality, more highly sophisticated and cost effective solution to the client.

However, what many know but do not spell out clearly is that the management of assets is the most remunerative of all financial services components. Charging more for what is already a very high cost adventure for the retail client seems perverse.

Yet again we have a marketing machine intent on charging more for what can and should be done for less.

Andrew Teasdale

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A rare financial conscience, 14 October 2007

WealthyBoomer.ca, Cox cites fed easing; moves 5% bonds into equities

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/10/12/coxe-cites-fed-easing-moves-5-bonds-into-equities.aspx#comments

Good to see a member of the establishment with a quoted conscience. Private equity was very much behind the business income trust saga that is still to run its full course in Canada. Unfortunately many of Canada's financial institutions sold on, helped finance and profited from many of these private equity securitized product launches.

Andrew Teasdale

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The importance of financial advice

WealthyBoomer.ca, Why most of us should use a financial advisor

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/10/10/why-most-of-us-should-use-a-financial-advisor.aspx#comments

I do agree that individuals without the expertise, discipline, systems, time and resources to manage their money should opt for a professional advisor backed by an organization able to deliver the appropriate portfolio and wealth management solutions. But not all advisors can and do and this is the rub.

Well done the Financial Planning Standards Council for stressing ethics and communication in writing as a prerequisite of professional and accountable advice. But I would warn investors that when choosing a financial advisor you really need to do your homework and that not every advisor is the professional you are seeking.

Andrew Teasdale

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The importance of financial advice

WealthyBoomer.ca, Why most of us should use a financial advisor

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/10/10/why-most-of-us-should-use-a-financial-advisor.aspx#comments

I know what Jonathan is saying. Investors do need sensible financial advice and i certainly do not recommend that investors in general go it alone. I have no disagreement with his basic premise because it is fundamentally correct. Low industry standards are nevertheless one of the reasons why the DIY sub culture is as strong as it is.

Andrew Teasdale

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Systematic financial and economic risks – 10 October 2007

Juggling dynamite, Upsetting the status quo is the first step to valuable thought

http://www.jugglingdynamite.com/blog/_archives/2007/10/9/3280678.html

The physics of the current economic and market reality are clear. Few people seem to understand that the only way we got through the last cycle in the shape we have has been due to a very long period of very low interest rates and an asset price bubble built on debt and financial innovation.

If we look at the historical relationship between interest rates, inflation and money supply, we find that the current market crisis started at a point which has probably never before precipitated a crisis. Skipping the necessary detail and analysis, the world's financial system is very unstable and the two most likely potential outcomes are a period of high inflation and lower economic growth (stagflation) or an outright depression.

The US economy has been dependent on an asset price bubble built on debt and by implication and association so has the rest of the world.

The global financial system can no longer cope with the current level of debt. Take away the supply of debt and you take away the support for assets and expenditure. Take away consumer expenditure and you take away ......and so on and so on..............

We have vast structural imbalances, the collapse of these imbalances will be ramified by the natural forces of the economic multiplier. Those who disagree ignore the impact of low interest rates, hedge funds and financial engineering on extending the structural imbalances to the point where a small subsector (sub prime) of small GDP component (4 to 6% of US GDP over the last few years) can impact the entire world's financial system.

It has nothing to do with scaremongering or losing your cool, it is pure physics.

Andrew Teasdale

The TAMRIS Consultancy

Guaranteed Minimum Withdrawal Benefit Plans, 3 October 2007

WealthyBoomer.ca, Longevity Insurance -- Income Plus is getting better

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/10/03/income-plus-is-getting-better.aspx#comments

It is rare for me to share the same platform with the income trust lobby group, but I have to admit that they are spot on.

Take a look at Manulife's web page and their proclamations.

http://manulifeincomeplus.ca/

"Guaranteed income now for life" - This is not a guaranteed income, since income is a return on capital. It is more or less a guarantee of return of capital even with the extended time frame of the guarantee. It is also not a guarantee of today's money; the 5% withdrawal rate is nominal and not real and at 3% inflation will be worth a real 3.72% in year 10, 3.2% in year 15, 2.76% in year 20 and 2% by year 30.

All the growth potential of the market - I am sorry but it is all the growth potential of the market less management expense ratios and guarantees which if the maximum income plus fee is charged is some 3.9% to 3.95% for growth portfolios - charge for growth portfolios = 3.7% MER plus the 1.25% pa max charge currently 0.75% pa.

You never lose the money you invest - yes you can lose the money you invest if you withdraw capital in excess of the annual withdrawal amount and net returns are less than inflation. In real terms, it is possible to lose some real value of capital invested even if you keep to the maximum allowable withdrawals and live beyond the original 20 year time frame.

It is difficult to understand how the regulators of financial services in this country can allow such misrepresentation of the true nature of risk and return of these contracts. It would be very difficult for an individual with a "nominal" income objective to run out of capital with a low cost, appropriately structured, simple asset class alternative.

But what if there is an outlying risk event that placed such capital at risk? Would Manulife still be able to meet its obligations? This is not addressed anywhere in the literature and this risk would obviate the proclaimed guarantee. So even the capital guarantee is not properly substantiated. Is it indeed a cast iron guarantee capable of passing any risk event, or not? Manulife depends on healthy markets and economies for its own financial viability and a severe and long lasting risk event could place its business at risk.

However, the product is indeed a valid solution when set against the industry's high cost and often inappropriately structured wealth management solutions. But investors should not be cornered into buying such products by default. In this context it would appear that this product's raison d'etre is really the devil you know.

Andrew Teasdale

The TAMRIS Consultancy

http://www.moneymanagedproperly.com/New_Folder/

Income Trusts, 3 October 2007

WealthyBoomer.ca, Longevity Insurance -- Income Plus is getting better

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/10/03/income-plus-is-getting-better.aspx#comments

My position on income trusts is well known as is my position on these variable annuities. I agree with CAITI on their criticism of these products but disagree with their views on tax advantaged investment vehicles. I have no issue with the basic premise of mature corporations distributing earnings to shareholders as long as a) the valuation of these earnings are not leveraged for tax payers via a tax advantaged structure and b) any return of capital is not incorporated into the yield leading to a spurious valuation.

Part of the problem with income trusts was the misrepresentation of risk and return to the individual investor and we see the very same issue arising with GMWBs. I will question any provider of products, securities and services in the interests of transparency and accountability.

Andrew Teasdale

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http://www.moneymanagedproperly.com/New_Folder/

Guaranteed Minimum Withdrawal Benefit Plans, 3 October 2007

WealthyBoomer.ca, Longevity Insurance -- Income Plus is getting better

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/10/03/income-plus-is-getting-better.aspx#comments

Please note an error in my first comment. MER should read 2.7% and not 3.7% which with the max income plus premium would total 3.95%.

One other point. I disagree with the suggestion that GMWBs could be considered suitable for investors who would normally go for the lower risk GIC or government bond option. These people tend to have an aversion to capital loss and quite often excessive consumption of capital. As such a GMWB is not a comparable investment. The only way the GMWB retains the characteristics of cash is where the total return is more than the total plan charges plus the cash or bond yield and the accessible value of the deposit at any point in time never falls below the unit value of the original nominal investment or in the case of a government bond the accessible value of an appropriate benchmark. In order to take this risk the return on equities would need to be higher than this differential, meaning that the equity risk premium would also probably need to be higher than Canada's long term average equity risk premium.

There are far too many structural issues with these products to pen them all in such a short space. Again, they are designed for the financial services industry.

Andrew Teasdale

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Guaranteed Minimum Withdrawal Benefit Plans versus annuities, 3 October 2007

WealthyBoomer.ca, Longevity Insurance -- Income Plus is getting better

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/10/03/income-plus-is-getting-better.aspx#comments

Life annuities would provide a better than 5% annuity for a 65 year old, close to 7% in the Uk and 6% in Canada for a single life fixed annuity.

The problem with nominal life annuities is of course they are exposed to inflationary risk and capital invested goes to the life company in the event of death.

The variable annuity is designed to provide the opportunity for higher capital return and inflation protection as well as a return of residual capital, but the current costs of these vehicles mitigate their effectiveness.

With a straightforward life annuity you are effectively investing all your capital in fixed interest which is an inefficient allocation for the time horizons of many retirees. The viability of a strategy comprised of a significant allocation to equities depends on the return differential over lower risk assets and the risk of that return differential. High costs can reduce the return to negligible proportions while retaining all the risk.

The variable annuity is giving you a lower guaranteed annuity than a traditional annuity could provide while making it harder (given the costs) to benefit from the more flexible structure.

What are the life companies saying? If you give me your capital "I" will more or less promise to repay the nominal amount to you over the next twenty to thirty years for a fee of close to 4% a year, but "I" will guarantee nothing more. At 3% inflation, a guaranteed 5% annuity over 30 years would return only 99% of the real value of the original deposit.

Keeping your capital outside of a traditional annuity provides much more flexibility and allows you to manage a far wider range of personal and financial risks and preferences. The traditional life company annuity (at least in the UK) was based on cost effective pooling of assets and a cost effective solution needs to be provided by any alternative, product or otherwise to be a viable and genuine alternative.

Andrew Teasdale

The TAMRIS Consultancy

Greenspan on financial crisis – 1 October 2007

Juggling dynamite, Of black swans, grasshoppers and dumb, dumb policies

http://www.jugglingdynamite.com/blog/_archives/2007/9/28/3258391.html

Tough words Danielle.

I must admit I was surprised by Greenspan's statement re that it was only sophisticated investor capital that was at risk. These funds were leveraged and leverage in the credit derivatives market has helped support the real estate bubble. Leveraged hedge fund activity therefore has a direct impact on asset prices, asset price inflation and the integrity of the banking system via banks' hedge fund brokerage and lending businesses and off balance sheet conduits.

In fact, all this third party financial leverage smacks of back door financial deregulation. Just investor capital? Think again Mr. Greenspan.

Andrew Teasdale

The TAMRIS Consultancy

Canadian Seniors – 13 September 2007

WealthyBoomer.ca, No free lunch for seniors

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/09/12/no-free-lunch-for-seniors.aspx#comments

I have tried to educate individuals and organizations responsible for the welfare of Canadian seniors to take the issue of such financial abuse seriously. But far too often this is to no avail. On a daily basis you see retirement homes and other seniors' organizations develop relationships with financial services firms when they should be clearly and demonstrably independent of any such relationship. Most seminars are indeed sales opportunities. Unfortunately there is money to be made and business to be developed by such association.

Andrew Teasdale

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Hedge funds, 13 September 2007

WealthyBoomer.ca, Why didn't hedge funds shine in August?

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/09/12/why-didn-t-hedge-funds-shine-in-august.aspx#comments

I am of the opinion that hedge funds are in the main unsuitable for retail investors for reasons discussed in my 2006 report on hedge funds. They should only be used by portfolio managers where the hedge fund strategy, asset allocation, security selection and risk profile of the fund fits into their own valuation framework. I would hazard a guess that many retail investors and/or their advisors purchase hedge funds without such a framework.

People can of course get a well hedged portfolio simply by allocating to traditional asset classes and much of the vaunted hedge fund return profile can be achieved by traditional contrarian/value investments styles.

One of the problems with hedge funds nowadays is that there are far too many of them. Whereas once upon a time they were able to feed off the market's correlation relationships they have now more or less become the market and to a large extent determine the correlation relationships.

Hedge funds are exposed to risk events where liquidity is being withdrawn from the market place. They more or less depend on stable relative demand relationships between different securities and asset classes. Once these relationships break down highly leveraged funds become heavily exposed. Unfortunately the last big bear market was not such a risk event and it was the relative performance of hedge funds during the last bear market that is often used to sell these vehicles.

If there is one crucial reason why hedge funds have become popular among retail investors and advisors it is probably the lack of a true understanding of what constitutes a properly managed portfolio and the lack of the systems and expertise to deliver properly managed portfolios to the retail investor.

There are of course some good hedge funds and hedge fund managers out there, but there have always been good managers at the margin in the traditional asset management field.

And remember, there is no such thing as a free lunch and hedge funds are no different!

Andrew Teasdale

The TAMRIS Consultancy

ABCP and Money Market funds – 23 August 2007

WealthyBoomer.ca, How safe are money market mutual funds?

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/08/24/how-safe-are-money-market-mutual-funds.aspx#comments

The following is a copy of my e mail to Jon regarding money market funds and their commercial paper holdings. This is a very complex topic and anyone interested should understand what commercial paper is, why it is limited to short time frames, the size and importance of the commercial paper market and the structures and relationships under pinning it..

"Yes, I do think they should be concerned. I think they should be concerned because financial institutions are concerned as evidenced by the reluctance to roll over asset backed commercial paper.

One of the problems is that nobody really knows how much many of the assets/debts supporting the commercial paper are really worth and hence the risk. If you do not know how much an asset is worth or its risk profile you should not buy it and if you hold it you cannot sell it.

Worse, much commercial paper is often backed not just by debt, which in itself would be subject to considerable risk in the event of a US recession, but they are backed by much more complex collateralized debt obligations. The risks of these CDOs are turning out to be much closer to the credit rating of the underlying debt/asset just as these risks are themselves increasing. If the rating agencies start (as they already have) to downgrade this paper, money market funds will take a hit to their net asset values.

The fundamental problem with commercial paper is that it is often backed by longer term debt/assets and it is this mismatch with higher risk assets/debt that is critical at the current moment. In effect money market funds that hold ABCP are not holding cash but higher risk longer term debt.

Obviously, money market funds that promise liquidity cannot hold illiquid assets. They are going to have to get rid of their illiquid commercial paper holdings. At a fundamental level cash is meant to be a very short term asset.

The commercial paper and asset backed commercial paper markets have become very important to the financing of the economy over recent years. In a way, if financial institutions stop investing in such paper there will be very significant consequences.

At the present moment in time the risk of money market funds depends on the extent to which a financial institution will support their funds, the allocation to commercial paper (the actual underlying quality of the paper) and the actions of other unitholders; if everyone starts selling an institution will be forced to repatriate the liquid assets first leaving remaining holders with a much greater exposure to the CP/ABCP.

In a fully fledged credit crisis banks may not have the capital to support their money market funds. In the event of a US recession there will be sections of the Asset Backed CP market that will be worth nothing. After all, the value of the debt is dependent on the ability to pay the promised interest and to repay the outstanding capital.

A loss of confidence in the commercial paper market would have very far reaching consequences. The fact that money market funds are at risk is testament to the degree to which credit risks have built up within the financial system.

Andrew"

Andrew Teasdale

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Portfolio construction and mutual funds – 23 August 2007

WealthyBoomer.ca, MacDonald leaves Trimark -- We love them and they leave us Part 13

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/08/23/macdonald-leaves-trimark-we-love-them-and-they-leave-us-part-13.aspx#comments

In my opinion you should not be constructing a portfolio based on star managers. Include such a fund by all means if you have an allocation component of a portfolio that matches a star manager's allocation and style and you prefer an active as opposed to an indexed allocation.

Portfolio structure and allocation should be driven by your investment discipline and your valuation, allocation and management process. If your allocation profile is contrary to that afforded by the index and you are looking to managed vehicles to build up this allocation, then I see nothing wrong in selecting a top performing manager for that component.

However, the most important decision is buying a fund because of the underlying allocation stance or investment style; that is it should fit into your valuation and/or allocation framework.

In my experience much of the performance of star managers has come from the style and asset allocation stance they have taken over the period of their performance. Just focusing on the best performers risks exposing yourself to a buy high strategy without attention to valuation or allocation.

But by the time you come to select a fund you should have already ascertained your own style and investment discipline and have a firm rationale for why you are taking a specific active or a passive stance within a given sector or market. The fund selection is the final decision, not the first.

Andrew Teasdale

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Global Diversification – 21 August 2007

WealthyBoomer.ca, Will foreign content help Canadian investors in correction?

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/08/21/will-foreign-content-help-canadian-investors-in-correction.aspx#comments

If you are a modern portfolio theory investor who uses correlation coefficients to reduce risk per unit of return then the increased correlation of asset classes is of significance. The higher the correlation the less impact diversification has on reducing risk per unit of return. However, because assets should still theoretically be efficiently priced (if you believe in 100% efficient markets, which i do not) the investment choice transcends into one of how much risk do you want and how much return do you want; this does not invalidate a global allocation. All that happens is that the allocation decision in the mean variance optimiser is determined by two parameters (risk and return) and not the usual three (risk, return and correlation).

Also, during significant market and economic risk events the movement of stocks and markets tend to become more highly correlated for one reason or another. As such, global and market diversification is also not of immediate benefit during the initial correction phase even where assets are less closely correlated during periods of normal risk.

However, diversifying across global markets and market cap does diversify long term economic risk and if you are a Canadian investor this is an important risk to manage.

What is more important to immediate financial security is that you are not exposed to short term market and economic risk, which means a portfolio structure that pays attention to the allocation, the costs, the credit quality and the duration of the low risk fixed interest relative to the size and timing of financial needs. If you can cover this market and economic risk, diversification still has important long term risk reduction benefits.

Too properly understand this argument you need to understand the investment arguments of both fundamental valuation driven theory and "statistical driven modern portfolio theory".

Andrew Teasdale

The TAMRIS Consultancy

Panic and portfolio structure in a risk event - 16 August 2007

WealthyBoomer.ca, Stand pat and take the pain?

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/08/16/stand-pat-and-take-the-pain.aspx#comments

People who panic do not know what they are doing or what is happening and why.

Decisions wrought from rationale thought based on a good understanding of what is happening and why are not panicking. But, this may well be a moment of truth for many investors. Have they received appropriate advice or are they now standing at the edge of a precipice?

If you have a "properly" constructed portfolio you should be able to survive through and beyond significant market and economic risk events. But this also assumes that your income and capital withdrawals are being conservatively managed.

I personally feel that a portfolio needs to be able to meet financial needs through the duration of a significant risk event, irrespective. This means a portfolio should be capable of meeting planned financial needs during the time it takes a market (or equity portfolio) to recover either a previous nominal high or preferably to equal the total return on lower risk asset classes without having to realize assets for consumption at a loss.

Based on historical analysis of risk, a portfolio needs to protect financial needs over periods as long as 8 years, certainly no less than 5 and, at advanced market and economic cycles for longer. If you have to sell assets at a loss to meet financial needs or other liabilities your portfolio may not been properly constructed; distressed hedge funds please take note.

In my opinion, withdrawals need to account for market and economic risks to the ability of those assets to meet returns. An individual with a well constructed portfolio but inappropriate withdrawals will be as much at risk as an individual with an improperly constructed portfolio and sensible financial demands.

If you have no idea how your portfolio is positioned to cover an extreme risk event and how the portfolio is structured to manage these risks and still meet your planned expenditure you should seek clarification from your advisor. If your advisor cannot explain or support the ability of their structure to do the same then you may have reason to be concerned.

No portfolio and no individual's financial security should be hostage to events. A properly constructed portfolio relevant to your financial demands should be able to weather most storms. No portfolio is immune to the impact of risk. Just because your assets are falling in value does not mean you're financial security is at risk.

The magnitude of the current risk event is normal and declines of far greater magnitude are certainly within the realms of probability and should be understood and expected when an equity investment decision is made.

Within a properly constructed portfolio with sensible withdrawals the current market declines will be of little or no consequence. Proper structure, planning and discipline should allow a portfolio to emerge from far greater falls of much longer duration.

The current environment is certainly the most complex I have encountered in the 20 plus years I have been in the financial services industry and this includes the 1987 crash and the 2000 to 2003 bear market. What is different today is the amount of risk that cannot be quantified by either an assessment of economic or market/security valuation. These financial system risks are unquantifiable at this moment in time and it is this uncertainty which is of greatest concern.

Panic always does more harm than good even where an orderly retreat is warranted. Well constructed portfolios should be able to deal with significant market and economic risk events but they are incapable of managing risks well outside these parameters. An event that threatens the stability of the capitalist system would of course lay waste to the best laid plans.

Andrew Teasdale

The TAMRIS Consultancy

PS Over the last year I have addressed a number of issues that relate to current markets events. These are discussed in my reports on derivatives, hedge funds, the US consumer. the global economic bubble and the March 2006 review on safe withdrawal rates.

http://www.moneymanagedproperly.com/New_Folder/technical.htm

My report on derivatives made the following comment.

While many in the pro derivatives camp do not feel derivatives pose a risk to the financial system and, indeed the broad averages probably back this up (net liabilities outstanding after netting of trades and collateral), it must be stressed that a) this is not the risk the market will face in an extreme event and, b) averages hide a multitude of sins.

The greatest risk is posed by the transfer of risk from exchanges with many counterparties to a less liquid over the counter market place with few. It is a risk because contrary to the fundamentals of diversification, risk is being transferred to the few and to a medium that will be directly impacted by a risk event and the associated defaults of risk positions held by counterparties. Importantly it is a risk that has been transferred to the heart of the financial system, and, not away from it.

It is possible that the excess liquidity and low interest rates in the financial system has helped create a derivative induced risk pricing bubble. It is also probable that derivative aided risk pricing bubbles will be a feature of the future as they continue to extend their global reach and from the institutional to the retail investor.

One of the greatest concerns is the lack of transparency over the risk in a market place whose primary role is to earn a return and promote the expansion of its risk products. To say that this is a moral hazard is an understatement.

Systematic financial and economic risks – 15 August 2007

WealthyBoomer.ca, Mr. Market's feeling blue again.

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/08/15/mr-market-s-feeling-blue.aspx#comments

I agree with the main thrust of the article. That is if you have a "properly constructed" portfolio with an "appropriate strategy" staying put is sensible.

However, I do feel that the current risks in the market place are extreme. No-one really knows the full extent of the sub prime credit risks, the full impact of the unwinding of these risks on credit derivatives and market liquidity, market leverage and hedge fund risk management and ultimately economic activity.

These risks are in addition to a very real and significant downturn in the US real estate market, which precipitated the current risk event, and a very highly indebted US consumer.

Yes, the world economy has been growing strongly in the first half of 2007 with central banks worldwide (with the possible exception of Japan) more concerned over rising inflation and capacity constraints, but this world economy has been and remains to a large extent dependent on US consumer demand which is itself in a very difficult situation.

We always have economic and market risk, to lesser or greater extent, but what has been proven already is that these risks are now leveraged and quite probably to a far higher degree than they have ever been. It would not be so bad if we at least knew the full extent of the risks. Unfortunately we do not.

Many exotic hedge funds, as expected, have been found wanting in a true risk event. It is likely that the best manager of risk in the current environment is an un-leveraged conventional portfolio capable of managing significant market and economic risk through structure and attention to valuation.

Just because you have an IPS does not mean that you should hold tight.

Andrew Teasdale

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As Larry points out, your investment policy statement needs to be structured to be able to deal with risk events in advance relative to your own financial needs and risk preferences. However, not all investment policy statements are made equal and an inappropriate strategy or structure cannot be validated by the mere fact that it is ensconced within an "IPS". Structure and planning and good management discipline are critical. The mere existence of a piece of paper with allocation parameters does not necessarily = appropriate structure or planning or indeed value for money. It is the underlying expertise, discipline and process that supports and substantiates the parameters recorded in the IPS that is all important.

Andrew Teasdale

The TAMRIS Consultancy

The cost of financial advice - 13 August 2007

WealthyBoomer.ca, How much is good advice worth?,

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/08/13/how-much-is-good-advice-worth.aspx#comments

It is impossible to charge a fee of 0% for management, but it is possible to charge as little as 0.10% for providing the asset allocation, the security selection and the planning to boot. If individuals take an indexed approach the financial services industry of the future is capable of charging no more than 0.35% for a passive personalized (asset and liability matched) portfolio. The industry is not ready for such change because it is not in its interests.

I disagree that it is not possible to out perform through active management. I do however agree that for the majority of investors the mathematical odds of doing so are low and fall further as management fees rise.

But, index investors are not currently paying the true cost of the index allocation. Active investors underpin the management of the index's composition. The market needs a subset of active rationale investors to make the necessary security allocation decisions and these market agents need to be paid. In an efficient market the cost of index investing would either need to rise (active investors would need to be paid) or the returns for active management would need to rise. Either way the proportion of active investment in the market would need to fall significantly (perhaps to no more than 20% of the current weighting).

The only obstacle to the development of an efficient market place is of course the human being.

Andrew Teasdale

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Fred

The answer lies in technology, competition and choice.

The technology exists to allow institutions to deliver integrated wealth and asset management systems that are capable of operating profitably on margins as small as .10%. How do I know? I have been involved in the development and costing of just these types of business processes and systems.

Of course this is a costing for an internet based delivery system where an individual chooses to provide the necessary data entry and go through an online interactive education and risk assessment process. The institution provides all the security selection and asset allocation, integrated asset and liability management (its decision rules determine the final portfolio and planning solution) and investment discipline as well as far higher levels of communication and education. Technology allows you to centralize and automate and to provide advanced personalized solutions at a far lower fixed cost. And once you have competition and technology you have greater choice.

Investors who want to access a personal service would of course have to pay a higher fee, which is whatever the market can bear and you can justify and, this is where advisors come in. Advisors will need to be able to justify the value added for the fee.

But without a competitive imperative there is little reason for an industry to develop solutions which would change their own reason for being. As it is, you are of course right about two things.

The real world, or today's world.

What I am talking about is not of course "today's" world. Then again who would want the reality of the 17th Century today? I would also hazard a guess that there would be few who would want to go back to the computer technology of the 1980s - higher costs, lower functionality - even though today's technology would not have been of the real world back then. I am also not so sure that the realities of today's retail financial services industry (high costs, low standards) are a reality I would like to see persist.

Remuneration

You are also right that the individual financial advisor would not be able to survive on 0.1% of funds under management. If technology allows us to deliver a better product at a cheaper price, this will free both financial capital and labour capital to perform other functions within the economy.

You should be able to break down your fee into the individual components of the wealth management process. You should know how much you are charging and how much excess return you are earning on each component. In a competitive market place you should also be looking to reduce costs, to automate and to improve the quality of your service/product with respect to the market segment you are operating in; to either increase margins or to maintain or increase market share through lower prices and better quality. If you are not operating in a competitive market place and your market segment is not concerned over price or quality then you may not have an issue. In this case, there is no imperative to lower costs, to automate or to pay attention to product and/or service quality.

Andrew Teasdale

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Agreed - There are always conflicts of interest.

A fee basis (whether an hourly rate or a % of funds under management) provides the client with a costing and hopefully a service description which allows the investor to make both a quantitative and qualitative decision about the fee and the service. Where assets are being managed the advisor should also provide a performance analysis against which the advisor's service can be assessed. Importantly it allows the investor to assess the value added by the service throughout the relationship.

Providing all commissions and costs are disclosed, a performance analysis provided and the advisor clearly explains their service and why, how and what they are doing for the client, there is no reason why a commission based service should be inferior to a fee based service in terms transparency and accountability.

As long as the client knows what they are paying, what they are getting and the comparative value they are receiving, the method of remuneration "should" be of little consequence. I have nothing against commission based advisors that are delivering value for money and that are accountable. Alternatively I would have an issue with fee based advisors that did not know what they were doing. Fee based does not necessarily equal quality or value for money.

However, a commission based transaction approach is much more open to abuse for the simple reason that you do not make a return until you make a transaction. Also, if you do not need to account for performance then there is nothing stopping you from making unnecessary transactions.

My main concern with a transaction based approach is that the remuneration is tied to the point at which the transaction is made. In fact the transaction should always relate to the suitability decision which means remuneration should be tied to the costs and the quality of the wealth management service delivering suitability. Suitability means that transactions have to relate to financial needs, risk preferences, existing assets and their allocation, costs, investment discipline and current market conditions (depending on your investment style or discipline). Ensuring that an investment is suitable requires a high level of service, organization, expertise, discipline and communication and it is this which the client should be paying for.

I would be very interested in widening this debate. In particular, instead of the very general discussion that we had here to date I would be interested in a much more detailed explanation of how advisors support, deliver and justify their recommendations and services to their clients. There are very good advisors out there who operate on one or the other remuneration basis (commission or fees) and these advisors should be leading the way in terms of service standards irrespective of their remuneration model.

Information on the TAMRIS Consultancy can be found at the following web page.

http://moneymanagedproperly.com/New_Folder/Home.htm

Andrew Teasdale

The TAMRIS Consultancy

Conflict of interest - 1 august 2007

WealthyBoomer.ca, Carping about CARP

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/08/01/carping-about-carp.aspx#comments

At one level the CARP money 50 plus website would appear to be a financial services marketing operation given its clearly defined links to the Investment Planning Counsel (note the CARP Certified ICP Financial advisors) and the promotional nature of some of the site's content.

The question is, does this conflict with their claim to represent the needs and rights of seniors? It is a moot point.

Perhaps it is time for CARP (as a senior's lobbying group) to clearly separate itself from its current business interests and for those business interests to clearly separate themselves from CARP and any association with the representation of seniors' interests.

There is of course nothing wrong with a financial services orientated website and magazine targeting seniors. This is really what the website at issue has become. However, at the present moment in time there is nothing to stop wolves in sheep’s clothing from taking advantage.

A seniors' lobby group should only receive funding from seniors and other non profit organizations and/or government bodies and should have no business relationships with those whose interests are purely financial.

We need to understand that seniors are most at risk from financial abuse and those in positions of responsibility with regard to seniors should not be encouraging business relationships with financial services entities. Endorsing a financial product or service to one’s members in exchange for remuneration is a clear conflict of interest for any organization pretending to represent seniors’ rights.

I see too many entities with responsibility for seniors’ well being acting inappropriately when it comes to developing close associations with financial services organizations for one reason or another.

Canada and Canadians need to get serious about protecting investors instead of finding yet more ways of selling to them.

Andrew Teasdale

The TAMRIS Consultancy

US market valuation – 26 July 2007

WealthyBoomer.ca, Templeton sees U.S. large caps as bargains; Canada overpriced

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/07/26/templeton-sees-u-s-large-caps-as-bargains-canada-overpriced.aspx#comments

I get nervous when fund managers point to P/E ratios alone as an indicator of value. We are at the peak of an economic cycle and corporate profits are at historically high levels. While P/E ratios are indeed below the late 1990 peaks there are a number of factors which suggest they are nevertheless in extended territory associated with below average long term returns. The following is a useful perspective on this issue.

http://www.hussmanfunds.com/rsi/adjustingpes.htm

http://www.hussmanfunds.com/rsi/profitmargins.htm

Guaranteed Minimum Withdrawal Benefit Plans - 23 July 2007

WealthyBoomer.ca, Looking at Retirement upside down,

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/07/23/looking-at-retirement-upside-down.aspx#comments

There are of course a whole host of other issues including private equity leverage and hedge fund exposure to changes in interest rates and volatility.

The TriDelta analysis did ignore the impact of significant short term stock market and economic risk and its analysis did not specifically consider the ability of an alternative solution to deal with periods of such risk and the duration of the risk. Without this there is nothing to suggest that the TriDelta solution can manage the risks the GMWBs are set up to address. However, the costs and risks of these new products are very real and substantial and an appropriately structured low cost investment solution is more than capable of outperforming these new products both in the risk and the return category.

At a basic level the individual investor need only purchase indexed investments and direct government fixed interest securities (asset and liability matched over the duration of significant short term risk) to provide both the risk management and the return component. Direct fixed investments cost nothing to manage and major market ETFs cost an annual 0.25%. The sequencing of returns discussed in Sun Life and Manulife should be water off a duck's back for even a basic portfolio solution. Of course, compared to the average retail solution full of either high cost mutual and segregated funds where investors are drawing down on capital at all points in time without short term risk management, a GMWB is a valid option.

But, just as Sun Life and Manulife criticize TriDelta for not addressing the sequencing of returns they too have likewise failed to compare their solution against structured lower cost options. The GMWB in a world of options is not the only option available. The only reason the GMWB has merit is because the retail financial services industry is hopelessly inefficient in matching the demand (investment) for and supply (savings) of capital.

My October 2006 report looked at the US market risk and returns since 1962 (including inflation risk) and compared the risk and return profile of a 100% indexed allocation to a GMWB product (3% annual costs) and found that even a simple ETF allocation with point in time withdrawals would out perform a GMWB over every 20 year time period irrespective of the risks. Only a fool would run a 100% equity allocation, yet even this foolhardy low cost allocation came out tops with data at hand and the hundreds of individual scenarios analyzed; the model effectively hit both the GMWB and the ETF with different levels (mild to extreme) of both market, economic and inflationary risk.

I would be very, very wary of supporting these products not just because of the costs but because of the risks associated with some of the investment planning that might go with them. Investors would be penalized if they take more than the 5% withdrawals and this may well happen if planning for future needs is taking into consideration a rate of return that does not take into consideration risks to return. The product literature is also misleading and does not provide the investor with all the information required to make an informed investment decision.

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Investors are downside risk averse but the GMWB does not protect capital against downside risk in a withdrawal situation since it only guarantees the repayment of capital over a 20 year lifespan; investors will still see the value of their assets falling. Indeed, with the higher costs they will see enhanced risk of capital loss during periods of poor market returns. Investors' myopic behaviour is being taken advantage of within these products.

The only time an investor would be better off would be the occurrence of a very serious market and economic decline that would see capital run out well within the time frame of the product and which may very well expose the life company's ability to support capital repayments. Indeed, capital needs to run out well within the 20 year time frame for investors to recoup the higher costs.

Investors in sensibly constructed portfolios would be exposed to less risk during market declines and the risk of running out of capital beyond the 20 year time frame would also be considerably reduced. Market declines would be seen by investors in both portfolios. It would make more sense to structure a portfolio to manage the significant short term risks and to communicate the ability of the portfolio to manage this risk. Investors have short and long term needs and disciplined professionals should be committed to focusing on the management of these two complementary demands.

The pricing of the GMWB rider at 50 to 80 basis points is no doubt well priced but this ignores the other costs of the product. It is easy to prove that the 50 to 80 basis point cost is cheap. Just look at the long term equity risk premium relative to the insurance cost; even in the light of the lowly 2.1% risk premium in the Canadian market between 1960 and 2000 the cost is small. However, once we add the MERs and the segregated fund costs we end with an annual expense ratio of some 4%. This is pretty much the entire equity risk premium. I note that in one of Milevsky's earlier reports that he states the insurance costs of these products under price the risk. If these products are under pricing the risk then the risk of not being able to meet the guarantee in a precipitating risk event must be significant.

Also, as professionals we must not view the attractiveness of the product to the investor at the time of purchase, we must look at the risks and the impact of the product over time.

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If indexed funds were to be used it is unlikely that the GMWB rider would be as low as stated. In reality it is not as low since the segregated fund fee is part of the insurance cost (at least with Sun Life). In this case the insurance cost for the Sun Life plan is closer to 1.4% per annum (0.65% segregated fund cost for 75% guarantee + 0.7%GMWB rider). Note the GMWB rider cost falls as the segregated fund premium rises.

What we do not know are the assumptions being used by Sun Life or Manulife over the risks of the product and the management of these risks. What we do know are the costs of insuring risk per unit over the 20 year period. The longer the time frame of risk you are intending to manage the greater the proportion of the portfolio you are insuring at any one point in time.

If we say the time frame of significant risk is 3 years and let us say that 15% of a portfolio would be sufficient to cover the withdrawals over this 3 year period, the actual insurance cost for the time frame rises to 9.3% (10/1.5 x 1.4% risk premium) per annum of the capital being insured. For 5 years and 25% of the portfolio the respective cost would be 5.6% (10/2.5 X 1.4%). Even an 8 year time frame would see an effective insurance cost of 3.5%.

There is little point in the context of the product to be insuring the entire portfolio for the full 20 year period.

In truth the above confirms that an investor could take a cheaper alternative, allocate sufficient capital for say 8 years (optimised allocation taking into consideration dividends and interest), have at least as much if not more security, lower overall costs and higher relative overall return to risk ratio.

The above means that the long term equity component (8 years plus) within the plans would have an annual management expense ratio of some 2.5% (insurance costs taken out) and the short term component an expense ratio of 6% (insurance costs concentrated at the short end of the portfolio). In other words the equity allocation at the short tend of the GMWB portfolios needs to earn a higher return than the longer portion of the portfolio to justify the product, which is clearly insane.

By allocating to low cost lower risk assets at the front end of the portfolio investors would be taking a lower risk approach than the GMWB and would be no worse off than the GMWB up to a return that equaled the low risk return plus the 6% annual management expense and insurance costs of the GMWB product, even without allocating to low cost ETFs at the long end of the portfolio.

Allocating to lower cost ETFs would further enhance the benefits of a non GMWB investment. Also, because an optimized portfolio would take into consideration dividends and interest the actual capital allocated to low risk assets for a fixed nominal withdrawal would be less than 40% (for eight years). A 40% allocation would therefore be able to build in an inflationary increase component to the portfolio further enhancing the alternative to the GMWB.

Andrew Teasdale

The TAMRIS Consultancy

Options and market timing - July 16 2007

WealthyBoomer.ca, Reverse index funds and ETFs

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/07/16/reverse-index-funds-and-etfs.aspx#comments

Investors need to make sure that their advisors are not making unsubstantiated knee jerk allocations to put options and other hedging instruments.

What is more important than a hedging strategy is a portfolio structure and investment discipline that is capable of managing risks to the ability of assets to meet financial needs in the event of significant market and economic risk.

If your portfolio is exposed to the extent that you rely heavily on hedging to manage short term market risk then it is likely that the process governing structure, planning and management is inappropriate.

There are of course two main hedging instruments, options and futures (or forward contracts). Put options allow you to manage the downside risk of your equity positions without losing out on all the upside. A future or forward contract on the other hand allows you to fix the price at which you want to sell while forfeiting any return above this price. Hedging strategies that rely on futures are more complex than options based strategies and the comments here refer to options based downside risk management strategies.

In terms of downside risk management, hedging is mostly a short market timing exercise.

It is a short term exercise because a long term hedging strategy takes away the equity risk premium on stock market investments leaving you with a lower risk return profile. Holding a long term hedge therefore makes no sense.

It is a market timing exercise because the market movements required to make a short term options based hedge pay are much greater than volatility implied by option contract pricing. If you are using an options based strategy to manage risk what you are effectively saying is that you know better than the market when a market is fall by a significant amount.

At a fundamental level what an options based risk management strategy effectively does is to swap your equity investment for a lower risk investment for the duration of the contract. At a fundamental level, in terms of matching assets with liabilities, you only need a lower risk asset if the duration of the liability is longer than the duration of significant market and economic risk; note that options are not covering the volatility risk of an equity investment since the option's premium covers this risk for the writer of the option.

Your basic portfolio structure should be able to manage volatility and the longer duration of significant market and economic risk through diversification and the matching of assets and liabilities. Significant market and economic risk is the time frame it would take for the total return on a market index to equal the return on a lower risk or risk free asset following a significant market (bear market) and economic risk event (recession) – the time frame will vary throughout the market and economic cycle.

If you are going to undertake any options based risk management strategy you also need to be aware of absolute and relative valuations. There is little point in hedging a relatively under valued security, sector, market cap component or market; this is illustrated by return based hedging strategies that go long relatively undervalued and short relatively over valued securities.

Therefore, you need a framework that can manage the relationship between the size and timing of liabilities to the size and duration of significant risk and a framework that can value and manage both relative and absolute valuations.

There is a place for an options based risk management strategy but within a well run portfolio it should be a marginal and not a core strategy, should preferably be driven by an asset and liability relationship and requiring of a relative valuation framework to identify those assets and asset classes that justify a hedge. Above all, no sensibly structured portfolio should ever “need” a hedge to survive since the portfolio should already be naturally hedged.

If you are undertaking a hedging strategy you cannot do this without valuation expertise because use of a hedging instrument implies that markets are not efficient. If we assume that markets are not efficient at managing valuation risks we need to be able to value to effect strategies to manage those risks. Once you start using options and futures to enhance return you really must make sure that you are accessing the type of expertise that can manage these strategies and that the risk of these strategies can be safely accommodated within your portfolio.

The less attention you are paying to asset and liability matching, the less diversified your strategy and the higher your equity content the greater the need for options based risk management strategies and vice versa.

A downside risk hedging strategy can also increase risk and lower return. If you get your timing wrong the costs of a hedging strategy will negatively impact your Sharpe ratio..

Systematic financial and economic risks - 9 July 2007

WealthyBoomer.ca, Juggling Dynamite

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/07/09/juggling-dynamite.aspx#comments

My research into derivatives, leverage, hedge funds and collateralized debt instruments (and the Private Equity debt binge) suggests that the latent risks in the financial system are of significance and would have a disastrous impact on financial markets if an outlying risk event were to occur. Warren Buffet labeled derivatives as "financial weapons of mass destruction" and I would agree.

However, as far as the management of a portfolio of assets is concerned we need to be focused on all risks and all time frames and while a significant move to cash and bonds just prior to a catastrophe would be a smart and coveted move it is a practical impossibility most of the time and for most of those who participate in the market. Indeed, if everyone were to move to cash and bonds world financial markets would be obliterated. A wholesale move for all market participants to lower risk assets would be an outlying risk event and is something no-one should ever recommend.

Investment professionals need to structure portfolios capable of dealing with significant market and economic risk at all times and for those with a higher level of dependence on their assets for financial security an increase in the cash and bond allocation (or a move to relatively under valued asset classes) is an eminently sensible move at cyclical market and economic peaks. Adjusting allocations to risky assets with respect to the size and timing of future liabilities is not a market timing exercise since this a once and for all portfolio adjustment. Trying to time markets is a fool’s game but a structured approach to the management of risks to the ability of assets to meet future financial needs is not. While we may not know when a market is about to rise or fall we should know within reason when markets are significantly overvalued.

Moreover, it is the time frame of the risk event that is of the greatest consequence. At some point in time, even cash and fixed interest asset classes would cease to have value since the value and marketability of both depend upon the integrity and health of the capitalist economic system.

Buying low, selling high, mutual funds – 18 June 2007

WealthyBoomer.ca, How to choose global mutual funds

Investors do need to be aware that while aggressive contrary index positions provide the best chance of out performing the index, it also increases the odds of under performing the index. You need to be able to discern whether you should buy the contrary weighted fund that is currently out performing or the contrary weighted fund that is currently under performing. If you are going to select an active stance you therefore need to be aware of the relative valuations and the relative risks of those allocations. A fund that is under performing may be focused on out of favour sectors, while a high flying fund may be heavily weighted to over valued investments. In other words pay attention to relative valuation (and hence relative demand) when you allocate.

Options strategies – 5 June 2007

WealthyBoomer.ca, Modern Portfolio Theory or "Insurify?"

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/06/05/modern-portfolio-theory-or-insurify.aspx#comments

Please bear in mind when reading the following comments that I have not read the book and that the comments represent my views about options.

There a number of issues worth pointing out.

Financial insurance is different from home insurance. Not all houses burn down at the same time, so your home insurance premium is covering a much smaller risk to the insurer than the risk of a market decline for someone writing put options on the market. If all houses were capable of burning down at the same time the insurance company would need to charge much higher premiums.

The people who write options make money off them and continue to intend to do so (they have to otherwise they would not be selling them) and therefore you will lose a component of your long term return by blanket purchases, so over long periods of time you are effectively substituting one risk for another potentially larger compound risk. Over long periods of time the cost of a put option should more or less be equal to the differential return on equities over a risk free asset.

For example the cost of an 18 June 2008 SPX put (S&P 500 puts with a strike price of 1400) comes out at a cost of 35.8 (ask) or 2.3% of the current index level. If you hold till 18 June 2008 you will only be protected against a fall once the index falls below 1400 (and lower if you adjust for the cost of the option), which means you need to experience a drop of 8.3% (loss of 10.6% including the option price) between now and then before you can start to benefit from the put. This means you need to be focused on a significant market correction.

If you wanted to protect the current level of the market (1530) till June 2008 (S&P 500 SPX again) the premium cost (before commissions) would be 4.4%. The yield on a 10 year bond on a US Treasury is about 4.95%, the two combined (option opportunity cost and bond yield) is a before tax total return of 9.3%.

There will also be times when the cost of an options strategy will increase. Implied volatility is below average as measured by the VIX and with the major determinant of the price of an option being the volatility for a given duration, option costs could quite easily increase.

Once you start using a blanket options management strategy throughout the market cycle the risks of moving out of such a strategy are much more pronounced than if you had not entered the strategy in the first place; your risk is now the accumulated opportunity costs of the strategy plus the cost of a risk event without the protection.

If you are going to use options you will also need to understand the importance of implied and historical volatility in options pricing and valuation and will therefore need to know the basic Black-Scholes and the Cox Ross and Rubinstein binomial option pricing models.

I would disagree about the fact that you no longer need to be diversified in low to non correlated asset classes (or indeed styles, markets and sector components of the same asset classes) since a blanket put option based insurance policy will only cover you against a downward move, not long term poor relative performance caused by shifts in demand for asset classes or asset class components. You can engineer higher return though the management of relative valuation which is a correlation based strategy.

While options are valid tools for those looking to manage the risk of specific trading strategies they are not necessarily a must use since risks can be managed via a variety of different structural techniques as well as valuation disciplines.

What this issue with respect to options raises is of course the fact that MPT is lousy at managing liability risks and that while the structures derived from mean variance optimizers may have theoretical integrity they are less stable when faced with short term niceties such falling markets and significant liabilities. The financial, market and economic reality we live in is different from the one portrayed by MPT.

What we are really talking about when we suggest blanket options coverage is market timing and liability risk management, with the costs and the risks of market timing averaged out over a very long period of time. While Moshe Milevsky pointed out that you could combine puts and call writing to manage this risk, he also pointed out that the costs would far too expensive and would outweigh the benefits.

A much simpler approach is to have a portfolio weighted to asset classes appropriate to the size and timing of financial needs, thereby foregoing the costs of put options; protection not needed at either the short end (cash and bonds) or at the longer term diversified equity component (not needed within the time frame of significant market risk). The use of options at the margin between the short and the long term sections of the portfolio nevertheless does have merit, especially when markets and economies are in cyclical high territory and, this is where I personally see an options strategy being most useful and most cost effective.

There are of course other options strategies, for example the CBOE Buy/Write indexes which are based on the S&P 500 SPX indexes and these broader based buy/write strategies have historically shown to have reduced risk and increased yield.

http://www.cboe.com/micro/bxm/BuyWriteQRG.pdf

http://www.asx.com.au/research/indices/buy_write_history.htm

Nevertheless it is worth noting that a number of more active narrower focus buy/write strategies have hit the proverbial brick wall in the past.

I also discuss the issue of MPT, liability management, risk and portfolio structure in the following document.

http://www.moneymanagedproperly.com/technical%20docs/Fundamentals%20of%20Asset%20Allocation,%20Weaknesses%20of%20MPT%20and%20a%20Fundamenrtal%20Portfolio%20Foundation.pdf

Income Trusts – 27 April 2007

WealthyBoomer.ca, Deceptive trust yields need investigation?

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/04/27/deceptive-trust-yields-need-investigation.aspx#comments

I cannot fault Mr. Levant for sheer bravery because only a brave man in total command of the facts would want to take on Al Rosen in figure to figure combat.

Unfortunately Al Rosen has written at length over the impact of intangibles and as far as I am concerned is well aware of their impact on income trust valuations. I would not wish to cross swords with him on this issue or any other accounting issue for that matter.

I would counter that once you bring intangibles into the equation, the urgency of the issue of return of capital becomes more and not less pronounced and the ability to mislead and misrepresent greater and not less.

I also fundamentally disagree how the ordinary investor can possibly make an informed decision by reading the income trust prospectuses alone and will substantiate this in future reports. There are some well written textbooks on differential calculus that I would recommend as an easier read for the retail investor than the standard income trust prospectus and that is both perverse and true.

If anyone wants to read up on intangibles just go to your local library and pull out the International Accounting Standards handbooks and read IAS 38 and the relevant IFRS. Also, for a valuable comparison of the treatment of intangibles in Canada read the CICA handbook on the same subject. Then go to an income trust such as Yellow Pages and try and make sense of their treatment of intangibles and, yes, Al Rosen has some valuable comments on this too.

Because the costs of internally generated intangibles are largely expensed, you will not be able to pick up on return of capital as easily as you could if the business depended mostly on tangible assets. All that can be readily seen in income trust financial statements is the amortization related to the capitalization of a limited number of intangibles that have been acquired. Brands and other intangibles are fickle commodities. If anyone wants to read up on how much one the world's biggest brands has to spend to keep its brand intact just go to Coca Cola and compare Coca Cola's financial statements with an intangible bloated Canadian income trust.

Income Trusts – 25 April 2007

WealthyBoomer.ca, Selling opportunity for income trusts?

http://network.nationalpost.com/np/blogs/wealthyboomer/archive/2007/04/25/selling-opportunity-for-income-trusts.aspx#comments

Fury over tax leakage clouds real trust issue

With respect to the above article I would like to make a few contextual enhancements to some of the comments made. Before I do so would like to point out that Jonathan Chevreau attempted to contact me before the article went to print but I was unavailable for comment.

First of all I would like to point out that I did not specifically say that investors should be selling their holdings. This is a complex area for their advisors to manage, or if individual investors are managing their own investments, a decision they have to make themselves.

However, we did talk about what investors should be doing and quite frankly Jonathan is right to be digging for an answer here. All we have heard about since the tax loophole was closed is the outcry over the "government's error". Rightly or wrongly the advisors who put investors into these investments or the individual investors who thoroughly valued and bought these investments on their own behalf should have been aware of the risks and should have mitigated these risks through portfolio structure and risk/return management; valuation, allocation and the management of the two. If they had mitigated these risks, those with appropriate allocations to income trust holdings should be able to weather the storm no problem.

My point with regard to a point blanket sale was that this was not really an option for the majority of investors. If everyone were to sell, prices would fall like a house of cards and we would end up with investors selling at ridiculous prices. There is no way every investor can sell their holdings and get out at a reasonable price. Recommending a blanket sale is therefore not a consideration. But this does not help the ordinary investor that does not possess the valuation and portfolio management expertise necessary to make this decision or to manage the risks if exit is not warranted.

The hard truth is that for those who are inappropriately exposed to income trusts, managing the allocation and the consequences of an inappropriate allocation will be a very difficult job. At least some of the current furor is related to this problem. How do we all head for the exit at the same time whilst keeping our physical shape? The answer is we cannot, it is a physical impossibility.

We did quite rightly talk about private equity. My comments with regard to private equity was that this capital was clearly providing an exit route for many income trust investors, a route that would not be available in a less accommodating credit environment, bear market or recession. We also discussed the fact that private equity was paying heady cash flow multiples for acquisitions in general and that all things considered income trust prices could well be benefiting from this largesse.

Jonathan is right to treat the issue of income trusts as one demanding of answers that relate to the immediate reality. There has been an accident, what is your first priority, attaching blame or seeing to the health and safety of the survivors? Should they be selling, or should they be holding and why?

Getting into an investment is always the easy bit (getting others to accept your money), getting out is the hard bit (getting others to give up theirs). Any investment professional worth their salt should have a sound valuation basis for their security selection and asset allocation and if they do not possess the valuation expertise to have at least a disciplined asset allocation process capable of managing the market risks of such an allocation.

Finally, and back to the whole point of this particular report. The taxation arguments put forward by the pro trust lobby group just do not add up. Quite why individual investors should be clamouring for the return of highly priced and hence higher risk investments that distribute taxable return of capital is beyond me. I just do not get it and I have seen no report that fully substantiates such a line of argument.

The Insanity of Income Trusts Part 1 was not financed by any particular group or individual, with any particular bent. It was written independently without financial or other incentive.

Andrew Teasdale

http://network.nationalpost.com/np/blogs/wealthyboomer/default.aspx?PageIndex=20