THE TAMRIS REVIEW
Products & Related Issues
September 2005

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This review focuses on products, the reasons for their recommendations and provides a critical look at their overall raison d'etre.

It looks at some key products (balanced funds, model portfolios, Principal Protected Notes, segregated funds) and their impact on an individual's financial position. In the same context it provides a critical perspective on income trusts.

Why are products sold? Who do they benefit and what are their risks? What should advisors be doing and, what should they do to justify their recommendations? Read on………

Products, the whys and wherefores

Most advisors do not possess the expertise needed to personally construct, plan and manage portfolios. This is one of the reasons the industry is product and transaction driven.

Products are packaged solutions that allow advisors to sell investment expertise and solutions to problems without needing to possess the expertise themselves.

All they need to know are the benefits of the products and, to whom they are most attractive.

While many products are necessary and help deliver effective financial solutions to investors, many more are not and, those that are, are often incorrectly applied.

The trouble with products is that more often than not, they represent one off solutions. They also tend to be more expensive and, are often difficult to integrate into a portfolio structure or, an integrated financial solution.

The risk for investors in being advised by individuals who sell products is that many will end up with a collection of products and, not a portfolio of investments. They also risk lower returns, higher costs and ultimately in consequence, greater risks.

The major problem with a product is that it is designed as a solution to a single problem.

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

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

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

What problems do products solve?

If you are a conservative investor and only want to invest in lower risk investments, an advisor who depends on commission for their remuneration is unlikely to be able to earn any fees/commissions from you.

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By providing you with a product that apparently protects you against the risk of stock market investment while giving you a stock market return, the advisor can convert your capital into an investment which provides remuneration not only for him or her, but for the financial institutions that create these products.

As such, this is one of the reasons for product development and the financial institutions that develop them are more often than not the major beneficiaries.

A good advisor will not use one sided arguments to induce you into any investment, but should give you a well balanced and clear explanation of the risks and rewards of investment.

But just what is a good advisor and, just what do they need to possess to be able to give you the education you need, to help you make your decisions and, ultimately, to help structure your assets to meet your financial needs over time?

These qualities and requirements are discussed in the TAMRIS website, in particular the sections on "is your money being managed properly" and "what your wealth manager should be doing".

This TAMRIS review looks in particular at a number of products, their problems and what your advisors should be doing to justify their recommendations.

Products and portfolio structure

Every asset within a portfolio has a role and a relationship with every other asset. Where the portfolio is structured to meet financial needs over time, every asset also has a relationship with the size and timing of financial needs over time.

Every product that is sold will affect the shape and structure of your portfolio. Merely stating that a product reduces risk and increases diversification is not enough. Your advisor needs to be able to assess the effect of its inclusion on the structure of your portfolio and its ability to manage current and future financial needs.

In truth all your needs can be met from the basic asset classes; cash, fixed interest and equities. Many products merely represent expensive combinations of all three. Since you should have all three in your portfolio, irrespective, it is unlikely that a hybrid product will reduce risk or provide worthwhile extra diversification over the long term.

In fact, what makes products difficult to add to portfolios is the fact that they often incorporate many of the characteristics of the different asset classes. They may themselves have an internal relationship, but this specific relationship is incapable of relating to the investor's own portfolio relationships.

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

So why add it? Of course, the institutions that develop these products do not have your needs in the forefront of their minds. If they did, they would develop integrated solutions and not products, they would lower costs and only sell you assets which truly reduced risk and enhanced return..

What should your advisor do?

If you care about the standard of advice you are receiving, your advisor needs to justify the recommendation within a portfolio construction.

- Does the product complement the roles of all other assets without having to force the sale or the purchase of another investment?

- Does the addition of the asset positively affect the ability of the portfolio to manage risk and return and meet financial needs at any point in time and at all points in time? If this is stated as a reason, it needs to be backed up.

- Is the advisor able to model the interaction of the new asset within the portfolio and its ability to meet financial needs over time?

- Does it provide better management of liquidity? Is it cheaper? Does it provide the opportunity for better performance?

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

The detailed mechanics, the pros and the cons, of the product need to be provided in summary form and in plain English. While a mandatory prospectus is necessary, the investor should not have to rely on it to find the salient details.

If your advisor is not full frank and honest, he or she is either unscrupulous or incapable.

Products Under A Microscope

The following section describes a number of the more popular products that investors are sold, their drawbacks and their effects on portfolio structure.

Detailed descriptions of these products can be found virtually anywhere on the internet and from your advisors and the objective of this review is not to introduce you to these types of investments.

What many readers of this review will not find is the objective analysis of these products provided herein.

Balanced funds

These are funds that provide a balanced exposure to cash, fixed interest investments and equities.

They are often referred to as conservative investments and sold as such.

But the truth is that management expense ratios (MERs) on many of these funds defy logic. Consider a fund with a 2.5% MER and say a cash allocation of 10%, a bond allocation of 40% and an equity allocation of 50%.

A 10 year government of Canada bond yielding some 4.2% would provide a yield of 1.7% after these charges. Deduct the management expense ratio from the cash returns on the fund and you have a negative cash return.

Are these really lower risk investments, or are the management fees exposing the investors who hold them to long term financial risks?

Even the very small investor who may have very limited options should be provided with a better solution than this.

Investors need to appreciate that there are low cost managed bond fund options available just as there are low cost investments that access stock markets. Exchange traded funds allow access to the Canadian bond market and equity market at management expense ratios of 0.25% and at much lower initial transaction costs.

Balanced funds in general are for those advisors who do not know how to construct even the simplest portfolios.

Holding your low risk investments in a balanced investment vehicle reduces the effectiveness of the low risk investments.

Why?

If you need access to the capital, you have to sell units in the fund. You cannot just sell the low risk component of the fund. If equities have fallen in value, you will be selling both low risk investments as well as equities. The benefit of the low risk investment is lost.

Proper portfolio structure, whatever your wealth, should ensure that you should not have to sell equities at the same time as you need access to lower risk investments.

If these portfolios were simply cheaper and more competitive they may yet provide some value to the smaller investor. As it is they are more likely to harvest wealth for the product provider than the consumer.

Model portfolios

Model portfolios represent another financial services product designed to override the lack of expertise at the point of sale and are just larger versions of the balanced fund.

Many of these investments incur high management expense ratios and incorporate all asset classes within one investment structure; cash, fixed interest investments and equities.

Some portfolios are paying at least 2.8% a year for a 50% cash and fixed interest content. What on earth is the point of holding low risk assets in such a high expense environment?

Additionally, model portfolios are incapable of dealing with an individual's personal financial needs. By their very structure, they assume that you will not need access to the capital.

As already stated, combining fixed interest content with equity content within one unit holding degrades the lower risk characteristics of the investment if you need access to capital. Overall, you end up with a higher cost, lower return investment.

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A cheaper and more efficient portfolio structure would have the cash and fixed interest allocations managed separately at much lower cost. The lowest cost structure of all is to hold fixed interest securities directly.

As noted in the TAMRIS website in the section dealing with costs and value for money, please pray what is the advisor doing receiving a 1% trailer fee when the security selection, asset allocation and the asset management is being handled by someone else?

Segregated funds

Segregated funds are insurance contracts with investment content and are essentially mutual fund investments with an element of insurance.

These funds can provide a guarantee of up to 100% of your initial capital invested, provided they are held for a full 10 year term. What this means is that if at the end of the 10 year period the capital value of your investment is below the initial capital you invested, the company will guarantee to repay the balance.

Therefore, if you are a conservative investor who wants to take advantage of stock market investments but is afraid of the risk of losing your money, these may seem a good idea.

Investors need to consider the following.

It is not uncommon to see these funds with management expense ratios in excess of 4% a year. The management expense ratio does, however depend on the guarantees you are looking for.

> The lower guarantee of 75% is hardly worth the cost. If we assume annual inflation of 2% over a 10 year period, the guarantee is really only 57% of the value of your initial capital in today's money.

Additionally, many segregated funds are balanced investments with allocations to cash and fixed interest investments. While a conservative investor may feel more comfortable with a conservative asset allocation, it makes no sense at all to hold lower risk assets in a fund with such high charges. All the benefits of the low risk investments are being eaten up.

Additionally, if you want a stock market investment, why pay up to 4% a year for the privilege. .

- A fund with a management expense ratio of 4.4% would mean that your investment would have to provide a total return in excess of 53% over the ten year period before you made a profit.[1]

- A fund with a management expense ratio of 3.25%, would mean that your investment would have to return 38% before you made money.

- An exchange traded fund with an MER of 0.25%, would require a total return of only 2.5% before you made money.

Investors in segregated funds are more likely to need the guarantee because of the charges than because of the risk of stock market investment.

The above breakeven points do not even include the effect of initial transaction costs.

Over ten years, the risk of a stock market investment declines significantly.

If stock markets are highly valued and pose a risk to your future financial security, then your advisor should be aware of these risks and adjust the investment strategy accordingly.

A well structured portfolio, where the advisor takes into consideration your risk aversion and financial needs should be able to provide you with the security you need and an allocation to stock market investments at a much lower cost.

If you really are concerned about the risks of equity investment then you would probably be better off in a low cost, low risk investment vehicle than a higher risk, higher cost segregated fund. Your segregated fund with a 4.4% MER would be hard put beating the return on a 10 year government of Canada bond (with no MER), even with the income from the bond reinvested at the low rates of interest currently available on cash deposits.

> Investors who are concerned about the ups and downs of stock market investments, please note that segregated funds will be going up and down just like every other investment. If you need access to the money within 10 years, you are not only

[1] This is just a simple compounding of a 4.44% MER on some segregated funds. This rate is more or less equal to the annual rate of return needed for an investment with no initial costs to breakeven. The same goes for the other examples.

taking the same risk but are ***paying through the nose*** for the privilege.

Bottom line!

Investors need dividends and interest from their assets and long term capital growth in order to meet their financial needs over time. Segregated fund charges eat up the interest and dividend income and reduce the potential for capital growth, acting as a drag on your financial security.

Segregated funds are more often than not sold by those without portfolio construction expertise and the net result of a transaction is the conversion of your capital into a vehicle that generates returns for your advisor.

Principal Protected notes

Investors, please note that a "well structured" portfolio should provide you with all the features of a principal protected note; that is capital security and the potential for capital growth, all at a lower cost.

What a principal protected note does provide, is

- little or no income relative to a lower risk investment,
- little or no liquidity relative to both a lower risk asset and an equity and,
- less potential growth than a pure equity investment.

What they provide is a guaranteed return of capital invested (**not a guaranteed return**) in the notes and the opportunity for an equity type return if the "equity component" of the structure provides a return in excess of management fees and charges.

> The cost of this guarantee comes at a price; an initial charge (advisors can get up to 4.5% commission) and annual management expense ratios of up to 3% (most have expense ratios of 2.95%).

While the investor purchases the note which is guaranteed by a financial institution, the capital raised is invested in a combination of real investments and derivatives or notionally invested in real assets via derivatives.

Ostensibly, principal protected notes offer the conservative investor the opportunity to obtain stock market returns while at the same time providing them with a capital guarantee on the initial investment.

2.95% compounded over 7 years is give or take 22.5%. This is more or less the hurdle rate of return on the investment. Any return above this is yours. However, when looking at the rate of return you would need from the note, you need to compare it to the rate of return on other investments.

> For example, let us say the yield to redemption on a government 7 year bond was 4.5% and the initial transaction costs were 2%, a PPN with an initial charge of 4.75% and an annual MER of 2.95% would need to earn a return of 9.3% per annum to clear the costs and fees and equal the return on the bond. This assumes the bond yield is reinvested and accumulated at 2% interest. This example does not include the effects of taxation, but is designed to show the cost and return profile of PPNs.

What does this mean? It means that the only way you are going to get a decent return from this investment is if equities are fairly valued, because otherwise how the hell are they going to generate 9.3% per annum total return over 7 years. It also means that you may be just as well off in lower cost lower risk investment.

Most notes currently being offered have a minimum term of seven years. If you are a conservative investor and you depend upon your assets to meet your financial needs, you should not be exposed to stock market risk over a seven year period anyway.

Another problem with protected notes is their impact on the structure of a portfolio. They ultimately incur additional costs and risks.

Where do you take the capital from to make the investment?

Do you take it from a lower risk asset?

> By taking lower risk assets away from the portfolio for seven years, more lower risk investment need to be purchased to bring back the yield and liquidity.
>
> This will mean selling equities or other longer term investments, which means more transactions.

Do you take it from an equity investment?

> An existing equity investment will already have incurred its transaction costs, selling it will incur additional costs.
>
> If equities are so highly valued and there are not attractive opportunities (domestically and globally), is the only option to sell them and buy a principal protected note?

If your advisor is charged with the construction, planning and management of your portfolio, he or she will not be able to manage the allocation under pinning the note. But, they will receive the 4.5% commission and of course a trailer fee.

> **A good advisor, if indeed, there is a role for the investment, would give you both the initial commission and trailer fee, because they would already be charging you a fee for the management of your assets.**

Investing in any asset with high costs, low levels of liquidity and limited opportunity for return should be a difficult sell for any portfolio.

Discipline is important, and, if the discipline of your asset management is to use these investment vehicles over the lifetime of your portfolio, your return and financial security will most likely be lower and your costs significantly higher.

If your manager is concerned about market valuations, there are cheaper and better shorter term risk management solutions available.

These investments are great ideas for salesman who cannot construct portfolios.

They are great ideas for banks who want to turn your capital into fees.

If your advisor is recommending them!

- Ask them for the point at which the return on the investment will cover the fees and initial charges. It is beyond this point that you will be receiving a return on your investment.
- Ask them to compare the fees and expenses on the investment relative to lower cost equity and fixed interest investments.
- Ask them to calculate the return required on the underlying active investment to outperform a low cost lower risk investment.
- Ask them to illustrate the impact of the investment on the structure of your portfolio and the portfolio's ability to provide liquidity as well as return.

Ask them to tell you exactly how much they are earning.

Where there is indirect investment in say a mutual fund the manager must point out the risks of the fund, they must also be able to value the underlying investment and to give you an assessment of its valuation and its risk.

Income trusts

Income trusts are companies that have converted to a legal trust structure.

Trusts allow "companies[2]" to distribute to shareholders their cashflow free of corporate taxation. However, the trust structure means that companies must pay out all their cashflow.

Income trusts provide very high yields compared to the yields available from traditional stocks. This makes them very attractive at a time when interest rates on cash and conventional fixed interest investments are relatively low.

However, investors must realise a number of important factors.

- Companies that are growing need to retain earnings to invest in future growth. If all earnings are paid out, future growth in earnings and hence future growth in the share price may be limited.
  - o Because all cash flow is paid out, what investors are effectively doing is swapping future income for current income.
- While the payments from the trust enable investors to receive a more tax efficient income

[2] They are no longer companies in that they are not governed by company law and corporate taxation, but they are companies in the sense that they are still viable businesses.

today, investors are sacrificing future capital growth, which is itself taxed more advantageously than income.

  - While retained earnings are indeed taxed within traditional corporate structures, retained earnings applied to future investment do effectively receive tax relief.

- Companies that pay out all income risk depleting the capital that underpins the company's ability to generate income.

  - The risk therefore is that future income from these trusts may fall and the value of the price of the trust. Traditional stocks on the other hand, provide opportunities for growth of both dividends and capital.

  - Including income trusts within the portfolio may have an impact on the long term ability of the portfolio to provide for financial security. This needs to be managed.

- The high level of distributions in a low interest rate environment may force an incorrect valuation of the income of the trust relative to the trust's underlying assets and the relationship between the ability of the trust's assets to provide income over time.

  - Because the valuation of the trust is very sensitive to income distributions, falls in a distribution are likely to significantly affect price. If you actually rely on the capital as well as the income, your security may be at risk if your portfolio is incorrectly structured.

- While the conversion to a trust will reduce the tax on income, the cost of that income will have risen as a result of the conversion. A company's stock has tended to rise prior to a conversion. One of the main benefits of a trust conversion is the ability of the previous shareholders to realise greater shareholder value. Purchasers of the trust have actually paid more money for the capital of the trust, thereby effectively neutralising a portion, in value terms, of the enhanced income tax benefits.

- As such, the risks of these investments need to be carefully managed. A proper portfolio structure and advanced planning is important.

Specific information on income trusts can be obtained from your investment advisor and there are many resources available both online and in the business sections of your local libraries.

Effect on portfolio structure, planning & management

If the income from your investments is insufficient to meet your financial needs, then it may be tempting to include income trusts to raise this yield.

Investors need to be aware that the effect of this could result in long term depletion of capital. While long term depletion of capital is a reality for most investors, it needs to be carefully planned and managed within your portfolio structure.

Because the value of the capital and the distribution from these investments is subject to risk, your portfolio should be able to cope with a large fall in both the capital value and the income distributions without affecting the ability of your portfolio to meet your financial needs over time.

This means careful structure and conservative asset and liability modelling.

If the income from your investments is more than sufficient to meet your needs, buying income trusts will raise the income from your portfolio to levels which may be inefficient. Excess income needs to be reinvested, which raises transaction costs.

Whether an income trust is of benefit depends on the valuation of the trust and the risks to the ability of the trust to maintain distributions. Unlike a product, an income trust provides a much cleaner and more efficient access to its main asset class, thereby enabling it to be more easily incorporated within a portfolio structure.

Income trusts are complex vehicles

An advisor needs specific expertise in valuing companies and the risks to the ability of these companies to meet future distributions and, specific expertise in managing the risk of income trusts within a portfolio structure.

Income trusts are far more complex animals than straightforward fixed interest investments and should not be compared to them. The long term risks of distributing all cashflow also means that they require a slightly different methodology for assessing their risk return profile than a normal stock.

Above all, your advisor needs to be able to manage the long term risk of the investment within your portfolio and should clearly address these risks and, how their strategy will deal with them.

Any advisor can recommend investments, but, few know how to value them, how to position them within a portfolio and how to manage them properly.

Misrepresentation

It seems as if the investor is fair game. Many products can be sold in today's market place with misleading assertions (in the sense that they are not supported by balanced arguments) and insufficient justification and consideration of the transaction and its impact on portfolio structure, planning and management.

Products do not just affect today's portfolio, they impact on tomorrow's portfolio, on every investment in the portfolio, on the risk and return management, on the costs and ultimately on the portfolio's ability to meet future as well as immediate financial needs. Above all they cannot be considered on their own merits alone.

The Dark Ages

Financial Services in Canada are still stuck in the dark ages and, while the standards of the industry may have been acceptable in the early stages of its development, current standards of service, disclosure and professionalism are below what is acceptable and achievable.

Charges in general are far too high and products are often recommended with insufficient justification. There is far too much hype and insufficient balance in the representation of the risk and return characteristics as well as costs of products.

Financial services education needs to change from an over emphasis on products and "suitability" to an emphasis on the rationale and justification for the transaction within the portfolio construction, planning and management process.

Above all, there is a tremendous dearth of expertise available to construct, plan and manage portfolios capable of relating the management of assets (both their risk and returns at a point in time and over time) to the management of financial needs at all points in time.

TAMRIS is an Asset Management Research & Investment Rights consultancy dedicated ***"towards improving the structure and quality of wealth and asset management for the private investor, to creating a competitive financial services market place, to educating those in positions of responsibility about the reality of and the need for the integration of the management of assets and the management of financial needs and, to rid the industry of endemic and institutionalised financial abuse."***

TAMRIS does not earn a return from advising on the buying or selling of products and specific securities, nor does it earn its return from managing assets or from wealth management referrals. It also does not publish newsletters recommending investments nor does it earn any return from advertising industry products or services. TAMRIS is completely independent of the conflicts of interest inherent within the financial services industry.

This review is not intended to endorse or recommend any product but to raise issues relevant to the use of products within an investor's wealth and asset management services.

It is intended solely to raise awareness and to provide the individual investor with a perspective they may not be receiving from their advisors. If they are receiving this perspective then this review will serve to reinforce and support those advisors that are managing your money properly.

Investors need to understand that we live in a market place where the demands of the consumer are key to shaping and influencing the standards of service they receive.

If you do not question and you do not demand high standards, why should the industry listen and bother to deliver them. Competition drives prices. This a critical rule of a competitive market place.

So demand!