HIGHVIEW FINANCIAL GROUP™

Facilitating Excellence in the Management of Wealth

Back to Basics

By Greg Rodger, CFA, *Chief Investment Officer* — HighView Financial Group

January 2008

> *"Ben Graham wasn't about brilliant investments and he wasn't about fads of fashion. He was about sound investing, and I think sound investing can make you very wealthy if you're not in too big of a hurry. And it never makes you poor, which is even better."*
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> *Warren Buffett, CEO, Berkshire Hathaway Inc.*

Introduction

On January 17, 2008 Merrill Lynch reported a net loss for 2007 of $8.6 Billion. Much of this loss was attributable to write-downs of $22 Billion related to Collateralized Debt Obligations (CDO's) comprised of Asset Backed Securities (ABS's) and exposure to U.S. sub-prime residential mortgages. In his commentary following the release of these eye-popping results John Thain, Merrill's new CEO, emphasized the importance of returning to the firm's bread-and-butter business of selling stocks and bonds to investors and stated "none of the trading businesses (within Merrill) should be taking risks…that wipe out the entire year's earnings of their own business, and of course they certainly shouldn't take a risk that could wipe out earnings of the entire firm". What Mr. Thain is of course referring to is the need for proper and effective risk management.

Unfortunately Merrill Lynch is not alone in this situation. Many of the world's largest financial institutions got caught up in taking on too much risk in an effort to generate significant profits. We suspect some firms knowingly took on significant amounts of risk assuming (incorrectly) that they could manage their way through the rough times when and if they arose. However, many other firms appear to have ventured into the sub-prime mortgages, ABS and CDO minefield without really understanding the kind of risk they were exposing their firms (i.e. shareholders) to. Neither is acceptable, but in many ways the latter is worse and is a situation that has repeated itself throughout history. Those who should know better follow along blindly with the latest investment fad in hopes of earning substantial profits and out of the fear of being left behind by others who are aggressively pursuing the flavour of the day.

While this is an example of what has happened at many large corporations, unfortunately the same can be said for individual investors. No matter how many times a "can't miss" investment trend implodes, investors have demonstrated a regrettable penchant for chasing the latest short-cut to wealth creation. Let's have a look at few that have taken place just over the past decade.

The Tech Bubble

During the late 1990's and into early 2000 many investors thought their Advisor was out-of-step with reality if they did not have them heavily invested in technology stocks. After all we were in a new environment where the internet was going to change everything and the traditional measures of valuing a stock were no longer appropriate. It was even suggested that Warren Buffett had "lost his touch" and was no longer relevant since he did not own any technology stocks.

On a personal note, in late 1999, I had a client with significant wealth (in excess of $50 million) who I had invested in a well diversified portfolio of stocks and bonds which was well structured to meet his goals, objectives and risk tolerance. After numerous meetings where he expressed his frustration with our limited exposure to technology stocks he closed his account as he said he had been doing some of his own trading and was significantly outperforming what we were doing for him and for that he did not have to pay a fee. Two years later, after the technology bubble had burst, the same individual came back to me and said "I now understand what you were trying to tell me" (about the benefits of proper diversification). He opened his account again and we began to reinvest his significantly smaller portfolio.

Unfortunately this story is not unique. Many investors and many Advisors got caught-up in this new-economy theory and put an inordinate amount of their assets into this single asset class with the expectation that it would continue to generate incredible returns. However, as we all now know, the sell-off was swift and painful.

FROM MARCH 2000 TO SEPTEMBER 2001, A LITTLE OVER 18 MONTHS, THE TECH-HEAVY NASDAQ INDEX LOST OVER 70% OF ITS VALUE.

Income Trusts

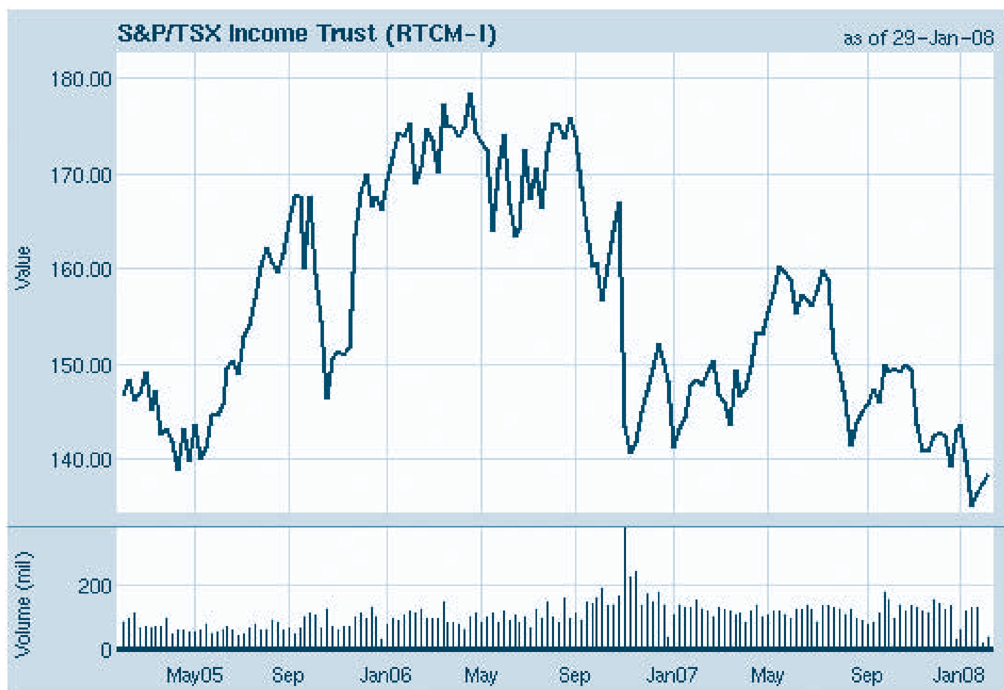
In an era of relatively low interest rates, many investors have been seeking investments that will provide a higher level of income than they receive on their bonds or GIC's. Income Trust units appeared to be the perfect solution to meet this need. Many of these structures provided an income yield of 6% or more and did so in a tax efficient manner. What could be better? Investors in Canada flocked to these types of issues and as demand increased the Investment Bankers were more than happy to meet that demand with a growing supply of new Income Trust issues, many of which were of questionable quality and did not suit the Income Trust structure which was really designed for mature companies with steady and predictable excess cash flows.

One of the common mistakes investors have made when investing in Income Trust units is viewing them as a replacement for GIC's or bonds and expecting them to be just as safe. In reality they were (and still are) equity investments which happen to have a large payout. Many of the most conservative investors (e.g. retirees on fixed incomes) put a large amount of their hard-earned savings into these investments in an effort to enhance their income. Then, two things happened:

1) Some of the lesser quality Income Trusts realized they could not maintain the income payout ratios that were initially planned so they had to significantly reduce them (or suspend them altogether). Investors received less income and watched as the unit values of their investments dropped substantially.

2) In his now infamous Halloween surprise (October 31, 2006) Canada's Finance Minister, Jim Flaherty, back-tracked a Conservative Party promise, and announced a change to the way in which Income Trust distributions would be taxed (commencing in 2011). This led to an immediate and drastic reduction in the value of the entire Income Trust sector. While some have recovered from that initial plunge, many have not.

Below is a chart of the S&P/TSX Income Trust Index over the past 3 years. As can be seen, from its peak in May of 2006 to its current levels, this index has dropped by over 25%. For an equity investor this type of decline is certainly not unprecedented and should be expected from time-to-time. However for those ultra-conservative individuals invested in this space, this was an extremely difficult period to stomach.



Principal Protected Notes

During the three to four year period prior to 2008, Principal Protected Notes had been some of the best selling investment products both in Canada and internationally. And make no mistake about it they are products. These are investment vehicles that have been packaged-up and marketed by financial institutions. On the surface they seem like a great idea for conservative investors. They offer the up-side potential of various stock markets or sectors with a guarantee that you will get at least your principal back at maturity. However, one of the challenges with these notes is understanding what you are truly getting and what fees are imbedded in them. With many of these offerings you are paying a very steep price for the downside protection and you are locked in for a pre-determined amount of time with little if any liquidity. Also, in the current environment it is very likely that many investors in these notes will be getting their original principal amount returned to them and no more. For a conservative investor who has been invested in one of these for the past 5 years a return of 0% is not going to be very appealing. In fact, when you factor in inflation they have actually lost money. If we assume inflation averaged 2% over the 5 year holding period and the investor received back only their original capital, their actual return is a compounded annualized rate of -2.2% after inflation. We suspect the financial institution that engineered the product will have faired much better.

These are just three examples of some of the "hot trends" that investors have chased in the past few years that have gotten many into trouble. This list is obviously not exhaustive and there are numerous other examples such as hedge funds that have imploded, Asset Backed Securities that have not been able to repay investors upon maturity, etc. As Advisors meet with potential clients, they should keep in mind that many of these individuals may have experienced this type of frustration over the past number of years by either trying to manage their investments on their own, or by taking poor advice from their Advisors, who too often do their best to sell the latest hot trend.

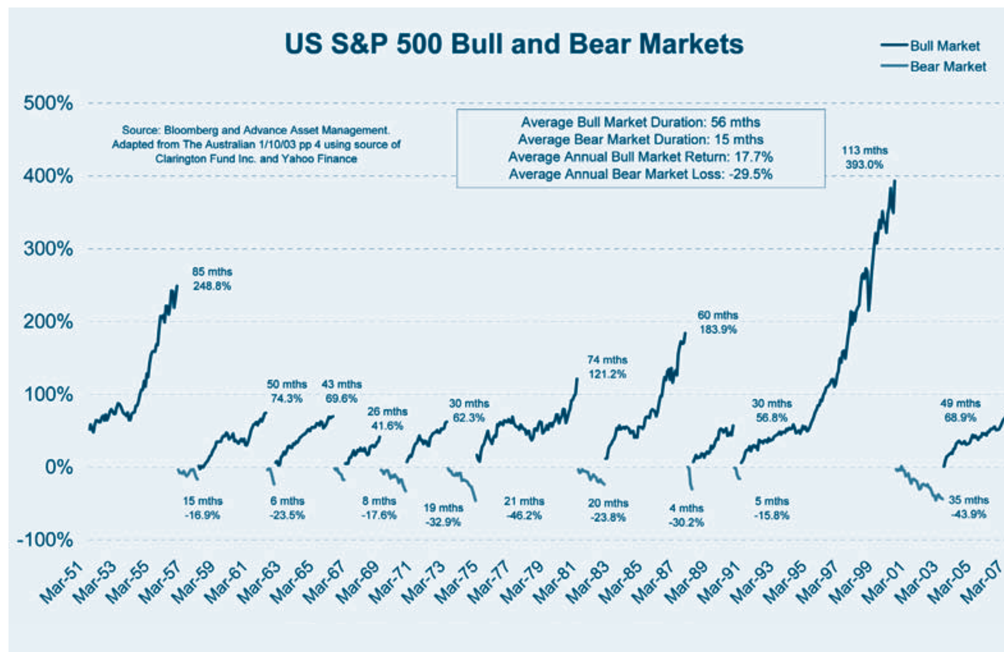
So what is an investor (and Advisor) to do? Much like John Thain (of Merrill Lynch) has recognized, the best advice is to focus on the basics, understand the risks, and manage those risks effectively. From an investor's perspective, the basics include stocks, bonds and money market securities. Most other investments are some derivative of these core components.

We believe to be successful an investor must focus on the following:

- Understand their short-term and long-term needs, goals and ability to withstand short-term fluctuations in their portfolio value (i.e. risk tolerance)
- Document all of these needs, goals, and risk tolerance in a detailed Investment Policy Statement (IPS). This document should be referred to on a regular basis and provide you comfort when a market downturn has you questioning why you are invested the way you are.
- Invest in a portfolio that is professionally managed, well diversified (but not over diversified) and designed to meet all of their unique needs which have been detailed in the IPS. The portfolio structure should only change when the investor's needs and/or goals change, not as a result of changes in the markets.
- Search out and engage great quality managers with a proven ability to add value over time.
- Have a deep understanding of the risks (or hire someone who does) and monitor those risks closely.

To those who say this type of investing is boring and unlikely to produce spectacular returns, I say "you're right". But, if done correctly it should produce the returns one requires over the longer term and will moderate the losses when unexpected events take place (which they always do). As Warren Buffett said in the quote at the beginning of this article, *"…sound investing can make you very wealthy if you're not in too big of a hurry. And it never makes you poor, which is even better."*

Even in a well constructed portfolio designed to meet their needs, at certain points in time, such as the market environment we are currently experiencing, the investor is going to feel quite uncomfortable. As an investor's emotions swing from greed to fear their natural instinct will be to sell their stocks during a market downturn. Or, they will feel that their Advisor should have at least discussed with them the option of reducing their exposure to stocks prior to the market sell-off. Clients have been known to say to their Advisors phrases such as "it was obvious that the markets were heading for a tumble, you should have sold". And indeed with the benefit of hindsight, a market sell-off is perhaps understandable with all the information that is now known. The problem is, it is not possible to predict short-term market movements with any degree of certainty or consistency, and the price you pay for being wrong can be severe (opportunity cost). Also, it is not only the timing of the decision to get out of the markets, but of equal importance is the decision as to when to get back in. While an investor will always feel distinctly uncomfortable during a market correction, they should take solace in the fact that corrections are generally short-lived and over the longer-term the global equity markets tend to rise more (in both quantity and duration) than they fall. The chart below highlights this point.



What Do The Ultra-Wealthy Do?

We at HighView Asset Management have been fortunate to have had the privilege of dealing with some very affluent families (i.e. in excess of $100 million). The process we go through with them is very similar to what every individual investor should go through. We work with them to truly understand their needs, goals, views on risk and based upon that knowledge construct detailed Investment Policy Statements. From there we arrive at an appropriate Asset Allocation Framework and then create an Investment Mandate for each Asset Class. All of this clearly articulates the overall structure that the portfolio will take and the guidelines within which each component will operate.

Once the portfolio structure has been decided upon, we then seek out outstanding managers to fulfill each of the Investment Mandates, and then engage each of those managers directly to manage each portion of the overall portfolio. On an ongoing basis, our job is to ensure the IPS remains relevant, to oversee each of the underlying managers, and to present reports to the family so they can see how each component of their portfolio is doing as well as the overall portfolio itself. This is a very common methodology in the Family Office world and is quite similar to the process that Pension Funds go through.

For investors of more modest means, there is no reason they cannot engage in a similar disciplined process. The challenge is that they are unlikely to have assets large enough to allow them to directly engage some of the world class money managers that those with more wealth can. The solution is a professionally run Multi-Manager Managed Account Program. Assuming the client is effectively profiled at the outset, this type of solution will provide the individual investor with a well structured, prudently diversified portfolio, run by outstanding underlying managers. Further, the client can rest assured that each of the underlying managers is being professionally monitored on an ongoing basis and will be replaced if circumstances warrant.

Even within these Managed Account solutions clients are going to feel short-term pain when the markets correct. The role of the Advisor is to prevent them from giving in to their fear and changing their portfolio structure. And, the opposite is just as important. During those times when the markets appear to be going straight up, the investor is likely going to feel their portfolio structure is too conservative and perhaps they should have more money in stocks. It is important for the Advisor and the investor to resist these temptations. By the way, we face these exact same issues with the ultra-affluent as, at the end of the day, they are still human beings behind the money and they also, from time to time, let their emotions get in the way of sound decision making. However, it is the disciplined policies, procedures and guidelines that prevent them from making ill-advised moves.

What history has taught is not that we should necessarily avoid things such as technology stocks and income trusts when they become popular, but like most things in life, moderation is critical. Merrill Lynch was not necessarily wrong to get into CDO's and sub-prime mortgages. The mistake they made was taking on too great of an exposure to them.

When we focus on the basics, set realistic expectations, understand the risks, manage those risks effectively and are patient, great things will come irrespective of what the market may do over any short period of time.

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HighView is based in Bronte Harbour in Oakville, Ontario. The Town of Oakville is a beautiful community situated on Lake Ontario, just 30 minutes from Downtown Toronto.

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Updated January 13, 2010