Contents:

1, October 1998 was the best month in 16 years on the Toronto Stock Exchange. The media generated and reported mood of investors changed dramatically in the last few weeks. Many people see this turn of events as a new proof for the importance of investing in equities and staying invested during bad times. This assessment is probably fundamentally correct. However, an unwarranted, exaggerated faith in the fast self-correcting nature of markets has strengthened as well, … and that is foolish.

In the first issue of this newsletter, in mid-June, I cited Prof. Krugman, who argued against the overly optimistic believers of a "new paradigm" who didn't believe that a serious market correction can happen soon. At the end of September, when there was a lot of talk about recession and depression, I wrote that perhaps it was time to start/renew cautious equity investments. Now, I would like to warn against getting overly optimistic just because of what we saw in the last 2-3 months. While I still do not think that we are going into a long recession or major correction with very slow recovery soon, I think its probability is higher today than it was half a year ago. I think so because the gap between the happenings and mood of the stock markets, on the one hand, and the underlying real economy, on the other hand, has probably grown wider in the last few months. The sudden bouncing back of stock markets probably reinforced the blind faith of many people (see also: definition of 'boom'), while the economic prospects in the major markets have become less promising. All in all, even if we can avoid a serious recession, we probably do not have to wait for years for the next correction similar to the one we went through during the summer. Nobody can predict the time, duration, and extent of that next drop. What can probably be predicted is the continuation of the increased volatility experienced recently. This makes proper diversification and regular investment even more important than before. Also, this makes it important to remember Peter Lynch's comment: "the key organ [to stock investing] isn't the brain, it's the stomach".

2, The reluctance to hold on to mutual fund investments during times of crisis costs investors dearly -- as much as 10 per cent each year, - states a new study summarized below:

A new study of investor behaviour, by U.S. research firm Dalbar, shows that U.S. investors aren't heeding the buy-and-hold messages presented by fund companies and advisers. The study analyzed cash flow and retention rates to determine the "real" returns experienced by investors, as opposed to the returns of funds, over the period from January 1984 to December 1997.

The study had two main conclusions. Investors aren't holding their funds any longer than they did 13 years ago, and investors continue to act contrary to their own interests by chasing hot sectors, and dumping losing investments at the wrong time.

"When investors do not earn the returns that are published by mutual fund companies, they tend to blame the funds, instead of looking to their own behaviour and how it directly affects their real returns. Practicing a buy-and-hold strategy earns investors higher real returns than those investors who attempt to time the market and switch in and out of funds," the study notes.

In Too Late, Out Too Early

"Investors jump on the bandwagon too late, and switch in and out of funds trying to time the market. By not remaining invested for the entire period, they do not benefit from the majority of the equity market appreciation," the study noted.

The effect of this is substantial. While index-level returns would have been roughly 17 per cent each year, the actual average annualized return for a U.S. equity fund investor was less than 7 per cent. Over the 14 years studied, that's a difference between $2,482 and $9,203 on an initial $1,000 investment.

The average return for fixed-income fund investors also lagged, again due to investor impatience and trying to time hot sectors or asset classes.

The study also found that the average fund holding period for equity and fixed income investors is relatively unchanged from 1984 at about three years for both equity and bond funds. That's partially attributable to new investors, but the study said the main reason again was investors chasing hot sectors for "better returns and trying to time the market to gain from sectors or asset classes that are temporarily in favour."

Another studies shed light on an interesting gender difference in investor behaviour: women achieve better investment results than men, mainly because they trade less. Not surprisingly, women are more willing to seek and accept financial advice. There was a telling difference found even among men: Single men traded more than married ones, and, again, achieved lower returns.

3, Beside the general futility of market timing efforts, the fallacy of stock or fund picking is the other big issue which is so hard to accept, because it is so un-intuitive. Returns from various funds can be, and have been, so obviously different, even in the long run, that it is understandable why investors may focus on finding the single best fund. They make a mistake if they become too fixated on this aspect though. Research has shown that about nine tenth of investment returns from a long term portfolio comes not from hitting the bull's eye in the fund picking game, but from other factors, mainly from proper diversification among various investments. Every investor should have a clear view, based on expertise, data, analysis, and discussion of objective and subjective factors, of what kind of diversification is the best in her/his portfolio. Various experts distinguish various numbers of distinct portfolios. Using one of these systems, some historical return data (for the 1926-1996 period) of selected US asset allocation portfolios look like this:

Type of portfolio	Average annual return	Average of down years (when return is negative)	Two year return 1973-74	Worst annual loss	Best annual gain
Aggressive growth (15% bond, 85% stocks)	10.1%	-10.9%	-30.9%	-37.2% (in 1931)	46.2% (in 1933)
Growth (5% short term instrument, 25% bonds, 70% stocks)	9.4%	-8.8%	-24.0%	-30.9% (in 1931)	38.3% (in 1933)
Balanced (10% short term instruments, 40% bonds, 50% stocks)	8.3%	-5.8%	-14.5%	-22.5% (in 1931)	27.8% (in 1933)
Capital preservation (30% short term instruments, 50% bonds, 20% stocks)	6.2%	-2.4%	1.4%	-9.5% (in 1931)	22.0% (in 1982)
Short -term (100% short-term instruments)	3.7%	0.0%	15.5%	0.0% (in 1938)	14.7% (in 1981)

The table clearly shows that the more aggressive a portfolio is, the higher the return that can be expected from it on the long run. The price for this higher return is bearing with higher volatility.

4, To demonstrate how uneven any fund's performance can be, I collected the following data from Globe HySale, one of the best mutual fund tracking, comparison and analysis software products:

I made a search for funds (by category) that achieved at least 6% return in each calendar year, from 1993 to 1997. Only 2 of the possible 130 Canadian equity funds satisfied this seemingly not so stringent criteria. US equity funds were a bit better: 8 of 59. International equity funds: 10 of 58; European equity funds: 3 of 11; Balanced funds: 1 of 107.

	Total # of funds on Oct 31, 1998	# of funds started before Jan 1, 93	# of funds with at least 6% return in each calendar year, 1993-97	# of funds without negative year, 1993-97
Can Money Market	146	91	0	91
Can Bond	181	92	0	0
Can. Equity	294	130	2	40
Balanced	287	107	1	13
US & International Balanced	70	9	0	6
US Equity	219	59	8	38
International Equity	244	58	10	34
European Equity	60	11	3	9
Total	1501	557	24	231

The numbers in the last column are also interesting. They would be even more so if inflation

The numbers in the last column are also interesting. They would be even more so if inflation was also considered. More about nominal vs. real rates of returns in the next newsletter. Notice that I used calendar year returns in the table. In general, it is very important to look beyond the usually offered 1, 3, 5, or 10 year returns, because those numbers can and do significantly vary, according to the exact date (period ending month and day) of calculating them. No wonder that companies play games with this when promoting their funds.

5, Segregated funds, 'the best kept secret of the insurance industry' for many years, have become quite popular lately. Several strong features explain the heightened interest. 'Seg' funds are essentially insurance products, but without medical underwriting. They provide two important guarantees: return of invested capital at death or at the maturity, which is after 10 years. If the money is paid out as a death benefit, there is no probate fee to be paid. If a beneficiary was named, the invested amount can be protected from creditors. These features are just the bare essence of the concept, implemented with significant differences by increasingly more partnerships between insurance companies and well known mutual fund companies. (Just to indicate some of the differences: some seg funds guarantee 75% of capital at maturity, others guarantee 100, or even more; the number of possible 'locking-ins', that is restarting the guarantee period, varies widely; the insurance cost of this risk-protection is not the same either; in some cases, the death benefit guarantee is less than 100% beyond a certain age.) Especially in more volatile times, these guarantees and features can be attractive for many people. One additional feature is that these guarantees enhance long-term thinking in investors, because they help them to stay calm at times of upheaval. Also, there is one rarely mentioned feature that some people can find very useful: even when kept in an RRSP, at least until January 2001, there is no foreign content limitation as in ordinary RRSPs.

Apart from the difficulty of comparing hardly comparable seg fund offerings from various companies, there is one big problem with seg funds, in general. It is that actually nobody really knows if they are correctly priced. In most cases, the maturity guarantee will kick in only if there is a long lasting recession in the future; otherwise, the fund value will grow in 10 years, and the insurance feature is not triggered. In the unlikely, but possible, event of a long recession, or depression, however, where fund values may be lower in 10 years than at the beginning, the insurance companies have to have enough reserves to be able to fulfill their guarantee obligations. Since there is no past experience with such products built on highly volatile mutual funds, and since competition forces the insurance protection cost downwards, there is some probably legitimate concern that some of the guarantors could fail if a very bad scenario in the economy unfolds.

Keeping all the above in mind, seg funds are clearly not for everyone. They are better for seniors, risk averse people, or business owners, but probably a bad idea for young employees who want to build a retirement fund far down the road. Perhaps the most important advice that can be given for someone thinking about them is that much attention should be paid to the financial strength of the insurance company involved. Another tip can be that there is much more sense in protecting more volatile funds than funds that can only theoretically result in a loss in a ten year time frame. Finally, since the guarantees refer to the total value of funds under the contract, it is sensible to make separate contracts for each fund, so that a possible loss in one couldn't be eliminated by gains in another. (If there is a loss in ten years, the investor will want compensation from the insurance company, not from his/her own better performing other fund in the contract.)

6, Reacting to my discussion of index funds in the previous issue, someone suggested to me that with so much systemic interdependence among the participants of markets and economies, and perhaps due to highly developed and widely accessible information sources as well, it doesn't really matter today where we put our money. 'We cannot escape the system', and the returns from various investment alternatives will get evened over time. I think, there really is some movement in this direction, but the process is quite far from being finished. Having index funds in a portfolio is in accordance with the cited view, I think. As I have said, I do see sense in having some index funds in one's portfolio. It is an unavoidable fact that an increasingly high proportion of active money managers under-performed the S&P 500 or TSE 300 in the last few years. For example, as another simple search with Globe HySale revealed, there were only 12 Canadian equity funds that outperformed the TSE300 total return index in each year of the 1995-97 period. If we go back four years, we can find only 4 such funds; and if we go back five years, there is no fund that would satisfy this search criteria. The number of outperforming funds in the individual years (1993-97) were 36, 50, 43, 47, and 81, – but there was just a moderate consistency at the individual funds' level. Therefore, even those few funds that did achieve better returns for the whole period than the TSE300 were unable to do it in each and every year. However, it is not the whole story. Below, I would like to offer some recent facts that I see as evidence in favour of actively managing funds (as opposed to passively following benchmark indices).

According to an analysis of the performance of Mackenzie STAR Portfolios, since their inception in 1995, these portfolios effectively protected investors' wealth in all the five down-market periods that occurred until now. In each and every case, even the most aggressive portfolio had smaller losses than the TSE300 index.

Beside returns, low volatility of investments is also an important factor for long term growth. Individual funds are usually more volatile than the whole market. However, as the STAR example shows, with proper diversification the market volatility can be controlled. Another issue with index funds is that you cannot actually expect to get the return of the index from them; even if they have low MERs (management expense ratios), they are not free. The minimum entry level of investment into them is also higher sometimes than that for actively managed funds. Finally, kept outside a registered plan, many of them (at least those 'mimicking' foreign indexes) are more heavily taxed than equity funds, further eroding their undeniable advantages over many actively managed mutual funds.

One more aspect that raises flags against 'jumping on the indexing bandwagon', as respected financial writer Jonathan Chevreau called the recent increase in the popularity of investing in market indexes: The last few years were much more bullish for large, 'blue chip' stocks, the ones that determine the performance of major market indices, while most funds invest in a larger proportion in mid-size companies which have not done as well. There are signs of, and credible arguments for, the reverse of this situation: stocks of small and mid-size companies, in general, may outperform those huge companies' stocks in the coming years. If this happens, more actively managed funds can outperform the major indexes again. The main arguments supporting this notion of smaller companies' gaining at the expense of the determinant companies of yesterday and today are the same macro-level or global tendencies that provide the main reasons for long-term optimism, in general:

- **mass application of new technologies that will shape the next few decades, – communication and biotechnology being probably the two main broad areas in this regard;**
- **demographics that almost 'prescribe' booming economic activities and financial markets (the more dangerous consequences of aging of the baby boomers are predicted to occur only in the second decade of the next century, according to William Sterling and Stephen Waite, authors of a new book, Boomernomics: The future of your money in the upcoming generational warfare, and managers of a new mutual fund, based on the lessons from Boomernomics);**
- **opportunities outside North-America for a rejuvenation of unifying European countries and shattered economies in Asia and elsewhere;**
- **huge changes in society and economies everywhere due to, and increasingly urgent because of, the need to address environmental problems.**

Briefly, it seems likely that there will be a speeded-up 'changing of the guard' among the major players of the economy in the next few years, and this provides opportunity to smart money managers to achieve better returns in these new areas than the inevitably more slowly changing market benchmarks.

7, There was an interesting observation published in the Toronto Star a month ago. It revealed a strong regularity in North American stock returns, linked to presidential elections. Between 1932 and 1995, the total, non-cumulative, S&P500 index gain in the 41 mid-term years (like, e.g., 1998 is) was +82%. The same total for the pre-election years (like 1999 will be) was +330%, for the election years it was +262%, and for the post-election years, it was -3%. This past October is a shining example that such regularities cannot be taken for granted, of course. Still, it might indicate that the transition to the next upsurge in markets may happen without major turbulence. I, personally, do not believe in a smooth ride but it cannot be excluded either.

8, The year-end is a particularly good time for many to overview their financial matters. This is the last chance to make some tax-related decisions that can influence your tax liabilities for the year. Mutual fund distributions tend to happen towards year-end, for example, and they might make it necessary to rebalance your RRSP portfolio. This can happen if reinvestment of distributions from foreign funds would push the foreign content of the portfolio, calculated not on current value but on book value, above the permitted 20% limit. Unfortunately, many people have no chance to face this issue, simply because they do not even approach the 20% foreign content in their RRSPs. Fewer than 30 percent of Canadians who have RRSPs hold any significant foreign content in their plans. There are many others – whom I would call the 'enlightened' ones – who do whatever they can to increase the foreign content even beyond the 20% limit. There are such possibilities.

As you have probably heard many times, the Canadian market is just a tiny, 2-3 percent, fragment of the world market. It is perhaps less known that returns on Canadian stocks have consistently under-performed their counterparts elsewhere, … almost everywhere. Also, having foreign content usually decreases the volatility of one's portfolio. Finally, it can help to limit the risks of decline in the value of the Canadian dollar.

9, I promised that I would elaborate in this newsletter on various aspects of Registered Educational Savings Plans. I didn't know then how much information will be widely available by now. Since this is the case, I'll make just short comments here about three rarely mentioned aspects: (1) RESPs do not have limitation for foreign content; (2) Moving money from in-trust accounts into RESPs is not that simple, but not impossible either; (3) RESPs can be started for a particular child, or as a family plan.

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