Alternative Indexing

I typically recommend smaller investors utilize passive investment techniques. That is, investing in open-ended no-load index mutual or exchange traded funds.

I have not mentioned that there are different ways to construct market indices. There are.

The normal market index is weighted by market capitalization. The bigger the company, the higher the weight in the index. The vast majority of index funds you consider will be this type.

But there are alternative indexing options out there too. I want to touch on them today.

Weighted Average Market Capitalization

The normal index methodology is the market cap index.

This index provides a realistic representation of the market. The big firms that drive the market and economy have weightings that reflect their stature. Key industries are strongly represented. This is a positive.

However, its biggest drawback is that it is a representative representation of the market.

What?

Consider perhaps the most famous index, the S&P 500. 500 key U.S. companies representing 80% of the U.S. equity markets. Good representation of the U.S. But under a weighted average system, the larger companies have bigger pieces of the index holdings. Exxon and Apple alone make up 5% of the index. And the 10 largest companies comprise 18% of the index.

A drawback, but not what I consider a deal-breaker. In fact,

on the whole, I want larger companies to have more impact on the portfolio. Perhaps not to the extreme as South Korea (unless you want a pure play on Samsung), but I do want the bigger companies to dominate my weightings (unless I am seeking a small-cap or similar strategy, but then I am investing differently anyway).

For my money, this is a good methodology for smaller investors who seek well-diversified portfolios. Not that a market cap index guarantees strong diversification. But it is fine when building portfolios.

Equal Weight Market Capitalization

Each company in the index is given equal importance. With the S&P 500, the top 10 companies would only warrant a 2% share of the index. Not their current 18% under the weighted method.

If you want to get more bang for your investment dollar from smaller stocks, then this may be of interest. But there tends to be higher fund expenses due to typically higher turnover, rebalancing, pricing discrepancies, and trading costs with respect to holding higher proportions of smaller companies.

Also, smaller companies that may be less established than the mega-cap firms, like Exxon and Apple, may have higher stock volatility. By increasing their weights, you may be raising the risk level of your portfolio.

If I wish to strategically or tactically invest in smaller companies, I personally prefer to add small-cap funds (or stocks) to my overall portfolio (or weighted average index funds). Not invest in equal weighted indices.

Fundamentally Weighted Indices

This type of index fund is becoming more prevalent. I use them with my clients as they can satisfy a strategic niche or investment objective on a relatively low cost basis.

For example, perhaps you want to focus on dividend income to generate decent cash flow. Yet you also want to participate in the upside (capital gains) if the company does well. A generic index will include both dividend and non-dividend paying companies. What to do?

Well, how about investing in the S&P500 Dividend Aristocrats Index? This is a sub-index of the S&P 500 Index, but only includes companies from that index which have increased dividend payments annually for the last 25 years. Problem solved. Note as well that there are similar Dividend Aristocrats Indices for Canada, United Kingdom, and Europe.

You can find many fundamentally constructed indices that meet a multitude of criteria. I personally find them useful. But, as I always say, the more complex a fund, the greater the expense ratio will be. Always keep an eye on your cost structure.

Alternative Index Comparisons

Investopedia

Investopedia compares the above methodologies in, "3 Types of Indexing for ETF Success".

I am not sure I agree with the conclusions as it is more an apples to oranges comparison. The apples being mega-cap stocks that dominate weighted average indices versus small and mid-cap stocks (oranges) that are higher weighted in equal weight or many fundamental indices.

That said, for long term investing, I personally like smaller cap, value companies (yes, based on historic research results), so it does not surprise me to see those conclusions. Just be aware it is not apples to apples. And that the risk profiles between large, established companies may be significantly different from small, relatively young businesses.

Vanguard

I also recommend Vanguard's, "It's Not Your Father's Indexing" and the "Alternative Equity Approaches to Indexing: Buyer Beware" that is linked in the initial article. Maybe a tad (just a tad) technical, but some excellent points made. Note specifically:

> *Unlike a market-capitalization-weighted approach, none of these strategies will enable you to "own the market." Instead, they will either do better than the market or worse. The trick in deviating from a market-cap-weighted index is to find the investment manager or the rule that puts you on the winning side. The risk is ending up a loser relative to the index or having a poor outcome given the portfolio's specific exposures. The cost is whether you pay more than you would if you were in the (cap-weighted) index fund.*
>
> *We believe that what investors expect when they buy an index is that they will own the market. However, a rules-based, non-cap-weighted strategy doesn't give you that kind of exposure. You are, in fact, making a bet against the market or some segment of the market.*

Using non-weighted indices is more a tactical play than a long-term strategy. I agree with that. And there is nothing wrong with that if you can consistently time market movements. But that is difficult.

In the "Alternative Equity Approaches to Indexing" analysis, Vanguard adjusts various factors to try and create an apples to apples comparison. Their finding?

> *Our research shows that alternative weighted indexes tend to tilt toward the smaller and value stocks in the targeted market. The chart above shows that, after controlling for these factors, there was no consistent significant excess return associated with these strategies.*

> *We believe a better, lower-cost implementation option is for you to use cap-weighted indexes to get the risk-factor exposures inherent to these alternative strategies.*

So on an apples to apples basis, "no consistent significant excess return" to invest in alternative indices. I agree, although if you are willing to increase your risk, you may see higher expected returns over the long term by increasing your share of smaller companies.

Investment Analyst Reports

I do not believe small investors should invest in individual stocks.

Limited capital makes it difficult to diversify portfolios and increases transaction costs.

Smaller investors typically lack the investment expertise, experience, and tools to successfully analyze stocks or time markets.

Stick with low-cost, well-diversified exchange traded and open-ended index mutual funds.

The reality though is that many smaller investors do invest in individual stocks. A high percentage rely on analyst reports to help them select which equities to buy.

This post is for you.

The Financial Post looks at "5 things to watch out for in analyst reports and company statements". A (rare) good article

which you should read.

Analyst reports are not written for individual investors

Agreed.

Use analyst reports to learn about the company and industry. Not to assess whether it will be an investment winner or loser.

“We are cautiously optimistic” and Hold recommendations

A major problem with analyst reports is that you have to read between the lines and understand the underlying meanings for phrases.

A friend tries to set you up on a date. “What’s he/she like?” “Great personality!”. Okay, then. That tells you a lot of other things about the person. Sadly, I do not even have a good personality.

It is what the analyst does not say, or how something is said, that actually tells you the key things. If you intend to rely on analyst reports to invest, spend some time learning the jargon and how to interpret the real meaning from the words.

Price targets

I understand price targets. Take all the data, put it in the model, generate what you consider to be fair market value. That is the price target.

Price targets are largely based on estimated future price-to-earnings ratios.

Price-to-book, dividend yield, earnings growth rates, are other popular quantified variables.

The problem is that there are so many possible factors and so many ways to assess the variables, that one small error can completely alter reality.

There is also the issue of efficient markets. A huge number of analysts and investors follow larger companies in major markets. With access to the same data, many come to similar valuations. As a result, future expectations are very quickly factored into the current price. This makes the possibility of obtaining abnormal returns difficult.

“Some orders were delayed, or pushed into the next quarter”

Another example of how reality can differ – even slightly – from forecasts and projections in computer models and analysis. Slight delays, a lost order, a new competitor, a bad snowstorm, etc., all can impact actual results and alter earnings and price multiples.

It is also another good example of needing to read between the lines. Assessing the real meaning of a statement is crucial for your own analysis.

Use analyst reports to gain an understanding of a specific company and the industry.

Do not use analyst reports to select your investments for you.

A Good Investor Always Saves

I am not a fan of Jim Cramer. Simply because he plays to the cameras. And I hate the theatrics.

But he talks about a time when he was doing poorly in life. And he makes a great point that should apply to all investors. So we shall give him a listen.

Good Investors Always Save

According to Jim Cramer, good investors must:

> *Save. Whatever you can – whenever you can. But always save.*

I agree this is pivotal for successful long term wealth accumulation.

> *Quite simply, a good investor always saves – period.*

Learn to become disciplined and consistent in saving. Even if only a little each period.

It may take a few months to adjust to having less disposable income, but you do adjust. If your rent goes up $100 per month, you adjust. You have to. Pretend your rent, car loan, utilities, etc., went up and put the difference into your investment account, rather than your landlord's.

How to Save

Take advantage of automatic deductions from pay cheques to make direct deposits into investment accounts. If you are able to use tax-deferred accounts, so much the better.

Sign up for dividend reinvestment plans (DRIPs) where available. Over time, you must watch the tax liability on income earned but not received. But starting out, there should be no issues.

Note that you can invest directly in some public company shares using DRIPs or Direct Stock Purchase Plans (DSPPs). Also, if employed by a public company, there may be Employee Stock Purchase Plans (ESPPs) available. All of these provide the opportunity to periodically invest small amounts while saving on costs.

While I prefer exchange traded funds (ETFs) in general,

consider open-ended, low-cost, no-load index mutual funds when beginning to invest. Why?

Most ETFs have transaction fees when you buy or sell. There are a few no-transaction fee ETFs out there, but most ETFs charge brokerage fees. Even if you only pay $9.99 per transaction, that is 10% on a $100 purchase. If you wish to invest in ETFs (because they are cheaper than mutual funds, allow intraday trading, etc.), I recommend you accrue your periodic deposits, then purchase an ETF once you reach a critical mass (say $1000).

Mutual funds tend to be more expensive than comparable ETFs. However, when starting out, you may choose to pay more in annual expense ratios to avoid transaction fees. If you stick with no-load funds you will not pay any fees when buying or selling (but watch for potential charges or penalties if you sell a no-load fund within a certain period from purchase date). At this stage of life, do not even consider any mutual fund with loads.

If you look for low-cost index mutual funds, annual expense ratios may not be too insane. They will be higher than the same ETF though. But in the first few years of saving, the tradeoff between higher annual costs versus paying transaction fees on ETFs may be worthwhile.

Often the initial investment index mutual funds is relatively low, $500 or $1000. This may take a few months to build to with minimal savings. But for many of these funds, once you have met the initial minimum you can usually make additional purchases for extremely small amounts, such as $50 to $100. This helps the wealth accumulation process.

Also, these small subsequent purchase thresholds lend themselves well to dollar cost averaging. An excellent tool to build wealth slowly, while reducing some of the volatility impact on your holdings. So this is another advantage of no-

load mutual funds over ETFs in your early years.

But we still want to keep costs down in the long run. Over time you can sell your mutual fund and replace it with a less expensive ETF. But wait until you have adequate capital for this to make sense.

One final thought – remember our previous discussions on the power of compound returns. The sooner you start to save, the less you actually have to save over time to reach the same result. Similarly, the more you save now, the much greater it will grow over time. Look at Nicole and Matt to see what I mean.

Even a little saved consistently when you are young will grow significantly by retirement. As Lao Tzu supposedly said, “A journey of a thousand miles begins with a single step.”

So take even a small step today and start on your path to amassing wealth.

Invest Better Than the Pros?

In “Want to Invest Like a Pro?” we looked at attributes of successful professional investors.

I definitely believe one can learn a lot by watching how the pros invest. Nevertheless, I stated that following the professionals was “maybe a good plan, maybe not.”

This example nicely sums up that statement.

According to this article from The Guardian, a cat has managed to outperform a team of professional investors in a stock

picking challenge.

Now to be completely fair to the professional investors, it was a cat and not a dog. And the professionals did manage to beat a group of high school students in the same challenge. So I give them part marks!

Lest you think this a huge anomaly, there are many other examples out there. Not all involving smart cats either.

Chimps seem to do well. Perhaps something to do with vodka and bankers. And I do know a British banker with identical suspenders.

Even the trusty old dart board beats investors.

Why I Like These Stories

One, further evidence that stock picking is tricky. It is difficult to separate winners from losers over the short term. Even for professionals, with years of training, access to the best available research tools and data, and who analyze investments as a full-time occupation.

Two, I am not quite a Random Walk guy, but I do believe that efficient markets negate quantitative analysis to a large degree. Not entirely and definitely not in less efficient market segments, so financial analysis can still add value in the long run. But when you factor in transaction costs, management, marketing, commissions, administrations fees, etc., it makes it that much harder to beat the benchmarks.

Three, cats continue to prove that they are smarter than investment professionals. As someone who has spent time with both groups, very easy to believe.

Finally, these tales provide me with much amusement. I sent the story on Orlando the cat to my nephew (who is currently studying to become a financial analyst). Now he is spending more time hanging out with Simba and Blossom than reading his

finance texts.

I love it! Of course, his mother is mad at me for all the extra hairballs littering their home.

What Do These Stories Mean?

Maybe nothing, maybe something.

<u>Limited Time Frames Mean Little</u>

A very limited investment time frame tells us little about longer term strategies.

I see this a lot with the various investment challenges out there. Especially in universities (where I kind of shake my head). Investment challenges with a 6 to 9 month time horizon. Where the winner (or top three) get a prize and there are no consequences for finishing last.

There are always a few groups investing everything in one asset. Something leveraged, a derivative, non-diversified, etc. If they bet correctly once, they win. If not, no problem. Sort of like playing roulette in Las Vegas with house money. Why not just take the $100,000 and invest in lottery tickets?

If they really wanted to teach students how to invest (versus speculate, purely gamble), assign grades to the various quartiles at completion. Finish in the bottom 5%, get an F (or shot). Maybe have the students put in real money. Nothing like a little skin in the game to alter one's risk approach.

Or run a simulation over multiple years based on historic data. That way investors will experience more realistic results. You might pick the right horse in one race. But to do so consistently over many races is much different.

If you are ever part of an investment challenge, two recommendations.

Bet on a non-diversified, highly leveraged, speculative single investment. You may win some money or accolades. Or you may finish last with no consequences.

Alternatively, realize that you have little real shot at winning (depending on the rules and number of participants who choose option one) and concentrate on the process. Learning how investing works may add some value in the long run.

Publicity Alters Behaviour

Publicity changes behaviour. Just watch any reality show on television. How people act in their own lives changes when it is open to public scrutiny.

I guarantee that the UK professionals did not want to lose money. So they took less potential upside to prevent an embarassing capital loss. And it worked, they came out ahead.

Had they taken on additional risk, perhaps they would have beat the cat. Or perhaps they would have lost money and been embarrassed nationally. Better to play it safe than become the brunt of jokes.

As we know, cats have no concept of shame. Win, lose, or draw, Orlando will continue to treat the human race with feline disdain.

So in the sense of time horizon and publicity potentially altering behaviour, I am not sure these type of contests tell us much about long term investing strategies.

Active Versus Passive Management

That said, it does add some fuel to the fire on active versus passive investing.

Over the course of the year, the professionals earned a paper profit of £176, a 3.52% return for calendar 2012. Good, bad, who knows? Lost to Orlando the cat, but how did the pros do

versus the market as a whole?

According to the December 31, 2012 FTSE Factsheet, the FTSE All-Share Index returned 12.3% for 2012. That even beats Orlando’s 10.84% return. The other FTSE indices also had strong returns over 2012. Two smaller indices had returns greater than 25%.

Over this one year period, the professional investors significantly underperformed their benchmarks. That does not even factor in any fees the professionals would charge for their stock-picking expertise. And you had better believe they would be charging the same fees regardless of the actual results. In only very rare cases, some hedge funds come to mind, do mutual funds adjust their fee schedule to reflect performance (always upwards).

If the high school students had simply purchased an exchange traded fund on one of the available UK indices, they would have easily won the investment challenge. No effort on their part. Just find a broad index like the All-Share, invest on January 1, head off to the cricket pitch, then come back December 31 and collect their winnings.

Of course, if they passively invested in an index fund they would not have learned anything about the benefits of analyzing individual stocks and the investment process.

Or maybe they would. Did you?

And to my nephew, less time in the litter box, more in the textbooks, and a strong daily dose of castor oil. That will best get you ready for June.

Planning to Start Investing?

Just starting to invest?

Perhaps you just graduated from school, got your first real job, and now want to start saving money and building wealth.

Or maybe you are older but personal issues precluded you from beginning to seriously invest for future retirement. Student debt, home mortgages, and children, are just a few things that greatly impact the ability to invest for individuals in their late 20s and 30s. But now you have decided to focus on wealth accumulation.

Regardless of where you are in the life cycle, today some good tips for those beginning to invest.

The Wall Street Journal offers four simple recommendations to new investors. I have covered them myself, but they do bear repeating.

Start Early

The sooner you start investing, the better your long term wealth accumulation. This is due to the power of compound returns.

> *"A study by Maria Bruno, a financial planner with Vanguard Group, illustrates why: No matter how conservative or aggressive the hypothetical portfolio, projected median portfolio balances at age 65 are significantly higher for investors who started saving at an early age than for investors who began saving at older ages."*

It is incredible how beginning to invest early in life has such an impact on capital growth over time. If you are in your 20s, this is great news. Hopefully it will spur you to sacrifice a little now when money is tight, because the lon-

term benefit is so high.

Now if you are in your 40s, it is all right to groan a bit at this realization. But what is past is prologue. You did not save in your 20s and we cannot turn back the clock.

On the positive side, not too many people do begin saving in their 20s and early 30s. Not the best approach, but the common one among adults. So if you have yet to start seriously saving, you have plenty of company.

Today is the first day of the rest of your life. Or, as another old saying goes, the longest journey begins with but a single footstep.

The power of compound returns works at any age. The sooner you start investing, the better the results. But you need to make that first step and then continue onwards.

Starting at 25 is better than 35, but so too is starting at 45 better than starting at 46. Additionally, life expectancy today may be between the ages of 80 and 85. Even at 45, you have ample time to allow your wealth to accumulate over time. But every day delayed negatively impacts wealth building.

So assess your financial situation today. See where you can make some modifications in spending and come up with money to invest.

Save Often

> *"Ms. Bruno found that the amount of money someone ended up with at retirement was more influenced by how much money was saved than by how that money was invested."*

How often and how much you save is more important than what you invest in.

Obviously, this refers to a well-diversified portfolio of

assets and not investing everything in the next Apple. Nor placing all your money in a term-deposit of savings account.

But the point still stands. Timing and amount are more crucial to long-term wealth accumulation than the individual assets invested in.

Invest Early and Often

> *"The two levers an investor can directly control—savings time horizon and savings rate— will generally provide a higher probability of success, rather than relying on the possibility for higher portfolio returns."*

I wanted to highlight this statement.

Asset growth over time is a function of three variables. The rate of net return, time horizon, and invested capital.

If you are 25 years of age and invest $4000 annually for 40 years earning 8% per year, your ending capital is about $1,119,000. If you wait until 35 to begin, you will have to contribute $9150 annually at 5% to reach your goal. Perhaps that is doable. But if you wait until age 45, you will need to find $22,650 annually to reach $1,119,000. Perhaps not so doable.

Within limits, you can control when you begin investing and how much you invest over time.

However, your actual investment returns are out of your control. It is difficult to consistently identify individual assets that will outperform the market. That is why active asset management does not normally beat a passive approach.

You can control your asset allocation and that does affect your portfolio's risk-return profile. For example, by adding higher risk (with higher expected returns) assets to your portfolio. But asset allocation and adding assets with greater

return potential can only go so far.

In our above example, say you waited until age 55 to start saving. At the 8% return, you would need to invest $71,500 annually over 10 years to reach $1,119,00 by age 65. Not very likely.

Even projecting higher annual returns may not help that much. Say you manage 16% per annum, you will still need to invest about $45,500 annually to hit $1,119,000. Or you get 24% (triple our original figure which means a lot of added risk), you still must contribute $28,500 each year. A fair bit of free money to find beneath the sofa cushions.

Focus on the two controllable factors (timing and amount) as they are more important to long run success than relying on riskier investments to provide higher returns.

Invest Frugally

> *"Investment costs are another, often overlooked variable that investors can typically control and that can have a big impact on a portfolio's longterm performance."*

Often-overlooked variable? Well not if you read this blog!

Transaction costs, commissions, management fees, operating costs, and taxes eat away at your gross returns and greatly damage your long-term growth. Every dollar that you pay to someone else – fund manager, brokerage house, tax agency – is one less dollar that will compound over time on your behalf.

Put your money to work for you. Minimize your costs to the greatest practical extent possible.

Divide and Conquer

Okay, you want to start investing, but you have debts and other needs that also must be met.

"Mr. Ritter suggests young adults tackle these major goals simultaneously. "Put a bit of money toward each goal," he says, "and work toward being able to do more over time." "Once one goal is reached—for example, after debt has been paid off—you can redirect money toward another goal, such as building an emergency fund. And once that is fully funded, with around six months of living expenses, you can save more toward retirement. Even if your contributions are small and come from a parttime or lowpaying job, Mr. Ritter says, they will pay big dividends in years to come. Remember, it's the little steps that count."

I agree with this approach to some extent. It gets you on the investing path. It promotes a consistent and disciplined investing style, which is important for long-term success.

Also, investing a little is better than nothing. And, as your debts are paid off, you can indeed reallocate your cash and invest more over time.

Finally, I like the psychological impact that comes from seeing your investments actually grow. Even if you still have student loans outstanding, it is reassuring to see your investment account growing every month.

So I like this approach.

That said, I tend to see debt as a negative investment. And I prefer to invest my capital where I get the most return for my money.

Say I have $1,000 in cash on hand, owe $5000 on my Visa at 18% per annum, and want to invest monthly in a balanced fund expected to return about 6% annually. Now does it really make sense to split that $1,000 50-50 between my Visa and the investment fund? No. At an 18% non-deductible interest rate, I want to get rid of that balance as quickly as possible. So while I agree with the recommendation (especially getting

people started on the investment process), you do need to assess your own situation.

While I think you should start saving and investing as soon as possible (and then consistently investing over time), you also need to be aware of your debts and the interest payable on them. If the interest payable on debt exceeds what you can earn on your capital, you may want to pay off your debt first.

And make certain you factor in the tax consequences. Interest payable on debt is often non-deductible for tax purposes while interest income, dividends received, and capital gains are usually taxed to some extent. So ensure when you do your calculations you consider the after-tax amounts, not the gross.

A Formidable Investing Foe

There are many variables that make successful investing a challenge.

And one of your biggest foes may just be you.

What do I mean by this?

Are You Your Own Worst Investment Enemy?

In my last post, Mutual Funds Lag Their Benchmarks, I linked to a Wall Street Journal article, It's Not Your Fault Your Fund Can't Keep Up.

According to the article, you are also at fault as to why your portfolio lags its benchmark.

> *The average equity-fund investor saw annual returns of only*

> *3.49% in the 20 years through 2011, according to the latest analysis from Dalbar. Compare that with the average 7.81% annual return of the S&P 500.*
>
> *For the average investor, that's more than half the possible returns left on the table.*

That is significant in both relative and absolute terms.

If you started with $100,000, made no additional investments, and earned 3.49%, over 20 years your capital would grow to $198,595. But had you earned 7.81% annually, that $100,000 would become $449,967. A lot of money to leave on the table.

Why the discrepancy?

> *The reason is most investors fail to hold mutual-fund investments for long enough, and instead try to time their investments. But they tend to enter the market after it has risen, Mr. Harvey says. So they are likely buying at a higher price. They also are apt to leave the market after it has dropped, therefore selling at a lower price.*
>
> *The result: investments that will massively underperform against their benchmarks.*

A lot of this is due to emotional investing based on lack of investment expertise. Individuals wait too long before buying – they want to see a clear upward trend first – and/or miss the price peaks. A good example of this would be investment bubbles.

Even many knowledgeable investors can get caught up in the hype. It is not easy or popular to take contrarian stances. Better to get it wrong like everyone else, than to get it wrong while everyone else is correct. The herd mentality is quite common in the investment world.

Also, it is extremely difficult to time market or stock movements. Or identify the best individual investments. Even if you manage to stay unemotional. That is why professional money managers typically underperform their portfolio benchmarks. And why the “best” investment analysts seem to change from year to year.

What to Do?

> *investors looking to close the gap should be buying mutual funds, whether they be stock or bond funds, for the long term. Don’t be tempted to bail when performance is poor because, over time, that has been shown to be a losing strategy.*
>
> *And don’t try to chase performance by getting into funds that have performed well recently. This is the equivalent of buying high and selling low—the exact opposite of what investors should be doing.*

You know me.

If You Cannot Beat Them, Join Them

If you cannot beat the market, try to match it as closely as possible. That means passive investing in open ended index mutual and exchange traded funds (ETFs). Keep costs low and replicate the benchmark as best you can. Actively invest under only a few scenarios.

ETFs Over Mutual Funds

As for the article’s comment on ETFs over mutual funds, I generally agree.

I prefer ETFs for their potential trading and cost advantages. But there are a wide variety of cost effective mutual funds out there. Many are extremely popular with investors. I still think they have a place in one’s portfolio. So long as you

focus on cost and net performance.

Also, as the popularity of ETFs grow, so do the number of ETFs offered. Not all are cost-effective or simple structures that replicate clear benchmarks. Be careful if considering investing in such things as leveraged ETFs, actively managed ETFs, life-cycle ETFs, alternative asset ETFs, and ETF wraps.

Buy and Hold

Identify solid investments and invest for the long-term.

I like the buy and hold approach for funds, although not so much for individual non-diversified assets. The buy and hold promotes investment discipline and works well for most investors in shifting markets.

Note that you still need to periodically review your holdings and rebalance as necessary.

Dollar Cost Average

I also like a dollar cost averaging approach.

By investing a fixed amount on a periodic basis, you buy relatively more shares when the asset is cheap and less shares when the price is high. That smooths your purchase stream and provides some protection over time against volatile markets.

Mutual Funds Lag Their Benchmarks

In the U.S., the Standard & Poor's 500 stock index (S&P 500) is up 12.6% year to date 2012.

That is the good news. The bad?

Your mutual fund is likely not meeting or exceeding this benchmark.

Why the underperformance against investment benchmarks?

The Facts

From The Wall Street Journal's, "It's Not Your Fault Your Fund Can't Keep Up":

> *A Morningstar survey for The Wall Street Journal Sunday found that only eight of the 25 largest actively managed funds—all types, from bond funds to foreign—beat the S&P 500 for the quarter.*
>
> *That's right in line with previous analyses. On average, fully two-thirds of mutual funds lag behind their respective benchmarks, according to Morningstar. (Such studies stacked bond funds against bond indices; and stock funds were compared to stock indices.)*
>
> *And over the long haul, according to fund guru John C. Bogle, virtually all fail.*

If you own a mutual fund, there is a strong probability that it will underperform its relevant benchmark. There are a few reasons why.

Individual Asset Selection Is Not Easy

Part of the problem is that active mutual fund managers historically, and on average, do not beat the markets with their picks.

Timing market movements and/or identifying the best individual assets is not simple. Even the professionals get it wrong a fair amount of time.

Larger Funds Become the Market

Even if the asset manager is a great individual asset selector, the larger the fund becomes, the less impact an individual selection makes on the overall portfolio.

The linked article mentions a few large funds: USD 59 billion large-cap American Funds Investment Co. of America Fund (AIVSX); USD 54 billion American Funds Washington Mutual (AWSHX); USD 37 billion Vanguard Windsor II fund (VWNFX).

At those sizes, even if they find the next great company, how much can they add to their portfolios? There are limits as to what one can buy.

Large funds need to buy large companies. Investing in a small company will result in too few shares to have any overall portfolio impact. Or buying too many shares and running afoul of securities regulations in regard to ownership levels.

If stuck investing in large cap companies, large funds essentially become the market themselves. An advantage of small funds – and often a reason why funds are capped – is being nimble.

Consider AIVSX. 4.45% of AIVSX's total fund holdings is Philip Morris (PM) stock as at December 31, 2011. So AIVSX owned about USD 2.63 billion of PM, which itself has a market cap of around USD 150 billion. AISVX could probably invest a few billion more without getting into problems. But that is because PM is a very large company. The same is true for their other big holdings – Microsoft, AT&T, Dow Chemical, Royal Dutch, Apple.

But are these stocks not simply the equity market itself?

What about investing in the best performing stocks of 2011?

According to The Street, the five best-performing S&P 500 stocks in 2011 were: Cabot Oil & Gas (COG); El Paso Corp.

(EP); Intuitive Surgical (ISRG); Biogen Idec (BIIB); Mastercard (MA). The April 9, 2012 market caps of each were: COG, USD 6.5 billion; EP, USD 23 .2 billion; ISRG, USD 21.7 billion; BIIB, USD 30.0 billion; MA, USD 55.0 billion. With the possible exception of Mastercard, it would be difficult for AIVSX to acquire enough shares of these companies to have any real impact on the fund performance.

Fees Hurt Net Performance

I write about this a lot. Fees may be the biggest reason for underperformance.

You own a fund that beats its benchmark by 1%. Pretty good. Until you realize that you are paying a 2% management or total expense ratio each year.

You want to improve your performance, focus on fund fees. Stick with passively managed open ended index and exchange traded funds (ETF) to minimize costs.

For example, AIVSX has an annual expense ratio of 0.61%. Not bad for a mutual fund. Its top 10 holdings at December 31, 2011 were Philip Morris, Microsoft, AT&T, Dow Chemical, Royal Dutch, Apple, ConocoPhillips, Home Depot, Abbott Laboratories, JP Morgan. These stocks make up 27% of the fund, so a big impact on overall performance.

Yet consider the iShares Russell Top 200 Index Fund. Its top 10 holdings include Apple, Microsoft, AT&T, and JP Morgan. Significant overlap with AIVSX.

And the iShares ETF only charges 0.15%. Almost half a percent less than AIVSX.

Oh yeah, it is up 12.8% to March 31, 2012, versus AIVSX at 11%.

What to Do

The article provides some good advice for investors:

> *investors should look for funds with low expenses and pick fund managers with long, consistent track records of success. They should avoid newly established funds, or those with relatively inexperienced managers. Then, look for funds without wild year-to-year swings in investment return.*

As I elaborate in *Why Active Investing is not Optimal*, avoid the expensive active management approach. The payoff is usually not worth the price. Keep costs low and try to match the market as best you can. That means passively managed open ended index mutual and ETFs.

If you do consider active management, look at long-term fund management performance.

You want to see how the manager does over time and in both up and down markets. Remember that a fund may be in place for a long time, but management can change. What a prior manager did 5 years ago may not be relevant to what the current manager will do tomorrow. So study the manager and not simply the fund.

Next time I will have a few words on the last part of linked The Wall Street Journal article. Namely that you face a formidable investing foe: yourself.

Investors Shun Risk

A relationship exists between investment risk and expected return.

The safer the asset, the lower the expected return. The

greater the investment risk, the higher the required return. Or it can be a tad more technical if you like.

Investors should take an objective view of investment risk. Unfortunately, investors tend to be emotional creatures and these volatile times lead people to become fearful of investment risk.

So what is happening? And what should you do as an investor?

Investors Shun Risk

According to Morningstar, *Shaken Investors Shun Risk*.

> *The demographic bulge of aging baby boomers is becoming ever more risk-averse as it continues its march toward retirement. At the same time, investors as a whole have become financially and emotionally scarred by bear markets. The result, says financial-services consultant Goshka Folda, has been a flight to safety.*

The first sentence makes sense. Younger investors have a significant time horizon. Young investors have more time to ride out the increased volatility of higher risk assets. As such, young investors should seek out relatively higher risk assets to reap higher expected returns.

As investors approach retirement, there is less time available to deal with highly volatile investments. Safety and certainty are more important. That is why you see older investors shift their capital into lower risk asset classes. And receive lower returns.

The second sentence though, reflects how emotions play a significant role with investors. Emotions should be avoided when investing. That said, I realize how hard it is to maintain a disciplined, unemotional, investment strategy when markets are moving like a roller coaster.

How This Impacts Asset Allocations

> *Of the more than $3 trillion in investible assets of financial wealth, more than $1 trillion is sitting in deposits (Source: Household Balance Sheet Report, 2011 Edition). In addition, close to another $1 trillion consists of short-term instruments with maturities of less than one year.*

A lot of investors appear to be heavily invested in low-risk, low-return assets.

While this low risk approach might be reasonable for retirees (but beware that a 65 year old retiree may live until 90, so may still desire/need some higher risk assets to finance a 25 year retirement), a low risk strategy is probably not suitable for younger investors.

Asset allocation is extremely important for investing success. It should not be based on emotion and fear of loss. Your asset allocation should be unique for you, based on your personal situation.

What to Do?

> *"After so much damage, clients are now in a risk-averse stance," says Folda, "But the reality is that many households still need growth, they need exposure to at least some equity."*
>
> *"So volatility, while damaging for everybody," says Folda, "can be opportunity for advisors to even further underscore the importance of good advice and solid solutions in establishing the right risk profiles for portfolios."*

I think there are a few keys to effectively deal with volatile markets.

Investors need to construct investor profiles and Investment Policy Statements. These will determine a proper target asset allocation and help maintain long-term focus during periods of short-term volatility.

A properly diversified portfolio will reduce portfolio risk without lowering expected returns.

Low cost investments such as open-ended index mutual and exchange traded funds will help with diversification and cost-effective investing.

While I understand that many advisors, banks, brokers, etc., want to sell investors innovative new products (that usually are quite profitable for the seller), be cautious. Minimizing your costs is a key to maximizing long-term success. Do not pay someone else 1-2% of your capital each year simply to purchase the flavour of the day.

Dollar cost averaging will also assist in dealing with volatility and staying disciplined.

If you use these techniques you will reduce emotion in your investment decisions. This will improve your portfolio construction and your probability of long-term investment success.

Will Your Growth Stock Keep Growing?

Investing in growth stocks normally requires a growth premium to be paid.

The growth premium reflects the above average expected growth

rates in the company's earnings. So you better be sure that the company earnings continue to grow over time.

There are a few areas of quantitive analysis to help assess future growth prospects.

The Wall Street Journal outlines these areas in *How to Tell if a Growth Stock Can Keep on Growing*.

Organic Over Acquired

> *"Organic" revenue growth, which comes from winning new business, is generally better for shareholders than growth fueled by acquisitions, experts say, because it tends to cost less and carry fewer risks. Management's discussion of operations in its quarterly reports often contains clues to how much of the growth is organic.*

It may be easy in the short term to buy growth. But the costs of integration and ensuring that old and new corporate components move in lockstep, can be a costly process.

Also, be aware that some companies use acquisitions to distort prior years' performance comparisons.

Growth Over Cost Cutting

> *But keep in mind that any earnings growth driven by cost cutting and share repurchases might not last for long. Just as important is to look for increasing revenue, the hallmark of long-term growth.*

Earnings is a function of revenues and expenses.

Revenues come from the sale of products and services. New products that are highly sought by customers indicate revenue growth. Revenues are great because they can grow forever.

But you want to see more that just sought after products. Is

there a pipeline of new products that will enter the marketplace to spur continuing growth? Is there protection in place (e.g., patents, cost to produce, control over inputs, etc.) that prevent other firms from entering your market and stealing business? Are there any regulatory (e.g., reclamation costs for mines) or other potential issues (e.g., doing business with clients in a newly sanctioned country) that can impact future revenues? And so on.

Expenses, on the other hand, cannot be cut forever. If a company is experiencing earnings growth due to cost cutting, layoffs, asset sales, etc., those can only go so far. These measures will have a one-time impact on earnings, but will not generally drive future earnings growth. I say generally because lower costs may allow a company to reduce sales price which may stimulate demand. If competitors cannot match, then it may drive long term sales growth.

When assessing current growth rates, make certain you understand where the growth came from. And if it is sustainable in the future.

Return on Invested Capital

> *Another place to spot sustainable growth is a measure called "return on invested capital," which is listed on some stock-quote websites. The measure shows whether companies are finding lucrative projects that can power future growth. Today, numbers in the 13% to 16% range are ordinary, while those above 30% are excellent*

I would caution about following the given guidelines. Today, 13-16% may indeed be ordinary. 5 years from now, 35% (or 5%) may be ordinary. Never take a guideline as forever. Always put things in context against the circumstances at the time you are assessing. Do comparisons against the company's history, its peer group, and the market as a whole. Never rely on the fact that someone told you once that "such and such" was the

correct benchmark.

This is one area that is making me a little jittery about Apple and their dividend announcement. Granted, Apple has a pile of money under its iMattress. But, in general, companies that have excellent projects to develop will finance those through internal cash flow (or debt or equity financing).

That is why growth companies typically do not pay out dividends. They believe that their shareholders will get a better long term return by having the company reinvest its profits in new corporate ventures than by paying out dividends. And growth investors agree.

However, companies that do not have new projects in the pipeline with acceptable internal rates of return tend to pay out more money to shareholders. The idea is that the shareholder is better off with the cash, so that he or she can invest in other opportunities that may provide better returns.

When I see any company raise its dividend rates or buy back shares, it makes me wonder if long term growth prospects are dimming.

Work Forward and Backward When Analyzing Investments

> *Mr. Koller favors another method for telling which growth stocks are worth their prices: working backward on the math.*

With any potential investment, you want to analyze from all sides. Sometimes the numbers make sense in one sense, but less so in another.

What Goes Up Can Come Down

> *Above all, investors should keep in mind that with fast growth comes the possibility of a swift tumble if that growth slows. P/E ratios in the high teens or even low 20s don't increase an investor's risk significantly, Mr. Koller says.*

> *“But once you get above 25 you’d better have a very clear understanding of the long-term potential for the business.”*

More good advice. Although remember that a price-earnings (P/E) ratio of 25 may be high today. It may be reasonable (or insane) next year.

The premium paid for a growth stock is kind of like leverage. As the stock’s prospects shine, the premium may rise and enhance the company’s share price more than the base fundamentals. Part of this may be due to hype and investor excitement.

When the company fails to meet expectations, it may be punished by unhappy investors.

Consider Intuitive Surgical, the company we looked at in *Growth Stock Premiums*. As at March 23, 2012 it closed at USD 533.51 and its forward P/E ratio was 31.51. So expected one year future earnings are USD 16.93.

Perhaps Intuitive meets those earnings forecasts, but investors are underwhelmed and lower the growth premium to a P/E of 20. Still high, mind you. That would cause the share price to fall to USD 338.60, down 37%. Yet, in this scenario, Intuitive met its earnings projections.

Even worse if Intuitive stumbled. Say they only earned USD 14 in earnings next year. 17.3% less than expected. At a P/E of 36, that translates into a share price of only USD 441.14. Still a 17.3% decrease. But if the growth premium falls so that the P/E ratio is 20, the share price will go to only USD 280. A 47.5% reduction.

If you buy low and a growth premium starts to reflect in the P/E ratio, great. But if you pay a premium for the stock, be aware that if the company’s prospects slow, you can get hit in more than one way.

Those are a few of the common areas used to assess a company's future growth potential.

Accounting, Finance, and Business Knowledge is Key

Investing in growth stocks can provide excellent investment potential, but it is not always easy to implement. Identifying growth stocks might be straightforward. Assessing the growth premium that must be paid and whether the company can sustain its growth rates rates is much more tricky.

As you can see in the above points, analyzing companies requires the ability to comprehend financial statements and business forecasts. It is also important to understand the business – market, products, competitors, trends, regulatory, etc. – if you wish to successfully analyze stocks.

And, yes, this applies with value investing as well.

If you want to become a better investor, spend some time in other areas of learning.

Or stick to passive investing. Where you can spread out the investment risks in a well-diversified portfolio of identified growth (or value) stocks.

Growth Stock Premiums

I have written a bit about value investing lately. Mainly in the context of Warren Buffett and Benjamin Graham, two staunch advocates of value investing.

But there is also growth investing. A slightly different approach to investment analysis.

Today we will show a little love for those who wish to acquire growth stocks.

Value or Growth?

I think there is opportunity in both areas. Put a gun to my head and I would choose value investing. If the gun is cocked, small cap value investing. But that is just me.

Growth investors can also do quite well.

And many investors jump between the two investment styles. Probably the best approach as economic/market circumstances that are favourable for value plays often are less so for growth. And when growth stocks are in vogue, value stocks may lag.

Ceteris paribus, I prefer value investing for long-term investing. I believe it is easier for me to identify under-valued assets than to outguess other investors on premiums paid for current growth rates and future growth projections. However, when market conditions are right, I definitely utilize a growth strategy.

The Growth Premium

It is not that difficult to identify a growth stock. Just look at prior, actual and future forecast growth rates. Both in absolute terms as well as comparative (the company, peers, market).

If a company is projecting next year earnings growth of 15% and the market is projecting only 7%, you probably have a growth stock. If the company is forecasting 20% growth, but its peers are expecting 40%, it may not be a growth stock. You always need to put your investment analysis in context.

So identifying growth stocks is not too hard.

However, in exchange for growing earnings, buyers of growth

stocks must pay a premium. Evaluating this premium is the tricky part. Ah, there is always a tricky part when investing.

Is Your Growth Stock Worth the Premium?

Will the growth stock continue to grow at a rate to justify the premium paid? That is the question explored by The Wall Street Journal.

For example, consider Intuitive Surgical. A company cited in the linked article.

> *Intuitive Surgical, a maker of medical robots, is expected to increase its earnings by 33% this year.*
>
> *That is tantalizing growth at a time when the broad Standard & Poor's 500-stock index is projected to see a 9% gain in operating earnings this year, versus 15% last year and 47% in 2010.*

A growth stock? Most likely. But, and there always tends to be a but.

> *But investors might pause before buying Intuitive when they see the price: 36 times this year's earnings forecast, compared with 13 times for the S&P 500.*

Is the 33% projected growth rate – a key driver of share price – worth paying 36 times earnings per share? Quite a premium as the average stock only trades at 13 times earnings.

That is the question. And the challenge for successful growth investors.

You must pay a premium to acquire a growth stock. So you had better make sure the company's earnings continue to grow at a rate justifying the premium paid.

Next time, we will discuss ways to assess a company's future

growth prospects.