IN THE INVESTMENT RACE, WHO WINS...

REALIZING YOUR TRUE POTENTIAL

When it comes to realizing our potential, we all think in terms of providing for our families, fulfilling our passions and giving back to our communities. You may want to make it possible for your children or grandchildren to attend the university that gives them the best opportunities, or you may want to provide some seed capital to help them launch that great new business. You may even want to help them with their first home. When it comes to our passions, we are all different –for you, that could mean a dream vacation, for me, a cottage at the lake, to someone else, their very own art collection.

You may also feel strongly about leaving a legacy for your favorite charity or community project. Whatever your dreams, they are important in a very personal way.

UNDERSTANDING THE TWO PHILOSOPHIES

The investment industry is notorious for complicating the investment experience with confusing jargon and convoluted methods. This can be very intimidating and makes investing difficult to understand. In reality, investing is not that complicated. There are two major philosophies:

You believe in ...
Active Management: the ability to consistently "pick a winner" and that you can consistently "time the markets."

Or you believe in...
Efficient Market Theory (Passive Management): that price movements are unpredictable and random and that it is nearly impossible to consistently out-perform the market over time.

Active management is employing the skill of stock picking and market timing. It's the ability to spot inefficiencies in the stock market and exploit them on a regular basis. Passive management, on the other hand, refers to a buy-and-hold approach. It doesn't try to find these inefficiencies, because it believes that not only is it futile, but it is expensive. In the strictest sense, neither philosophy is perfect; in fact, there will always be examples of both success and failure in each camp.

By examining these two ideas you can decide which belief system more closely matches your own.

THE CASE FOR THE "EFFICIENT MARKET THEORY"

The active versus passive debate has been argued since at least the 1960s when Eugene Fama (professor of Finance at the University of Chicago) first coined the term *Efficient Market Theory.*

Eugene Fama defines his theory as follows: The *Efficient Market Theory* is the theory postulating that market prices reflect the knowledge and expectations of all investors. It asserts that any new development is instantaneously priced into a security, thus making it impossible to consistently beat the market. *(Sinquefield)*

Essentially, this means that it is virtually impossible to beat the stock market over time. In fact, history proves this over and over. Standard & Poors produces a report called the SPIVA report. It documents how many money managers are beating the simple index – be it the S&P 500 in the U.S. or the S&P\TSX in Canada. The report finds that just one-third of money managers beat their respective indices over a five-year period.

So maybe we should invest with these managers. The problem is we don't know that they will actually pull it off until they've done it. Worse yet, the managers that do outperform rarely do it for any length of time. How can we possibly pick the money manager before he or she surpasses the index averages, and how do we know when to fire them before they start under-performing? Efficient Market Theorists believe all this activity is a big waste of time and money.

The following observations made by Westin Wellington, Dimensional Fund Advisors (DFA), reminds us of how futile it is to try to "pick the right horse."

" In a cover story recapping the past year and reviewing the prospects for 2007, Barron's reporter Michael Santoli pointed out that U.S. stocks were on track to deliver above-average rates of return for 2006 but questioned

By Randy Perram

THE TORTOISE OR THE HARE?

whether market participants were enjoying the results since so many professional investors were having a difficult time keeping up with broad-based market benchmarks."

More than 70% of active large-cap fund managers were trailing the market as of October 31," he observed. "To have exploited the year's twists and turns fully, one would have had to bet heavily on a commodity boom until May, a sharp slowdown and commodity bust into summer and a recovery led by consumer spending this fall."

"Or one could have owned a market portfolio, spent the year on the golf course, participated fully in every 'twist and turn' the markets could muster, and outperformed most of the experts."

Santoli, Michael. "Polished Performance." Barron's, December 11, 2006.

So if we concede the fact that we can't consistently pick stocks and time markets over time, what can we control? There are two answers to that question: the amount of risk taken, and the level of fees associated with the portfolio.

THE INVESTING ROLLERCOASTER

We are all poorly wired for investing, because our finances are an area where we tend to get emotionally involved in the outcome; these are our dreams, after all. Emotions are a powerful force, and more often than not they cause us to make the wrong decisions.

How many times have you gotten a "hot tip" from a friend or acquaintance? You probably decided that you wanted to watch for a while first. You've no doubt been burned before and you aren't going to just jump in quickly. Before too long the "hot tip" starts making a move and you are starting to be a real believer. You move from feeling hopeful to feeling that this is the one; greed kicks in and you buy the stock.

You know what comes next. Soon after you buy the "hot tip" it starts to drop. Almost immediately you start feeling that you made a big mistake and you get that sick feeling in the pit of your stomach. You can only watch in dismay as the "hot tip" keeps going lower. Finally, you can't take it anymore, and you capitulate; you throw in the towel and sell.

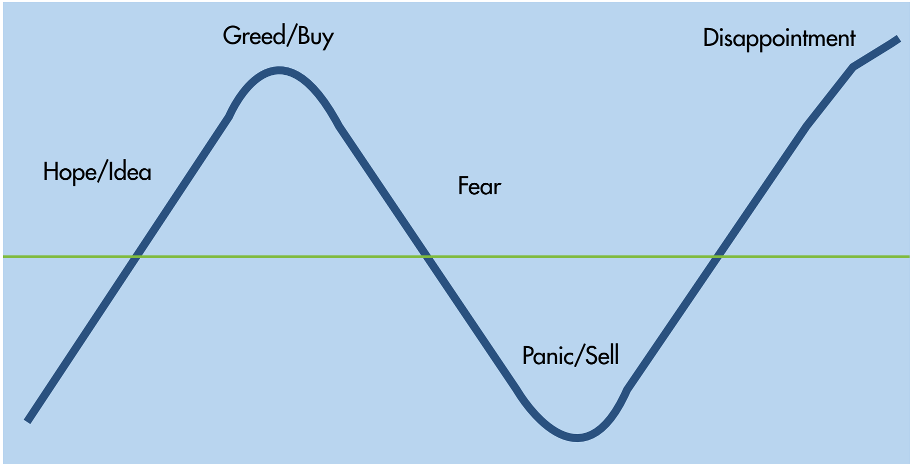
Many times new information comes out and the "hot tip" starts moving to new highs, and all you are left with is a deep sense of disappointment and a lighter wallet.

This is a classic investing scenario that everyone has experienced. If we allow emotions to drive our investing, we run the risk of doing serious damage to our nest egg and to all our financial dreams. *(See Figure A)*

RISK AND RETURN ARE RELATED

The returns in your portfolio are directly related to the amount of risk taken. Returns are quite literally compensation for accepting risk. The best way to control risk is through diversification. Diversify within each asset class and diversify globally as well. Keeping risk in check reduces those wild swings in the portfolio. As you can see in the following chart those wild swings, or volatility, can have a dramatic effect on real returns. (*See Figure B*).

The Emotional Curve of Investing (FIGURE A)



VOLATILITY AND ITS IMPACT ON RETURNS

Volatility essentially means the degree to which a security, index or portfolio moves in price. Wide swings in price indicate a high level of volatility. As indicated in the previous chart, even though both portfolios had an average return of 8% over five years the net effect is that the consistent portfolio realized an additional 2.61% or $16,933. As a prudent investor you definitely want to lower the volatility in your portfolio.

LOWER TURNOVER AND TAXES

Mutual fund companies are required to distribute 98% of taxable income each year. Every time a mutual fund sells a security for a gain it must make a capital distribution to its shareholders. A study by Stanford University economists John B. Shoven and Joel M. Dickson found that taxable distributions had a negative effect on the rate of return for many well-known retail equity mutual funds. High tax-bracket investors ended up with only 45% of the funds published performance after reinvesting the after-tax distribution. A middle-tax bracket investor realized just 55% of published performance. Lower turnover results in significantly lower taxes, which in turn increases the overall net return.

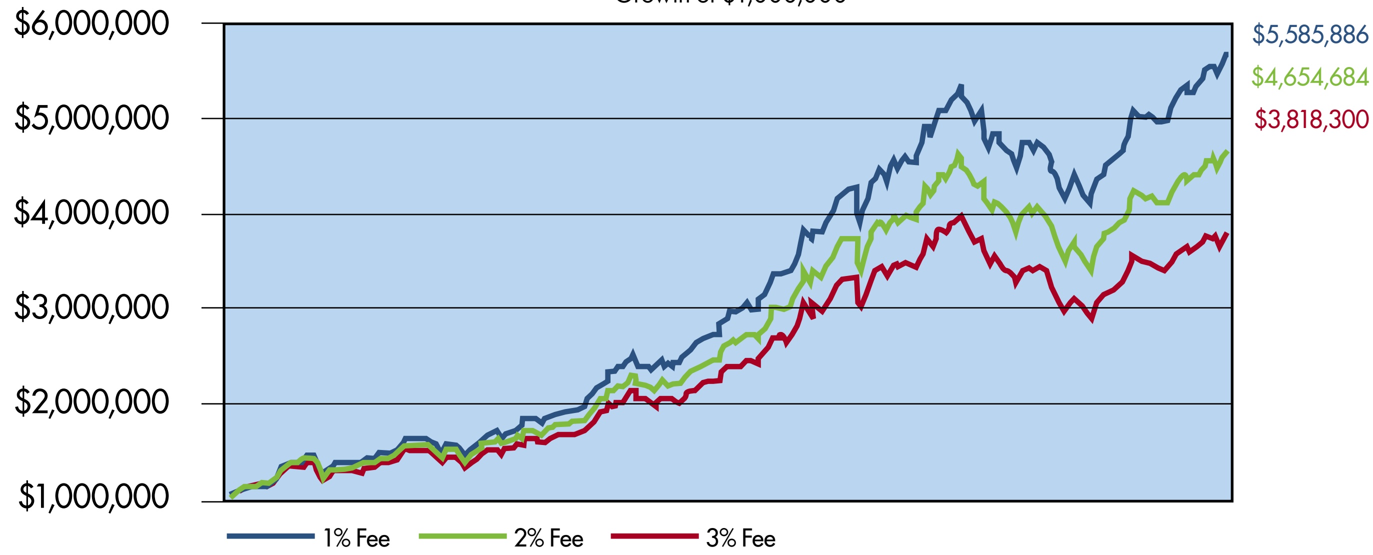
THE REAL COST OF FEES

Fees have a very dramatic effect on returns over time. We all understand the fundamental impact of compounding returns. The same can be said for the negative effect of compounding when fees are factored in. The chart, Fees Matter, clearly demonstrates the importance of keeping fees low. Excessive turnover, or trading, by portfolio managers can lead to higher transaction costs, higher commissions, wider spreads and market impact costs. The average retail mutual fund has a turnover ratio of 97%. For every $100,000 portfolio, $97,000 is traded in a 12-month period. (*See Figure C*).

The compounding effect of fees is very substantial. While it is impossible to predict market movements with any degree of accuracy, costs are within our control. You can see in the above chart that in real dollar terms, all else being equal, the negative impact to the portfolio is close to two million dollars over a twenty-year period.

Fees Matter (FIGURE B)

Growth of $1,000,000



(FIGURE C)

Consistent Investment	Rate of Return	End Value	Volatile Investment	Rate of Return	End Value
Beginning Value		$100,000			$100,000
Year 1	8%	108,000	Year 1	30%	130,000
Year 2	8%	116,640	Year 2	-20%	104,000
Year 3	8%	125,971	Year 3	25%	130,000
Year 4	8%	136,049	Year 4	-20%	104,000
Year 5	8%	146,933	Year 5	25%	130,000
Avg. return	**8%**		**8%**		
Compound Return		**8%**			**5.39%**

DECISIONS ABOUT RISK

Deciding to become an investor can be a very daunting experience no matter what your background is. I've seen the same level of stress with the college student opening her first RRSP, the business professional that is trying to plan for his family's financial freedom and the retired couple worried about weathering the next economic storm. The common denominator is risk. Most people understand that they have to take on risk in order to realize gains. The question is how do you really measure risk, and how do you know if you are taking on too much risk or not enough?

The good news is that it doesn't have to be a gut-wrenching experience. Follow these five steps and let the magic of compounding work in your favour.

MODERN PORTFOLIO DESIGN

Prudent investors need to keep the following in mind when building an efficient portfolio. Together with your financial advisor you can construct a lifelong investment strategy.

1. Determine acceptable risk level
2. Employ asset class investing
3. Global diversification
4. Lower fees and taxes
5. Rebalance the portfolio annually.

DETERMINE ACCEPTABLE RISK LEVEL

The first order of business is to determine the ratio between fixed income and equities in your portfolio makeup. Volatility does lower as fixed income increases. The correct balance of higher expected returns with equities and the defensive nature of fixed income is a personal decision taking into consideration your age, your tolerance for risk and your needs as you get closer to retirement.

EMPLOY ASSET CLASS INVESTING

Exposure to different asset classes will give you the diversification required to lower risk. An asset class is a group of investments with the same risk factors and expected returns. If you own many securities in the same asset class, you are not adequately diversified because they tend to move in a similar fashion throughout market cycles.

GLOBAL DIVERSIFICATION

Adding to this theme we look at global markets because international markets do not move in the same fashion as Canadian or American markets. By definition they are a separate and distinct asset class.

LOWER FEES AND TAXES

Unlike the average fund that has a turnover ratio of 97%, the prudent strategy is to deliver a specific asset class return with as low a cost as possible. Because mutual funds cannot keep capital gains on the books, they must distribute 98% of these to unit holders every year. The reality is that taxes on gains must be paid and the benefits of tax deferral are lost. As your personal success grows the impact of fees is dramatic.

REBALANCE THE PORTFOLIO ANNUALLY

Very simply, rebalancing forces you to buy low and sell high. For example, let's say that you decided that you wanted to put 20% of your portfolio in international holdings. If the international asset class did exceptionally well and became more than 25% of your portfolio, you would reduce the position back to 20%. You are effectively selling high. You could then add that 5% to whichever asset class is underperforming which would be buying low. This is a very effective strategy that should be methodically followed at least annually and more often if the markets are moving dramatically.

If you structure your portfolio and take a long-term view you can be assured of financial success. It's time to start living your dreams. ■

Sinquefield, Rex."Active vs. Passive Management." Transcript of opening statement in debate with Donald Yacktman at the Schwab Institutional conference in San Francisco, October 12, 1995. February 18 2007, http://www.ifa.com/Library/Support/Articles/Popular/SinquefieldActivevsPassive.htm#