The Responsible Investor

Ken Kivenko

About six years ago I was a member of one of the OSC's Fair Dealing Model's subcommittees (FDM), the performance measurement team. I was the only retail investor member; the others were dealers and lawyers, along with OSC (Ontario Securities Commission) staff. A number of firms suggested that the cost of providing personalized returns would be prohibitive. A few argued it was a value-added service that should be subject to fees. Concerns were expressed about the unrealistic short-term expectations that can be fostered by periodic performance disclosure if clients do not have an appreciation of market risk. Nevertheless, there was general acceptance of the proposal to focus on improved periodic performance reporting, especially of personal performance against goals, but there was some concern expressed about the way in which performance would be measured, the development of uniform performance measurement requirements and the use of performance benchmarks. There were many other good ideas to protect investors. Unfortunately, the FDM died when other provincial regulators didn't buy into its modern concepts, and industry lobbyists rallied aggressively against its principles.

Responsible investing requires that before any investing takes place that a foundation be built. This includes paying off high cost credit card debt, providing adequate insurance coverage, writing a will and setting aside an emergency fund. After that, investing can proceed.

Responsible investing requires measurement and analysis. The financial services industry places far too much emphasis on marketing/hype and too little on providing meaningful client account statements and personalized return information. In a September 2010 news release , Dalbar, a respected research firm, reported: " A telling sign that mutual fund statements are not meeting basic client expectations can be found in the area of performance reporting. According to a consumer preference study that Dalbar conducted, the most important statement feature valued by investors is overall rate of return information on their portfolio. A disappointing 68% of mutual fund providers are omitting this crucial piece of information on their statements."

Investor advocates have argued for years that "advice" without measurement is not advice. The 2008 financial meltdown was a five-alarm call for many investors, especially seniors and retirees, who were caught off guard when the market tanked. In 2009, the Ombudsman for Banking Services and Investments, www.obsi.ca, reported a record number of investor complaints. Retail investors blissfully trusted their advisers to manage their investments, paying little attention to their portfolios. Those who had been encouraged to borrow to invest suffered financially, emotionally and even physically. Responsible investors understand that leveraging increases risk, as well as potential return.

Since a majority of advisers are commission based, investors should, but often do not, understand that this may skew the recommendations made. In any event, most investors have no idea what their returns are or how they compared to benchmarks or what risks they were exposed to. Responsible investors do not let this happen. They ask questions, they understand what they are being sold, they appreciate simplicity, they value liquidity, but most of all they pay attention to their accounts. They want to see their portfolio grow and take steps to protect it from harm. They also understand the consequences of the consequences. That's how you build wealth.

I've always felt that if you don't control your own destiny, someone else will. Today, more people are taking responsibility for their nest eggs – some are choosing to self-manage their portfolios because they feel they have the confidence and capability to do so. Others just want to stay more informed and aware of what's happening with their savings. Still others depend on an adviser for a portion of their investments but also manage a portion on their own. Some discount brokers offer online tools and calculators that rival the best of the full-service brokers. RBC Direct Investing (RBC DI) has become a leader , now offering an online rate of return calculator. RBC DI have created a unique, fully integrated portfolio management system and tools to walk investors through the necessary steps of managing a portfolio, from goal setting, to analyzing, to rebalancing, to monitoring through your rate of return.

RBC DI clients also have the ability to compare their rate of return on a monthly, quarterly or annual basis to a known benchmark such as the S&P/TSX or S&P 500 or they can compare their returns to a standard investor risk profile.

A core feature of being a responsible investor is knowing your portfolio's rate of return. This figure helps you structure your investments to meet your financial goals, risk tolerance and objectives and keep you on track towards building a nest egg. Rate of return information will tell you whether you are progressing towards meeting your goals.

Many have found an annual checkup to be prudent and useful. It can also help you assess the value added by your adviser. Typically, most do-it-yourselfers and even those with advisers, assume that if their ending balance is greater than their starting balance or book value, the difference is their rate of return. But that doesn't take into account all the intermediate transactions that have to be considered to get an accurate picture of what their actual rate of return is. For example, are you on a DRIP program? Have you invested more money or withdrawn cash from the account? These cash flows have to be considered if you want to calculate your true rate of return. Sadly, few firms provide this information. If you can't extract it from your adviser, you can do it yourself. A great free portfolio return calculator tool is available at http://www.weighhouse.com/resources/portfolio_return.aspx but you've got to enter all the numbers during the period of interest. I tend to view "advisers" who are unable or unwilling to provide personalized return information as salespersons.

A benchmark for comparison is critical to ensuring a portfolio is performing. A benchmark comparison allows a responsible investor to ask important questions of him/herself and/or the adviser. By comparing your portfolio and its rate of return to a standard risk profile, you can see whether or not you are achieving your goals. A number of professionals suggest taking 5 years as the base period for evaluating portfolios. Create a strawman portfolio, against which you can measure your own holdings. Start by noting the percentage of your portfolio in five key asset groups: cash, bonds, Canadian equity, U.S. equity and international equity. Then, find the correct benchmark indexes for each of these asset classes and build your strawman portfolio by adding them in the same proportion they represent in your portfolio. If you have 50% in bonds, then 50% of your strawman portfolio will be represented by the DEX Universe Bond Index. If the index made 5% in a year, then it contributes 2.5% to your strawman portfolio return, ie. 0.50 x 0.05 = 0.025. Realize that markets don't monotonically increase. Losing money in a year is integral to investing, even if you have a well-diversified portfolio: It's the longer term that should concern an investor with the proviso that risk exposure should follow a suitable path as you age.

Now, if you aren't hitting the benchmark, is it because the portfolio investments are not in line with your target portfolio (or incongruent with your Investment Policy Statement)? Or is it because currency swings or excessive fees have distorted results? Weak returns in an asset class does not necessarily mean changes are needed. Just because international funds, for example, didn't do much for a portfolio in a given year doesn't mean they're not playing a useful role in your portfolio. Once you understand the situation, you can make the necessary adjustments to your portfolio mix, contribution level or your expectations.

Online tools are also available to help you to determine if your asset allocations are in line with your target portfolio profile, eg. http://retirementaction.com/AssetAllocation.aspx and http://www.smartmoney.com/investing/basics/the-smartmoney-one-asset-allocation-system-17605/. Also see http://www.ipers.org/calcs/AssetAllocator.html. This U.S.-based calculator helps you decide how to allocate your investment assets among stocks, bonds and cash. You can experiment by changing the variables and see the effect.

A responsible investor will also confirm that your level of savings is adequate. The stark reality is that far too many investors expect their retirement portfolio to generate index-beating performance that will rescue them from years of undercontributing. This desperate expectation leads to portfolio allocations that are excessively equity biased close to retirement. The impairment in 2008 of millions of retirement accounts held by retirees is a case in point. Realize that risk and return are close relatives. That's why the annual checkup includes portfolio rebalancing.

Another important point involving risk and investment choices ties in with Bernoulli's Hypothesis. Mathematician David Bernoulli's Hypothesis states that an investor's acceptance of risk should incorporate not only the possible losses that can occur, but also the utility or intrinsic value, of the investment itself. For example, a retired investor with ample savings already accumulated should not be exposed to a highly volatile or risky investment, as the potential benefits are unlikely to be worth the risk even if he/she has the risk tolerance and loss capacity associated with the risk. Someone who has sufficient savings may be content with GICs if the income generated by the savings is adequate. The responsible investor takes risks only to the extent needed to meet financial goals.

The last part of your portfolio check-up is an assessment of the fees you're paying. Fees count – fees are one of the key determinants of returns. Check out the fund fee impact calculator at http://www.getsmarteraboutmoney.ca/tools-and-calculators/mutual-funds/default.aspx.

The survey commissioned by online bank ING Direct found that 45% of Canadians were unsure of the annual management expense they are paying for mutual funds. Furthermore, 28% were unable to even suggest what they considered to be a fair fee. The survey also found that in the aftermath of the recession, 39% of respondents are questioning whether they are invested in the right products, and nearly a quarter (24%) are looking for a simpler, more proven way to save for retirement. See http://www.ingdirect.ca/en/aboutus/whoweare/whatwereupto/PR_2011-01-24.html. If your adviser never mentions low-cost ETFs or index funds, you should raise the issue.

Among the fees to consider are interest on loans, stock-trading commissions, mutual fund management expense ratios and sales commissions at the time of purchase, early redemption fees, switch fees, annual administration fees, currency conversion fees in RRSPs and advisory fees paid to advisers in fee-based accounts. Responsible investors ensure fees add value to a portfolio.

There are a few other tasks a responsible investor needs to do. These include:

- Ensure Know-Your-Client information is up to date.
- Check out your adviser and the dealer's reputation with regulators. As my granddad said, "Trust everyone, but shuffle the deck." Don't do side deals with your adviser or make cheques out to anyone but the dealer.
- Don't chase returns; don't buy products that seem too good to be true or are too complicated. Emotions like greed and fear are major factors in destroying returns. An understanding of behavioural finance will help curb bad behaviours. Visit http://www.behaviouralfinance.net/ for excellent coverage on this topic.
- Be tax smart. Never forget that it's what you keep that counts.
- Get street-proofed so Bay Street games don't catch you off guard. A good start is to download Robert Goldin's excellent book *Investor Beware!*. It's free at http://www.macgold.ca/investorbeware.

At any time, not just annually, a responsible investor needs to react to anomalous events. This would include unauthorized trades, account statement errors, an unknown fee, inexplicable numbers, excessive commissions, mysterious account transfers and the like. The earlier you deal with a situation the less costly and painful it will be.

Being a responsible investor requires some effort and knowledge. Investing isn't trivial but it isn't rocket science. Your nest egg is worth some of your time and caretaking.

Ken Kivenko, PEng, President , Kenmar Associates, Etobicoke, ON (416) 244-5803, kenkiv@sympatico.ca, www.canadianfundwatch.com