



Clients Personal Goals

The purpose of this seminar is to provide the inexperienced small investor with information and advice, or at least, in the short time we have, some notion of where to look for it, and of what investments should be approached with caution. It may seem, from the following, that we take a particularly dim view of mutual fund investments. This is not the impression you should take away from this seminar.

Mutual fund investments may well be a very appropriate investment vehicle for certain small investors. The real issue is information. The impressive rates of return advertised by many funds should, generally speaking, signal to investors that these investments likely also entail more risk than, say, government bonds. There is a good reason why mutual fund investments are required to make prospectus-level disclosure to investors. They are complex investments. They are not the same as depositing your money in a bank. In order for investors to make an informed choice when comparing the “real” returns they are likely to see in mutual funds with those offered through other investments, they need a great deal of information regarding how the funds are structured, what sort of fees and commissions are charged, and what are the tax implications, before they can be comfortable that they have chosen correctly. The most important thing for the investor, then, is to know his or her needs, so that they can then understand how a particular investment will suit them.

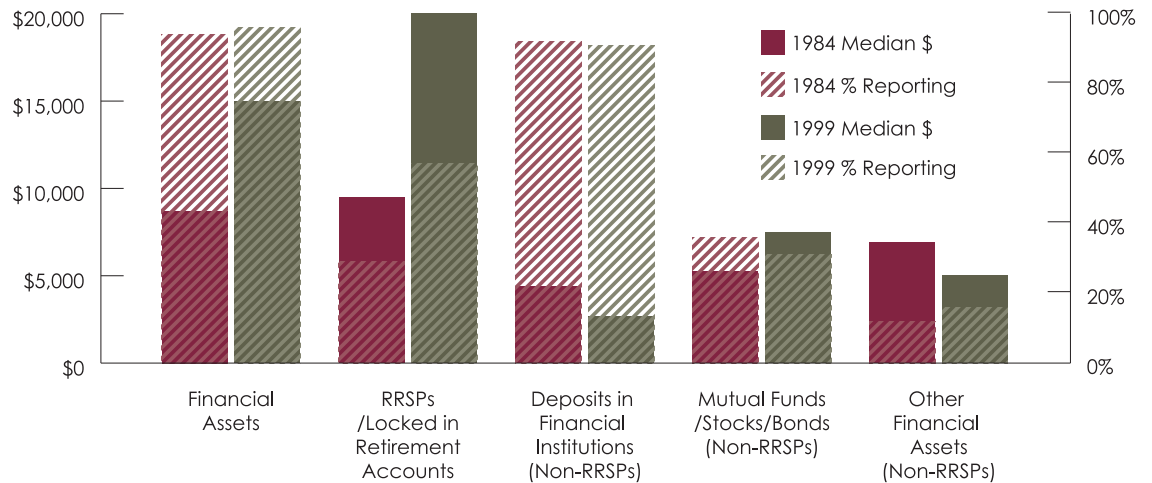
Know Your Needs

Today’s mutual funds have proved an enormously attractive and popular investment vehicle to the small investor. Its marketing success appears to stem, at least in part, from the fact that the basic idea of the mutual fund can be outlined to less sophisticated or experienced investors in terms that both make sense and make them appear to be a sound, low-risk, and lucrative investment. The basic concept, as most people know it, has many small investors pooling their resources and turning them over to highly-skilled (and therefore expensive) market professionals who work full time managing this investment. In this way, average individuals are, in principal, able to take advantage of the kind of investment advice previously open only to very large investors, and thereby (also in theory) enjoy the higher rates of return on investment once thought to be the exclusive preserve of large companies.



The following table evidences some of the increased popularity among average Canadians in financial investment vehicles, mutual funds in particular:

Figure 6.1 - Median Asset Holdings: 1984 versus 1999,* All Family Units (Medians Based on Those Reporting Ownership, in 1999)**



Note: Unlike average values, median values are non-additive, i.e., the sum of the individual categories does not equal the total.

*1999 data are adjusted to be made comparable to 1984 data.

**All family units include both economic families and unattached individuals.

Source: Statistics Canada, SFS, custom tabulations.

Sounds great! Unfortunately, the typical “small investor” often learns little beyond this before entrusting funds—often a sizeable fraction of their total net worth, and, moreover, that are critical to meeting the small investor’s basic needs, particularly in retirement—to one mutual fund or another in the hope of building on the small amount of wealth on which he or she is absolutely reliant. Also, the needs to inform oneself regarding investments is not only necessary because of the amounts involved, but because our individual needs when investing are different. The most prevalent reason for investing in the markets is, not surprisingly planning for retirement. There are, of course, others, such as saving for a child’s education, and other life goals. It stands to reason that what is at stake should, ordinarily, affect the kind of investment vehicle chosen and the level of risk the small investor should be prepared to tolerate. Other factors also serve to differentiate the needs of the individual investor, such as the length of time one is prepared to “stick with” a particular investment vehicle to “ride out” any potential market downturns. These latter are certain to occur, of course, but completely unpredictable in both their extent and timing.

Choices, moreover, have become more difficult. The number of mutual funds from which Canadians can now choose, for instance, has grown dramatically in recent years. The Investment Funds Institute of Canada reported in 2003 that, in the last decade, “[t]he number of mutual funds under management in Canada has almost quadrupled, increasing from 505 in 1991 to 1956 in 2002.” This fact alone can only render the task of making an informed choice a more difficult and daunting one for the inexperienced or untutored investor. Why investors need to seek out more and better information is made clearer by the somewhat alarming statistics regarding proportions of individual net worth that is handed over to these vehicles. In the United States, where fund investment is somewhat heavier than in Canada, a Statement made to the US Senate Committee on Banking, Housing,

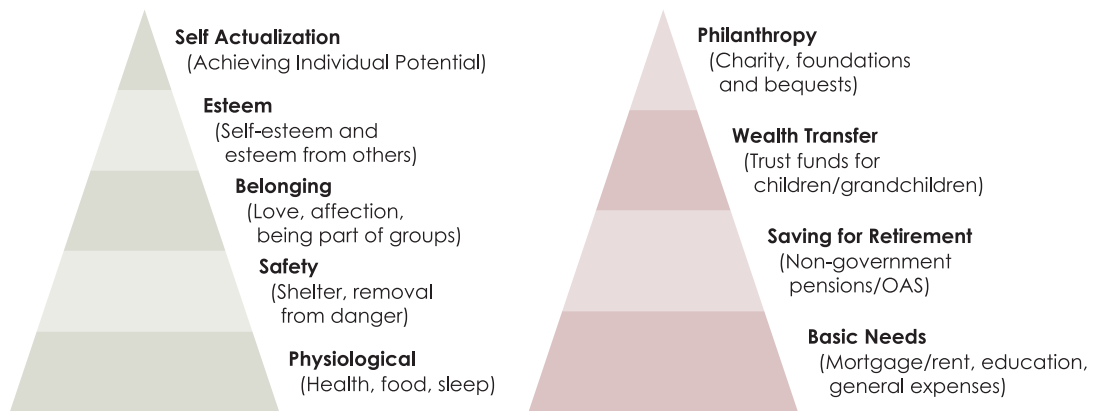


and Urban Affairs, noted that “33 percent of all mutual fund shareholders have household income under \$50,000. Of these shareholders, a staggering 44 percent of household financial assets are held in mutual funds, a testament not only to the power of the investment vehicle, but to the trust of the typical investor.”¹

When considering the gravity that such decisions have, the sheer size of the investment of small investors (both in absolute terms and relative to their net worth), and the potential impact on one’s financial security, the typical Canadian small investor does surprisingly little research into the variety of investment vehicles available, and the costs and risks involved, before committing to one or another. One writer has noted, for example, that “People often spend more time comparison shopping for a television set or planning their vacation than they do planning and managing their affairs to meet their current and future financial needs...”² Clearly such a large personal investment deserves closer attention from each small investor.

Individuals also need to be acutely aware of the needs they are addressing when investing in the markets, since this is an important determinant in choosing the right investment. It may be helpful to look at it in terms of the behaviorist Abraham Maslow’s graphic representation of our “hierarchy of needs”

Maslow saw an individual as addressing his or her particular needs in stages, building from the base of the pyramid to the top. Investors need to be aware of what region they are building upon when assessing invest-



ment choices. Sadly, particularly for the small investor, they are focused on the wrong part of the Maslow hierarchy. Those investors who are addressing their retirement needs really should be thinking of it in terms of needs near the base of the pyramid, where steady, predictable, and certain growth are priorities. Mutual funds, however, often carry inherent risks which are more appropriate for addressing needs located at the top of the pyramid. This is a critical mistake too often made by investors, their judgment too frequently clouded by the “get rich quick” allure of many funds.

¹ Statement of Tim Johnson, U.S. Senate Committee on Banking, Housing, and Urban Affairs, “Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry” November, 20 2003.

² Glorianne Stromberg, Investment Funds in Canada and Consumer Protection: Strategies for the New Millennium, prepared for the Office of Consumer Affairs (October 1998).



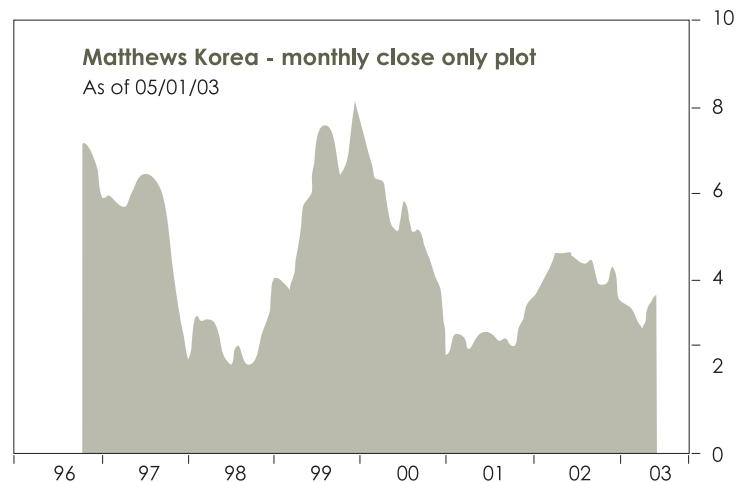
Know the Risks

Skillful marketing has been largely responsible for the ability of mutual funds to disguise the inherent risks involved in investing in a volatile market. Trumpeting the benefits of features such as “long-term” investment, “diversification”, and compounding, funds have largely succeeded in convincing investors that they are relatively “risk-free.” They also enjoy the image of being a regulated sector with demanding investor disclosure requirements. A closer look, however, reveals that these investments are far from “risk-free”. Funds sometimes advertise impressive rates of growth over extended periods. The problem is that, even if the average growth rate is strong, in any given year the fund can actually post a loss. If this downturn happens to coincide with a period at which the investor needs to draw on his investment, either for retirement or during periods of unemployment, this kind of natural volatility can have tragic consequences.

One of the common misconceptions that one must be aware of when choosing an investment vehicle is the rate at which managed funds tend to underperform relative to the market. In other words, although one would expect that funds carefully managed by market professionals to perform better than the average growth posted by the market, a majority of them actually perform worse. This is one of the most important statistics a prospective investor should keep in mind.

For example, in his book, *Stocks for the Long Run*, Jeremy J. Siegel found that, “the number of funds that - over the 30 years from the 1970s to early 2000s - outperformed the S&P 500, excluding fees, varied between 10% and 85% from year to year. And between 1982 and 2003, there have only been three years in which more than 50% of mutual funds beat the market! So, while it’s not technically accurate to say that only 20% of funds outperformed the market, we can say that most of the time, a majority of funds will underperform.”³ These performance statistics are equally applicable to Canada as they are to the United States.⁴

A further problem to be aware of is the very high likelihood that a fund manager’s goals, which necessarily take into account the needs of a great number of investors, may not coincide with your specific investment needs and goals, or with their timing. For example, the Matthews Korea fund, specializing in investments in Korean companies, showed a 5-year annual return of 34% as of December 2002. However, had anyone invested in this fund in December 1999, when its performance was especially strong, that individual would have lost 69% of his or her investment by December 2000.



³ Quoted from Shauna Croome, “Can You Pick the Winners at the Mutual Fund Track?” July 2, 2003, online: www.investopedia.com.

⁴ Paul Kedrosky, “Regulators Obscure Mutual Fund Dangers” National Post (Financial Post) November 4, 2003.



The view that fund managers cannot consistently “pick winners” and as a result underperform the market was first popularized in the 1970s by the Princeton economist Burton Malkiel, in his classic study, *A Random Walk Down Wallstreet*, where he infamously proclaimed that “[a] blindfolded monkey throwing darts at a newspaper’s financial pages could select a portfolio that would do just as well as one carefully selected by the experts.” For this reason, Malkiel consistently advocated that investors abandon managed funds and instead place their money in index funds, which choose a portfolio specifically to mirror the growth in the market. Investors would thereby avoid the management fees charged by funds, and still do as well or better than managed funds.

Index funds, however, carry risks of their own which small investors in particular may be unwilling to accept, once aware of them. There is in fact a bright line distinction between “risk-free” return, often represented by the rate of return offered through government bonds, and investments entailing risk. Index funds, even though they correlate with market growth, still fluctuate in performance from year to year. They may, say, have double the average annual performance of a government bond earning 6% per annum, but the 12% earned by an index fund represents only the possibility of a greater return; that is, it represents both higher potential returns and higher potential losses. Thus, the index fund returning an average of 12% per year on investment can be very high one year, and negative the next.⁵ Thus the tradeoff for this “risk premium” (in our example, the extra 6% = 12% - 6%) is having to accept greater volatility in performance.

Finally, and this by no means exhausts the question of the potential risks the small investor faces with regards to mutual funds, one should mention the potential conflicts of interest that arise between investors and fund managers; that is, the conflict between the investor’s desire for maximum growth at minimum risk, with the fund manager’s desire to maximize profits. This conflict of interest, moreover, is not hidden. It is an inherent aspect of managed funds, and probably has not been adequately addressed by appropriate regulations of the potential abuses. For instance, it has been noted specifically in a Statement to the US Senate Committee on Banking, Housing, and Urban Affairs (the same quoted earlier in this seminar) that situations in which “those in positions of fiduciary responsibility took advantage of their customers had to do with steering them to certain funds, not because they were appropriate for the investor, but because they yielded bigger commissions for the broker.”⁶ Indeed, a possible solution to this problem of conflicts suggested by one writer is a “return to a world in which investors build and manage their own individual portfolios.”⁷ For some small investors who seek out the appropriate kind of adviser, this may well be a realistic option. Also, this potential for breach of fiduciary duty as a result of conflicts of interest opens the door to potential legal actions on the part of investors against brokers and advisers in which, sadly, everyone’s a loser.

⁵ From “Financial Concepts: The Risk / Return Tradeoff”, online: www.investopedia.com.

⁶ *Supra* note 1.

⁷ Paul A. Tkac, “Mutual Funds: Temporary Problem or Permanent Morass?” Prepared for the Financial Markets Conference, Sea Island, GA, April 2004 at 26.



Know the Costs

We talked earlier of the relative performance of managed funds versus index funds, and the level of risk inherent to both of these kinds of investment. Even if, however, you happen to be one of those fortunate few who hitched their wagons to a winning fund that beats the market, it may well turn out that, after factoring the many costs and fees associated with managed funds, such as the Management Expense Ratio (MER) and various transaction fees (loads), the “net”, or “real”, rate of return of your fund is less than that of other investments which superficially appear to be less lucrative.

First, it is well known that all mutual funds have disclosed costs. Or, at least, if it is not well known, it should be. Quite simply, this is how the managers that trade in the funds get paid. The disclosed costs include the commissions paid (or early redemption penalties) and the MER. Thus, in order to determine one’s rate of return, one has to calculate how these fees bite into the reported annual rate of return of the fund. This furthermore, will differ based on how much you invest in the fund (discounts on front-end loads based on certain specified “breakpoints”), on whether the fees are “front-end” (one taken off your initial investment) or “back-end” (a deferred sales charge that serves as a penalty for early redemption), and on how long you hold. All of these calculations can become quite complicated and will lead to a different rate of return for each individual investor, but they are nevertheless necessary for any meaningful comparison of rates of return to be made. Knowledge of the costs of the fund is crucial, furthermore, because the impact of just a 1% difference in fees can have a staggering effect on the long-term return of your investment. Glorainne Stromberg has calculated that “[e]very 1% you pay in fees or charges will reduce your capital by about 20% over 25 years. That could mean the difference between being comfortably well off and struggling to make ends meet”.⁸

What is less well known, or perhaps one should say even less well known, is that mutual funds often have a number of undisclosed costs, meaning those that are not required by the regulations to be disclosed in a prospectus. For example, brokerage commissions (commissions paid by the fund manager when purchasing or selling certain stocks) range from 1% and up. These are added to the cost of the shares, and subtracted from the price received in their sale. In other words, they are paid by the fund company and are passed along to investors as a cost in the form of lower returns. This is further directly related to portfolio turnover. Thus, a fund that has a higher portfolio turnover will incur higher trading costs.

Fund returns can also be eroded through cash that must be held in order to pay redeeming shareholders. This is called the “liquidity ratio”. In the US, the average liquidity ratio for actively managed equity funds in 2002 was 6%. This is a problem because this cash on hand earns a very low return.

Taxation also has an effect on fund returns, and can affect them in one of three ways:

1. Individuals must pay tax on their capital gains when they redeem their investment.
2. When the fund sells a stock for a profit, those gains are passed to the shareholders who are taxed on the capital gains, even if they do not benefit from the gain. Thus, capital gains tax can be paid by the investor even when the fund shows a loss!
3. Finally, investors may become responsible for capital gains taxes on gains already embedded in the fund’s holdings at the time they initially purchased their investments

⁸ National Post (Financial Post- Investing Guide) October 30, 2003.



The long and the short of these “hidden” costs is that, by some estimates, they can increase the costs to investors by about 4%, and more than this if bought with a front-end load of 3-5% or with a deferred sales charge of 6-7%. This means that if a fund has an MER of 2.75%, the total costs to the investor could be as much as 6.75% a year. This is the return the fund would have produce simply to break even. The fund would in fact have to have an annual return of at least 11.75%, exclusive of fees, simply to post the very modest annual return of 5%. Some calculations of both disclosed and undisclosed costs have estimated that between one quarter and one third of a fund’s gross returns are required to cover its costs.

All of this should make it hardly surprising “that 88 percent of Canadians polled reported that it was ‘somewhat difficult’ or ‘very difficult’ to understand their options as consumers when making decisions about investment products such as mutual funds and RRSPs.”⁹ Of course, the average investor cannot be expected to know all the intricacies of the many investment opportunities that are available. Therefore, there is still a need for market experts. However, each investor’s needs tend to be so specialized, that a possible solution is to seek out an investment advisor that will tailor investments to your individual needs. There is still the potential of receiving advice that serves the advisor’s and not the investor’s interests due to a conflict. In these cases the legal liability created through the Know Your Client rule, which ensures that advisors have detailed knowledge of investors’ needs and risk tolerances, may serve to protect both the advisor and the investor.

⁹ Online:

<http://strategis.ic.gc.ca/epic/internet/inoca-bc.nsf/en/ca02108e.html>

Know the Guarantees

Now that we have looked at the various costs, disclosed and hidden, and risks associated with investment in the markets, can we not say, then, that there are at least some highly-diversified funds that offer both a high “real” rate of return and are relatively well protected from market volatility? Well, there may be select few that, historically, consistently outperformed the market. So why not invest in these? Simple: Because even an unbroken record of past success is no guarantee against future failure.

Malkiel’s original Random Walk study tracked the performance of the top 20 mutual funds of the 1970s through the 1980s. Only one of these, the Magellan Fund, succeeded in outperforming the market in the later period. What is more, the rest not only did not outperform the market, they didn’t even outperform the average managed fund. This data merely underscores the disclaimer that appears in every mutual fund prospectus (and is so often ignored) that states the painfully obvious truth that past performance is no guarantee of future performance.

What is more, the risk/reward correlation that suggests that higher risk leads to higher returns depends on an investment having a greater statistical standard deviation than less risky investments. What this essentially means is that the riskier investment is the one that is more volatile in growth. Thus, although in a market upturn the riskier investment would be expected to grow more than average, conversely, when the market slumps, the losses incurred by the risky investment would also be greater than average. For many small investors, it may well be unwise to play this sort of roulette with funds that are expected to provide one’s basic needs in retirement. This insight is supported by the accepted wisdom regarding achieving the correct asset allocation in one’s portfolio; which is, that the older a person gets (i.e., the closer to retirement) the lower should be the proportion of risky investments in one’s total mix of investments.



Know Your “Fallback”

The purpose of the foregoing seminar has not been to warn anyone and everyone off of investing in mutual funds (although it may well have sounded that way, at times). The purpose has rather been to alert consumers of investment products that making an uninformed decision concerning a major investment is tantamount to making a bad decision. Mutual funds may indeed be an excellent investment for some investors, when all the relevant factors have been considered. What this paper intended to illustrate, however, is that the sheer variety of funds available and the effects of costs and management fees, both disclosed and hidden, on ultimate returns present especially difficult hurdles to making an informed judgment on their suitability for the particular individual investor. Any professional investment advisor would have to be proficient in analyzing all of these factors, be able to properly advise on the tax implications of various investments, and basically know the client’s need, goals, and risk tolerances inside and out in order to offer accurate and appropriate advice.

While mutual funds may be appropriate for some, however, they are by no means appropriate for all. This is one of the basic facts to be drawn from the current seminar, and one that appears to be going unheeded, since mutual funds appear to be the investment vehicle of choice (not necessarily the investor’s choice) for virtually every variety of “average investor.” The risks associated with mutual funds are real, and perhaps therefore not suited for many aging small investors who are preparing for retirement. A telling figure in this regard is that reported in the Statement to the US Senate Committee on Banking, Housing, and Urban Affairs, cited at the beginning of this paper, where it was noted that “the ICI’s [“Investment Company Institute”] 2001 Profile of Mutual Fund Shareholders reveals that 91 percent of all mutual fund shareholders say the primary financial goal of their investment is to save for retirement.”¹⁰

This statistic is all the more disturbing when set alongside another poll finding that 41% of investors in mutual funds do not know what kinds of mutual funds they own.¹¹ As has been noted earlier in this paper, moreover, there is no shortage in the variety of investment vehicles available to investors that can be closely matched to one’s needs. The real problem lies perhaps in information asymmetry. Information about risk is especially critical for the small investor, given that they have very little cushion in their net worth, should anything go awry. The most important barrier, then, to protecting one’s wealth, is bridging this knowledge gap in order to be able to make the right choices. It is likely that refining services in this area will best help investors to help themselves.

¹⁰ Supra note 1.

¹¹ 12th Annual RBC/Ipsos-Reid poll, Wave I, 27 February 2003.