



Value for Money Investing

by Gordon Stockman, CA, CFP

Value For Money Investing means we wish to allocate and use our hard-earned resources in order to improve investment outcomes in a continuous and sustainable way at a fair and equitable price. In other words, achieve good investment returns AND receive fair value for the services provided.

If you are being assisted with your investments, you are paying for the service. Mutual funds have self contained fees deducted before the advertised result. Shares, bonds and many other products have commissions for buying or selling. Brokers may charge wrap fees and Advisors or Financial Planners may have fees for service. Your results should be evaluated after considering all costs for such services.

In Canada controlling costs can be difficult. Many investors use mutual funds and all the fees are imbedded and harder to see. A recent academic study being circulated for comments claims CANADA HAS THE HIGHEST MUTUAL FUND FEES IN THE WORLD. They compared Canada's 3,674 funds to the total 46,580 funds examined from 18 countries. Over a third of the total was domiciled in the US.

Mutual Fund Fees matter because higher fees depress performance. In Canada, we seem willing to believe that the higher fees are justified, since we have managers that do a consistently good job for us. But do they? Standard and Poors reports that "over the five-year period ended Q4 2006, just 10.8% of actively managed Canadian Equity funds have outperformed the S&P/TSX Composite Index ...and only 14.5% of U.S. Equity funds have outperformed the S&P 500 Index."

Now the surprise in the figures to me is that any equity mutual fund beats the index at all. Remember, mutual funds are reporting the result after deduction of their fees and those fees average over 2.5%. In fact, S&P reports that "Five-year average fund returns up to the end of 2006, show active funds underperforming the S&P/TSX Composite Index and the S&P/TSX Capped Composite, both on an equal and asset weighted basis, by roughly 300 basis points." In other words, average performance underperforms at a rate greater than the average fees meaning that managers are even underperforming on average before fees.

The 10.8% that are beating the index are indeed very good and that is who you want to manage your money. But here is the problem. There is no known way to reliably pick the manager that will outperform in the coming years. We can only reliably identify those managers that have beaten the index in the past, not the future. With average performance 3% below the index, it is never long before even the best manager starts having some bad years.

I like to describe this problem to my clients as follows: You are interviewing 20 prospective mutual fund managers. Each and every one of them tells you that they have the credentials, the training, the strategy and the smarts to beat the index. You know that some are going to be proven right, since it is established fact that the index can be beaten. BUT HOW TO CHOOSE? Without a clear rule or indicator to choose with, you must rely on probabilities. You have less than a 3 in 20 chance of getting the selection right. 17 managers will not beat the index, so you have a 17 in 20 chance of getting it wrong. Not good odds. In fact you are making a 3 in 20 bet to likely beat the index by only a couple of percentage points. It gets worse. You are making a 17 in 20 bet that you will underperform the index by more than 3%. How do we know it is more than 3%? Because the AVERAGE underperformance is 3% and when you remove the 3 that outperform the index the average shortfall must be even greater. Terrible odds if you believe that there is no reliable indicator.

So what to do? Realize that there are managers that can and will beat the market, but you do not know how to safely choose them. We all want to outperform the market but resist. The probable outcome (17 of 20) is that you will not. Why not take the sure bet and pick the index itself? You will be right 100% of the time. There are mutual funds and exchange traded funds that track the index. Your result will be the index less the known imbedded fees, a small tracking error less what you pay for advice. All known costs. Remember, your odds of bettering this strategy are heavily against you.

You have not heard of index funds? No surprise really. Most advisors do not sell them or recommend them because most of the available ones pay no commissions or trailer fees and remember most advisors work on commission. Without index funds, you are facilitating your advisors income with your poor odds of success.

One last point for those who do not use mutual funds, but rely on broker's advice. Remember that only 3 in 20 professional managers beat the index. They have the credentials, the training, the strategy, the smarts, staff doing research, access to the best minds in the worlds and are engaged in a single pursuit, managing your money. How does your retail broker stack up to this? Your odds may be even longer.



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COSTS DO MATTER

Look at the chart and determine how much more you could keep in your pocket after a 20-year period, if you could reduce the overall fees in your portfolio by just 1%

START VALUE	RETURN OF %7	RETURN OF %8	YOUR SAVINGS
\$100,000	\$386,000	\$466,000	\$80,000
\$250,000	\$967,000	\$1,165,000	\$198,000
\$700,000	\$2,700,000	\$3,262,000	\$562,000

Call us. We Can Help!

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Gordon is the Vice President – Financial Planning at Efficient Wealth Management Inc. a leader in cost efficient financial planning. He teaches at George Brown College in their Financial Services and Accounting area. He is also a frequent guest on television and has written numerous articles on investing and financial planning.