Drawing investment lessons from architects

A portfolio divided against itself cannot stand

INVESTMENT STRATEGY

By Jon Kanitz

Just as the architect has various materials at his disposal, the investment manager has various financial instruments with which to construct a solid portfolio. Only by knowing the strengths and weaknesses of these instruments can the investment manager use them with conviction.

Good buildings, as well as good investment portfolios, are characterized by balance, solidity and quality. They must be suitable for their clients, appropriate for the environment and constructed with reliable elements.

Both good architecture and skilled portfolio management incorporate an intelligent blend of science, engineering, art and intuition.

Ever since I originally wrote the two preceding paragraphs 20 years ago, I have wanted to write an article about architectural investing. It seemed to me that there were several themes common to both architecture and portfolio management.

A few pearls of wisdom drawn from the writings of several great architects, I thought, would provide some evidence of this. Let's see if you come to a similar conclusion. My candidates are as follows:

• "Well-building hath three conditions – commodity, firmness and delight." (Vitruvius)
• "Form follows function." (Louis Sullivan)
• "Each material has its own message for the creative artist." (Frank Lloyd Wright)
• "Structural architecture is based on logic, not impulses." (Ludwig Mies Van der Rohe)
• "Survival depends on design." (Richard Neutra)
• "A bold idea, plus precision, care and thought, make a good building." (Gordon Bunshaft)
• "We cannot *not* know history." (Philip Johnson)

These quotations appear in a book entitled *Architecture Today & Tomorrow* (1961) by Cranston Jones that my father gave to me in 1966. I read it cover to cover only recently. (And you thought you were behind in your reading!)

Each quotation could show up (*mutatis mutandis*) in a mission statement about investing. Here is my retread:

Well-constructed portfolios meet three conditions – comfort, strength and suitability. Form follows function. Each security carries its own information for the enterprising investor. Value investing is based on logic, not impulses. Profitability depends on systematic decisions. A bold idea, plus precision, care and thought, make a rewarding investment. We cannot *not* know market history.

Recent evidence indicates that the shares of companies domiciled in the same regions or cities rise and fall together as a group.

I could also say that you should construct your portfolio like you would construct your house, but that's just rhetoric. I could rehash the old 'investment pyramid' with savings bonds at the bottom and commodities at the top, but that's too simplistic. Most of you are more interested in the price of a tank of gas.

Frank Lloyd Wright was the most principled and systematic of all American architects. Wright alone had a fully developed method of design that was so intellectually embellished that it bordered on ideology. His designs were governed by the principles of balance, symmetry and integrity.

Balanced portfolios come in several varieties – bonds and equities weighted equally, small cap and large cap weighted equally, etc. Others are various methods of diversification among industry groups or market sectors, as well as geographic balancing.

Recent evidence indicates that the shares of companies domiciled in the same regions or cities rise and fall together as a group. Balance has structural merits in both buildings and portfolios.

As Wright strove for "geometric purity," geometric order naturally transcended into symmetry, which would not appear to have any investing analogue, except as an extension of balance. A particular house in my city shows what happens if elements of the Wright style are used without balance or symmetry. Analogously, a portfolio can become a hodgepodge without at least some form of balance.

When Wright modified Louis Sullivan's "form follows function" to "form and function are one," integrity became the most important principle in his work. Any further attempt to link architectural principles to investment principles seems grandiose.

Nothing in the stock market looks like a building except the four pillars, but they are ancient history. It is enough to idealize the "law and order" of architecture to which Wright frequently referred, and to simultaneously recommend what Leonardo da Vinci called "obstinate rigor" as the cornerstone of a superior investment style.

Natch, in these articles, I wish that I could be specific, stock-wise. But new disclaimer rules, to which I must adhere, and which I have mentioned once before, prohibit this. As a result, I write generic articles. Sometimes these, as in the present instance, belong in the category of creative writing as opposed to investment tip sheets.

However, all is not lost. The public prints these days are filled with specific opinions on specific companies, and so-called (presumably) proprietary research is widely available from a broad variety of hard copy sources, not to mention the internet. In a previous life, I contributed to the deluge with mixed, though usually good, results.

But that was then, and this is now. In fact, I have keenly embraced my new restrictions because they challenge me to write 'eureka' speeches that I didn't even know I had in me before pen was put to paper. This is more fun anyway than touting stocks.

Sometimes I wonder why I ever did that in the first place. I was Snow White, but I drifted.

Jon Kanitz Ph.D., is a first vice-president and investment advisor with CIBC Wood Gundy in Toronto. He and his clients own securities mentioned in this column. His views do not necessarily reflect those of CIBC World Markets Inc.

FINANCIAL PLANNING

A little used but mighty employee benefit tool

MERRICK WEALTH

By Peter Merrick

Recently I met with a client who owned a small business. For the last 10 years he had been paying bonuses to his employees based on his profits.

The problem he felt was that after he took off all the required taxes that he had remitted to the Canada revenue Agency (CRA) on his employees' behalf, the result was most of his people were left with little more than half of what he had intended to share with them. He asked me if there was an employee benefits plan in which:

• Contributions could easily be reduced in years he was not profitable.
• His employees could receive their entire bonus in a tax effective way.

The answer that immediately popped into my head was the deferred profit sharing plan (DPSP).

These plans are not widely used in Canada today. However, DPSPs are one of the most powerful employee benefit tools that an employer can include in their arsenal to attract and retain top-notch personal. In a nutshell, employers and employees appreciate the DPSP because it rewards employees for helping a company earn profits.

A DPSP is a simple and flexible arrangement. A company/plan sponsor distributes a portion of the company's pre-tax profits. Such plans are arrangements where an employer may share with either all or a designated group of employees the profits from the business.

Contributions and administration fees are tax deductible for the employer and accumulate, tax-sheltered, in the plan for the benefit of the employees or former employees, until paid out of the DPSP as stated in *subsection 147(1)* of the *Income Tax Act*. In years that a DPSP sponsor is not profitable the employer only needs to contribute one per cent of an employee's income.

In a nutshell, employers and employees appreciate the (deferred profit sharing plan) because it rewards employees for helping a company earn profits.

Usually the amounts payable by the employer under a DPSP are calculated as a portion of profits (e.g., 10 per cent of profits as defined in the plan), but the sum can be a fixed dollar amount per plan member, or a fixed percentage of payroll.

Points to remember:

• A connected person (an individual who owns directly or indirectly more than 10 per cent of a company) is not eligible to participate in a DPSP.
• Employer contributions into a DPSP are limited to the lesser of 18 per cent of the employee's compensation for the year or a dollar limit equal to one half of the defined contribution pension plan limit as follows:
– 2006: $9,500; 2007: $10,000; 2008: $10,500; 2009: $11,000; 2010: indexed.
– Contributions are not added to members' earnings and are not subject to payroll taxes such as employment insurance and Canada Pension Plan.
• Unlike a group RRSP or pension plan, only employer contributions are allowed under a DPSP. Most employers use a DPSP as a complement to a non-contributory group RRSP (i.e. an RRSP with no employer contributions).
• Contributions to a DPSP reduce the employee's RRSP room for the following year (but allow full RRSP contribution for the current year). The reduction shows up as a pension adjustment amount on the employee's T4.
• Contributions vest in members after two years and are not locked in. Usually a DPSP member has the right to withdraw vested benefits from the plan at any time. Contributions can be cashed out or used to purchase an annuity.
• Depending on the plan, DPSP members may withdraw their holdings while still employed. Terminated employees can withdraw the full vested amount, subject to taxation.
• The DPSPs requires trustees, with at least one trustee being fully independent of the employer and plan members. All trustees must be residents of Canada.
• All DPSPs must comply with the rules laid out in the CRA's informational circular 77-1R4.

Defined Profit Sharing Plans require specialties in areas as diverse as pension legislation, employment law and employee benefit plan construction.

Many employers and their accounting professionals, who think they would benefit from implementing a DPSP, will need to seek education to aid them in its set-up and maintenance stages. Therefore, it is worth the time to invest in learning more about the DPSP, to assist clients to take advantage of this under-utilized compensation strategy.

Peter Merrick, BA, FMA, CFP, FCSI is the President of Merrick Wealth Management Inc., a boutique fee-for-service executive benefit and financial consulting firm in Toronto. He can be contacted at *peter@merrickwealth.com* or *www.merrickwealth.com* or (416) 854-1776.