Making the case for managed money

By PETER MERRICK

Over the last decade I have been asked by both my clients and students: What is better, to hold stock or bonds directly or to own managed funds that own those same stocks and bonds?

Many in the media have objected to managed money because they say it adds another layer of people who charge fees.

Successful investors like Warren Buffet believe markets are not always efficient. According to pundits of the efficient market theory, they believe that the price of a stock reflects a company's true underlining value. Those that believe in the efficient market theory believe that no single entity can affect the prices of stocks or bonds.

In reality, the managers of Canada's largest mutual fund companies—Investors Group/ Mackenzie Financial, AIM Trimark, Fidelity—can buy a significant percentage of a Canadian company's stock, causing the price of that stock to go up, as other buyers follow in the wake of these mutual fund companies' purchases.

Those who buy Canadian shares from full service or discount brokerages usually have no idea when the buying began.

So what are mutual funds, money managed accounts and pool funds? They are a collective of sorts, in which people have pooled their financial resources under professional management.

These managers claim that an individual investor may be able to buy the same stocks cheaper on his or her own, but he or she would not have bought the same stocks at the same time with the same knowledge.

If markets were perfectly efficient and research did not make a difference, then relative fund performance would be based on chance.

If it was that easy to make money from investing in stocks, individual investors would only need to watch business news programs. But information in an efficient market is disseminated randomly.

From my experience I would argue that although information may be random at its outset, its development is sequential. Stories have a beginning, middle and an end. Sometimes hearing the news and acting on it first provides an advantage.

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Sometimes having the wisdom not to react will prove more successful. Sometimes it helps to know the people releasing the information in the first place.

Wisdom comes from making mistakes and then learning from those mistakes. These lessons can be expensive, especially for someone using their own money, as a hobbyist.

Money managers are people, like you and I. Maybe they are no smarter than we are, but they have the time and money to find that garage in Richmond Hills' Silicon Valley North where two recent grads from Waterloo University are working an Internet breakthrough.

Fund managers at Templeton and Fidelity are more likely to find out which companies in India or China will grow and which national government is about to fall. Efficient markets require that access to information be, if not free, at least equal.

Fund managers claim their information is not random, but the result of well-developed methodologies and access to information, which although public enough to avoid security violations, is too fresh to be widely disseminated.

When I took my Canadian Securities Course in 1990, the text stated that for a portfolio to be diversified it would need to hold between 15 to 30 stocks to avoid a single company's risk.

That is, the risk that a company's management team might do something stupid.

Some people can afford the time and the money to design their own portfolios.

Owning this many companies in one's portfolio requires multiple costs for transactions, time for tracking, following and measuring performance.

This all leads us back to my initial question.

If you believe in perfectly efficient markets, that there is no truth to the herd mentality then research does not matter, and there is no value in delegating you're investing—and there is no reason to buy money management products.

However, if you value your time and your money and believe that expert money managers can invest your money better than you, I have found the best criteria to pick these excellent money managers to run your portfolios are:

- Make sure they have done better than the average of their peers for a meaningful period of time, say 10 years.
- Make sure they have been running money for a while and had some combat experience, meaning managing money in both the boom years of the late 1990s and the bust years of the early part of this decade.
- Make sure they are long-term investors. They are owners of stock and bonds, they do not rent them.

In Canada, every time a portfolio is sold and bought, taxes are triggered on those transactions outside of RRSPs.

A low turnover in a portfolio translates into lower fund expense ratios, lower taxes and at the end of the day more money in your pocket.

As Warren Buffett says when it comes to company's in his portfolio that "our favourite holding period is forever."

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Priorities shift as life goes on

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Last week, I attended another 50th birthday party. Like weddings 20 to 30 years ago, my wife and I are joining lots of our friends and colleagues as we celebrate this important milestone.

In so doing, I have observed how the topics of discussion at these parties have changed a whole lot from kids, career, and business to lifestyle discussions. In a nutshell, many of us are turning our minds to life after work, or more accurately fitting work/career/business into our lives rather than the other way around.

I think our group of friends provides a good cross section of today's successful baby-boomers. Most have achieved significant success in their professions, trades or businesses. They enjoy their chosen fields, but they want more out of life.

Priorities have shifted to having more time off and building the infra-structure to make sure this happens through more savings, bringing in younger associates to their professional practices or starting succession planning in their business so it can operate independent of themselves.

I know that my group of friends is a good reflection of not only many of you, but of your client base as well. In the past few years, our firm, together with Advisor Impact *www.advisorimpact.com*, a Toronto-based market research firm that has surveyed the client bases of many accounting firms with a program called The Client Afirmsudit.

Boomers want more out of retirement.

The top three topics that clients say they would like to discuss with their accountant are:

Retirement planning
Financial planning
Estate planning

This may come as somewhat of a surprise to non-audit accountants because they often say that only a handful of clients have told them this in the past.

I think clients may have mentioned this before, but they were never asked, or at least in a manner that allowed them to put their issues into priority order. If accountants don't pay close attention to what their clients want from them, they may be missing a good golden opportunity.

Using my group of friends as a cross-section of baby-boomers, let me tell you about two of them.

The birthday boy at last week's party runs a food manufacturing business that has been passed down one generation so far. He is the first to say it just about didn't make it through the first generational transition, but I believe it will make it through this one quite easily because he is consciously working through a succession plan.

So far, in his transition he has brought in the next generation of key management. This allowed his wife to return to teaching, to capitalize on the summers off (no doubt in Muskoka) and to ensure that at least one of them has a pension plan. His next stage of retirement planning is to build his business profitability and value so that it is either attractive for someone else to purchase or ready to be passed to the next generation.

Another party-goer had a senior management position at one of the major Canadian banks. He was one of those unfortunate people who was "downsized" in his early 50s, but five years later couldn't be happier.

He started a consulting firm in his field of expertise; works; works about half the time and according to him is enjoying the best part of his career. Did I men-

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