SA CAPITAL™

For What Really Matters

THE SECRETS TO PROTECTING YOUR INVESTMENTS IN VOLATILE MARKETS:

What Successful Investors Do To Stay Ahead Of The Game

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THE SECRETS TO PROTECTING YOUR INVESTMENTS IN VOLATILE MARKETS:

What Successful Investors Do To Stay Ahead Of The Game

Today there are literally thousands of different mutual funds available in Canada. No wonder many investors feel overwhelmed by the scope of fund options readily available to them. For many investors, mutual funds represent the easiest and most effective means of diversifying their investment portfolios. They provide broad diversification, liquidity, and access to a professional portfolio manager.

While mutual funds are great, they do have some shortcomings. Canadian mutual funds have the highest investment fees in the world. Not only are the investment fees high, many mutual funds underperform the benchmark. That being said, for the average investor, mutual funds and exchange traded funds (ETFs) were the best way to diversify until now. Have you ever considered Separately Managed Accounts (SMAs)? SMAs offer average investors the best of both worlds: diversification and low fees. SMAs used to be only available to high-net worth investors until now. (Although portfolio managers have now lowered their minimums, it does not mean they are available to every investor or every investor qualifies. There are still some criteria that needs to be met, however, more Canadians than ever now qualify.)

Mutual Funds:

The Pros & Cons

While it would be nice to be able to use our crystal ball to predict the next Apple stock, the vast majority of us aren't expert stock pickers. Mutual funds provide diversification to average investors who cannot afford to buy individual stocks from hundreds of companies. While mutual funds have their benefits, they also aren't without their risks.

Mutual funds don't have a great track record of beating their benchmarks. In 2011, less than a quarter (23 percent) of actively managed equity funds beat their benchmarks. In fact, over the last five years (ending July 2013), 61 percent of equity mutual funds have underperformed the Standard & Poor's 500 Index.

While mutual funds offer investors diversification, there are some things they cannot offer. Due to their structure as an investment shared by many investors, mutual funds cannot offer the advantage of customized portfolio management, greater tax efficiencies and lower fee structures that can be negotiated by the investor.

To better understand mutual funds, it helps to understand what a mutual fund is. A mutual fund is a corporation investing in other corporations by buying stocks and bonds issued by those corporations. When you buy mutual fund units, although you share the ownership and expenses of the securities with investors, you don't own any of the individual shares held by the mutual fund. Although you can buy shares of the mutual fund, you cannot influence the mutual fund's decision to buy or sell shares of the underlying companies it invests in.

While you could buy individual stocks and bonds and make your own portfolio, that takes a long time and lacks the advantage of professional portfolio management. Portfolio managers, also known as investment counsellors, are held to one of the highest standards in the industry, even more so than your mutual fund or investment advisor. They are held to the same ethical standards as lawyers and doctors: a fiduciary standard. SA Capital works with some of the best portfolio managers in the industry who have the track record and numbers to show for it. High-net-worth individuals typically use SMAs as they provide access to professional wealth management, which means lower fees, and tax efficiencies and downside protection.

Inherent Dangers of Mutual Funds

- Cookie cutter, not really customized
- High Fees ranging from 2.5-4% + if invested, you could be locked in and unable to move. This could easily be 10's of thousands over a couple of years that you're leaving
- Highly susceptible to market volatility. Due to prospectus that guides the money manager, when the markets tumble they are unable to move outside their mandate to preserve capital
- Fees are non-deductible

The volatility of the market over the last 15 years

The markets have evolved. The vast majority of mutual funds still subscribe to the buy and hold (and hope) theory that seeks to manage risk by allocating money amongst a broad array of traditional asset classes and retaining these assets for an extended period of time regardless of market conditions. The problem with this theory is that markets have become a lot more volatile than they were in the past. See chart below;

From 1980-2000 even though there were losses along the way, there was a general upward trajectory of the market, so that even when there were losses, they were not huge and recovery was often rapid. However since 2000, the losses in the market have been more deep and more frequent, meaning that the more losses were incurred the harder it typically was to return back to 0 before eventually getting positive returns. See illustration.

Understanding Impact of Losses

What can one large negative year do to your portfolio?

				Gain Needed to Break-even		Years Needed to Break-even		
Starting Value	Loss $	Loss %	Value After Loss	Gain $	Gain %	4%	8%	12%
$100,000	$10,000	-10%	$90,000	$10,000	11%	2.8	1.4	0.9
$100,000	$20,000	-20%	$80,000	$20,000	25%	6.3	3.1	2.1
$100,000	$30,000	-30%	$70,000	$30,000	43%	10.7	5.4	3.6
$100,000	$40,000	-40%	$60,000	$40,000	67%	16.7	8.3	5.6
$100,000	$50,000	-50%	$50,000	$50,000	100%	25.0	12.5	8.3
$100,000	$60,000	-60%	$40,000	$60,000	150%	37.5	18.8	12.5
$100,000	$70,000	-70%	$30,000	$70,000	233%	58.3	29.2	19.4
$100,000	$80,000	-80%	$20,000	$80,000	400%	100.0	50.0	33.3

The Challenges Mutual Funds Face with Increased Volatility

Mutual funds being pooled funds mean that by nature a mutual fund is made up of the resources of a vast number of people. What this means is that they are usually quite large and need to be structured to cater to many people. This creates one inherent problem for the fund managers who are often not nimble enough to switch positions in a mutual fund due to the size of the fund, as a result they could often suffer big losses when the market goes south. Furthermore, in a down market, mutual funds are often unable to sit in cash or cash equivalents to stop the losses because the prospectus (a guide on how the mutual fund can be invested e.g. a balanced portfolio is often 60% Equity & 40% Fixed Income) dictates the asset allocations. So therefore when markets are doing badly, that is both Equities and Fixed income are getting negative returns, the portfolio manager cannot do anything but watch it tumble because they cannot move outside those allocations specified in the prospectus. SMAs generally don't have those same restrictions.

Just a quick side note: although separately managed accounts are a better alternative, it doesn't mean that they cannot be affected by economic downturns or cannot suffer losses. It simply means they have more flexible mandates and the ability to react faster to minimize losses. Many of the portfolio managers we work with use a tactical approach to money management, that is, contrary to Buy & Hold Asset Allocation, the portfolio holdings are adjusted on a continuing basis in response to both market and economic conditions. They do this by closely monitoring short, medium, and long term trends and signals and react accordingly, a strategy that is almost impossible to implement in a mutual fund portfolio. Furthermore, because they manage money for institutional investors and high net worth individuals, one of their primary goals is capital preservation, therefore they carry this mandate across their strategies. They aim to avoid the big losses such as the financial crisis of 2008.

The High Fees in Mutual Funds

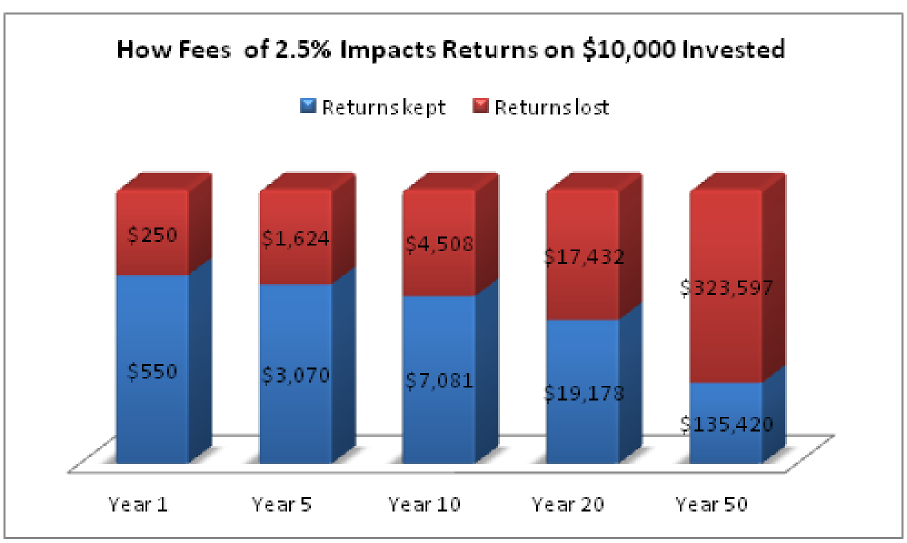
If the volatility of the markets has taught us anything, it's that nobody can predict the markets – not even the great Warren Buffett. No one has a crystal ball and can see where markets are heading next year and beyond. As an investor, instead of worrying about factors out of your control, focus on factors in your control. Those factors include investment fees, taxes, choices, and behaviours.

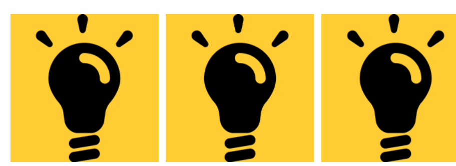
One of those factors in your control is investment fees. High fees can have a major impact on the overall performance and long-term growth of your portfolio. Here's a fact that will shock you: Canadians pay the highest mutual fund fees worldwide. (Don't get me wrong, high fees are fine, as long as the underlying mutual fund outperforms the benchmark.) A Management Expense Ratio (MER) of 2.5 percent may not seem like a lot, but the fees really add up.

> "Compound interest is the eighth wonder of the world. He who understands it, earns it… he who doesn't… pays it"
>
> – Albert Einstein

Compound interest can be your best friend or your worst enemy. When it comes to investing, it can help your investments grow exponentially faster. While most investors are aware of the power of compound interest, what a lot of investors overlook is the effect compounding has on investment fees.

To illustrate, let's take a look at mutual fund with a 2.5 percent MER. With a portfolio of $100,000, after one year, $2,500 will be paid towards fees. But that's not the whole story. Due to compounding, after merely five years, about 35 percent of your potential returns go to fees. If you're a lifelong investor, after 50 years, 70 percent of your returns go towards fees. If you're able to save just 1 percent in fees, you'll pocket an extra $60,590 after 20 years.





Understanding MERs

The investment return you achieve as an investor is after the MER has been deducted. Part of the MER goes towards the trailing commission your advisor receives. The trailing commission is the compensation your advisor receives for the services and advice he or she provides.

The trailing commission is paid until the fund is sold or redeemed. It's important to make sure you're getting good value for the investment fees paid. Many investors feel after the initial investment recommendation, little to no on-going service or support was provided by their advisor.

As an investor, it's important to make sure you're getting good value from your investment fees. Mutual funds that charge higher investment fees may not be a bad thing if the mutual fund consistently outperforms the market, but this is rarely ever the case. You should call your Advisor or mutual fund company to find out how much you pay in fees. If you pay high investment fees in your portfolio, consider finding better investments elsewhere. In our opinion anything over 2% is high.

It's important to be aware of the level of investment fees you're paying as an investor. As your wealth grows, the investment fees you pay should fall. If you're still paying the same investment fees, you're most likely invested in the wrong place and paying more fees than you have to. When you have direct access to portfolio managers and investment consellors you benefit from lower fees, full disclosure of fees, personalized solutions, and the ability to meet face to face with portfolio managers.

There are other potential issues with this model. For one, you may not be aware of the actual fee amount or percentage of assets that you're paying within the fund. The good news is that this is about to change as investors are demanding more transparency, soon your mutual fund statements will start to reflect how much you actually pay in fees clearly spelled out in dollar figures. This however does nothing to lower your fees. Being a retail investment, the fees are typically much higher than going direct. Another important issue is that you may be missing out on being able to include the fees paid on non-registered investments as a tax deduction.

If you're invested in mutual funds, ask your advisor if you can switch to a Series F fund (offered through fee-based advisors). These funds make fees transparent, so you can hold your advisor accountable for the quality of advice and service he or she is delivering. These funds also charge much lower management fees, since they're no longer paying commissions to your advisor. This also eliminates your concern that the advisor is recommending specific funds as a result of earning higher commissions.

The evolution of the industry and private wealth:

Separately Managed Accounts (SMA)

"Discretionary portfolio management had been historically reserved for institutional clients and high net-worth individuals. Due to recent technological and financial developments however, it is now much easier and more cost-effective for retail clients to access the benefits of this service."

Many investors are not aware that they could now qualify for access to institutional-styled investing with lower minimums which was only previously reserved for HNW (high net worth) and ultra HNW investors. While mutual funds are great, these investors may be able to save on investment fees and thus get better performance with SMAs.

SMAs are a lot like mutual funds – a money manager comes up with a model portfolio specializing in a specific area of the market and buys or sells investments to achieve positive returns. The main benefit of SMAs is you own the securities and your assets are not pooled with other investors.

By replacing your mutual funds with private wealth management, you can have your cake and eat it, too. You can build a suitable, diversified portfolio and achieve comfortable return, while minimizing the fees, risk, and volatility of your investments. It's a win-win situation for investors.

SMAs offer a number of benefits:

- **Fee May Be Tax Deductible**: Any fees paid in a non-registered account are tax deductible.
- **Fees are More Transparent**: Your fees are based on your assets; they are typically a lot lower than mutual funds. The better your investments perform, the lower your investment fees. The fees may also be tax deductible.
- **Individual Cost Base Tax Efficiency**: Capital gains are minimized through the selective realization of gains and losses. Unlike mutual funds, you don't share the tax base of other mutual fund investors. The cost base is your own.
- **Customized Risk/Reward**: Set your own return expectations, tolerance for risk, and cash flow requirements based on your expectations.
- **Full Transparency**: SMAs offer a higher level of transparency than mutual funds. While most mutual funds only list the top 10 holdings, separate account holders can typically view their investments whenever they desire through a safe and secure client portal.
- **Individual Reporting**: It's hard to know how your investments are doing if you can't track your investment performance. SMAs give you a clear picture, by showing you the exact return on your investments.

SA Capital is not a discretionary portfolio manager, however, through our strategic alliances we have access to high quality portfolio managers. If you'd like to consider an alternative to mutual funds, SMAs may be for you. You can avoid many of the inherent dangers in your mutual fund portfolio, simply by holding your investments in an SMA. You could qualify....contact us NOW to find out!

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