

# PORTFOLIO

## Comprehensive wealth management

### Performance traps

Don't let your clients fall into these losing investment strategies.

By Harry S. Marmer



**W**e've all heard stories about clients who make investment choices that end up backfiring. Let's examine these losing investment strategies and determine how you can help your clients avoid them.

**1** **Buying high and selling low:** This mistake occurs when funds are bought or sold based purely on recent past performance. This unproductive strategy results in investors suffering through what I call the performance trap: selling last year's loser

which becomes this year's winner and buying last year's winner which becomes this year's loser. Research by Frank Russell Canada Ltd. and others suggests that this error can cost investors 150 to 300 basis points, on average.

Here's how you can stop your clients from falling prey to this performance trap:

- Utilize sophisticated investment manager research.
- Review the three P's (i.e. people, philosophy and portfolio) of

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successful manager monitoring and selection that drive performance before making any manager changes.

- Employ a multi-style, multi-manager structure—this will help reduce both style and manager risk, two predominant causes of unnecessary investment manager turnover.
- Focus on total asset class performance. Begin client presentations by examining total asset class performance before analyzing each of the managers. This will help your clients think about the benefits of diversification within an asset class and shift them away from assessing each money manager relative to each other from within a horse race performance derby perspective.

**2** **Market timing:** Both novice and professional investors are tempted by market timing. And yet the overwhelming empirical evidence from the institutional marketplace clearly shows that the odds for success are relatively low as the median payoff has averaged minus 40 basis points. If sophisticated professionals have trouble timing the market, how do you think your clients will fare?

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To help counter the tendency to this loser strategy, zero in with your clients on total fund performance, emphasizing their long-term investment objectives and needs and the benefits of a well-thought-through policy. If necessary, review their investment policy statement with them to determine why they have set aside this money to begin with.

**3** Market drift: Avoiding market timing requires you to have formal rebalancing rules. Market drift—allowing your client's portfolio to move away from their long-term objectives due to market movement—can “cost” your clients a higher risk level than they would normally desire and consequently expose them to higher downside risk. Implementing formal rebalancing procedures and responsibilities can keep them on track to achieve their long-term goals. Our research has shown that the optimal rebalancing approach for

a pooled or mutual fund vehicle is to rebalance on a monthly basis if the asset class weights have moved by more than two to three percentage points away from target.

## Trial and error

Here's the price your clients will pay for some losing investment strategies.

Common Mistakes	Opportunity Costs
Buying high and selling low	150 to 300 basis points
Market timing	40 basis points
Market drift	higher risk
Holding excess cash	50 basis points
Emotional content	huge

**4** Holding excess cash: Cash can build up in a portfolio for a variety of reasons including ongoing cash-inflow, lack of investment opportunities and cash redemption needs. For long-term investors, cash is a

drag on performance. For example, if 10% of the fund is held in cash, this can lead to a drag of about 50 basis points in performance. Investing excess cash or using derivatives to equitize the cash can help eliminate useless cash drag.

**5** Emotional content: We don't always implement long-term investment objectives in a rational and unemotional manner. We can all be overconfident, sensitive to losses and poor assessors of probabilities. Our emotional factors should impact our risk tolerances and appropriate asset mixes. However, on a day-to-day basis, they will also produce irrational mistakes that hurt our long-term objectives. For excellent advisors, behavioural biases create opportunities to help

educate their clients and avoid self-defeating behaviour. **AE**

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