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Take stock of the future

Institutional-investment guru says market investors will be rewarded

By: **Joel Schlesinger**
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(MCT)

Big money buys big brains.

In the investment world, the institutional investor -- pension plans, sovereign states, large non-profits such as universities and other high-net-worth organizations -- have billions upon billions to invest.

As a result, they often command the best advice and research that, well, their money can buy.

In contrast, most people don't have that kind of change lying around and they get lumped into the retail investment world. That's not a terrible thing altogether. Many average folks still do quite well investing.

But the institutional investor is privy to research and investment opportunities that we 21st-century serfs can't access.

The brightest minds in the financial game are often in service of the big money. Among the chubbiest of the cerebrums in Canada is Harry Marmer of the Hillsdale Investment Management Group in Toronto.

Hillsdale specializes in managing money for large institutional investors and other high-net-worth clients, and Marmer has a 20-year-plus track record in institutional investment -- a good indication of market prowess, because institutional investors demand results.

Marmer was in the city recently for a speaking engagement with the Winnipeg Chartered Financial Analyst (CFA) Society and took time to speak to the Free Press afterward, offering up an institutional investor's take on markets in uncertain times.

For the retail investor, it's the opportunity to peek into an institutional investor's noggin and see what's simmering in the investment-idea kitchen.

The main course on Marmer's menu is equity investment. In fact, the title of his presentation to the CFA faithful was entitled The Death of Equities, Again -- a playful jab at those who would argue today the stock market is broken.

"Those of us with grey hair will remember that about every 10 years, somebody starts talking about the

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death of equities," Marmer says. "When I was a teenager, the cover of Businessweek in 1979 had the headline Death of Equities and then, of course, the market went on a tear in the 1980s."

Certainly the stock market isn't without its risks these days, he says. But investors seeking safety in long-term government bonds are exposed to more risk than they may realize because bonds are at the end of a long, profitable run since the early 1980s, when interest rates were at record highs.

To the layperson, this might seem counterintuitive. Interest rates have fallen since then to historic lows -- so one might wonder how falling returns from interest equate to a bull market. But bonds can be sold in the market and in a falling-rate environment, existing bonds, which have higher coupons (interest payments), become increasingly valuable relative to newly issued bonds that pay less interest.

So, for example, a $100 bond paying a five per cent coupon will increase in value if bond yields fall.

Marmer says capital gains on government bonds will be harder to come by in the near future because it's more likely government bond yields will rise than fall.

When rates increase, existing bonds generally fall in value, so a $100 bond, for example, might only be worth $95 if it's sold in the market before maturity. Of course, those investors who don't intend to sell their bonds on the market will receive the coupon payment until the bond matures -- and get paid back the bond's par (face) value. In that instance, interest-rate hikes aren't much of a concern.

But most retail investors don't own bonds outright. They own bonds funds, and fund managers often do have to trade bonds to realize gains and losses.

And funds holding government bonds likely are in for a rough ride in the next few years when abnormally low bond yields eventually rise.

Yet the potential downside of fixed income doesn't stop there, Marmer says.

Real yields on government bonds -- the return based on their coupon (interest payment) and market price after inflation -- are dipping into negative territory.

Inflation is the bane of fixed-income investments, but it's especially hard on low-yielding bonds these days -- even inflation-protected ones.

On 10-year U.S. Treasury Inflation-Protected Securities -- bonds that are supposed to neutralize inflation -- high demand for these securities has driven their real yield into negative territory.

"What that means is if you can buy a 10-year U.S. treasury for $100 today and 10 years from now when it matures, you would receive $100 back, you would have effectively locked in a loss of 80 basis points on your investment," Marmer says. "Would you call an investment that guaranteed you a loss a good, safe investment?"

By comparison, equities look rosier even though many retail investors remain leery, fearing the stock market is a dodgy racket that will sap them of their wealth.

This is not a novel sentiment. Many people have felt the same way in decades past, such as the late '70s and early '80s.

"Stocks then did what they're supposed to do, which is significantly outperform bonds and cash."

Today, stocks are already indicating they're trending that way once again. Stocks on average already are yielding more than fixed income.

"You have to go back 50 years before you had a sustainable period of time where stock yields are greater than cash and bond yields," Marmer says. "To me, this is an anomaly in the marketplace that tells you stocks are unloved and undervalued."

Many dividend payments from publicly traded companies pay investors more than yields from government bonds.

"We've seen cash flows move out of stocks, which have helped to create the imbalance between stocks and bonds and cash," he says. "But most people are missing out because of their fears of equities."

Taking the long view, stocks are likely in the early goings of a bull market run that could last a long time.

Marmer says it's likely a matter of time before they take off because a low-interest, government-interventionist market inevitably will lead to higher inflation.

And that will increase asset prices, such as stocks.

The sectors with the best upside right now are emerging markets and U.S. and Canadian small-cap companies -- firms typically with market valuations less than $1 billion. But most retail investors will have difficulty investing in these sectors on their own. They need "active management" -- mutual funds, for example -- that can leverage expertise and research to find value in a highly volatile sector,

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Marmer says.

Even though equities are poised for a run, it's likely the ride to higher prices will be bumpy -- but the intrepid eventually will be rewarded for hanging on over the next few years.

"It's very difficult to run against the herd, but think about it this way: People don't go to stores, waiting for prices to increase. They go when there's a sale. It's the same thing in the stock market," he says. "You want to buy when investments are on sale. In our mind, stocks are on sale right now."

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QUICK FACTS

A glimpse at an institutional investor's asset allocation: Harry Marmer manages an investment fund available only to high-net-worth investors. Here's a look at the allocation of money across different sectors in the Hillsdale Hedged Absolute Return Strategy (as of Sept. 30, 2012):

U.S. high-yield bonds: 22 per cent;

Canadian high-yield equities: 27.8 per cent

Inverse ETFs (exchange traded funds): 13.5 per cent*;

U.S. real estate investment trusts (REITs): 9.4 per cent;

U.S. high-yield equities: 8.9 per cent;

Canadian REITs: 8.7 per cent;

Emerging market bonds: 4.2 per cent;

International high-yield equities: 3.1 per cent;

Canadian corporate bonds: 2.4 per cent.

*a hedge strategy to reduce market volatility

Not all bonds have a bleak outlook

Marmer says value can still be found in corporate bonds because they pay higher yields than the secure and conservative government-issued ones. But the corporate bond market is limited for most retail investors and requires a fair amount of research to separate the good from the bad. Furthermore, they're still exposed to inevitable interest-rate hikes. Corporate bond mutual funds are likely a better option for investors with limited capital to invest and access to expert advisers.

Want an institutional manager strategy?

Hillsdale Investment Management's services are generally available to high-net-worth individuals, but investors with lesser means can invest in the Horizons Balanced ETF (HAA). The exchange traded fund has been available since 2010. It pays a distribution to investors with an estimated annualized yield of three per cent. The fund's management expense ratio is 1.04 per cent and its holdings are mostly Canadian equity with some fixed income. About 15 per cent of holdings are U.S. investments and less than 10 per cent of capital is invested in Europe, Israel, the Cayman Islands and Taiwan.

GICs... not in a million years

Marmer says he can understand retail investors buying GICs because they're secure, but the problem with these investments is they barely keep pace with inflation. Effectively, investors give money to the bank to lend out at a higher profit, he says. "I'd never buy them (GICs) in a million years," he says. "GICs, from a professional investor's perspective, are guaranteed inferior compounding."

Know your risk appetite

Just because Marmer says equities will outperform cash and fixed-income investments doesn't mean investors should completely shun these types of investments. Every investor needs long-term growth in their portfolio, and equities are best suited for that role. But they're ill-suited for short-term needs. "Clearly, you can't invest in the stock market if your time horizon for the money is tomorrow, a week, a month or a year."

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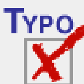

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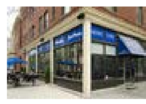

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