Picking Your Investments

Sooner or later you have to pick your investments. Once you have set money aside and determined what balance is right for you, you will have to make some decisions. Over the years we have talked a lot about how to make these selections, and we will continue to do that in the future. However, since we are in the heat of the RRSP season, it seems appropriate to give a little overview, and warn you of some common and easy to make mistakes.

First we will talk about your fixed income investments. We recommend that you stick to conservative short term investments. After all, this is not where you are looking for capital gains or excessive growth, that is what stocks are for, this is where you are looking to preserve your capital. If you are a small investor, you may wish to stick with investments like Treasury bills, money market funds, mortgage funds, Canada Savings bonds, and GIC's. As your portfolio gets bigger you may want to add short term bonds [ones that mature in five years or less]. Generally, we recommend that you stager the maturities between one and five years. Once this is done, each year approximately one fifth of your fixed income investments will mature, then you can replace the maturing investments with new securities that have five years to maturity. This will keep the

balance, as the ones that previously had five years to maturity now have four. As a rule we recommend against mid and long term bonds, and bond mutual funds. While these may produce a little higher return, especially when interest rates are dropping, they can also produce market losses when interest rates rise, or the managers miscalculate. We believe that this should be the secure part of your portfolio and that the equity investments are where you take risks in the hopes of higher returns.

Next, for the equity portion of your portfolio, you will want to decide between mutual funds, stocks or a mix of the two. We will not talk about stock selection here, as over the last few issues, we have talked extensively about that, and will be finishing that series in the next issue. We do wish to make some comments about equity mutual funds. This is the time of year when mutual funds seem to be all the rage. Schemes, methodologies, approaches and so called experts seem to be coming out of the woodwork. We suggest that you be very careful of these, regardless of the organization they represent. There are many people working for major publications, large institutions and financial planning companies. While many are very competent, there are also many who sound competent, but have not really done any research, or their research is flawed.

In general, for equity mutual funds, the following is what we suggest you look for. In selecting types of funds, select funds that are what we might call "The real thing," that is, funds that appear to concentrate on the basics. Look for Canadian equity funds [Canadian investors], U. S. equity funds, Small Cap funds and International equity funds. These will give you the type of coverage and diversification that you want. Avoid interesting or high flying funds. If you wish to add a little spice, you can put a little money in Specialty or Special region funds, but we recommend that you limit these investments to no more than ten percent of your portfolio. Also, remember that there is probably a better chance of losing money on these funds, then of getting the staggering returns that you were hoping for. We do recommend that you have some money in small or mid cap funds, but these are higher risk than the Canadian, U.S. or International equity funds, so be sure not to over-emphasize them.

When selecting the individual funds, look for well managed, high quality conservative funds. If you can obtain information on the manager's style, that is where you should start. We recommend you select managers who use a value or growth approach and who have indicated that they do not expect to see the shares in their portfolio turn over very often. We prefer an expected turnover of over five years. We would avoid sector rotators, market timers and managers who expect to turn over their portfolio in three years or less. Then look at the fund's volatility. A low standard deviation would indicate that the fund is less volatile, which means it is likely to be more conservative. If you have access to the fund's beta, this can also tell something. A beta of less than one means that the stocks in the portfolio, on average are less volatile than the market index. So the lower the beta, the more conservative the fund. Another interesting number is the fund's size. While very small funds may be more flexible, larger ones might be more stable. While this is not a number that we would pay a lot of attention to, for small cap funds we would prefer the fund be between one hundred and five hundred million dollars. We would probably avoid small cap funds bigger than five hundred million dollars, because they are likely to be too large to be selective. On Canadian equity, U. S. equity and International equity funds, the fund can be larger as there are more stocks to choose from and the fund can hold a higher amount of a large cap stock without influencing the market. Still, we might avoid the largest funds, as they may have less room to maneuver. As for a minimum, we prefer funds with at least 100 million dollars in them. Finally, there is the funds return on investment.

This is the area where you are likely to spend the most time. That makes sense, after all that is what you are after, isn't it? However, returns can be very deceiving, especially if we do not understand why they are what they are. For example, a few years ago bond funds were showing exceptionally high returns. No doubt, many investors stocked up in bond funds. Unfortunately, they did not realize that this was because bonds go up in value when interest rates drop. Since we had seen unprecedented drops in interest rates, we were seeing unprecedented returns in bond funds. How much do you think interest rates are likely to drop in North America today? The fund's circumstances may change. A fund manager may be very successful when their fund is small, causing people to flock to their fund, causing it to grow into a very large fund. The question is, will they be as successful when the fund is larger? The fund may be heavily weighted in a particular sector, because the manager prefers or is more skilled in that sector. A few years ago some managers were very successful because they had a lot of resources in their funds. They have not all done as well over the last few years. A fund holding a high number of financial institutions would have done very well over the last couple of years. The question is, how will they do in the future? So, when you are looking at returns, consider the underlying reasons as much as you can, is there a special reason, has the management changed, can the future be expected to mimic the past? Now, back to comparing the returns.

Watch out for High Flyers

There may be a reason that a particular fund did well last year. Is that reason still true?

We recommend you concentrate on the five and ten year returns, as these will tell you which managers have performed over a long period of time. Then if you have access to the one year returns for the last several years, review those to see how consistent the returns have been and if the fund has been in the top fifty percent of similar funds most years. After that look at the current one year return, but be careful. We have been known to dump funds after an exceptional year, because we did not feel that the funds were that good anymore, and we believed that those returns would not be repeated. We have also been known to purchase a fund that we liked after it had performed poorly, figuring that its turn would come. So as you can see, you have to be extra careful about how you apply short term results.

The above should give you some things to think about over the next while, when you are being bombarded with information by the various sales representatives. In future issues we will continue to talk about these areas in detail.

Investment Tables

To help you with your decisions, below are tables with information on returns as of Dec. 31, 1997. For more tables and details go to IFC Investor Watch Tables.

Table Of Financial Indexes as of Dec. 31, 1997

Index	1 Yr. ROI	5 Yr. ROI	10 Yr. ROI	15 Yr. ROI	20 Yr. ROI	5 Yr St.Dev
Consumer Price Index	0.9	1.3	2.7	3.2		0.7
91 Day T-Bill (Cdn.)	3.2	5.3	7.8	8.5	9.8	0.5
5 Year Avg. GIC Rate	4.8	6.4	8.3	9.3		0.4
TSE 300 Total Returns	15.0	17.5	11.0	11.9	13.5	12.4
Nesbitt Burns Sm-Cap	24.1	21.4	17.3	15.1		12.6
DFA Small Cap - Cdn.	24.1	21.4	17.3	15.1		12.6
Dow Jones Industrial US$	24.9	22.0	18.5	18.3	16.5	11.7
S & P 500 Composite (US$)	33.4	20.2	18.0	17.5	16.6	10.6
Gold: London PM (US$)	(21.4)	(2.5)	(5.0)	(3.0)	2.9	10.4
Globe Cdn Equity Avg	13.3	15.3	10.3	11.4	12.9	10.6
Globe Cdn Sm-Mid Cap Avg	11.1	19.4	12.4	13.1	14.4	12.9

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