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Spring Update - Is There Sunshine on the Horizon?

Probability Theory, What's All That About?

And the Confusing Nature of Fees in the Investment Business

Very divergent topics. Firstly, our 'forecast.' Weather prediction is a bit easier than short-term market projection, but just as there are more non-rainy than rainy days in spring (okay, maybe not in Vancouver or Costa Rican jungles), we can say that in the past hundred years or so, the stock market has risen more days, more months and more years, than it fell (with a probability of about 2/3rds of the time up and 1/3rd of the time down).

Probability theory can relate to weather forecasting. Insurance companies estimate the probability of hurricanes for example (in a given location) and price insurance premiums so that they earn an 'expected—but not guaranteed—profit' after paying expected claims and expenses.

The stock market has its own probability for a range of outcomes, such as a low probability of an extremely great or extremely poor market, with the majority of outcomes in the middle.

For those of you who took statistics, you may recall how potential outcomes are measured by calculating their 'standard deviation'; thus we can look at a whole range of past results to measure the expected return, and risk (volatility) of any given asset class. This information can then be used to combine different asset classes with a view to lowering portfolio risk for the same expected rate of return.

Here is a personal story about how a son can use probability theory to try and beat his Dad at something.

I recall my Dad getting bearish on markets a while back due to some things he was reading and hearing. He became highly convinced we were about to experience a bad month.

To digress for a moment, my Dad is someone who never bets. He knows, as we do, that casinos have odds (probabilities) that are stacked in their favor. To evidence his dislike of gambling, he likes to tell the story about the only time he went to Las Vegas. He made just one bet, wagering a 'whole nickel' in a slot machine—and 'lost it all on one pull.' Dad also taught me a lesson as a young kid, when he told me that half of my mini lotto 50-cent ticket (I am aging myself) went to the government and only half went to prize money. I didn't like those odds (again, probabilities) so I stopped buying mini lotto tickets with my 'hard earned 50 cents.' I did not understand probability theory at that age of 10 or so (which would have calculated my ‘expected long term rate of return’ on that 50 cent wager, to be only 25 cents), but even as a young whippersnapper, I learned from that example that mini lotto tickets ‘just weren’t fair.’

Anyway, as I was saying before, Dad was pretty convinced the market was about to drop so he offered to wager $50 that the next month would be a down month in stock market averages. I had never seen Dad offer to bet with anyone before so I jumped at the chance to beat him at something (father/son competitiveness never ends, eh?), while of course not knowing with certainty if markets would increase or decrease in a one-month period. I gladly took the bet though and covered myself (in case I lost) by saying “Dad, you have about a 33% chance of being correct, therefore an even odds bet looks good to me.”

As I had a 67% chance of winning, mathematically, my expected rate of return was .67 times $100 ($100 being the whole pot) or $67 on an investment of $50, a nice expected return (not as much as the government takes on lotto tickets, but still a good expected short-term profit). Of course, I can not make $67 on this $50 bet (as I could only end up with either $0 or $100) but if I made this bet a thousand times, my expected profit would average out to about $67 per $50 bet…nice odds.

As it turned out, the odds worked in my favor, the market went up, and I gleefully collected Dad’s crisp $50 bill—sweet victory! I think this cured his new found urge to gamble.

To circle back to Las Vegas again, casinos know odds and therefore probability theory as well as anyone, so they structure the games, as you know, such that there is an ‘expected advantage’ for the house, thus the old adage of “better to gamble ON the casino stocks, and not IN the casinos” – less entertaining though.

We won’t get any more into ‘probability theory’ here (which ties into all the stories above) but suffice to say, it is a bit of that, and our previous experience and training that guides our investment process, i.e., “How to try and position your portfolio for the best expected rate of return, with least degree of risk.” This also ties into our confidence that regardless of short-term ups and downs, investors who take a very long term view tend to do the best in the long-term. The great Warren Buffet has said this countless times.

How do markets look going forward?

The past five years or so have seen well ‘below average’ market volatility and pretty good returns overall in client accounts. Realistically, probability theory projects that we should expect volatility to increase to normal (and at times higher levels of volatility); thus we need to be prepared for a period of time where we experience some above average volatility on the downside. On the plus side though, global stock market averages are just a bit higher than previous highs from six years ago, and stock, real estate investment trust (REIT), and preferred share valuations, while not cheap, are not expensive.

Perhaps we will have the traditional advance well above previous highs (as retail investors continue to return from their long absence) before we see a ‘large downturn.’ A regular sized correction, which happens typically about once a year, can easily occur though, in any fairly valued market such as we have now.

If we get to much higher levels, valuations will become expensive, and we will accelerate our decrease of risk in client accounts. In the meantime, we continue to play it reasonably safe in terms of bond and equity selection, and consider equity to fixed income rebalancing in each client meeting based on our rebalancing process.

The latest 'headline risk' is coming out of the Ukraine. Clients who have worked with us for a number of years know our standard advice on 'political risks': that they can affect the market in the short term and never affect the market in long term. Within a period of time, this issue will be settled one way or another and markets will move on to a different political risk.

How are most investments doing?

In terms of individual investments, our typical client holds a number of positions for diversification reasons - often about 60 to 90 investments. Almost all are trading well or 'as expected.'

In terms of individual stocks and stock exchange-traded funds (ETFs), most are doing well. All our REITs are performing reasonably well of late, but we have two energy trusts that have performed poorly (Argent Energy and Eagle Energy). Both are based in the U.S. We were attracted to U.S. based energy trusts due to their low (two percent) corporate tax rate, higher U.S. (vs. Canadian) oil prices and our previously high Canadian dollar. Both stocks have been affected by lower production and higher drilling costs than were projected.

Bond wise, all but one of our many positions (about 30 main bonds, spread out in various client accounts) look sound and are 'holds.' We have one 'problem child' bond (Just Energy Group Inc.) which has improved (and we rate it a hold) and we own one weak preferred share (Atlantic Power Corp) which has also improved of late.

Fees -- what are you paying, where, and how?

This whole topic is not well understood by Canadian investors, and frankly our industry needs to pull up its socks in terms of ensuring investors more easily see how much they are paying. There is a new report on the way, starting in July 2016, that will provide more disclosure, so stay tuned.

On our team, we believe that we are disclosing fees and educating clients in this area, but we are always looking for ways to improve. Visible fees are fairly easy to understand but what can be hard to know is what you are paying on what are called 'managed products.'

In every client meeting, all fees on managed products are shown on our pretty, technicolor Pope Team model portfolio sheet (included in your review package). We will provide this report and explain it anytime on request. We can also give you a good estimate of what you are paying ‘all in’ anytime you wish.

We can’t control short-term market movements but we can control how much is being paid by clients. The mathematical reality is the higher the fee, the lower the expected net client rate of return. The lower the fee, the higher the expected net client rate of return.

How much do you pay?

Our average Pope Team client pays about 4/10th of one percent (each year) to CIBC Wood Gundy.

Most clients own high yield bond funds and ETFs (indexes). These outside entities also earn managements fees that are deducted from your investment return. The cost here averages at about 2/10ths of one percent (of the value of the whole portfolio). Including these ‘outside our firm costs,’ our average client pays about 6/10th of one percent, per year (all in).

Thus for every $3 in cost, about $1 stays with outside firms, CIBC Wood Gundy earns about $1 and our team earns about $1.

As our team earns about half of what CIBC Wood Gundy receives, we earn half of the 4/10th of one percent -or 1/5th of one percent (of the value of client assets under administration). This puts us in the bottom third of what CIBC Wood Gundy investment advisers charge (as a percentage of client assets under administration). That does not mean we are ‘cheap’ though, ha-ha.

How fees are charged

Our typical mid-sized to larger account has a Portfolio Partner™ account for equity (fee paying, and therefore commission-free); combined with ‘non-fee paying accounts’ (which are therefore subject to trading commissions and bond spreads). In these non-fee paying accounts, we hold various long-term investments such as bonds, preferred shares, REITs, a pipeline stock such as Inter Pipeline Ltd., a utility stock such as Northland Power Inc. and perhaps a few legacy blue chip stocks.

We believe it is not in your best interest to pay a 1% annual fee on all assets with us, just to avoid trading costs on your longer-term investments. This is simply because you pay much less than 1% per year right now on these longer-term investments.

The more active equity based Portfolio Partner® account incurs no trading commissions. We price it at 1% which competes very well with any form of managed equity. We launched this model portfolio of individual stocks and ETFs about 11 years ago as an alternative to stock mutual funds (for our medium to larger sized accounts) and we are glad we did so. Due to our firm's minimum fee of $2,100 per year (to have a no trade cost account), we need $210,000 plus in equity money to do this account at the 1% fee level.

Annual account fees: The main one is the annual Registered Retirement Savings Plan (RRSP) administration fee of $125 plus GST. Our firm now mails out (once per year) an information sheet that shows every fee 'under the sun' a client could pay. We have accounts set up in a manner where virtually all clients pay almost none of those fees, including no Tax-Free Savings account (TFSA) fees.

Households with less than $100k (in all accounts combined) are potentially charged a $250 per year fee, but we have structured these accounts so that the fee can be avoided.

You can also avoid the $125/year RRSP fee if we use 'in house' CIBC owned mutual funds. Due to the cost factor of mutual funds, we just go this route for smaller RRSPs. We encourage children of our clients to have an account with us and do not want these accounts paying annual $125 fees.

Portfolio Partner® Fees: This is 1% (plus GST). By the way, the GST collection center for Canada is located on Pope Road, named after my ancestors, in Summerside, PEI. The center brought in so many jobs that locals there call 'GST' the 'Good Summerside Tax'- true story.

The 1% cost is for what we described above as our 'alternative to equity mutual funds', namely our 'Index and Stock Strategy'. It is currently invested in 32 stocks and six ETFs.

The fee can be tax deductible in non-registered accounts (talk with your accountant about deductibility). This account has commission-free trading and as said, investments are held inside a Portfolio Partner® account.

Commissions: This applies to certain purchases and sales of investments not held in a Portfolio Partner® account.

Our regular buy commission is a discounted flat 1.5%, minimum $125. For very large orders, we charge closer to one percent, or lower. We waive commission if the trade is small, if we are doing a tax-related sell (and buy back) or if the investment did not perform to expectations.

We take a long-term view with most investments in commissionable accounts, thus commissions are not charged often.

Many clients have asked us why 'Greg Johnson's' name appears under 'name of advisor' on certain trade confirmation slips. Greg is our Branch Manager who is located downtown. Our 'commission free account' has Greg's name on it as, technically, he must approve free trades in non Portfolio Partner® accounts. Since Greg is a 'nice guy,' he has always said 'yes.' When we were a larger branch (a couple years back) which I managed, my name used to show up as advisor on the free trading account.

Bond spreads: When we buy a bond, our branch marks the price up by one point. In other words, if we buy the bond from our Toronto bond desk for 103, we sell it to you for 104. You don't see the one point cost as it is built into your buy price; about half of the one point cost stays with CIBC Wood Gundy and about half of that is paid to our team. If we sell a bond prior to maturity, we typically waive the one point spread cost.

Guaranteed Investment Certificates (GICs): There is no cost to the client and we broker good rates from numerous banks and trust companies, although a good rate these days is still a 'low rate.' The Bank or Trust that issues the GIC pays CIBC Wood Gundy 0.25% for each year of the term of which the team receives about half.

Mutual Funds: We do not use stock mutual funds for our medium to larger accounts (due mostly to their high cost) but most clients own **'high yield bond funds**.**'** We use a mutual fund for high yield bonds to diversify the risk of owning below investment grade bonds that have a degree of risk on an individual bond level.

The average management expense ratio (MER) is about 1.3%. Of that, 0.8% is retained by the outside mutual fund company and the remaining half of one percent is paid to CIBC Wood Gundy. As said, our team earns about half of the half percent, thus 0.25%.

We buy all our mutual funds 'no load,' which means no cost to buy and no cost to sell, so don't worry when you receive a general prospectus that lists numerous different 'loads,' commissions, declining or deferred loads, etc. We simply buy the 'load fund,' waive the front load cost to zero, and thus effectively turn a 'load fund' into a no load fund- in or out. If I were not in the business, I don't think I would understand what I just said. No wonder it is so hard to figure out how all this works!

Stock Mutual Funds: We use low fee mutual funds only and just use these for smaller accounts. Having said that, in general, stock mutual funds in Canada are 'expensive.' Canada is ranked number one in the world in hockey (great!) and also 'highest' in the world in mutual fund management expense ratios (not so great).

The average stock mutual fund in Canada charges a high 2.60% per year and many insurance company mutual funds charge as much as 3.75% per year...which can easily turn 'freedom 55 into freedom 72.'

We continually review what your funds are charging versus other competitors (of similar quality) and do 'no cost' switches if we find a new fund company that is just as good as what you own now, but lower cost.

Right now, a typical expense ratio on stock mutual funds (that we use on our team) is about 1.8%. CIBC Wood Gundy is paid 1% of the 1.8%. We are working to get this cost lower.

ACM Commercial Mortgage Fund: The MER is 1.38% and dropping as they continue to grow in size which allows for lower fees over time. Our compensation is the same as for 'high yield bond funds' (see above).

Closed End Funds (Enervest, DDJ, Aberdeen Asia bond fund): Typically, closed-end funds charge about 1.25% in management fees. CIBC Wood Gundy does not earn any portion of the fees on these three funds.

We have only bought these funds when they have traded at around a 10% discount to net asset value (NAV). Without getting into some complicated math, your extra yield earned (as we bought income paying investments below market value) basically pays for most of the management fee. All are sell candidates if their discount to net asset value decreases.

New issues and 'secondary' new issues: We try and buy many of our preferred shares on a new issue basis and we buy some REITs in this manner as well. Our firm's underwriting department earns a fee and CIBC Wood Gundy also earns a commission of about 1.6% (typically) from the company who issues the security. Clients do not pay any cost. Again, our team earns about half of the compensation that CIBC Wood Gundy receives, so in this case that is 0.8%.

ETFs: The average 'expense ratio' on ETFs we use is very low, about 15/100th of one percent. None of that fee is paid to CIBC Wood Gundy. There are thousands of ETFs out there these days. We focus on the larger, lowest cost ones.

Not all clients own all of the aforementioned investments and there are few sundry investments we did not cover, but the above examples of where and how clients incur cost is quite comprehensive. We encourage all clients to ask us about this topic either over the phone or in meetings.

Community Involvement: Part of our earnings in December of each year contribute to CIBC Wood Gundy's Miracle Day Charity. Our team (and the other advisor team in our branch) choose to fund the Scientist in Residence program at various inner city schools. This year, with your help, we funded the program at Lord Selkirk Elementary. Neil Pope and Tom Hasker recently visited the school while students were treated to some fascinating lessons on electricity and magnetism by UBC research associate James Day.

Also enclosed (or attached if you received this by e-mail) is our firm's 'Monthly World Market Report.' It includes information on three Pope Team picks: TD Bank, Chartwell Retirement Residences REIT and a new addition, WPT Industrial REIT.

We celebrate the end of tax season (as does Cheryl, our Queen of tax reports) and we wish you all the very best as the weather turns warmer and sunnier. Call any of us, any time.

Cheers,
CIBC Wood Gundy

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