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If I'm on a crusade, it's a crusade of promoting that approach as a necessary evolution from the transactional, tied-selling approach.
—Steve Lowrie, CFA

THE FOLLOWING COMMENTS ARE EXCERPTED FROM A WIDE-ranging discussion about how to demystify and simplify approaches to investing. Steve also talks about how his desire to serve the best interests of his clients has driven an evolution towards a more holistic practice model that includes wealth planning issues.

When I meet someone for the first time in a social setting and they ask me what I do for a living, I usually pause before answering. I then say something like, "I'm a financial advisor." The reason I pause is that I know what their next question is going to be. Almost invariably, they will ask me where I think the stock market is going, what stocks I am recommending, or how I feel about the XYZ stock at \$25.

People ask these questions because they are mirroring the message that Wall Street, Bay Street and the financial media is constantly reinforcing—giving investment advice boils down to making a forecast. People want an advisor to look into a crystal ball and predict the future.

It's hard to explain to a stranger at a cocktail party that there is another approach, one that does not rely on predictions or speculation. An investment approach grounded in solid theory and coupled with broader wealth management issues. That is what I am trying to do here.

Determining the bottom line benefit to my clients.

I consider the bottom line benefit to my clients of any investment activity I undertake on their behalf. This acts as a constant top-of-mind regulator in my daily work.

I actively search out best practices. I work hard to pull in the most advanced, unbiased thinking on the technical and scientific aspects of investment management. I partner with organizations and individuals who are committed to earning optimal returns on investments that are commensurate with the degree of risk taken. My practice is based on a holistic model that considers the broader wealth management issues in my clients' lives.

Although I take professional pride in belonging to a segment of financial service professionals who are highly qualified to do what they do and uphold rigorous standards of practice and ethics, I want to do more for my clients than is usual for an investment counsellor or financial advisor. For investment counsellors who have come out of the brokerage business, as many of us have, a transactional approach to a client's affairs is habitual. So is the active stock picking strategy, where the goal is to manage a portfolio of investments to beat the market. A lot of these portfolios end up looking very similar, with concentrations of Canadian individual stocks and four or five US stocks. In addition, client portfolios are often managed as if they were for tax-free institutions, with

little attention paid to tax issues or turnover or transaction fees. The focus is on whether the portfolio of stocks is doing better than the Canadian market or the US market or whatever benchmark is being used.

Of course, a major difference between the brokerage business and that of investment counsellors is the way we are remunerated: most brokers work on a commission basis and are compensated by the investments that they recommend. Investment counsellors, on the other hand, by regulation can receive fees only from clients; we cannot receive compensation from the investments we recommend. This avoids some of the conflicts that are inherent in the brokerage business. Given that compensation drives behaviour, a broker making a choice between two investments has a financial bias to recommend the one with higher compensation.

However, I think the investment counsellor world generally needs to go more in the direction of helping our clients plan for big life events. As a profession, instead of just taking a pool of money and managing it, I think we should be spending more time with clients trying to figure out what they're trying to achieve with their money, and then setting up a plan that would meet their goals with the least possible amount of risk. That's the direction I am taking with my practice.

Investment management: science trumps fad.

Years ago, when I moved to a market-based or indexing approach plus a fee-for-service model, I was like a reformed smoker: I was glad I discovered this approach when I did, but I wished I had found it even earlier. I think it's better for my clients and it's more in line with my personal philosophy. If I'm on a crusade, it's a crusade of promoting that approach as a necessary evolution from the transactional, tied-selling approach. I strongly believe clients should pay you directly for your services, because there are inherent conflicts in being paid a commission by the manufacturer of the investment you are selling.

I get very frustrated when I hear stories of what has happened to people when they have been given bad advice or a financial professional has mishandled their affairs. These things don't have to happen.

In the investment philosophy I subscribe to, science trumps fad. It rests on some simple ideas that are nonetheless powerful enough to have garnered a Nobel prize in 1990. Firstly, risk and return are related: increasing expected return increases risk. Secondly, diversification helps distinguish those risks that are worth taking—because there are economic reasons investors will be compensated—from those that are not. Thirdly, active management—trying to predict the future and then speculating by picking stocks or managers—is futile and expensive, incurring costs in trade impact, taxes and expenses. Traditional passive

management (strict indexing where you trade to closely mirror the benchmarked index) also involves excessive and expensive trading. Finally, investing is different from speculating. An investor, in the true sense of the word, has a purpose and function: by providing capital, the investor actively supports those companies who are contributing to a healthy economy, both here and globally.

One benefit of this investment philosophy to my clients is that it supports holistic investment solutions and an emphasis on the big picture. Rather than delivering investment products which are driven by manager skill (which research suggests is irrelevant), the focus is on the total portfolio structure. Every diversified, passive portfolio is an equal risk/return tradeoff.

Research and product development driven by investor demand.

In choosing individuals and firms to partner with, it is very important to me that we share a similar investment philosophy. I feel very fortunate to have a partnership with Dimensional Fund Advisors (DFA), a US based company. Not only do they share my investment philosophy; to a large extent they pioneered many of the strategies taken for granted in the industry today. DFA was founded in 1981 with a goal to apply academic research to the practical world of investing. Among its consultants and board members are the University of Chicago's Eugene Fama, Nobel laureates Myron Scholes and Robert Merton, Dartmouth's Ken French and Yale University's Roger Ibbotson. Although it is unlikely that most non-financial professionals have heard of these academics, this list is a *Who's Who* or an all-star team

to financial professionals. Their academic research brings an empirical and scientific rigor to the field of investment management. Initially, DFA worked exclusively with institutional investors; however, in the early 1990s they started selectively offering their strategies to individual investors through a limited number of approved financial advisors.

I use their funds because they are very good at what they do and add a lot of value for my clients. They also function like a research department: we profit from an academic feedback loop with their advisory board, which includes a number of Nobel prize winners. They don't push product: they let client demands drive product development. When, as portfolio managers, we have a question or a suggestion, they take it to their academics, who then come back and say, "Yes" or "No, you can't do that but you might be able to do this."

For example, a group of Canadian portfolio managers asked Dimensional, "Is there a way you can capture public real estate outside of Canada?" They took it to the real estate experts on their advisory board, who came back to us and said, "Okay, here's how you do it, and here's how you manage the funds. What do you think?" We said, "That's great, put it together and we'll use it."

At the core of my investment philosophy is this finding by S&P: if you capture the market rates of returns—and do it consistently—you're ahead of 90% of the other investment options out there.

In this way, DFA acts as a conduit between financial economists and investors. DFA does not deal directly with the public. Clients can get access to their funds only through an advisor who has gone through a process to become a DFA “approved advisor.” Currently there are approximately one hundred advisors who have been approved in Canada.

The futility of searching out the latest investment guru.

I’m always looking for more effective approaches to the investment management side. I do a great deal of research: I attend conferences and read widely and deeply, searching out research by academics who have distinguished themselves in their respective fields.

The instinct is to look for the latest investment gurus, and that’s how the usual sales pitch is framed in this business. Everyone wishes they had invested with John Templeton fifty years ago or Warren Buffett forty years ago, but the problem is, you only know who these gurus are after the fact. Today everyone knows who Warren Buffett is, but investing with him now doesn’t yield you the returns he previously achieved.

History shows that in the long run, a thoughtfully designed diversified strategy of passive funds typically beats all but a few active managers. It’s not easy to structure and maintain such a strategy. It requires some initial research and discipline to stay the course. But it’s much easier than predicting which active managers will randomly beat this approach.

A good first step is to start paying attention to where your information is coming from. Is it from people who are trying to sell you products? A better approach might be to look within the academic world, where the emphasis is on providing unbiased research. Some publications which seem credible to non-academics or non-industry professionals are seen by academics as having the credibility of a supermarket tabloid. There are also different levels of research (and significantly different levels of journals) in the academic community. There is noise in the academic community, just like in the financial media, and it takes experience to sort through and focus on the most relevant and credible publications.

Investor behavior is often self-destructive: when the going gets tough, investors panic.

Dalbar Inc.’s *Quantitative Analysis of Investor Behavior* measures the effects of investor decisions to buy, sell and switch into and out of mutual funds. Not only does the average investor in mutual funds earn less than they would if they simply bought the market, they earn significantly less than the mutual fund performance reports suggest. Funds report the results as if investors held the same investment throughout the given period of time—but that’s not what people do. The average investor buys

when stocks have gone up and sells when they’ve gone down. Over the last twenty years [Dalbar reported in 2008], the returns of the market have been about 9% per year, but the return of the average investor has been about 2% per year. That’s not just a 7% difference . . . that’s 7% compounded over 20 years! These investors would have been better off just leaving their money in a bank. These results are partly due to erratic behavior on the part of investors, but I think many have received bad advice as well.

John Bogle, the founder of Vanguard, and is among those who have compared the returns of the market and the returns of the average mutual fund, and then compared them to the returns of the average investor. What they have found is that the returns of the market are there for the taking: you can buy an index fund and you’ll capture those returns on the market—and you can do it at a very low cost. The average mutual fund, however, underperforms the market roughly by the amount charged in its fees. Although you’re paying for professional advice, the returns you get don’t even equal the market returns. Let me emphasize that this is the finding for the average fund. Some funds do better; however, many do a lot worse.

To sum up, at the core of my investment philosophy is this:

according to research done by S&P, if you capture the market rates of returns and do it consistently, you’re ahead of 90% of the other investment options out there.

Simple message that is not getting heard.

But this simple message is not likely to get out there because the marketing budget of the average academic researcher is zero, and the marketing budget of the average mutual fund is millions and millions of dollars. If someone gets on a business TV network like CNBC, Bloomberg or RobTV and says, “No matter what anyone says, just ignore them and buy the market,” the network isn’t going to sell many commercials.

Research shows you can become a better investor if you turn off the business TV networks, stop reading financial books and magazines, and stop paying attention to the many other media sources. Listening to these sources for anything other than entertain-

ment value will likely cause investors to simply trade more. A well-known paper in the academic world by Barber and Odean—*Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*—shows that the more you resist trading, the better off you will be in the long term.

My best guess is that less than 5% of the individual advisors in Canada use indexing strategies. In marked contrast, in the institutional world—those big pension plans with billions to invest—60% use indexing strategies. Why is there this huge gap between what the best professionals in the business do and what the average investor does? Partly I think it’s due to over-confidence. No

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one's ever going to admit that they can't beat the market. People think, you're smart, you do your research, why wouldn't you be able to beat it? But in the end, what are the results?

Interestingly, Warren Buffett has given the similar advice: "I think that if you buy equities across the board, which means an index fund, and if you do it over time so that you don't put all your money in at the wrong time—and it's a low cost index fund—that's probably the best investment that most people can make."

Easy to say . . . not so easy to do.

So, what's my role if I tell my clients to just buy the market? Basically, that of a trusted, competent and knowledgeable advisor. I help my clients work through some planning issues, do some projections and basic structural planning, and structure a portfolio that gives the best chance of meeting these needs. Common planning issues that come up are things like—Do I have enough money to retire? How much is enough? Do I have enough money now to maintain my lifestyle? How can I pay for my kids' education? How can I reduce the tax I pay now? What is the most effective way to transfer money to my children or my favourite charity? It's sometimes difficult to foresee what these issues will be, but I've often earned my fees many times over by giving good planning advice.

And, yes, I'm rather oversimplifying things by saying, just buy the market. Over time there are innovations, which often come out of the research world and are applied with varying degrees of success to the real world. I think it's another role of the advisor to keep on top of the latest research and track successful applications over time.

To give a specific example, an influential paper written in 1992 by Fama, French said that the primary determinants of stock market returns are based on three factors: the overall exposure to the stock market, exposure to lower priced "value stocks" and exposure to smaller stocks (Fama, French Three Factor Model). It is debatable why value and smaller stocks have had higher returns than other areas of the market: one reasonable explanation is that they are higher risk. These risks are worth taking, however, because investors have been handsomely compensated for doing so. The practical application of this research is that investors can increase their expected rate of return by buying a broadly diversified portfolio and adding more exposure (tilting) to value and smaller company stocks.

The Fama, French work translated well into the real world and has added significant value for investors. Again, you have to pay attention to where research is coming from before you apply it: many investing theories that are put forward work well on a computer or in the lab, but they fail with real money because of trading issues and transaction costs. I stay informed and closely follow practical and applicable innovations in finance. If something makes sense and can add value, I will proactively implement this in clients' portfolios.

Sticking to the plan.

I also help clients avoid the behavioural traps that investors often fall into. It's not always easy to stick to the plan when everyone around you is panicking. Because investment counsellors do discretionary investment management, each client must have an Investment Policy Statement. The IPS outlines the target asset mix and lays out the goals of what you are trying to achieve.

In the heat of the worst market turmoil we had in decades, many clients came close to the bottom end of their target asset mix range or even below it. Having an agreed upon target ahead of time helped to steer off irrational or emotional decision-making which might have cost them hundreds of thousands of dollars in lost opportunity costs.

Advanced wealth planning.

Helping my clients with their overall wealth management—either directly or through my team of related professionals—is a distinct function from creating and implementing an investment management strategy on their behalf. What happens in one area of a client's financial life can affect everything else. It just makes sense for related professionals in tax planning, wealth preservation and estate planning issues to work together in a coordinated way.

I'm happy to work with my clients' accountants, lawyers and other professionals. In addition, I've been building a team of outside experts whom I have dealt with before and know to be trustworthy and highly competent in their respective fields. For example, if a business owner needs help with succession planning, I can bring in a team of outside experts to help. A well thought out and properly structured plan can result in enormous tax savings.

To sum up, my goal is to offer my clients optimal investment management and personalized service, and to put their best interests first. ■

Stephen Lowrie, CFA

has 17 years industry experience with both small and mid-sized (non-bank owned) firms.

His **Chartered Financial Analyst (CFA)** designation—earned in 1997—is globally recognized as the pinnacle of professional excellence within the investment community. In offering unbiased solutions to help his clients achieve their financial goals, he combines his expertise with the science of investing to develop and implement investment strategies.

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