

# Investment

## Review & Update



June 2007

## The Myth of Diversification through "Advisor Allocation"

**Most** experienced investors understand the value of diversification as a tool to reduce risk. Diversification comes in many forms, but essentially it is achieved by holding a variety of asset classes (such as equity, fixed income, cash and foreign currency et.) that have a low correlative effect to each other. This manages what is called "market risk", or the tendency for different market sectors, or geographic regions to respond differently to global or regional market influences. Diversification can also occur in one asset class by holding across several different companies. So we may elect to hold shares of four or five financial institutions so that the negative impact of one (for example, Bank of Montreal's gas trading) is not magnified by the holding of only that stock. This danger inherent in individual stocks is called "company specific risk", and diversification is very effective at mitigating it.

**More** recently, we have seen a number of prospective clients who have multiple investment

advisors. This practice, known as "advisor allocation", allocates investments among different advisors in the hope of diversifying risk. People employing this tactic argue that by reducing the amount managed by any single advisor, they mitigate the effects of any instance of incorrect advice. They further suggest that since advisors generally have similar mandates they will encourage their various advisors to compete on the basis of investment returns. Although on the surface this argument resembles the one for asset diversification but we see four major problems with this chain of reasoning.

### 1. *Improper Risk-Return Analysis:*

Although it is easier to compare rates of return on different portfolios, incorporating the risk factor into this analysis is more difficult. Real performance is only measured by risk-adjusted return. So, a portfolio which has high short term returns may risk the long-term finances of the investor. Firms and advisors that are competing for "pieces of the pie" will be primarily

concerned with short term gains instead of long term health and a balanced portfolio.

### 2. *No Investment Overview:*

As long as any advisor has access to a portion of a client's investment, they are going to be limited in their ability to actualize the potential of all investable assets. For example, three advisors each with a third of investments create similar balanced portfolios for their allocated amount. However, these three balanced portfolios add up to a single imbalanced one, because each advisor is unable to plan based on the strengths and weaknesses of the whole amount. The client also begins managing the investments themselves, deciding which assets go to which advisor, defeating the purpose of hiring a trained professional

### 3. *Higher Aggregate Cost:*

More management means more cost. Instead of paying one commission the investor will be

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paying several. Besides this factor the investments themselves are more effective in gains together.

### 4. *Poor Tax Structure:*

Investors are able with their combined assets to more easily access pooled funds with minimum investment amounts, and improve their tax efficiency. The fees for these funds are lower and tax deductible. Furthermore, if a family combines its investments the advisor can create a family model reflecting overall portfolio risk.

**This** year we performed an assessment of the impact advisor allocation had on one prospective client. In this case, Advisor B had given an inferior return to Advisor A but had a greater equity exposure 80% versus 60% and thus more risk. Advisor B was competing on performance, betting that equities would outperform fixed income. He also invested heavily in income trusts which were adversely affected by government changes to their taxation.

**The** P.R.I.S.M (Personal Risk Management) process developed here at Investaflex creates the most effective advisor diversification because we select managers or investment counsel firms with proven track records in managing each asset type while at the same time always assessing the portfolio as a whole. In this process, the focus is as strong on managing risk as it is on managing returns and alpha (the value by which the managers outperform their benchmarks). Perhaps the most important reasons for having a single advisor develop your investment strategy are tax efficient

portfolio design and integrated portfolio reporting, both of which Investaflex PRISM clients know and appreciate.

### **Market & Portfolio Update**

**The** world equity market remains healthy, and this is reflected by an average year to date return of 13.35% on our selected equity funds. The sole exception to this trend is the Mackenzie Universal World Real Estate fund, the performance of which currently stands at -13.26%. The main factors contribute to this underperformance: firstly a strong Canadian dollar resulting in a currency exchange loss, secondly the fund's overweight in recently weaker European/UK real estate markets. The Asian sector has performed well, particularly Japan, but unfortunately has only a 6% exposure in the fund. To add to this, Yen has depreciated by 15% against the CAD, and so returns are muted compared to local currency gains. Nancy Holland, the fund manager, said that she remains confident in European equity markets, claiming that Europe is still the cheapest place to be and therefore attractive to value investors. Her team unfortunately will not be able to control speculators who feel (after a 40% gain last year) that stocks are trading at a premium. However, global real estate stocks are trading at a 3% premium to their intrinsic value (Net Asset Value, or NAV). This premium is certainly justified in that the funds allow a level of liquidity unattainable via actual property ownership. We believe this fund requires more time to ride out the current valuation, and recommend against any immediate

action, though suggest placing it on a watch list.

**Globally**, as asset growth is likely to put pressure on inflation (as mentioned in last month's update), fixed income instruments may under perform in this period. Fixed income however should continue to be present in portfolios to protect against any down turn in a the equity market.

### **Recommendations**

**We** suggest a change from US Chou Associations to RBC O Shaughnessy U.S. Value fund for the following reasons. Firstly a strengthening of the CAD against the U.S. Dollar warrants that foreign or global funds be hedge/neutral in their foreign currency exposure. Secondly the high Cash holding within the Chou fund is causing performance drag.

**We** will contact each of you individually in the coming week to discuss any changes appropriate to you. We hope that that the article on advisor allocation and its risks was of benefit to you and, as always, welcome any feedback on the topic.

Best regards,



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