FINANCIAL FOCUS

MAKING SEN$E OF INVESTING

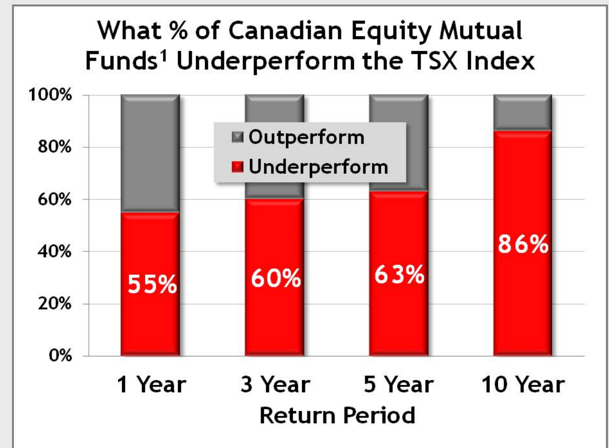
WHY DO MOST CANADIAN EQUITY MUTUAL FUNDS UNDERPERFORM?

"Practice makes perfect". We've all heard this adage so often that we've come to accept it is a universal truth, applicable in all circumstances. But does it apply to investing? The answer may surprise you. If practice *did* make perfect in the investment world, it would stand to reason that the longer a mutual fund has been managed, the more likely it is to outperform. But according to a recent study performed by the investment team at STYLUS Asset Management, the opposite actually holds true. As Chart 1 shows, the longer the time horizon, the more likely it is for a mutual fund to *under*perform. What's even more revealing is that, no matter the time frame, most Canadian Equity mutual fund managers underperform the benchmark S&P/TSX Index. How is it possible that most mutual funds—even those that have been around the longest—cannot beat the performance generated by an index? How could it be that practice makes *im*perfect? Let's explore some of the more common reasons behind the mutual fund industry's poor results.

WHY DO MUTUAL FUNDS UNDERPERFORM?

- ***Focus is on building assets instead of generating performance***
- ***The larger the fund, the more limited are its investment choices***
- ***Think they can successfully "time the market"***
- ***Lack of discipline***

Chart 1



The majority of equity mutual funds have underperformed the index across all time periods.

[1]Source: Fundata.com; Globefund.com; Analysis includes funds classified as Canadian Equity, Canadian Dividend and Income Equity and Canadian Small/Mid Cap Equity. Data as of September 30, 2012

OUTPERFORMING IS NOT THE #1 GOAL

The unfortunate truth is that, for most mutual fund companies, outperforming does not appear to be the primary goal. Mutual funds generate revenue by charging their clients management fees — the more assets, the more fees are collected. As a result, to maximize fees, the goal of many mutual fund companies is to manage the most assets. To gather those assets, the mutual fund companies that actually have strong *past* performance use that to their advantage. But as Chart 1 shows us, most funds do not have great long-term performance! So what do they do? They resort to using marketing campaigns that promote the broad benefits of saving for retirement, with very little emphasis on performance.

Once mutual funds grow large enough, an interesting phenomenon often occurs: they shift their focus from *building* assets to *keeping* them. The friendly advertising campaigns disappear and investors are left to deal with the harsh reality of "deferred sales charges (DSCs)". Often buried in the fine print, DSCs are fees investors must pay if they wish to switch to another fund company within the first few years after an initial investment. We call the use of these types of fees the "Berlin Wall" method of managing money, since assets are essentially blocked from leaving the mutual fund company's coffers, potentially for years.

Once they reach a certain size, many fund companies also switch gears when it comes to their investment strategies — instead of trying to *out*perform, they try to *not under*perform. The difference between trying to win and trying not to lose has an impact on every facet of how a fund is managed, including the number of stocks held and how they are purchased and sold.

In order to minimize underperformance, funds have a natural tendency to become more "index-like", which means they end up owning the same stocks as the index with similar weightings. The irony is that most of these so-called "closet index" funds are destined to underperform the index for the simple reason that they charge management fees and the index does not. This means to keep pace, the fund must outperform by at least what it charges in fees—which most mutual funds simply cannot do. Because most mutual funds are incented to grow as large as they can as fast as they can, they are destined to underperform.

SIZE MATTERS

Consider this cause and effect scenario: a sensible investment strategy is implemented by a capable mutual fund manager, resulting in strong performance. This leads to an extensive marketing campaign, which in turn leads to increased assets under management and more fees for the mutual fund. So before you invest your hard earned dollars in the fund, you should demand an answer to the following burning question: Has the investment strategy been forced to change because the fund now has vastly more assets under management? Unfortunately the answer is probably...yes. It is a poorly understood fact that as assets grow, it becomes increasingly difficult for a fund manager to maintain a consistent investment strategy. This occurs because, paradoxically, the fund manager has *fewer* investment choices as assets grow. How can this be? It happens because there just aren't enough Canadian stocks whose shares trade in large enough quantities to make it feasible for large funds to buy. As a result, a manager may end up selecting a stock just because it is easier to trade, rather than because it is a great company to own. In this way, increased asset size hinders the investment strategy and subsequent performance.

"The problem is, the goal of most mutual fund companies is to gather the most assets, not to outperform"

We offer the following example to illustrate this phenomenon. Of the largest 22 mutual fund firms in Canada (which account for nearly two-thirds of all Canadian equity mutual fund assets) the typical firm has approximately $5 billion invested in Canadian equities. In order for a fund to buy a 3% weighting in one stock for its portfolio, it would need to purchase shares in that company worth $150 million. This begs the question: how many stocks are there in Canada that trade at least $150 million in a reasonable length of time, say, one month? Our analysis reveals that there are only 117 such stocks in Canada. That's really not a lot to choose from considering many funds hold 60 stocks or more.

So what's the alternative? Consider a firm that has only $100 million invested in Canadian equities. A 3% portfolio weighting would equate to just $3 million invested in a single stock. Not surprisingly, as Chart 2 shows, the pool of stocks from which this smaller firm can choose is much higher; in fact, it's nearly five times as large! In addition, smaller, more nimble investment funds typically have an easier time buying shares in companies whose earnings are growing the fastest (a key attribute that fund managers highly prize) that are often too small for large managers to access. More choice equals better opportunities to outperform which is a distinct advantage for a manager with less assets under management. In the investment business, size truly does matter – and in this case, bigger isn't better.

Chart 2

Source: Morningstar Inc. as of September 30, 2012

MANAGERS TRY TO TIME THE MARKET

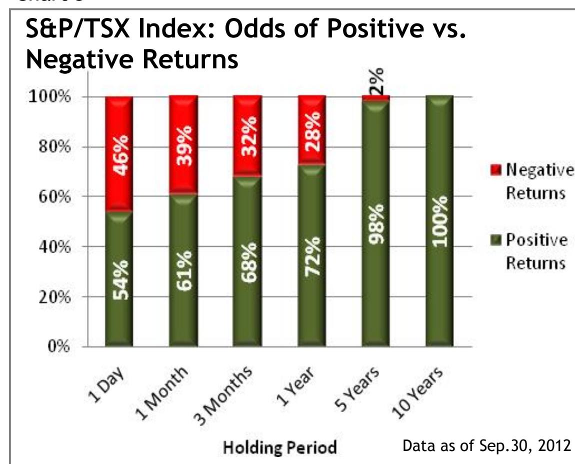
"Timing the market" is an attempt to sell stocks before the market goes down and buy them back before the market recovers. While the concept of market timing sounds simple, its execution is actually extremely difficult. Success depends on accurately predicting not only when to exit the market but also when to re-enter. As difficult as this strategy is to successfully implement, it is a huge temptation for investors who believe they can 'outsmart' the market.

A quick look at two common market timing strategies reveals their ineffectiveness. The first, called "Sell in May and Go Away", involves only being invested in stocks for the six months between November 1st and May 1st of each year—for the rest of the time, the theory suggests, you are better off in cash. We ran the numbers to see if such a simple strategy works. It did work well — from 1956 to 1991 — adding 2.5% per year above a strategy to always stay invested (assuming no transaction costs). However, in the past 20 years, this market timing strategy has been a failure, *under*performing the "stay invested" strategy by nearly 7% per year. Clearly the "Sell in May and Go Away" strategy's best days appear to be behind it. A second common market timing strategy involves switching out of stocks during periods of rising interest rates, when conventional wisdom says stocks are likely to fall as bonds begin to offer higher yields. A review of the numbers however proves otherwise: stocks have not weakened but have actually *gained* an average of about 6% during periods of rising interest rates since 1956.

As for other market timing schemes, despite their catchy names - the "January effect", the "Super Bowl Effect", the "Hemline Effect" – they have all proven to be inferior. Why? Because investors' attempts to capitalize on them renders them ineffective.

The simple truth is that, in its 55-year history, the S&P/TSX Index has experienced 38 positive years, been flat three times and declined in only 14 years. So the odds of success when you are holding cash rather than stocks are stacked almost three to one against you. Investors who are just trying to make a quick buck implementing a market timing scheme are fighting the odds—while those with longer time horizons have the wind at their backs. As Chart 3 shows, the odds of a positive return on any given day are only slightly better than 50-50. But as the holding period grows, the odds of a positive return increase. And for

Chart 3



investors with time horizons of 10 years or more, losses in the Canadian stock market have NEVER occurred. The message is clear: the odds favour staying invested.

> **"The more assets a mutual fund has, the fewer are its choices"**

LACK OF DISCIPLINE

Anyone who has ever tried to quit smoking, lose weight, or develop an exercise regimen will all tell you the only route to success is through **discipline**. The investment industry is no different: success depends on following an investment style with unfailing discipline. Managers who attempt to operate without discipline face the nearly impossible task of overcoming the countless distractions that interfere with sound investment practices. As we say in the business, "there's a lot of noise out there" and if one is not careful to filter most of it out, it can paralyze a manager, or worse, cause a detrimental change in an otherwise sound investment strategy. A manager's own biases can also have a harmful impact. Managers sometimes "fall in love" with a company's products or management and

continue to own shares longer than they should. Other times they avoid certain types of stocks because they consider them to be either socially objectionable (cigarette manufacturers, casino operators) or too risky (small caps, gold stocks) despite knowing that such rules limit their choices and could hurt performance. Sometimes managers just get bored and they venture off their proven path to chase after the "next big thing", like many did with technology stocks in the late 1990s. Finally, some managers try to carry out investment strategies that work well in theory, but are just too complicated to put into practice. The $9 billion loss at U.S. bank J.P. Morgan caused by a failed, convoluted hedging strategy is just the latest example. The best way to avoid many of these investment pitfalls is to develop a well-defined set of investment rules and stick to them! We call that...being disciplined.

A SOLUTION

Canadian equity mutual funds have a bad track record of underperforming in both the short and long term. While it is impossible to explain all of the reasons, there are clearly some significant structural issues in the mutual fund industry that work against these investment managers.

Investors do have a choice. They should look for investment firms that don't face the significant hurdles confronted by the mutual fund industry. They should look for firms that aren't trying to be the biggest, but rather the best performing and have long-term track records to prove it. They should look for firms that manage assets on a scale where they can stick to their discipline so that their investment strategy won't be compromised. And finally, they should ask the most important question of all: Does the investment manager have their own money invested in their own fund?

WHO IS STYLUS ASSET MANAGEMENT?

STYLUS Asset Management is an independent investment firm based in Oakville, Ontario that manages its own five specialized pooled funds. We use a rules-based investment decision-making process to help avoid the many distractions inherent in money management. More importantly, we offer proof that our process remains consistent and that we are disciplined in how we manage money.

Our focus is to be the best investment firm, not the biggest. In so doing, we have deliberately chosen to focus on managing performance-oriented funds for a limited number of clients. We believe fees earned by an investment manager should be directly related to how well the manager performs, not solely on the amount of assets under management. Lastly, our goal is to remain fully invested to avoid the pitfalls of trying to time the market.

If you have any questions regarding the content of this newsletter or would like more information about STYLUS and the funds we manage, please contact Brennan Carson at (416) 847-5900 who would be pleased to talk to you about how STYLUS can help you achieve your investment goals and objectives.

STYLUS Asset Management

- **Performance-oriented investing: the STYLUS funds are among the top performing funds in Canada**
- **Pioneers of disciplined investment management**
- **The investment team has been together for 20 years and are the largest investors in the funds**
- **STYLUS funds are available only from STYLUS**
- **Available with a minimum investment of $150,000**

KNOWLEDGE

EXPERIENCE

DISCIPLINE

PERFORMANCE