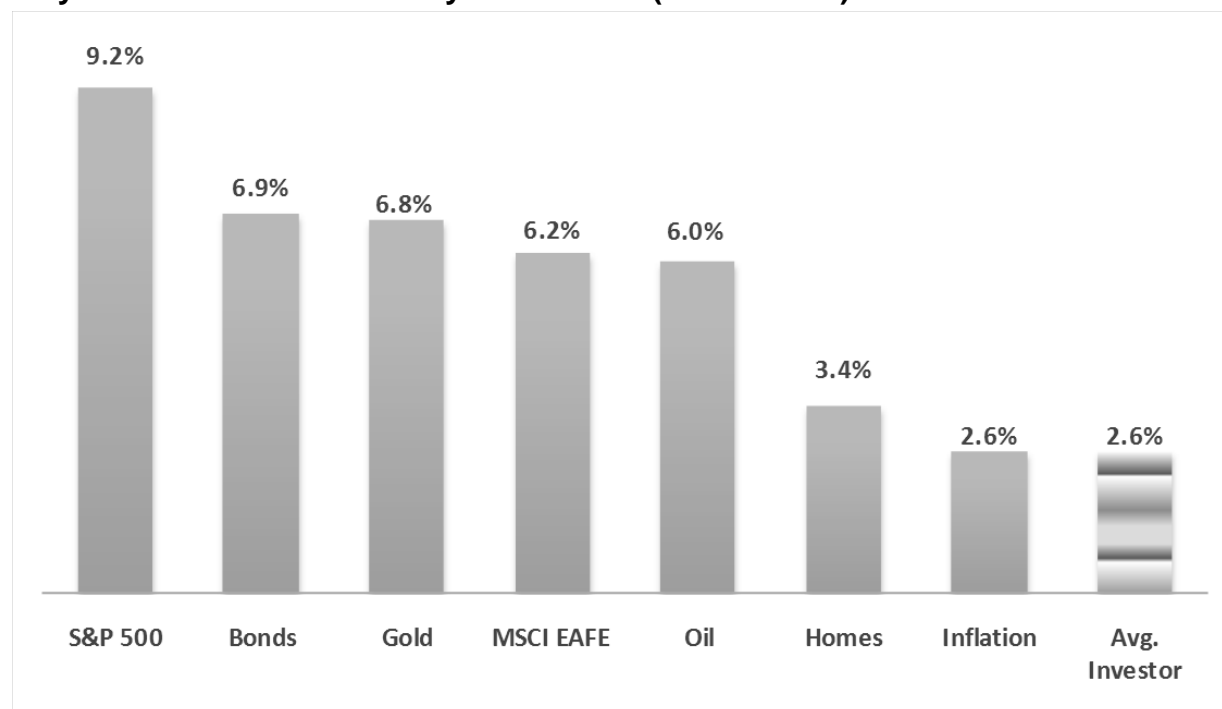


Some unfortunate facts

By Geoff MacDonald, portfolio manager

To start, here's a chart that highlights one of the most unfortunate facts about investing.

20-year annualized returns by asset class (1991 – 2010)



Source: JP Morgan, Bloomberg. Bonds: Barclays Capital U.S. Aggregate Bond Index; Oil: Bloomberg WTI Cushing Crude; Homes: S&P/Case Schiller U.S. Home Price Index; Inflation: U.S. Consumer Price Index; Investor returns: Calculated using Dalbar fund flow information. The MSCI EAFE index includes a selection of stocks from 22 developed markets, but excludes those from the U.S. and Canada. All returns annualized in US\$.

Don't be a Patsy

For simplicity's sake, let's call the average investor "Patsy." Of course, Patsy could be male or female but since it's also short for Patricia, we'll make her a "she" in our example. Unable to curb her emotions when investing, Patsy moves from investment to investment and suffers the consequences of the most unfortunate fact outlined above. She has a long-term investment horizon, yet with each feeling of greed or fear she experiences, she forgets about the investment approach that will get her the results she needs.

Even old farts have a long-term investment horizon

Before anyone claims not to have a long-term investment horizon, let's look at other fortunate, or unfortunate, facts:



- 1) If Patsy is 65 years old, there's a 53% chance she'll live another 20 years, to 85. If Patsy and her husband are both 65, there's a 72% chance one of them will live another 20 years. If you were 65-year-old Patsy, wouldn't you have a long-term investment horizon?
- 2) If Patsy is 75 years old, there's a 16% chance she'll live another 20 years, to 95, and a 63% chance she'll live another decade. If Patsy and her husband are both 75, there's a 22% chance one of them will live to 95 (20 more years) and an 82% chance one of them will live to 85 (another 10 years). If you were 75-year-old Patsy, wouldn't you still have a long-term investment horizon?
- 3) If Patsy and her husband are both 85, there's a 36% chance one of them will live to 95.

(Calculations based on data from the Society of Actuaries, *Retirement Participant 2000 Mortality Tables*.)

Try to understand real risk

It can get frustrating to hear people's excuses as to why they don't have a long-term investment horizon. "I'm old. I don't need any of that growth stuff." Or worse, "Due to my age, I can't afford to lose any money." This is exactly how Patsy feels right now. She's completely unaware that her greatest risk isn't losing money today, but not having enough tomorrow. If she heeds her fears, she'll be subject to another unfortunate fact about investing today – either running out of money before she dies or having to dramatically alter her retirement plans. This will happen because of two more unfortunate facts regarding investing today. First, the dire starting position of the average investor (Patsy), and second, because of what Patsy feels comfortable buying.

False prosperity

Let's talk about the unfortunate facts concerning Patsy's starting position. According to TD Canada Trust, 40% of Canadian baby boomers surveyed have stated that they'll still have a mortgage when they retire! This might not be a huge deal if it weren't for another unfortunate fact. 72% of Canadians have no corporate pension to look forward to, which means they'll have to survive on their own investments! How is Patsy going to manage this? Of course, Patsy is going to save for retirement. She'll put what she can in an RRSP and hopefully be able to save outside of that as well. This is her only hope and she'd better generate decent returns on her savings. But how can Patsy protect herself – from herself – with those savings?

The quest for low returns

That second unfortunate fact, about what Patsy feels comfortable buying today, is tied to Patsy's unfortunate quest for low returns. She moves from one investment to another, unable to get past her fear in order to buy investments at low prices and unable to get past her greed in

order to sell at high prices. Not to mention, she always puts new money into whatever has recently performed well.

As you can imagine, this isn't entirely Patsy's fault. She gets lots of help from the average mutual fund company. They're always around to tell her what to buy, taking the path of least resistance along the way, and are happy to feed her what she thinks she wants rather than what she needs. It's easy to find out what stuff Patsy feels comfortable buying today. Look no further than industry statistics about the types of investment products being bought and sold. But that would be boring and wouldn't address the real concern behind this unfortunate fact.

The path of least resistance

Another way to discover what Patsy wants to buy today is to simply examine the typical fund company's advertising budget. They're masters at playing to Patsy's fear and greed. You see, what Patsy doesn't fully appreciate is these companies' composition. For simplicity's sake, let's call the average fund company Dewey, Burnham & Howe, a famous gag name used by the Three Stooges that also appears in many other parodies.

Dewey, Burnham & Howe was created decades ago by investors. Its founders have since retired and the next generation of leadership is composed of individuals who've excelled within the firm at sales, marketing or operations – not investing! Some fund companies have no history of being investment led and have always been sales and marketing driven. I'm sure you're thinking that an investment company should be headed by investment people, but that's seldom the case anymore. How does a sales or marketing person (with all due respect to my sales and marketing friends) know what investment products Patsy needs? They're better at figuring out what Patsy wants. Unfortunately, history has shown that what Patsy wants is rarely what she needs.

Perusing an investment trade magazine adds colour to Dewey, Burnham & Howe's current path of least resistance. Here's a full-page ad for an income fund promising to "provide your clients with the income they're looking for," with "7% targeted annual distribution" in big letters. Nowhere does the ad publicize the fund's 2.42% MER. If I understand the math, the portfolio manager should find investments that yield 9.42% a year ($7\% + 2.42\%$) to meet the 7% target. A 10-year Colombian government bond yields 3.4%. A 5-year BCE bond yields 2.7%. BCE's stock, which sports a very high yield, gives you a paltry 5.1% compared to the required 9.42%. Spain and Italy (both apparently might be going bankrupt, by the way) yield 5.1% and 6.9%, respectively. What the heck does this fund own for Patsy? If Patsy doesn't understand, does it matter?

Turn the page and here's yet another full-page ad. This time, one about "target maturity corporate bond ETFs." Three pages over, there's an ad with the headline, "Looking for Income?" On the page after that, behold – an ad asking, "Need Income Options?" Though hard to believe, you can turn the page once more to see another full-page spread, in which Dewey, Burnham & Howe is advertising eight of its funds. Of course, all eight are income funds.

This quick investigation reveals that Patsy feels good buying income products today and that Dewey, Burnham & Howe are pushing them as aggressively as a drug dealer would crack.

Were these same sales- and marketing-driven companies advertising bond and income funds in 1999 and 2000? Of course not. Patsy was excited back then. She was making lots of money investing and wanted to make more. Like a drug dealer, Dewey, Burnham & Howe was happy to cater to Patsy's desires. Who are the sales- and marketing-driven companies to decide what Patsy needs? They'd either have to admit they don't know or that it isn't their job. So why not take the path of least resistance and convince her that she wants even more of what she didn't need. It's a much easier sale and isn't that their goal? Today, Patsy's sense of fear is being targeted and history is likely to repeat.

The quest for low volatility, a hunk of metal, low income and again...that quest for low returns

Besides peering into Dewey, Burnham & Howe's advertising budget, we could also look at recent fund launches to see the mistakes Patsy is likely making today. These are the "investment products" that sales and marketing organizations create to boost their assets under management and thus fees.

I could write a book about this year's product launches. Other than the odd fund promising Patsy ownership of a hunk of metal (copper, silver, gold, etc.), 2011 launches mostly consisted of products that promised either low volatility or to somehow deliver income. It seems obvious by these launches that scared investors are approving of big claims of a cure-all for their woes, and desire "solutions" over returns.

Here's a recent example. It's called a "low-volatility income fund." It was created to invest in an equally weighted portfolio of the 30 or so equities with the lowest relative volatility and a minimum specified yield at the time of investment. What about this new "investment product" talks about making money for Patsy? Doesn't the valuation, quality of management and future prospects of the 30 companies matter, or is only their volatility important? What relationship does low volatility have to strong long-term investment returns? And do you really think the employees of Dewey, Burnham & Howe have a large chunk of their net worth tied up in this product? Is making money for investors becoming secondary to catering to emotions and

providing “solutions”? My advice to the industry: try to make the average investor some money! Now that's a solution.

The real risk

Today, Patsy – the casualty in this real-life saga – is again mistaking real risk with perceived risk. She's afraid to lose money and afraid of volatility. She's buying non-volatile securities that pay a yield. Problem is, the more of that she buys in this market, the greater the chance (in our estimation) that she'll run out of money or have much less than she needs long term. This is a far greater risk than a bit of short-term volatility.

Why does this have to be explained?

The best way to explain the problem is to look into some of the typical names that Patsy now owns in her portfolio. Patsy likely holds lots of BCE thanks to its large, 5.1% dividend yield. Take off her fund's MER of, say 2.35%, and Patsy's now making 2.75%. Subtract inflation (approximately 2.9%) and Patsy is getting 0.15% poorer each year. Her only hope of being spared from losing money year in, year out solely rests on BCE's ability to grow. What are her thoughts on BCE's growth?

Patsy also probably owns lots of pipeline stocks, like Enbridge. Enbridge's dividend yield is an attractive 3%. Take off that 2.35% MER and Patsy is earning 0.65% a year from that dividend. Deduct inflation and Patsy gets 2.25% poorer every year, unless Enbridge can grow its value to offset this erosion. Trading at around 25X earnings, how does Enbridge grow 2.25% a year?

Bonds are a great way to generate income. I'm sure Patsy owns 10-year Canadian and U.S. government bonds in some of those income funds, and both sport a super-robust yield of approximately 1.97%. After fees and inflation, the portion of her savings invested in these non-volatile, income-generating investments will make her 3.28% poorer a year. There's no opportunity for growth here, only loss of purchasing power. For crying out loud, Patsy, at least give yourself a chance!

What return does Patsy need to live properly in 10 or 20 years? How will these very popular "investment products" get her there? Is there an obligation to tell investors that the income after fees is unlikely to match the level of returns generated over the past couple of years?

You're not wrong if everybody is wrong with you

"You're not wrong if everybody is wrong with you" is the unfortunate belief potentially at the root of Patsy's problem. This mantra allows Dewey, Burnham & Howe to continue to live another day despite the measly returns it generates for Patsy. If those income funds being hawked provide Patsy with little in the way of real returns over the next decade, will anyone look wrong?

Representative of the average investor, Patsy performed as expected, like the average. Sure, her lifestyle might need to change, but she'll simply commiserate her fate with other average investors. She won't even feel all that wrong with so many others in the wrong with her. Considering the popular purchases by the world's Patsies and the messages advertised by Dewey, Burnham & Howe, a less-volatile income product seems to be conventional wisdom. Can't blame them for following convention. And if Patsy learns nothing from the experience, she's doomed to be a Patsy all over again.

What about my EdgePoint investment?

Edifying as this may, or may not, have been it's time to talk about your EdgePoint portfolio. Though gratifying to beat the S&P/TSX Composite Index in 2011 by approximately 1%, our one-year return was nevertheless negative. EdgePoint Canadian Portfolio's biggest detractor in 2011 was Research In Motion. We're aware of the challenges faced by the company and acknowledged as much earlier in the year, in our [second-quarter commentary](#). Those challenges continue and have impacted RIMM's share price. We continue to question whether our thesis is intact and are looking for much better execution from the company in the future.

Since our inception just over three years ago, EdgePoint Canadian has compounded at a rate of 18.39% a year. Our goal when we launched this investor-led company was to be at or near the top of our peer group over 10 years. Though three years is a short period, we're well on our way towards achieving that goal.

The fact that the Portfolio was down over the past year, yet still up more than 18% a year since inception, emphasizes the trap of focusing on short-term performance. Old fart or not, almost everyone needs a long investment horizon. If you read our commentaries, you know that we don't like to talk about short-term performance, positive or negative. It's noise. In the spirit of doing the opposite of our peers when it makes sense, we'll do so for this subject as well.

Following is our view on short-term results, taken from one of our previous commentaries:

The industry's obsession with annualizing quarterly and annual returns is akin to annualizing the score sheet of one inning in a baseball game. Perhaps there is some valuable information about that one inning, but how can this information be used? Can it help you pick the winner of the next inning? Does it matter who wins the next inning? Is the goal to win an inning or to win the game?

What's also worth noting is that we added five names to your EdgePoint portfolio in 2011. Two of those names, Enerflex and MI Developments Inc. are already top 10 positions.

Enerflex is a global leader in natural gas compression. As natural gas use continues to grow, more compression equipment will be needed globally. Natural gas is a relatively clean burning, abundant commodity increasingly being substituted for higher-priced oil and nuclear plants that people no longer want in their backyards. Enerflex is valued at approximately 10X the free cash flow they'll likely generate in 2012. That's an implied 10% return before factoring in the business's potential growth. It's purchasing attractively priced companies like Enerflex, leaders in their field with understandable growth prospects, that will help us to achieve our investment goals over the next 10 years.

There's a serious amount of conviction, backed by our substantial personal investments in EdgePoint Portfolios, that Patsy's uncertainty is causing dislocation in the market. This dislocation means companies that can grow are much more attractively priced than bonds and slower-growing, dividend-paying companies. Though we suspect the dislocation will eventually be painful for Patsy, it's a large opportunity for investors in our portfolios.

Sincerely,

Geoff

The above companies were selected for illustrative purposes and are not intended to provide investment advice. EdgePoint Investment Group may be buying or selling positions in the above security. Standard performance for EdgePoint Canadian Portfolio is as follows: 1-year, -7.80%; 3-year, 17.32%; Since inception (November 17, 2008), 18.39%. Commissions, trailing commissions, management fees and expenses may all be associated with mutual fund investments. Please read the prospectus before investing. Copies are available from your financial advisor or at www.edgepointwealth.com. Unless otherwise indicated, rates of return for periods greater than one year are historical annual compound total returns including changes in unit value and reinvestment of all distributions, and do not take into account any sales, redemption, distribution or optional charges, or income taxes payable by any securityholder, which would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. This is not an offer to purchase. Mutual funds can only be purchased through a registered dealer and are available only in those jurisdictions where they may be lawfully offered for sale. This document is not intended to provide legal, accounting, tax or specific investment advice. Information contained in this document was obtained from sources believed to be reliable; however, EdgePoint does not assume any responsibility for losses, whether direct, special or consequential, that arise out of the use of this information. Portfolio holdings are subject to change. EdgePoint mutual funds are managed by EdgePoint Investment Group Inc., a related party of EdgePoint Wealth Management Inc. EdgePoint® and Owned and Operated by Investors™ are registered trademarks of EdgePoint Investment Group Inc. Published January 6, 2012.