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Investing Outside In

Vol. 12 Issue 2

You've accumulated a decent-sized investment portfolio. So how come you're still paying retail? Here's how to start thinking and investing like an insider

By Bruce White
Illustration by Jason Schneider

Through years of hard work and investing, many Albertans by the age of 50 have joined the half-million club. That is, they've accumulated wealth in their RRSPs worth between \$250,000 and \$500,000. They have stocks and bonds and various flavours of funds and maybe professional management on their side. They are financially secure and confident that their portfolios can break through the magic million before they turn 65.

Deep down inside, however, they are also frustrated. They know there's more to life than grinding out 10% annual returns. They know of a guy down the street who makes serious money buying chunks of companies before their public offerings, or have an in-law who dabbles in exotic plays like F-class funds, private equity, angel investing, venture capital, real estate and hedge funds. And here's the worst part: it's the regular Joes paying full mark-up for their investments who are helping make these insiders richer.

"Most people in Canada just invest their money ad hoc and the mutual funds take advantage by charging exorbitant fees for investments that don't perform," says Richard, a consultant who works in the insurance industry in Calgary and has, while still in his 30s, amassed a nest egg in excess of half a million dollars. "So people get tired of that and they try to do it themselves. The trouble is, most people have their own jobs and don't have the time or the education to invest properly."

So how can retail investors put some insider mojo into their portfolios? They can start by thinking like an insider and realizing that, as their wealth increases, an array of new investing choices becomes available. Here are some ideas to move your investing strategies onto the inside track.

Get real about fees

It's sobering to realize how fees can erode a portfolio's total return. For an RRSP with \$500,000 that earns 8%, cutting the various fees from 2.5% to 1.5% will increase the account's value by \$84,450 in 10 years (to \$939K versus \$854K) without adding a cent in new investment. Yet most investors don't even know all the fees they are paying. Mutual funds – even the no-load variety – make money by charging a built-in management expense ratio (MER). These typically range from less than 1.5% on a Canadian bond fund to nearly 2.5% for a global equity fund. Even exchange-traded funds, which are promoted as fee-efficient, incur fees. The iShares Canadian energy ETF has an MER of 0.55%; the Canadian short-term bond index ETF, 0.25%. Plus,



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don't forget, you also pay a brokerage commission each time you buy or sell an ETF or make an online trade, so those monthly contributions get expensive.

"A lot of people drank the Kool-Aid through the 1970s, '80s and '90s and parked their money at the bank or a mutual fund company," Richard observes. "They'd get this relationship built up with a banker or adviser who might not be doing a good job due to their conflict of interest." Advisers can be under pressure to flog their company's fund family or securities their firm has underwritten. Richard is no fan of stock brokers, either. "I've yet to meet one of those who adds a lot of value, other than the fact that they drive a fast car and make a lot of money churning your money."

Richard prefers to work with an independent adviser who manages his account for a fee based on a percentage of his portfolio. "My gross fees to have my account managed are just over 1.5% a year," he reckons, with the fee charged by his adviser for non-RRSP money deductible against the income.

Consider using an adviser

Taking on an adviser can make sense, but only if he or she consistently makes you money. Advisers promise to improve a portfolio's performance in four ways: 1) by making better investments; 2) by making your portfolio more tax-efficient; 3) by making your holdings more fee-efficient; and 4) by creating and following a financial plan that makes your investments fit your lifestyle and estate needs.

Bob Gorman, chief portfolio strategist for TD Waterhouse, says that, for the great majority of investors, the benefits of paying an adviser more than make up for the fees. Most advisers take costly emotions out of investing, earn higher returns, take less risk and help the client sleep better at night. "Professionals will generally outperform amateurs in any field," says Gorman. "Although there are many great individual investors out there who are fine on their own, I think most people will do better with someone who has some experience."

Adviser fees depend on the level of service provided. Expect an adviser to ask for 1.5% or so for accounts in the \$500,000 range and 1% if you're investing more than a million dollars. These are negotiable and an investor has the right to expect results.

Look at low-fee funds

"If you're going to pay a fee for investment management, I don't want to see a portfolio that looks like the index," says Mike Robinson, the independent adviser who manages Richard's portfolio. "If I'm going to pay a fee over and above what an index fund would cost, I want to see some active management. I want to see investment into securities that will have a real impact on the portfolio."

Investors who have an adviser can buy special types of actively managed funds with MERs below those of mass-market funds by about 0.5% on fixed-income funds and 1% on equity funds. These so-called F-class and I-class funds offer investing strategies similar to ordinary mutual funds, in all the familiar flavours: global growth, Canadian dividend, Canadian small cap, and so on.

"Because the investment provider is only dealing with large accounts, there are economies of scale and they can lower the management fees," says Robinson, whose firm, Signature Financial Security, generally advises clients with \$500,000 to \$2 million to invest.

Richard's portfolio consists largely of three low-fee, high-performance funds – Canadian equity, U.S. equity and foreign equity – managed by an independent investment counsel firm. He sings the praises of the management of his Canadian equity fund, which has on average returned more than 17% annually over the past 15 years with only two shallow down years.

"Investment counsels fly under the radar and manage a lot of sleepy money in the country – pension money and high-net-worth money – and their services are becoming more accessible," Richard says. A generation ago, investors needed \$2 million or more to buy these funds, but now they are becoming available for as little as \$250,000 invested in a fund family.

Hedge your bets (if you dare)

Originally meant to shield a portfolio against volatility, hedge funds have morphed into all sorts of species, many of them exotic and risky. Gorman says most investors should focus on funds designed to protect them from market swings while providing a stream of returns regardless of market conditions. One such vehicle is called a multi-strategy, multi-manager fund because it employs several managers specializing in different aspects of investing to – in theory – provide consistent returns and principal protection.

The proper role of hedge funds is to stabilize a portfolio and they shouldn't be used as a core strategy, Gorman maintains. Before buying a hedge fund, he advises investors to check the manager's track record in the type of investing he is proposing to do. Hedge funds have the highest fee structures in investing, typically a 1% or 2% management fee plus a hefty slice of the fund's profits.

Robinson, who has a degree in investment finance, likes the concept of investors using hedges to increase return or reduce risk in a portfolio. But he needs to see better

regulation before he starts putting "buy" recommendations on hedge funds. "Currently in Canada and the United States, hedge funds are so under-regulated that I see them as a huge risk," Robinson says. "They don't disclose what they're doing, what they're investing in, and that can be a real challenge."

Crash the private party

Many stalwart Canadian companies such as BCE and Inco have fallen into private or foreign hands. Prime income trusts like Calgary's CCS Corporation have gone private too. A growing worry is that there are fewer good Canadian stocks for individual investors.

Time to consider going with the flow. TD Waterhouse's Gorman says it's becoming easier for individuals to put money into funds holding private placements. Although usually sold to institutional investors, some private clients have bought into such funds for \$250,000 US. These aren't for the average Joe. Investors need to commit themselves for at least a decade, which means they need a lot of faith in the fund's management. "You'll probably do quite well on it, but there's a long horizon and typically they are not very liquid, so you can't sell them readily," Gorman explains.

Get smart about taxes

As long as our portfolios are sheltered in RRSPs, taxes aren't a big consideration. That changes as investors max out their registered accounts. "Most people in the million-dollar range have a lot of non-RRSP money. And as you become more conservative, you end up in more fixed-income vehicles, which can have a major impact on your taxes," Robinson says. Taxes on interest income are higher than on dividends and capital gains.

One tax-saving route is the "corporate class" mutual fund. These are versions of low-fee F-class funds (see above) that are organized as mutual fund corporations instead of trusts. This structure enables managers to deduct the fund's expenses against interest income and to pay out a greater portion of its returns as dividends and capital gains. Corporate-class funds also provide ways to defer capital-gains taxes.

Use life insurance strategically

Another investment option that isn't in your day-trading platform is the ability to use life insurance for tax savings. Life insurance strategies help clients transfer wealth to beneficiaries without paying tax on the growth of the client's investments. "For example," Robinson explains, "someone who has a lot of money that they aren't going to spend can use the investment component of an insurance policy to grow their money completely tax-free and then have it paid out completely tax-free."

Segregated funds are another insurance-based product that, like mutual funds, hold various types of investments, but which also protect the invested capital from losses on the downside.

Get accredited or exempted

Once you've accumulated enough wealth to become an "accredited investor," you have more options to make (or lose) another fortune. The definition of an accredited investor has been harmonized across Canada and is set out in a document known as National Instrument 45-106. You are an accredited investor if:

1. You and your spouse have net assets worth at least \$5 million;
2. Or you and your spouse have financial assets of at least \$1 million;
3. Or if your net income before taxes was \$200,000 in each of the past two years or the net income of you and your spouse was \$300,000.

A broker or issuer can sell securities to an accredited investor without issuing a full prospectus. Blaine Young, associate director for corporate finance for the Alberta Securities Commission, explains that exemptions to disclosure rules make it possible for everyone from a corner store to the next Microsoft to get started in business without being smothered by paperwork.

In addition to accredited investors, there are about 50 exemptions in NI 45-106, Blaine explains. Two used frequently by small companies to raise capital are:

- I Family, friends and business associates. An issuer can sell securities to officers, directors and control persons of an issuing company, as well as to people who are these individuals' close friends and family members, including parents, spouses, siblings and children. Exemptions also exist for employees, contractors or certain people with a close business relationship of trust with the issuer. But an issuer can't use this route to sell shares to someone they meet at a networking event, for example.
- I Minimum amount. If you are able to buy \$150,000 worth of a security (this used to be \$97,000), paid in cash, your investment is considered exempt. But you can't pool investments with a bunch of friends to reach the magic number.

Buyer beware, though. "Any time you're investing in one of these companies under any

exemption, you as an investor need to be very cautious," Young warns.

Invest close to home

Derrick Peterson, owner of D & A Financial Services Inc. in Red Deer, believes it's a good idea for sophisticated clients to diversify their investments, holding not only securities and segregated funds, but to also own land and business assets. "In Alberta, especially in the real estate business, there's a lot of buddy-to-buddy referral going on," he says. "It pays to keep your ears open and, if conditions are right, to get involved."

Before making a commitment, Peterson advises clients to ask a lot of questions and to get two or three professional opinions. He turns thumbs-down on deals that he feels offer too-good-to-be-true interest rates or tax-free growth offshore. And he advises against putting too much of one's wealth in one place. "If a person has only \$100,000 to invest and wants to put it all in one deal, I'd say forget it. But if it was \$10,000, it might be OK."

Fly with the angels

Angel investors are wealthy individual investors who invest in high-growth startup companies (see "How Angels Earn their Wings," p. 30). Randy Thompson has stakes in six angel deals. Like many angels, he has first-hand experience in building a company. He started Edmonton's first Internet service provider in 1991 and sold the company in 1996. He later was involved with DealGenerator, a publicly supported initiative that matches angel investors with screened investment opportunities. Thompson is CEO of the for-profit Venture Alberta Forum (no relation to this magazine), which recently celebrated its 25th financing.

"Angel investing is the highest-risk asset class going," Thompson cautions. "But when you make money, typically you make a lot."

Venture Alberta Forum hopes to soon offer a security that can be sold through investment advisers to individual investors able to invest as little as \$5,000. For investors who want to participate in the growth of small companies without the personal involvement, TD Waterhouse's Gorman suggests investors have a look at Canadian small-cap funds that have mandates that allow them to participate in private placements and managers with a record of successful investing in the small-cap space.

Be ready when opportunity knocks

Getting to the first million usually isn't the result of brilliant gambles. A surer way is by taking on professional management to build a balanced portfolio that reduces risk while minimizing taxes and fees. Then when the right opportunity presents itself – a real estate opportunity, your brother's construction company, a promising startup – you will be in a perfect position to put some of your money to work on the inside.

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