

STRATEGIES FOR THE COMMON SENSE INVESTOR

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Whether you invest independently, through an advisor or with a discretionary manager, successful investing is a result of setting appropriate goals and implementing effective strategies. Although not all-inclusive or necessarily for everyone, here are a few of the goals and strategies that Avenue Investment Management believes in and utilizes when managing private client portfolios.

There is an “I” in Investing

First define why you invest. What is it that gives your investing purpose? In our view, increased wealth is a result not a reason. Some reasons that our clients have mentioned to us are: freedom, independence, altruism, philanthropy, significant other, family, friends and all of the above. Once you have defined your personal reason for investing, define your objective(s). At Avenue we believe an appropriate objective would be to capture the long-term equity rate of return. Our Equity portfolio targets 8%-10% after fees while focusing on reducing the risk incurred to achieve this return. Our bond portfolio targets 5% after fees. Your personal objectives may be higher or lower but regardless, focus on not taking more risk than you require and target a reasonable and relevant return after fees.

If we invest for personal reasons and to achieve personal objectives, then investing must entail personal responsibility. Although it is the role of portfolio managers to provide investors with advocacy, education, transparency and governance in regards to their investments, every investor should take responsibility for their financial education. A financial education is the necessary foundation for successful investing and should be coveted by investors and promoted by portfolio managers. Once you have armed yourself with your reasons, objectives and responsibility, you will have the necessary foundation from which to create relevant investment strategies. Here are a few that we would follow.

A Cake of Many Layers

We believe that thinking of the market as a whole is less effective than considering its layers, such as specific companies, sectors and asset classes. Investors should assess each layer with an eye to defining those investments that offer consistent performance, transparency, good governance, growth and appropriate risk/return profiles.

For example finding consistently performing companies to invest in is easier than you may suspect. One could argue that the universe of suitable companies is actually quite limited. Recently we updated a simple screen which searched through all 3000 Canadian public companies in order to determine how many have paid or increased their dividend over the past 10 and 20 years. The results: 65 companies over 10 years and 42 companies over 20 years met the criteria. Now it is not always feasible that investment be made solely in the companies found in this finite universe. If however, investment is made outside of this universe define for yourself those reasons why you believe the company may become part of the universe in the future. Similarly, do not search solely for dividend paying companies; instead search through any list of consistently profitable companies and you will find companies that consistently pay dividends.

Appropriate diversification may be achieved by investing in a small universe of select and diverse companies in a variety of sectors and asset classes. Limiting the number of holdings of a portfolio (Avenue's Equity and Bond Portfolios are limited to 35 and 20 holdings respectively) also provides a built-in discipline that requires entry into the portfolio to be based on a best in class rationale as there is little room for portfolio creep. Buying an index is by definition a poor proxy for appropriate company selection. Buying an index entails having to invest in many ghastly businesses in order to own that handful of great ones. It also entails buying into sector allocations that are in some cases riskier (think S&P/TSX) than others (think S&P500). Create a diversified and proprietary sector allocation guideline for yourself if you wish to avoid Index replication; otherwise that is exactly why Index ETFs were created.

Diversify Opportunity and Risk

Avenue does this by actively diversifying its equity risk by investing at appropriate times in bond risk, specifically corporate and high yield bonds. Because of the high correlation between global equity markets equity diversification is at times ineffective. Retail investors generally ignore corporate and high yield bonds, due in part because they trade in an over-the-counter institutionally dominated market. These bonds at times can offer equity-like returns, while reducing portfolio risk and providing negative correlation to the equity markets. In addition, bondholders are creditors and stand ahead of equity investors who are owners in a company's capital structure in the event of bankruptcy.

Although bonds have out-performed equity numerous times in the past it remains true that equity has out-performed bonds over the very long-term. Regardless, most retail investors should avoid investing solely in equity. At minimum, a bond portfolio equal to 5 years of living expenses should be maintained to allow your equity time to recoup from down years. Withdrawing money from an already depressed equity portfolio will reduce your chance of recovery and increase your bias to chase returns and accept greater risk in an attempt to return your portfolio to previous levels.

Investment objectives are more likely to be achieved when focus is paid to both the selection of appropriate assets and the defining of appropriate price for these assets. Both require discipline. At Avenue, after we define the asset we wish to buy, we then define the price. We focus on companies and sectors that are neglected and out of favour and in so doing attempt to make part of our returns by buying well. We look to receive an above average return over a five-year investment time horizon. Some valuation metrics we use when deciding on when to buy and sell are: Free Cash Flow Yield, Price/Earnings, Price/Cash Flow, Price/Intrinsic Value, Price/Adjusted Funds from Operations and Bond Spreads.

Avoid comparing your equity returns to the rise and fall of risky equity indexes. Avenue believes that a long-term equity investor should concern themselves with out-performing the following three metrics: 1) achieving an annual absolute rate of return - not losing money, 2) beating inflation and 3) achieving the long-term equity rate of return with as little risk as possible. (see reverse)

Avoid currency mismatch whenever possible between your assets and liabilities. The average retail investor's focus should be to invest primarily in consistently profitable well-managed companies in the currency that their cost-of-living or liabilities are in. Only once you cannot find such companies in a certain sector then look internationally. Utilize greater price and valuation discipline when investing internationally, so as to protect against the erosion of market gains through currency volatility or hedging costs. Know your actual returns. What did you actually make after calculating currency exchange, management fees, trading costs, commissions, hedging costs and all inflows and out flows from your account?

“We are not sure who discovered water, but we are pretty sure it was not the fish” - Marshall McLuhan

Gaining market perspective is fundamental to achieving success when investing. Start by checking your ego and emotions at the door and by training yourself to be a “fear” contrarian. It is not easy to re-train our ingrained flight response. Start by training yourself to avoid emotional and impulsive thinking by allowing yourself to consider that the opposite may be true. During up markets investors are fearless; it is at this time that you should consider being fearful; consider taking profit. During down markets investors are fearful; it is precisely at this time that you should consider being fearless; consider investing. Baron Rothschild's ubiquitous quote refers to this same theme: "Buy when there's blood in the streets, *even if the blood is your own.*"

Market perspective is also gained through an understanding that markets distort perception. During rallies: short-term speculators believe that they are long-term investors; poor investment decisions seem like good ones; suspect advice will sound like solid research. As long as times are good bubbles will seem like nothing less than the Rock of Gibraltar. Falling markets tend to clarify these distortions but distort inversely.

Along with perspective, investors should strive to be proactive. The simplest way is to reduce the time lag between knowing results, seeking advice, devising a response, and implementing a strategy. It is important to mention that doing nothing can be a proactive strategy if it is arrived at after a timely decision process as opposed to avoidance, inactivity or procrastination.

Choosing Counsel

One of the most notable comments made by victims of investment fraud is that they felt that they were dealing with a trust worthy individual and had no reason to doubt the veracity of the information they were being provided. How then can you ensure that you are dealing with persons of integrity? Not surprisingly, personality, wealth, status, acquaintances, club memberships and organizational size have all been called into question as effective indicators of integrity. What is surprising to many is that, performance data and monthly statements which were assumed to be verified turned out to be central to attempts to mislead.

In retrospect, we are reminded that an effective fraud requires effective camouflage. One precaution investors can take is to ask for independently verified performance numbers such as Global Investment Performance Standards or GIPS® verification. Ensure that these performance numbers are net of all fees. In this way you will see the weighted average success of all the portfolios under management after fees and expenses (as these have a material impact) and not just the representative or best performing portfolio that may be presented. An important caveat: fraudsters by definition are resourceful, creative and unscrupulous. The best defense we can offer you is equal parts of scrutiny, skepticism and suspicion. The axiom that emerged from 2008 goes like this: lessons learned are oft forgotten; returns too good may be rotten.

Seek knowledge, second opinions, investment advice or discretionary management from transparent, independent, un-conflicted, registered and certified organizations and/or individuals. Look for those who apply a high degree of fiduciary duty (client's best interest first), invest prudently, have substantial personal investment in what they recommend, act accountably if they underperform, charge reasonable management fees in arrears of providing service and performance bonuses only after exceeding expectations. Seek access to those who make the investment decision and spend less time with those charged with gathering and keeping your assets. Asset accumulators may in some cases prefer to be accountable to sales managers, marketing departments and corporate finance groups in lieu of their clients. Finally, ensure that your assets are segregated in your name and held externally at an independent CIPF protected custodian.

Fees, a Four Letter Word

As my grandparents used to say, “Take care of the pennies and the dollars will take care of themselves.” Never be cavalier about potential risk or loss within your investment portfolio. There is no such thing as money you can afford to lose. Investment math requires that a 40% drop require a 67% rise in order to return to your starting point. This need for greater return may lead you to take greater risk. Reduce the downside and you will reduce the need for an exaggerated upside. As a corollary to this concept, do not be dismissive about the importance of low fees or the deductibility of fees. It is a simple truth that high fees can undermine investment gains. Focusing on keeping fees low as well as avoiding the payment of extraneous administration charges is as important a strategy as defining appropriate investment. This is a simple, controllable and material way to improve returns and is a necessary pre-requisite to ensuring investments grow over the long run.

Tax considerations are many and require specialized advice however, we do not believe in making investment decisions based primarily on tax considerations. We believe that focus should be paid to making appropriate company, sector and asset class allocation decisions first and then searching for the most effective tax treatment.

Finally, live within your means. Reduce unnecessary expenses. Pay off your mortgage and avoid excessive consumer debt. Save and invest early and stay the course. At Avenue we believe it is not as much about the bull or the bear, as it is about the tortoise and the hare. Avoid self-labeling as a “Value” or “Growth” investor. Be instead simultaneously Opportunity Focused and Risk Conscious. Understand the amount of risk you are taking in order to achieve the rate of return you receive. In this way, when people inevitably ask...“What type of investor are you?” you can answer, “Profitable!”