

Portfolio Construction and Investment Style

Once investment objectives have been established, our next step is deciding which asset classes and what allocations of each should be used to reach those goals. Studies indicate that these decisions will have the most impact on the variability of portfolios over time, so our process is rigorous and disciplined in nature.

Below we summarize our approach in evaluating each component of asset mix:

Equities – Equities are allocated and managed according to five criteria:

- 1) Geography** - We categorize equity positions into Canadian, US, Non-North American Developed and Emerging Markets. The Canadian component is usually the largest, given the tax advantages of Canadian dividend income and our desire to moderate currency risk. A substantial position of US stocks is also held, given the depth of that market and its attractive risk-reward characteristics. Emerging Markets are given the lowest weighting because of the inherent risk of this class, usually representing five percent of total equities.
- 2) Capitalization** - We believe all equity investors should have both large and small company holdings in their portfolios (often referred to as large-cap and small-cap). The core of equity investments is in large-cap holdings, but history illustrates small-cap representation boosts returns with only small increments in the portfolio's risk profile.
- 3) Investment Style** - All stock markets can be divided into stocks with high book values relative to their share price (value stocks) and stocks with low book values relative to their share prices (growth stocks). Although we believe equity investors should have exposure to both, strong evidence supports the outperformance of value stocks relative to growth stocks over time. For this reason we emphasize value stocks to attain higher expected returns.
- 4) Investment Approach** - Strong evidence shows it is very difficult to outperform markets on a long-term basis (see article: Mutual Fund Performance). With this in mind, we use low-cost Exchange Traded Funds and DFA institutional mutual funds for the core component of equity portfolios. These provide exposure to a large percentage of an entire market and deliver considerable tax benefits for the long-term investor (see article: Asset Location, Tax-Efficient Investing).

5) Stock Selection – We invest a portion of our Canadian equity exposure in high quality, “blue chip” stocks offering attractive, secure and growing dividends over time. In many cases these currently provide dividend income in excess of interest on cash reserves and short-term bonds. With the benefits of the dividend tax credit, after-tax income is further enhanced relative to a bond counterpart. As time passes, this gap expands. For example, someone invested in bank stocks over the last 20 years is now receiving over 15% in dividends relative to their initial cost - all due to dividend increases. A comparable bond would have to yield almost 20% to provide the same after-tax income. This illustrates that stocks can be purchased for income as well as capital gains, particularly for long-term investors. Our focus is therefore on yield, along with the growth prospects and the safety of dividends, rather than outperforming the Canadian market. We also gain broad based exposure to the Canadian market through DFA with a tilt toward small cap and value stocks.

Additional equity investments include REITs (Real Estate Investment Trusts) and Trusts. These investments enhance income, provide tax advantages and improve overall portfolio diversification. Our focus in this area is safety, so we emphasize diversification and quality to improve the likelihood of superior returns.

Fixed Income - This asset class serves three purposes. First, it provides an income stream if the client needs it. Second, it provides stability to the portfolio during weak equity markets. Finally, more than stabilizing, it can act as a counterbalance to other classes, providing impressive returns during unsettling times - bond prices tend to go up when stock prices go down.

Our style is low-risk, with the objective being to provide income and security even in the most serious recessions. We do not think risk is well rewarded in the bond market, unlike the stock market. Therefore, we invest the core of the bond portfolio in the highest quality bonds, keeping maturities relatively short and staggered. Federal and provincial government issues with maturities less than five years comprise most of this asset class. A small percentage (less than 30% of fixed income) of non-cyclical, high quality corporate bonds may be included to increase yield.

Cash Reserve - Our clients receive attractive rates on cash balances (Prime less 2¼% on Canadian cash and Prime less 3½% on US cash). This rate is comparable to most money market instruments, but we also buy high quality short-term bonds (under one year) if these rates are more attractive. Cash reserves are sometimes helpful to returns in the short term, but over longer periods of time they drag down portfolio performance, so as a rule they should be kept to a minimum.

We are confident our investment style and our disciplined process of constructing portfolios helps us deliver to our clients the best possible after-tax returns for the lowest level of risk.