Considering options

In the fall of 2009, I was thinking about retaining James Hymas of Hymas Investment Management in Toronto to manage my personal RRSP. Hymas's experience and expertise is in Canadian fixed income, and particularly in Canadian preferred shares. He runs a small mutual fund called Malachite Aggressive Preferred Fund (MAPF) – offered as a private placement to accredited investors – with an impressive performance record. MAPF's investment universe is *de facto* investment grade Canadian preferred shares, about 150-200 issues at any given time. At the end of September 2009, the fund had an eight year record, with gross annualized outperformance of about 950bp per year versus a standard benchmark during that period. Net of fees, the outperformance was still over 800bp per year.

Past performance is no guarantee of future results, but I had done my due diligence. His philosophy harmonized well with my own in most respects. As best I could tell, he and I both believe that it is of long run benefit, particularly in fixed income, to:

- Commit funds to an asset class as part of a diversified portfolio, and remain fully invested.
- Focus on security selection and relative value, not timing and absolute value.
- Measure performance relative to an appropriate benchmark.
- Get paid to supply liquidity instead of paying to consume it.

There was, however, one significant difference between Hymas's approach and my own: portfolio turnover. MAPF is a frenetic trader, often exceeding 100% turnover per *month* as Hymas tries to capitalize on fluctuations in relative valuations among securities in the universe. By contrast, I am a very sedate investor, most years having turnover of less than 10%. I had investments in Canadian preferreds in the fall of 2009, but I wasn't looking at or trading them every day. They were mostly a buy-and-hold chunk of fixed income, this asset class chosen because the accounts were taxable. In the fall of 2009, the preferred share slot in my own portfolio had outperformed standard benchmarks too, but not by MAPF's margin over time. I considered my options.

Investing directly in MAPF was one possibility. I wondered, though, if the high turnover in a fund that (a) invested in a small universe where I also had relatively static positions and (b) was offered by private placement would bite me come tax time if CRA ever came calling. I also figured that the fund would distribute large capital gains in many years, a situation which I usually try to avoid with my investments. Hymas offered separately managed accounts, but if I hired him to manage a taxable account, it would complicate my tax situation even more than an investment in MAPF. So I considered asking him to manage my RRSP as a separate account.

An RRSP is not a usual location for preferred shares in Canada. Investors have varying characteristics which create natural preferences to invest in one asset class rather than another. Canadian tax law means that a preferred share is intrinsically worth more to a taxable investor than a tax-deferred account like an RRSP. The end result is that a taxable investor can – and will – pay a higher price for such securities, and so taxable accounts are where they should all end up in the long run. Tax law creates a niche into which preferred shares should flow, and RRSPs are not part of that niche.

I decided at last that the niche argument wasn't enough to keep my RRSP away from Hymas. First, the segmentation of investors created by tax law didn't seem likely to disappear. If taxable investors could rationally pay more for a Canadian preferred share today than an RRSP could, it's very likely that the same would be true tomorrow or next year. On a pure investment basis, an RRSP cannot bid as much for a preferred as a taxable investor can. However, if one assumes that taxable investors will still exist when it comes time to sell, an RRSP can compete on price. Second, with Hymas there is no long run.

His relative-value approach causes big turnover, i.e. chances are that any position acquired today will be disposed of within a few months at most. As long as taxable investors will pay up, and that isn't likely to change in a few months, the long run is irrelevant. Who the natural owners of these securities are makes no difference when investing this way. As long as Hymas could truly generate alpha – and 800bp net of fees per year over 8 years is more than suggestive – I decided an RRSP would do just as well as any other type of account. It was his alpha I wanted and I could hedge away the added exposure to the preferred share asset class if desired.

I am an extremely fee-averse investor, choosing low cost products wherever possible. I am DIY when it comes to investing, and encourage others to invest for themselves too, because investing is not the complicated business it is usually made out to be. I am skeptical of active management, and history bears me out in that regard. Given these preferences, hiring Hymas to manage a portion of my portfolio was not easy.

The decision

The alpha was too much to ignore. I decided to proceed. I negotiated an agreement with Hymas to manage the account for a fixed percentage of assets, charged quarterly. I value diversification and don't wish to take on big credit risks, so the agreement restricted concentration by issuer to 20% and exposure to issues rated below P2(low) by DBRS to 25%. (Hymas has never put any substantial amount to work below P2(low). Returns have not come from chasing yield in low rated credits.) Trading authorization was completed in early October 2009, and Hymas went to work.

On the first trading day of 2010, the broker holding the RRSP suspended the trading authorization unilaterally. This led to a series of conversations and emails, but the eventual result was that the RRSP had to be moved to another broker and Hymas reauthorized to trade the account. His management of the account resumed in mid-March 2010, and continues to this day.

Although Hymas started managing the account a year and a half ago, the first quarter of 2010 is hard to measure as the carrying broker shut him out for most of the time. However, I now have five complete quarters of performance to examine, the last four consecutive.

Additional factors to consider

My RRSP suffers from a structural constraint that alternatives don't share. An RRSP cannot, by law, have a negative cash balance. The investable universe is composed of quite illiquid securities. The combination of these two factors makes it almost impossible to keep the account fully invested. It also makes it more difficult to take advantage of transitory mispricing, because securities must be sold before buying something that looks (temporarily) cheaper.

Meanwhile, the index is theoretically fully invested at all times. Passive alternatives (and MAPF) have some ability to borrow small amounts for brief periods in order to facilitate trades, so the RRSP is slightly disadvantaged. Hymas is diligent at reinvesting idle cash, but cash balances have occasionally been over 1% of the account. Since cash has no return these days, the expected performance drag would be 3-5bp and, given the actual performance since Hymas took on the account, the cash drag is more like 10bp.

There was also one occasion where I restricted Hymas from trading a security, because I wanted to avoid turning a loss realized in a taxable account from being considered superficial. Although the restriction was not onerous in this case, such constraints can cause a performance drag.

Last but not least, the management fee I pay exceeds that of the passively invested alternatives (and of course the index bears no fee). All these factors combine to handicap Hymas by 50-100bp per year.

Measuring the results

Investors in Canadian preferred shares have a number of obvious alternatives to a Hymas managed account. A few open-ended mutual funds exist. Two passive alternatives with relatively low MERs trade on the TSX under the tickers DPS.UN and CPD, the second being an ETF that tracks the S&P/TSX Preferred Share Index, a usable benchmark (albeit with some methodological flaws on rebalancing). The remainder of this analysis compares the performance of my RRSP with the S&P/TSX index and the two low cost passive alternatives available to investors on the TSX.

Return information for the RRSP and comparators are time-weighted. Cash flow into the RRSP was negligible during the period examined. For the publicly traded DPS.UN and CPD, performance is calculated using market prices at quarter end. The index return is gross; all others are net.

Results

	RRSP	Index	DPS.UN	CPD
Q4 2009	2.92%	3.04%	2.34%	2.46%
Q1 2010	-2.27%	-0.95%	1.24%	-1.07%
Q2 2010	4.78%	1.40%	0.93%	1.64%
Q3 2010	8.36%	5.47%	9.22%	4.90%
Q4 2010	3.67%	1.70%	-0.82%	1.50%
Q1 2011	3.40%	2.39%	3.86%	2.26%
Since Q4 2009	22.42%	13.65%	17.65%	12.17%
Managed quarters	25.25%	14.75%	16.21%	13.38%
Last 4 quarters	23.46%	11.37%	13.55%	10.66%

I have good reason to be pleased with these results, and am convinced more than ever that Hymas is capable of delivering alpha from his management of Canadian preferred share portfolios. I am happy that I hired him 18 months ago and will continue to use his services.

On a final note, I loathe advertising and I disdain active investing. I realize that the above smells very much like the usual ad for an actively managed fund. I intend no such thing. I am just a happy client, happy to see that my default investing philosophy is wrong in this instance, and happy to recommend Hymas's services to others. As long as he doesn't collect so much money to manage that he squeezes all the inefficiencies out of this asset class, I expect to continue collecting my alpha. And smile.

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