FIVE LESSONS FROM THE WEALTHY

Selling mutual funds undermines the five habits of the ultra rich, says Michael Lee-Chin.

Michael Lee-Chin has worn a lot of titles, and is best known to Canadians as a high-profile philanthropist and key mutual fund industry pioneer who amassed a net worth in the billions.

Indeed, Lee-Chin is back to his advisor roots. He recently sold his privately held mutual fund company, AIC Limited, to Manulife Financial, and says the sale hinged on his retaining lead manager responsibilities on the AIC Advantage Fund, which he’s managed since 1987.

And to hear him tell it, he’s happy to more or less be back in the role where he started.

When Lee-Chin first bought AIC in the 1980s he was overseeing $3 million in assets; in less than 20 years, the firm was atop $12 billion in the early part of the decade. But the last few years weren’t kind to the firm’s focus on financial services and wealth management stocks. When Lee-Chin finally sold the company in August, it only managed a third of the assets it had during its peak.

Lee-Chin is undaunted that the investment philosophy he employs—and counsels clients and advisors to embrace—will continue to work. And he insists there’s more to it than the “Buy, Hold and Prosper” tagline AIC famously employed.

“To be more specific, he says he’s recognized five investment characteristics that all very wealthy individuals possess, and through his career he’s demonstrated these with sometimes frustrating discipline.

“We need to make sure as advisors our behaviour has some resemblance to how wealth is created. At the end of the day, the client is coming to us and essentially saying, ‘Advisor, either make me wealthy or preserve my wealth.’ Those are the primary objectives clients have,” Lee-Chin tells AER. “The behaviour of folks in the wealth management industry.

FACEOFF

Is it better to recruit or retain?

A lot depends on the position you’re hiring for, but generally, if there’s a way to train an existing employee it can act as a strong retention tool and create excitement around the job.

However, you need to ensure the employee you train is excited about the position and capable of handling it. Both are important to our business. While recruiting fresh talent is necessary to retain staffing levels and grow business, our number one priority has been retention of existing employees. Our branch management team is generally promoted from within; it seldom tends to be fresh hires.

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BY JAMES HYMAS
Prepping for crises

Regulatory impetus to formalize contingent capital has been gaining strength.

INVESTMENTS
The recent credit crunch has had a devastating impact on banks throughout the world, much to the chagrin of regulators entrusted with ensuring that bankers’ exuberance in good times didn’t lead them to over-reach. The response of

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The Tax-Free Savings Account is one year old. How have advisors worked it into their practice? Check out www.advisor.ca/TFSA continued on page 3

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Investing in the storm
Investors need to stay mindful of the long-term effects of volatility on their portfolios.

Three years ago I embarked on an adventure and rowed across the Atlantic with my girlfriend. There were times when we were literally on the crest of huge waves having the time of our lives, but there were also times when we endured great hardships as we battled tropical storms and some very low moments.

After almost a decade as a financial advisor, the past two years presented similar ups and downs as all of us in the financial advisory world battled one of the worst economic storms since the Great Depression.

With that in mind, a recent meeting with a prospective new client (let's call her Tara) highlighted a point I feel many investors don't entirely understand.

When I asked Tara how her investment portfolio performed in 2008, she told me she thought it was down about 50%, but promptly added she was up close to 30% so far in 2009—“so I’m nearly back to where I was at the beginning of the crash.” In Tara’s case, a $600,000 investment portfolio had fallen to $400,000 by the beginning of March 2009 and had since recovered to approximately $450,000. In fact, she was still getting paid.

My investors share Tara’s sentiments that 50% down followed by 50% up gets you back to where you were. As advisors, we know this is far from true and that a 50% drop in value will require a 100% gain on the reduced portfolio to get back to where it was before the drop.

However impressive it might sound, informing Tara that my average client’s portfolio was down only 6.5% in 2008 and up over 11% into September 2009 probably didn’t make her feel any better. I wanted to emphasize to her that she will go through bear markets again in the future to stress the importance of protecting her wealth in bad times.

Now let’s consider the effect future volatility might have on her portfolio. Let’s assume Tara’s portfolio dropped by 7% in 2008 and recover by 10% in 2009. Using these assumptions over the same time period, by age 60 Tara’s portfolio would have grown from $600,000 to $1,355,499. A strategy that focuses on cash flow and a wider asset class diversification would produce a portfolio 38% larger than the first approach—with much less volatility along the way.

Losing a large portion of a client’s capital in bear markets makes it extremely difficult to recover, even over a long time period such as 20 years.

Pay attention to cash flow
Investment portfolios that generate cash flow (which is reinvested in the portfolio, growing it in better markets. Based on my calculations, this approach saw Tara’s portfolio drop about 50%, but recover 10% in 2009, and a bear market drop of 20% in 2008 and might be up to 10% to 30% year-to-date in 2009 is because of a heavy focus on equity markets.

Most new clients I meet have investment portfolios that commonly consist of about 60% to 80% equities and 20% to 40% bonds. The investment industry commonly refers to this asset mix as “balanced.” To me, a portfolio that consists of 70% of one asset class is about as close to balanced as I am to being an NHL hockey player (I am 31 years old, come from Ireland and cannot skate, let alone alone skate and use a stick at the same time).

A balanced investment portfolio should include other asset classes in addition to bonds and equities. History shows 80% of investors’ total returns come from their asset class mix and only about 20% comes from the actual security selection. Unfortunately, many investors focus most of their time and energy on something that is only responsible for 20% of their investment return.

Recognize and manage clients’ emotions
The speed with which information travels today is truly amazing, but it has facilitated another way for our emotions to interfere with our investment habits. We have access to and are bombarded with infinitely more information on a daily basis than we were 10 years ago. Today, one week’s worth of reading The Wall Street Journal is the equivalent to a lifetime of information 30 years ago (Out of Zone by Fisch, McLeod & Bronman). Having access to such a large amount and variety of information can be enormously positive, but it can also fuel clients’ emotions when it comes to their investing decisions, especially relevant given we can buy and sell stocks and funds with the click of a mouse.

We’re all emotional beings and when it comes to our hard-earned money, we’re naturally emotionally attached to it—I know I am. That’s exactly why professional advisors must guide their clients through their financial decisions and ensure they make well-informed choices and get the long-term financial results they desire.

The next five years will be challenging. Managing our clients’ wealth is as much about protecting it in bad times as it is about growing it in better markets. Based on the last two years, I believe now, more than ever, that is true.

Prepping for crises
(Tier 1 capital must be common shares and retained earnings."

Novo-equity capital
A growing regulatory dic- tate for non-equity forms of capital (preferred shares, innovative Tier 1 capital and Tier 2 capital) led S&P to downgrade a wide swath of European banks’ hybrid capital on March 31, 2009, with Moody’s and DBRS applying the rationale to Canadian banks’ hybrid capital at the end of June.

The regulatory revolution took concrete form at the European Commission in July 2009, when they stated “the discretionary off-
exchanged in this manner, with the total gain to the issuers being in excess of $16 billion. However, regulators have not failed to notice that although the book profit from these transactions is incorporated into retained earnings, there is still cash leaving the firms, and they are urging a greater use of exchange offers into more junior forms of bank capital.

A highly successful instance of such an exchange was the Citigroup’s exchange of its preferred shares and some subordinated debt into common shares. The 6.875% Enhanced Trust Preferred Securities were issued on June 30, 2006 and later listed on the NYSE under the symbol CPRO. These were 60-year notes, callable at par after five years, issued at $25 when Citigroup common was trading at about $48. CPRO saw a low of $2.60—about one-tenth of issue price—in the first quarter of 2009. Under the terms of Citigroup’s exchange offer, each CPRO could be exchanged for 7,40769 common shares of Citigroup, implying an effective conversion price of $3.42, less than one-tenth of the common share’s price on the issue date of the sub-debt. Citigroup closed at $3.02 on the date of the exchange offering, implying that holders of these subordinated notes had lost approximately 12% of the principal invested—but common shareholders had lost about 94%.

This is the type of burden-sharing that regulators are seeking to encourage; however, the process should be formalized to reduce the uncertainty that has proved so destructive to the capital markets over the past few years.

Contingent capital
Elements of a corporation’s capitalization that have some degree of seniority, but may be converted into more junior elements, are referred to as contingent capital. Regulatory impetus for the formalization of contingent capital has been growing in recent months, with the US Treasury musing about the possibility of “requiring some banking firms … to issue appropriately designed contingent capital instruments, including long-term debt instruments that convert to equity capital in stressed conditions.”

They were, however, quick to note the problems. “The feasibility of contingent capital instruments remains uncertain. The challenges of contingent capital include, among others, devising the right trigger event for conversion and designing an instrument that will be marketable by banking firms at a reasonable cost.”

HM Treasury provided a suggestion. “Once solution would be to make some of the debt (perhaps the subordinated debt tranche only) convertible into equity in the event of a systemic crisis and on the authority of the financial regulator.”

The idea received support from Canada’s Office of the Superintendent of Financial Institutions. Advisors will be interested in new types of investments, but two vital structural issues must be addressed:

The trigger: under what circumstances will the conversion of the more senior instrument into common equity become mandatory?

The price: what will be the terms of the conversion?

Conversion trigger
There are various proposals for the trigger. Prof. Mark J. Flannery of the University of Florida proposes that banks be required to finance 5% of their assets with contingent capital and that the market value of their common equity be a minimum of 8% of their assets. The conversion trigger would be a decline in the market value of their equity to below 8%, at which point sufficient contingent capital would be converted to top it up, with replacement contingent capital issued soon after.

The main problem with this proposal is regulatory dependence on market values. The past two years have provided ample evidence that market values can decline in a manner virtually unrelated to any calculation of intrinsic value, and that healthy institutions can see their equity price decline precipitously for no other reason than the existence of, shall we say, less healthy institutions.

In addition, the ability of management to make cosmetic adjustments to the stated balance sheet, together with the problems inherent in comparing book values to market values, provides a measure of uncertainty for investors with respect to the potential for conversion—and uncertainty, as we have seen, may rapidly become crippling in a crisis.

The conversion may also reinforce an equity market decline and
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make it harder for the institution to issue share capital directly.

The Squam Lake Working Group (SLWG), a distinguished group of 15 academics, has proposed a double trigger for conversion, the first being a declaration by regulators that a systemic crisis exists, the second being determined by the covenants of the particular issue (one possibility being the breaching of extant regulatory ratios).

The first of these triggers—the declaration by regulators—will introduce even more uncertainty among investors in a crisis, as the value of the investment in its initial state may be different from its converted value.

This increases the potential for regulatory capture and even corruption, in addition to harming the values of the bank’s capital in a normal arm’s-length transaction.

The SLWG’s purpose in specifying a double trigger is to maintain the current protections of subordinated debenture holders in normal times, when a bank may fail without endangering the world financial system, but the additional uncertainty introduced by the requirement for regulatory declaration would make such securities difficult to price, limiting the potential for systemic improvements in market discipline.

The use of regulatory ratios as a trigger is a feature of the Lloyds Banking Group exchange offer and two extant Australian issues, Commonwealth Bank PERLS III and Westpac TPS.

Such triggers have a superficial appeal, as they directly address the problem of potential regulatory action, but are flawed in that they may be adversely affected by future changes in the regulatory regime.

Not only may the calculation of Tier 1 ratios change in the future, regulatory requirements may change too. Canada, for example, has established a target of 7% for Tier 1 capital ratios, well in excess of the Basel II floor of 4%. With such a trigger, investors are being asked to provide capital that is not simply contingent upon an analysis of the issuer, but in also subject to regulatory whims.

Conversion price

Two basic models for the conversion price have been subjects of discussion: first, that the conversion price be equal to the market price at the time the conversion is triggered; and second, used for the new Lloyds Banking Group notes, that the conversion price is equal to the market price at the time the notes are issued.

The first option can lead to massive dilution in times of stress, which may make it more difficult for a bank to issue replacement equity capital in a normal arm’s-length transaction.

The Lloyds Bank model, in which the exchange price is equal to the common share’s price at the time of issue, is disastrous and, probably, makes such notes impossible to issue in a non-coercive manner. The use of the current market price implies that the noteholders have no first-loss protection—such an issue cannot even be considered a bond.

Market-friendly trigger

The currently proposed triggers and conversion price calculations are not good enough in times of stress when certainty is at a premium. Ideally, the non-equity components of capital will be required to meet tests of certainty before being granted regulatory status as “loss-absorbing” securities.

A more appropriate solution is to make the conversion trigger based on the price of the common stock. If, for example, a Tier 1 instrument is issued at a time when the common stock is trading at $50, conversion to common shares should occur when the volume-weighted average price of the common shares taken over any period of twenty consecutive trading days is less than half the issue-date price, or $25.00. The conversion price should be fixed at the same price as the trigger price.

Tier 2 instruments could have the same conversion pattern but with a greater degree of first-loss protection; the trigger and conversion price could be one-quarter the issue date price of the common, rather than the one-half proposed for Tier 1 instruments.

Such a solution provides:

1. the potential for dilution to be analyzed properly by prospective purchasers of equity new issues;

2. certainty as to the degree of this potential dilution; and

3. holders of the Tier 1 instruments to hedge their potential exposure to equity via the options market, and provide purchasers of the Tier 1 instruments with substantial first-loss protection.

In effect, the proposal formalizes such exchange offers as the Citigroup offer described earlier, but makes the conditions known in advance.

Some may object that a mandated conversion to common shares may make it impossible for bond funds to invest in such securities. This must be counted as a feature, not a bug. The surprising effects of the Primary Reserve money market fund “breaking the back” due to the Lehman default should serve as an object lesson to regulators. The pretense that risky instruments are risk-free is destabilizing."