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The Perils of a Piecemeal Approach

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Illustration: Michelle Thompson

Fragmentation Will Bomb

With today's low rates and lukewarm valuations, ignoring the perils of a piecemeal approach means investors could be losing precious returns.

The fast pace of life today makes time and attention scarce resources. This is particularly true for busy professionals and businesspeople grappling with an uncertain economy. As such, it is understandable that many people take a fragmented and passive approach to investing, splitting their investable assets among a hodgepodge of managers and brokers in a series of ad hoc decisions followed by only cursory oversight.

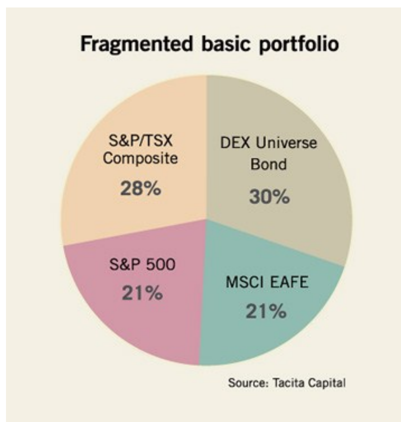
A typical investor's stable of managers is comprised of some old standbys who haven't been seriously evaluated in years, a couple of recent hotshots recommended by friends, and a broker running some stocks and bonds. And often, each manager is unaware of how much capital the others are dealing with or what they are doing with it.

Such a piecemeal approach often results in a host of costs that in aggregate can materially impair wealth creation and, in the extreme, inflict lasting harm. And, like the proverbial iceberg lurking under the surface, these costs are hidden from the unsuspecting investor, so the damage can persist and compound for years.

Toting up the costs of fragmentation

The forgone free lunch

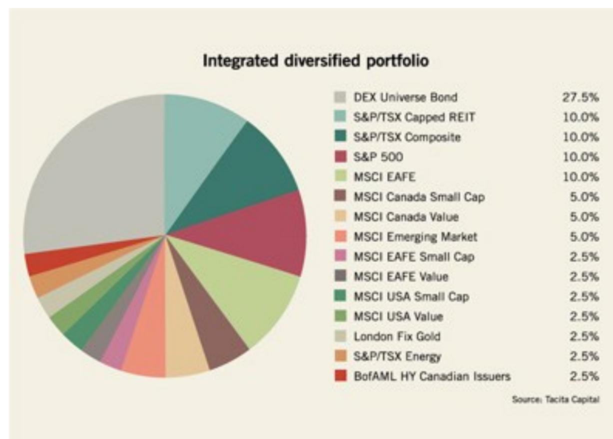
One of the most remarkable discoveries in modern finance is that diversification can improve the expected return of a portfolio without increasing its risk. What is extraordinary is that this higher return is absolutely free. All it requires is a thoughtful, integrated approach to portfolio construction. When a portfolio is assembled in a haphazard manner, many investors forgo much of the proverbial free lunch available from proper diversification.



To illustrate, compare two portfolios. One is fragmented among a grab bag of managers hired on an ad hoc basis and the other reflects an integrated approach to a unified investment plan. Assume that, as at January 1, 2001, the first portfolio is comprised of 30% Canadian bonds and 70% equities. To roughly approximate mutual fund asset mixes at that time, 40% of the equity portion is allocated to Canada, with the remaining 60% split equally between US and international developed countries. The asset mix of the fragmented portfolio is depicted in the pie chart at left .

While at first blush having a group of managers may appear diversified, in aggregate a jumble of managers is most likely to emulate broad market indices. On this basis, over the 10 years ended December 2010, a period that includes two severe bear markets, the fragmented portfolio earned a 3.6% compound annual return.

Contrast this with the integrated portfolio depicted in the pie chart below. This robustly diversified portfolio incorporates a broader range of assets and a greater diversity of equities. It still has 30% allocated to bonds but instead of being allocated solely to investment-grade bonds, a small piece is allotted to Canadian high-yield bonds. Equities are reduced to 55% from 70% of the portfolio to make way for a 15% allocation to real assets, including Canadian real estate investment trusts, energy stocks and gold. The equity component is much more diversified, with allocations to value and small-cap stocks as well as emerging markets.



This integrated portfolio earned a 6.8% annual return, leagues ahead of the 3.6% return of the fragmented one. As illustrated in the chart on page 24, $1 invested in the integrated portfolio grew by 93¢ to $1.93, more than double the 42¢ growth generated by the fragmented portfolio.

Yet, there was no difference in the volatility of these two portfolios. (The standard deviations of the fragmented and integrated portfolios were 9.25% and 9.24%, respectively.) Although they have similar patterns of movement over time, the integrated portfolio pulled far ahead in wealth creation.

Failure to rebalance

A portfolio must be balanced at regular intervals to maintain risk levels compatible with the investor's goals and tolerances. A failure to rebalance can result in unwarranted losses and over the long run forgone gains. Rebalancing imposes a discipline of selling high and buying low, as some of the better-performing assets must be sold and replaced by more poorly performing assets.

As markets oscillate over time, rebalancing has the potential to increase returns. For example, over the past four decades (January 1971 to December 2010), a portfolio made up of one-third Canadian, one-third US and one-third international stocks that was rebalanced annually had a return that was 0.4% per year higher than a non-rebalanced portfolio. And more important, this was achieved with slightly less overall volatility. Over 40 years, this rebalancing gain compounded to 15% greater wealth — a handsome reward for proper oversight.

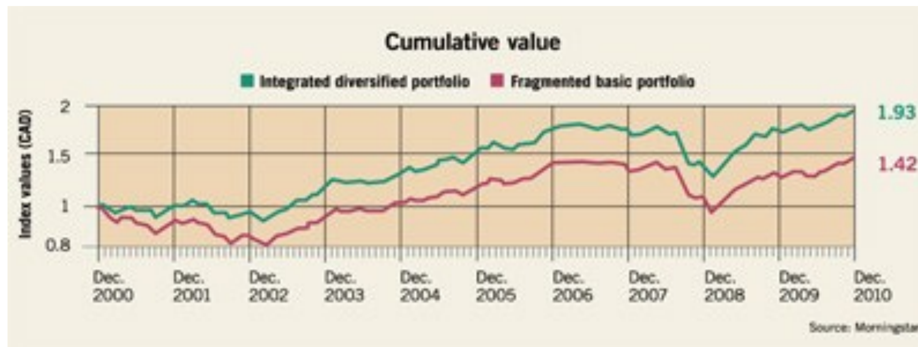
When capital is scattered among a number of managers, it's easy to lose track of the portfolio's exposure to risky assets. This is particularly true during bull markets when escalating stock values can lure investors into complacency. Over time, this unmanaged drift can result in excessive equity allocations that leave an investor perilously exposed to loss.

This happened often during the run-up of stock prices from 2003 to 2008. As Canadian stocks more than doubled, many investors revelling in their returns failed to rebalance their portfolios by selling equities to buy bonds in order to keep risk levels compatible with their goals and tolerances. The global credit crisis hit them like a tsunami. As stocks worldwide plummeted by more than 50%, many investors awakened too late to the excessive riskiness of their portfolios.

Balance-sheet blindness

Proper portfolio planning should extend beyond the investable assets to encompass the investor's entire balance sheet and, in particular, the nature of any business risks. When the selection of managers and their mandates ignores broader balance-sheet realities, risk levels and hence potential losses can easily escalate. In good times, it's easy to forget that the value of private businesses can be as volatile as public companies, a fact obscured by the absence of mark-to-market pricing for private company shares. In tough economic conditions, however, when businesses are under financial stress or even fail, it becomes only too apparent that these assets share many of the same risks as publicly traded stocks.

The savage downturn in the Canadian manufacturing sector over the past several years is a case in point. Integrated planning that considered cyclical, private-business interests as higher risk equity assets typically resulted in more conservative strategies for the investment holdings elsewhere on the balance sheet. Hence, as the value of private-business equity plummeted in 2008, assets such as federal and provincial bonds rose, helping to offset damage to the overall balance sheet and also acting as a source of liquidity.



Fragmented planning on the other hand can leave individuals in the dark while amplifying the risks they face. In one instance, a part owner of a small marketing firm placed a hefty part of her portfolio with a high-octane small-cap manager. Just as the recent downturn hammered her firm, her small-cap investment fell by more than 60% — a distressing double whammy. In another case, an owner of a business that was dependent on sales to the US was angered to find that the soaring loonie not only undercut his business but also wreaked havoc with his US stock portfolio.

Cognitive costs

Behavioural-finance experts have identified a litany of cognitive biases that can distort investor decision-making and lead to unnecessary costs.

First, investors frequently exhibit what is called "narrow framing" — the inclination to view facts in a narrow context, failing to consider the whole picture. When managers are selected on an ad hoc basis, it's easy to hire managers who have overlapping investment mandates. For example, over the past several years, stronger Canadian stock-market performance has led to many investors overallocating to Canadian equity managers, leaving global equity managers underrepresented in their portfolios and forgoing the opportunity for superior diversification.

Investors also display loss aversion and the disposition effect. Loss aversion is the tendency to feel more pain from losses than pleasure from gains. This contributes to the disposition effect — the tendency to hang on to losing funds, preferring to wait to get even rather than suffer a loss. When managers are hired in a fragmented manner and not objectively benchmarked against appropriate indices, losing managers may be retained simply to avoid the pain of a permanent loss.

Investors also evince the endowment effect — or the tendency to value what they have more than what they don't have. Over time, investors can develop an attachment to a particular stock or manager even in the face of chronic subpar performance.

Herd behaviour, the tendency to follow the crowd, interacts with cognitive biases, particularly loss aversion, to create a pattern in which many investors end up buying high and selling low as the market moves through its inevitable cyclicality.

The propensity to buy high and sell low means investors, as a group, earn returns well below those of their fund investments. Investment research provider Morningstar found that from 2000 to 2009, US mutual-fund investors earned returns 1.5% a year less than the funds themselves earned. Over the entire decade, emotionally driven investing cost investors 14% in forgone investment wealth.

A fragmented approach with only casual oversight allows these cognitive biases full rein, hijacking potential returns. Without a unifying investment strategy and process, emotions can more easily dominate, leading to ill-timed decisions, excessive trading costs and adverse performance results.

Needless taxes and penalties

Fragmented investing almost inevitably leads to unnecessary tax bills. In many cases a registered retirement savings plan (RRSP) is assigned to one manager or broker while other managers are handling the nonregistered investments. In the absence of strict guidelines, this typically leads to the RRSP being at least partially invested in Canadian equities. Meanwhile, the managers of the taxable accounts are busy investing a portion of the investor's capital in bonds, the interest on which is more highly taxed than Canadian dividend income or capital gains. The investor is left as the unwitting beneficiary of a negative tax arbitrage. As simple as this mistake is, it is extraordinarily common. One US study found that the average household misallocates one-third of its taxable bonds to taxable accounts.

Unnecessary taxes can also arise when investments are not appropriately distributed across the various household accounts. When a low-bracket spouse has nonregistered money, a fragmented approach can easily miss the opportunity to reduce taxes by allocating Canadian preferred and common stocks to that account to better capitalize on the enhanced dividend tax credit.

Similarly, dividends on US stocks placed within a tax-free savings account (TFSA) as opposed to an RRSP are subject to normal withholding tax since a TFSA is not a pension trust under the Canada-US income tax treaty, as is an RRSP. And, of course, the foreign tax credit for the withholding tax is not available in a TSFA as it is for unregistered accounts.

When investments are handled by numerous managers, it's possible for foreign stocks, bonds and exchange-traded funds to creep up to $100,000-plus in costs without the investor being aware. In such a case, if a T1135 Foreign Income Verification Statement is not filed on time, the investor could face a fine of $25 a day to a maximum of $2,500. And that's for each year of failing to file. Furthermore, the $100,000 limit applies to any time during the year, so monitoring this aspect effectively requires a monthly statement compilation.

Wealthier individuals using multiple managers can also unknowingly be exposed to US estate taxes. Speaking generally, under current law, if the value of a Canadian resident's worldwide assets exceeds US$5 million and he or she owns US situs assets, which include stocks and bonds of US companies, US real estate and US business assets, there can be US estate taxes on death. A family coping with an untimely death hardly needs the added unhappy news that the managers who independently loaded up on US stocks left the estate with a serious tax liability.

Advantages of scale
Big is beautiful in the world of portfolio management. Larger bond positions can be bought at better prices than smaller purchases. Similarly, trading commissions are spread more thinly over larger transaction sizes. Scale in the fund world means graduating from retail-unit classes to high-net-worth or institutional classes where fees are lower. Most portfolio managers and custodians offer tiered fee schedules where each successive tranche is charged at a lower rate. Some go so far as to consolidate multiple-family-member portfolios to help the family qualify for a lower average fee. By reining in the number of investment-service providers, material savings are often realized. While the indirect costs of fragmentation can prove damaging, paying excessive direct costs is certainly a luxury most investors cannot afford.

Method to the madness

The only sure way to avoid the pitfalls of fragmentation is to implement an integrated investment strategy. This process has five key elements.

A written investment plan
Called an investment policy statement (IPS), this written document sets out the strategic game plan for a family's investments. Like all good plans, an IPS starts with a statement of the investor's objectives. It should also define the investor's risk profile and identify an appropriate asset mix that is compatible with both the defined goals and risk parameters. A comprehensive IPS will also spell out rebalancing guidelines, manager-selection criteria and performance benchmarks, and the frequency of reports and policy reviews.

Experienced, do-it-yourself investors might try their hand at designing their own plan. For most individuals, the better option is the growing number of portfolio managers who will create a proper IPS as part of their service or develop one on a consulting basis.

Allocate your investments tax effectively
Proper investment tax planning should catalogue the entire gamut of existing and potential asset locations within the investor's household and the related tax reduction or deferral opportunities. These include traditional vehicles such as RRSPs, registered education savings plans and TFSAs, as well as the opportunities presented by a low-tax-bracket spouse or child. The recommended asset mix should be allocated appropriately across the household accounts, including any holding companies or family trusts, to minimize the present value of potential taxes.

Although the Canada Revenue Agency and the courts have eliminated some income-splitting techniques over the years, there are still ways to shift capital within the household. Spousal loans, family trusts and gifting strategies are examples. Accountants, in particular, can advise in this area.

Carefully select and assess managers
In an integrated approach, managers are assigned specific asset class and investment strategy mandates to form a cohesive portfolio-management team as set out in the IPS. Manager selection for these mandates can be undertaken by the investor directly or with the assistance of professionals. There are a growing number of independent portfolio-management firms that can assist in manager selection. The explosion in exchange-traded funds has dramatically increased low-cost and tax-effective index options and increasingly these are forming the core of an integrated portfolio. Individual management performance then needs to be assessed on a regular basis.

Consolidate reporting
One of the critical weaknesses of a fragmented approach is the absence of a regular consolidated picture of the family's investments. Whether it is compiled by the investor, an accounting firm, or a custodian or portfolio manager, it is a crucial step in understanding the performance status of the entire portfolio.

Monitor and rebalance
A portfolio is a dynamic creature that needs to be monitored and rebalanced as necessary; even an integrated portfolio is no place for cruise control. Accountants can play a vital role in monitoring changes to tax and pension laws as well as the investor's tax situation and overall financial situation. Revisions to the plan should be implemented sooner rather than later, since time is money in the investment world.

Investors who ignore the perils of fragmentation can leave precious investment returns on the table. In today's world of depressingly low interest rates and lukewarm stock valuations, investors can ill afford a piecemeal approach.

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