FINANCIAL POST

Saturday, December 10th, 2011

# Five things Wall Street doesn't want you to know

**Michael Nairne, Serious Money**

Illustration by Chloe Cushman

Wall Street would rather you didn't know that the phrase "low risk and high return" is an oxymoron.

Despite the blitz of flashy ads and seductive sales pitches this festive season, wise shoppers know that retailers have one paramount objective — to ring the cash register. Savvy consumers do their research, comparison shop, keep their impulses under control and hunt for the best value. Unfortunately, when it comes to Wall Street, many investors are bedazzled by the majestic pronouncements of market gurus and the illusionary reliability of short-term return numbers, and forget that Wall Street shares the same objective as Main Street — move the merchandise!

Here are five things that Wall Street really doesn't want you to know.

First, the phrase "low risk and high return" is an oxymoron. Sales stars in the investment business are masters at painting the opportunity of a lifetime — the surefire, sizzling return with negligible risk. Forget

that nonsense. Manias and panics aside, markets are pretty good at pricing risk. Low risk investments offer low return opportunities and the potential for return increases only as the risk climbs.

Certain hedge strategies, in particular, abound with risks not apparent to the average investor. Take some "low risk" credit arbitrage strategies. What some product purveyors neglect to tell investors is that leverage levels in the more aggressive versions of this strategy can reach levels of 15 times the investors' equity. Major unanticipated bonds defaults or massive market dislocations can trigger decimating losses.

Second, excess manager returns, what the industry calls "alpha," does not exist for the market overall. Fund marketers often fling this term around when referring to the latest hot manager — he's a big "alpha" generator is the typical claim. You need to keep in mind that "excess returns" don't exist for the market overall. At an aggregate level, there is simply the return to the market, a number which is then divvied up among hyper-competitive investment firms doing their utmost to outsmart each other.

"True alpha" in the sense of an enduring capability to deliver "excess returns" net of costs is scarce. What is usually packaged as "alpha" is either a short-term random outcome that could simply be luck or compensation for additional risk exposures such as illiquidity, small company exposure or leverage.

Third, past manager returns aren't persistent. Nearly every fund "dog and pony" show I've sat through boasted market-beating numbers. The implication is that yesterday's winner will also be tomorrow's. Yet, a litany of academic studies has found that, in general, past management performance is not predictive of the future.

So quit falling for dazzling returns. Unless there is a compelling qualitative rationale for a particular manager's outperformance, move on or better yet, invest in an index fund.

Fourth, costs matter. The volatile nature of returns obscures the dead weight that costs impose on a portfolio. It's easy to lose sight of fees in the massive swings of the market. Over the long-run, however, stocks have averaged annual returns in the 8-9% range while bonds averaged less, 4-5%. There just isn't the room for hefty fees. Investors are best served by firms that recognize this and price accordingly.

Fifth, firm profits are job number one. Remember that the directors and officers of a public investment management company have a fiduciary duty to their shareholders. As Charles Ellis, a long-time industry leader, has stated: "there is a continuing conflict between the values of the (investment) profession and the economics of the business." In his opinion, the industry is actually losing the battle to put its "professional values and responsibilities first."

Unhappy investors don't get to return the merchandise for a full refund; they just end up in the red. Keep that in mind the next time you are listening to a Wall Street pitch.

*-Michael Nairne, CFP, RFP, CFA, is the president of Tacita Capital Inc., a private family office and investment counselling firm in Toronto.*