making the list

It's 2005 (well, almost).

Do you know where your mutual funds are headed?
Anne Papmehl asked portfolio managers to look forward to next year and discuss new opportunities, geographies, asset classes and – most importantly – strategy, so you can help clients meet their investment goals of tomorrow, today

By Anne Papmehl

Photographs: Ron Fehling

W hat's up in the year ahead for mutual funds? The overarching theme is "stay out of trouble," and investment purchases are mirroring this sentiment. According to The Investment Fund Institute of Canada (IFIC), low-risk products such as dividend and income funds are leading sales while common share funds dominate redemptions.

But is putting all your money into low-risk investments truly playing it safe? Not according to Roger Mortimer, a fund manager with Aim Trimark. "There is no asset class in this environment that looks so secure or favourable that you'd want to put a disproportionate weight of your portfolio into it."

Earnings growth has slowed, making equities less inclined to generous, double-digit returns. The threat of rising interest rates bodes adversely for the bond and fixed income markets, and while real estate has appreciated dramatically in every market in North America, "most people would not feel comfortable increasing their exposure to that asset class either," says Mortimer.

With available returns expected to be in the high single digits across all asset classes, Mortimer advises focusing more on strategy rather than the funds themselves. "The most important thing is to have a diversified portfolio, effectively allocated across different asset classes and geographies."

Reasonable earnings

Equity mutual funds will continue to play a role in this environment, though results are expected to be more subdued. "Because the equity market has been well picked over, there is no obvious area to chase down, whether it be value, earnings momentum or long-term higher quality steady growth," says Fred Sturm, chief investment strategist with Mackenzie Financial.

That doesn't mean equities won't appreciate. "Though earnings are growing at a slower pace, they are still growing and if you can find reasonably priced investments that are generating reasonable earnings, you will get wealthy over time," he says.

Mortimer agrees, adding that investors should seek quality companies, or mutual funds that invest in quality companies, with a high degree of predictability and cash flow. He also recommends allocating away from the United States, pointing out that rising commodity prices and increasing taxes make it increasingly more difficult for American companies to achieve top-line earnings growth. "This leads to lower profits and lower equity valuations," he maintains.

By the same token, notes Mortimer, "America's foreign policy activities are an incremental burden on the cost structure, and once you factor in the rising interest rates and fiscal and trade deficits, you see that the U.S. economy has become a bit of a financial train wreck, similar to where Canada was 15 years ago."

The Canadian economy and stock market, however, are showing greater robustness, says Mortimer. "About one third of the Canadian index is comprised of global commodity companies where the commodity is priced in U.S. dollars. The benefit, even where the U.S. dollar is trading lower over time, is the commodity will go up, independently of all other factors." Additionally, says Mortimer, "by being a major commodity player, Canada has more exposure to some of the themes unfolding in Asia, particularly China."

The great white way

Bob Haber, fund manager and chief investment officer with Fidelity, believes there's still some bullishness to be squeezed out of the North American small- and mid-cap markets, albeit in a slightly more qualified way. He is also keen on Canadian resources, which have had an auspicious run over the last year. His main concern is that rising oil prices and oil taxes are starting to have a punitive effect on global economies.

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"If the oil tax is removed, economies can grow nicely and the benefit will accrue to the materials and industrials sectors – and somewhat to technology – now that it's had a decent correction," he says.

That could mean great things for Canadian resource stocks and certain sector funds. "If you look at what percentage of the market those areas represent in Canada, it is the highest percentage of any of the major developed markets," says Haber. "When these sectors do well, Canada does well, which in turn helps the service parts of the economy such as the financial type stocks. And

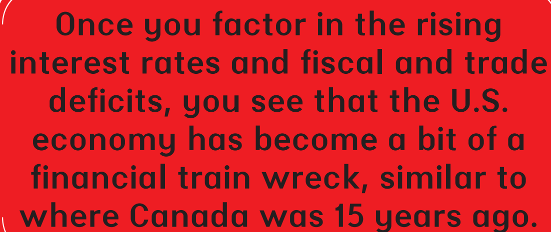
you get a richer market, including higher valuations for the Canadian market and an even stronger Canadian dollar."

For a much smaller portion of one's equity portfolio, Haber sees good buys in emerging market equities, such as Asia. "The most recent correction has created some more value in these areas that will grow faster at a slightly cheaper price than some of the more developed regions," he says.

Bond exposure

The threat of rising interest rates tends to scare investors away from fixed income products. "In any diversified financial plan, particularly with clients who are a little older, it makes sense to have a decent representation of fixed income products," advises Sturm. "We too allow for perhaps a better buying juncture, but on any sell-off in the bond market, particularly as longer term interest rates go over five per cent, we think it makes sense to be a buyer of fixed income again."

Dan Chornous, chief investment officer with RBC Asset Management, agrees that moderate bond exposure is appropriate in this market environment. "We recommend that whatever one's normal exposure to the bond market is, they should be somewhat below that in their asset mix right now."



But what types of bonds might be appropriate today? Being less vulnerable to rising interest rates, short-term bonds are expected to outperform medium- and long-term bonds. What you gain in safety of capital, however, you lose in the return. Chornous sees better opportunities with corporate bonds. "Within the bond market, corporate high-yield emerging market debt has done quite well since the end of the last recession and we expect that trend to continue," he says.

Chornous admits to having a mild preference for Euro Zone bonds over North American ones. "The valuations in our opinion are very similar right now in Europe. Bonds are expensive over there too, but the economy in Europe has been considerably slower and Euro Zone interest rates will be slower in rising than those in North America," he states.

There is one problem. Not being guaranteed, corporate bonds carry a higher risk. Here again is where investors should think more strategy than product and, according to Chornous, corporate bond mutual funds are part of that strategy.

"There will be bankruptcies, which you generally don't run into when you're dealing only with government credits. By investing in corporate bonds through a mutual fund, you expose yourself to fairly large lists of credits," he says. "You diversify across industries and different credit qualities and you bump the coupon income while minimizing the damage of any single one of these exposures going bad for you."

Golden opportunities

Gold, often regarded as an alternative investment, is also considered a hard asset currency hedge. Conventional wisdom maintains that gold is inversely correlated to the U.S. dollar, meaning that when the U.S. dollar sinks, gold rises. Most fund managers agree that nominal exposure to gold – say five per cent – is sensible asset allocation.

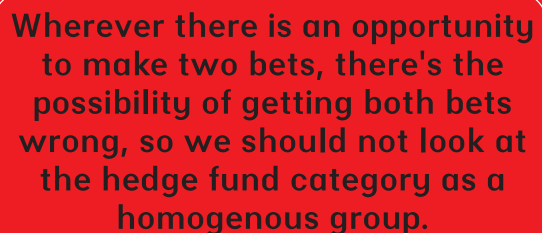
But what is the best way to get it? While bullion is the most obvious and safest way, there is an advantage to owning gold stock through a mutual fund, says Sturm. "Over time, if gold is likely to rise, you're better off owning the companies rather than bullion because their profit margins increase more than the price of gold itself," he says.

Guaranteed products, another alternative investment, were popular with investors last year. Yet they can come with a hefty price tag, warns Sturm. "Trying to ensure you don't lose your money has a cost that makes some of these products quite expensive. Properly applied, they make sense, but it's important that planners make sure that long-term investors aren't unnecessarily paying for this insurance because, over time, that insurance has less and less value," he says.

Sturm thinks the hedge fund category will continue to grow in popularity because it offers investors the opportunity to sell short. But he suggests investors be cautious. "The issue is wherever there is an opportunity to make two bets, there's the possibility of getting both bets wrong, so we should not look at the hedge fund category as a homogenous group," says Sturm.

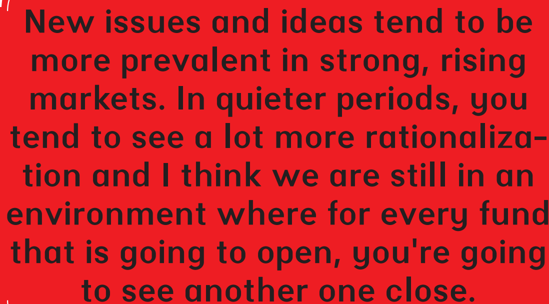
It's a wrap

Mutual fund wrap accounts appeal to investors looking for a low-maintenance way to get diversification. With new mini-wrap accounts coming to market, designed to attract the smaller investor, there is yet another mutual fund category to capture the investor's imagination. But as an investment strategy, wraps are not without shortcomings. They tend to be based on a computer model of mutual funds and, therefore, are not customized to the individual investor or the current investment environment. In addition, fund selection may be limited to proprietary funds. Tax advantages and fees may vary. There may also be underlying



mutual fund fees in addition to the wrap fees themselves.

New assets and trading strategies, previously the domain of sophisticated institutional investors, have been made increasingly available to investors in recent years. Exchange-traded and index funds are one example, though they are not expected to dominate new launches this year. "With their low management expense ratios, they appear cheaper to many investors," says Sturm, "but in order to do a little better in a market that is not strongly trended, you need to take a rifle shot in your selection rather than a shotgun approach."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Structured products seem to be enjoying the biggest growth spurt in the alternative investment category. Another institutional product that has found its way to retail, structured products offer investors different asset classes beyond the realm of a traditional mutual fund.

"They usually have other features as well," says Ian McPherson, president of Criterion investments, a subsidiary of VenGrowth Capital Partners Inc. For example, they may be structured to limit taxation, preserve capital or mitigate risk. "They can also come in different legal forms, which add to the complexity, such as bank link or note deposit. But more often, the normal course is a closed-end fund structure listed on the Toronto Stock Exchange," he says.

Activity and demand continue to increase, growing at between 11 and 13 new initial public offerings (IPOs) per month. "Obviously, it's an area of interest and the demand is there," says McPherson. "But certain features do cost, such as principal guarantee or the tax-advantaged strategies. However, the benefits on the tax side will often outweigh the incremental cost."

A quiet ride

Compared to five or 10 years ago, Canadian investors are more knowledgeable and educated about financial markets. "With more investors having defined contribution plans, there is greater need for them to take control over their financial futures," says McPherson. "I think there's a component of people looking for an edge or graduating away from general commodity products and who are able to understand the complexities, features and benefits of retail structured products."

But structured products aside, there are unlikely to be a lot of new issues in this market, according to Sturm. "New issues and ideas tend to be more prevalent in strong, rising markets. In quieter periods, you tend to see a lot more rationalization and I think we are still in an environment where for every fund that is going to open, you're going to see another one close." Among new issues over the next while, dividend funds, as sales figures confirm, are likely to be the most prevalent.

Few fund managers are bullish on real estate these days, believing that rising interest rates will soon hinder the sector. Mortimer takes a slightly contrarian view, however. "We don't see much latitude to raise interest rates in this environment and think that interest rates will stay low for a very long time. In this environment, real estate might be a better investment than most people think."

One thing that most fund managers agree on is this: Those big, corpulent equity returns of the late '90s are likely a thing of the past.

"You can't afford to make a mistake in a low-return environment," warns Mortimer. But you still have to invest your money somewhere – and cash is no longer king. The most stable growth platform comes from being choosy, avoiding duplication and diversifying across asset classes, sectors and geographies. Because remember, it's all about staying out of trouble. F