

THE GLOBE AND MAIL

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PORTFOLIO STRATEGY

Rob Carrick's ideas for managing your investments

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Back to basics: Get your investment house in order

The mourning period for your investment portfolio is over.

It's now time to re-think and rebuild.

For some help, let's consult with Keith Matthews, author of *The Empowered Investor* and a partner and portfolio manager with Tulett Matthews & Associates in Kirkland, Que.

"This is a great point for people to stop and maybe re-think how they put their portfolios together," Mr. Matthews said. "Do you want to rely on hope and an ad hoc way of putting together portfolios, or do you want to rely on something that gets back to the notion of risk and return?"

Warning: The portfolios that Mr. Matthews puts together for his clients are stripped to the essentials. There's no specific allocation to energy, gold, metals, high tech, infrastructure, agriculture, alternative energy or any other cyclical or trendy market sectors. To him, chasing the hot sector is a form of speculation. Instead, he uses four basic building blocks: fixed income, which means bonds or guaranteed investment certificates; Canadian stocks, U.S. stocks and international stocks, or those from companies located outside North America.

Model portfolios used at Mr. Matthews' firm have weightings in fixed income that range from 100 per cent for investors most concerned with preserving their money to 75 per cent of conservative types, 50 per cent for balanced investors, 25 per cent for investors who put a priority on growth and just 7 per cent for aggressive growth. If you're using bonds as opposed to GICs, then Mr. Matthews suggested using high-quality government bonds. "Keep it very secure," he said. "Keep your risk chips for equities."

With stocks, Mr. Matthews uses a philosophy for portfolio building that comes out of some research done by two



Portfolio manager Keith Matthews: 'We never, ever build a portfolio exclusively with value or small cap. Most investors would not be able to live through the difficult periods.'

CHRISTINNE MUSCHI FOR THE GLOBE AND MAIL

U.S. finance professors, Eugene Fama and Kenneth French. In trying to explain stock market behaviour, the pair found that two kinds of stocks outperformed the markets over the long periods of time: small-capitalization stocks and value stocks.

Value stocks trade at discounted prices according to various measures, usually because they're experiencing difficulties. The opposite of value is the growth stock, which is so healthy that it's increasing revenues and profits at faster rates than other companies.

Mr. Matthews said the superior returns from value and small-cap stocks are related to their higher levels of risk. Small companies may lack the stable earning power of large ones, while the very definition of a value stock implies a firm is facing some type of challenge.

As a result, he uses an approach of including broad-based exposure to Canadian, U.S. and international stocks, with a tilt toward value and small cap.

"We never, ever build a portfolio exclusively with value or small cap," Mr. Matthews said.

"Most investors would not be able to live through the difficult periods." All markets have been hit extremely hard lately, but small cap and value have fared the worst. The S&P 500 index was down 16.9 per cent for the year through March 12, while a value-tilted version of the index fell 22.4 per cent and a growth version fell 11.6 per cent. Over the same period, the S&P SmallCap 600 index fell 23.7 per cent.

A longer-term view shows why it's worth having some exposure to value and

small-cap stocks, even as they lead the markets lower today. The S&P 500 had a 10-year compound average annual loss of 3.4 per cent through the end of February, while the value version lost 2.5 per cent and the growth version lost 4.6 per cent. The SmallCap 600 index had an annualized 10-year gain of 3.5 per cent.

The lesson here for investors is that small-cap and value stocks tend to come under intense pressure in an economic slowdown, Mr. Matthews said.

“They tend to have weaker balance sheets, and they tend to be smaller companies. It makes perfect sense. But they have historically also come out better when there’s a market turnaround.”

The model portfolios used by Mr. Matthews’ firm – actual client portfolios may differ – are filled with no more than 10 or so securities, including those that cover the bond and stock markets. Bonds get the heaviest weighting in all but the most aggressive portfolios. For stock market exposure, holdings are divided among

large and broad-based stocks, value stocks and small-cap stocks.

The components Mr. Matthews uses for his portfolios are index products. Some of the money goes into exchange-traded funds, or ETFs, which are low-fee index funds that trade like a stock. The rest goes into index mutual funds from Dimensional Fund Advisers that take a unique approach in providing value and small-cap exposure. These funds are available only through a limited number of advisers. It’s possible to use ETFs entirely to build a portfolio with a value/small-cap tilt, but there are complications in the comparatively small, resource-heavy Canadian market. For example, the iShares CDN SmallCap Index Fund is almost 50 per cent weighted to oil and mining stocks and thus not well diversified. Risk-averse investors would want to keep strict limits on how much exposure to have to this ETF while emphasizing a broader based fund like Claymore Canadian Fundamental Index ETF, which puts something of a value

tilt on the broad Canadian market.

The ever-growing ETF universe provides lots of options for exposure to U.S. and international markets, with several options for value and small cap (see the accompanying chart for some ideas). Generally speaking, U.S.-listed ETFs have lower fees, while Canadian-listed ETFs focused on U.S. or global markets often provide currency hedging that makes fluctuations in the dollar irrelevant to your investment returns.

Some key things to remember if you rebuild your portfolio the way Mr. Matthews invests. One, you’re investing in asset classes, not hot sectors or star money managers. That’s the most efficient way to exploit the Fama-French finding that small-cap and value stocks outperform. Two, you need patience and fortitude to wring the benefits from this approach. “We’re talking 10 or 15 years or longer,” Mr. Matthews said.

RETHINK, REBUILD

Looking for ideas about how to get your portfolio on the right track again after the losses of the past six months? Here are some target portfolios adapted from those used by Keith Matthews, author of *The Empowered Investor* and a portfolio manager with Tulett Matthews & Associates. These portfolios are based on research showing that small companies and undervalued companies do better over long periods of time than large or growth stocks despite a higher risk profile.

Asset Classes	Conservative Investor	Balanced Investor	Growth Investor
Fixed Income			
Broad bond market	65%	40%	20%
ETFs to consider: iShares CDN Bond Index Fund (XBB-TSX); Claymore 1-5 Yr Laddered Government Bond ETF (CLF-TSX)			
Inflation linked	10%	10%	5%
ETF to consider: iShares CDN Real Return Bond Index Fund (XRB-TSX)			
Canadian Equity			
Diversified Large/Value	7%	14%	18%
ETF to consider: Claymore Canadian Fundamental Index ETF (CRQ-TSX)			
Small cap	3%	6%	7%
ETF to consider: iShares CDN SmallCap Index Fund (XSC-TSX)			
U.S. Equity			
Large	2.50%	5%	9%
ETFs to consider: iShares Russell 1000 Value Index Fund (IWD-NYSE); iShares CDN S&P 500 Hedged to Canadian Dollars Index Fund (XSP-TSX)			
Large value	2.50%	5%	8%
ETFs to consider: S&P 500 Value Index Fund (IVE-NYSE); Claymore US Fundamental ETF C\$ Hedged (CLU-TSX)			
Small cap companies	2.50%	5%	8%
ETFs to consider: iShares Russell 2000 Index Fund (IWM-NYSE); iShares CDN Russell 2000 Index - Canadian Dollar Hedged Index Fund (XSU-TSX)			
International Equity			
Large	2.50%	5%	8%
ETFs to consider: Vanguard Europe Pacific ETF (VEA-NYSE); iShares CDN MSCI EAFE 100% Hedged to Canadian Dollars Index Fund (XIN-TSX)			
Large value	2.50%	5%	7%
ETFs to consider: MSCI EAFE Value Index Fund (EFV-NYSE); Claymore International Fundamental Index ETF (CIE-TSX)			
Small cap	2.50%	5%	7%
ETF to consider: iShares EAFE Small Cap Index Fund (SCZ-NYSE)			
Emerging market companies	none	none	3%
ETF to consider: Vanguard Emerging Market ETF (VWO-NYSE); Claymore BRIC ETF (CBQ-TSX)			