

FINANCIAL POST

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Benchmarks for the real world

Richard Croft, Financial Post

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DING REAL WORLD BENCHM

	SYMBOL	CONSERVATIVE	PORTFC B
D			
ix Fund	XBB	70%	
e Index Fund	XIC	25%	
E Index Fund	XIN	0%	
x Fund	XSP	5%	

Croft Financial, Andrew BarrBuilding Real World Benchmarks.

Last week, I talked about the rationale behind having a benchmark. This week, we will talk about how to construct appropriate benchmarks.

Before getting into the nuts and bolts of how to construct a benchmark, we need to know whether you intend to work with an advisor, or to do it yourself. That's important because if you are working with an advisor the advisor has to be paid, and we have to incorporate that into a benchmark.

To bring some substance into this discussion, let's look of the world of index-based exchange-traded funds (ETFs). Writes Dave Paterson, of Paterson and Associates, an independent consulting firm providing mutual fund and hedge fund research, "an ETF provides a low-cost alternative to a traditional mutual fund by allowing investors the ability to access market indices or sub-indices for a cost that is in some cases less than 1/10 of the cost of a traditional mutual fund."

With index-based ETFs, investors have the ability to build well-diversified portfolios by holding four low-cost funds: the iShares Canadian Bond Index Fund (XBB/TSX), iShares Candian Composite index Fund (XIC/TSX), iShares Canadian S&P Index Fund (XSP/TSX) and iShares Candian MSCI EAFE Index Fund (XIN/TSX), which provides exposure to the MSCI EAFE Index.

When you think about the makeup of these products, four ETFs that trade on the TSX provide you with global diversification, and deliver world-class performance for an embedded management expense ratio of 30 basis points. If you are a do-it-yourself investor, why do anything else?

Having said that, advisors can play a valuable role, particularly if they excel at financial, estate, retirement and tax planning. In fact, I would argue that tax is probably the most important consideration when building long-term portfolios. It is not just about what the portfolio returns, it is about how much of that portfolio you are able to retain after tax.

Good tax planning can represent as much as 25% of your total after-tax return, so paying an advisor who has expertise in that space adds value. For example, keeping with the aforementioned four ETFs, tax planning can play a role in structuring your investments.

For example, one of the four ETFs is a fixed-income product. In other words, it is a portfolio of bonds, and the distributions are taxed as interest income. Interest income is the least efficient means of earning after-tax cash flow. Depending on your tax bracket, dividend and capital-gain income is more efficient, and, if structured properly, can increase your after-tax cash flow, often without significantly increasing your risk level.

Speaking of risk, that takes us to another important advisor trait. Successful long-term investing requires that you stay with the program. And the only way to ensure you do that is to build a portfolio with a risk level you can tolerate. We can mitigate risk by raising or lowering the percentage of the portfolio invested in bonds or similar income products, with, perhaps, a tax twist.

When it comes to an asset mix decision, we would expect conservative clients to invest a larger percentage of their portfolio in fixed-income assets, while growth investors would typically overweight equities. Balanced investors would fall somewhere in the middle. Fine-tuning that decision can be a useful exercise, which is typically what advisors who focus on financial and investment planning excel at. That has real-world value and should be factored into the costs of a real-world benchmark.

If we are to quantify the value an advisor brings to the table, it probably ranges somewhere between 50 basis points (0.50%) to 150 basis points (1.50%) annually. Often, advisors scale their fees based on the size of the investor's portfolio. The real key to fees is making certain the client knows how much the fee is, and what services they are getting for that fee. For example, is the advisor preparing your tax return, helping you plan succession through an estate plan, building long-term retirement models, etc.?

So, for those using an advisor, a real-world benchmark should account for the costs of working with an advisor. You could build such a benchmark using the four ETFs as a starting point. You would then build three real-world benchmarks based on the asset mix used in the three FPX indexes, which would look like the accompanying table.

If you are using an advisor, you should then adjust the performance of these four ETFs to account for distributions and for the fees paid to the advisor. If you are a do-it-yourself investor, then adjust for distributions and beat the benchmark.

Another approach is to use the three Real World benchmarks we created on our Web site (www.croftgroup.com).

These Real World benchmarks are simply the FPX indexes adjusted by a 1% per-annum fee. We have historical data back to April 1, 1996, which you can access by clicking "Benchmarks" and then "Return Calculator." Your portfolio objective is to beat the Real World benchmark that applies to you.

--- - Richard Croft is president of Croft Financial Group and co-author of *Protecting Your Nest Egg: A Canadian Guide to Wealth Protection*.

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