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Worried about equity exposure? Here's why you shouldn't be

By Fred Vettese

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As you watch the market flirt with correction territory and the year's gains on the verge of being wiped out, are you itching to call your financial advisor?

Maybe you would feel a little more comfortable if you were less exposed to equities and are hoping he or she can put you in some safer investments to weather the storm.

If history is any guide, this kind of tinkering is a waste of time.

Using actual historical returns, we compared three scenarios for a simple portfolio holding a Canadian equity mutual fund and a long-term Canada bond mutual fund, with an average annual management expense ratio (MER) of 2.4%. In the first scenario, we left the ratio unchanged no matter what happened in the markets. In the second scenario we adjusted the equity portion higher in good times and lower in bad times, and in the last instance we did the opposite by adjusting equities up in bad times and down in good times.

Does this mean that talking to an advisor is a waste of time? Not at all, but you do want to pick the right advisor

Our analysis shows little change in the outcome regardless whether you took a passive, active or contrarian perspective.

Looking back over the past 50 years, you would have achieved an annual return net of fees of 7% by leaving your investments in a long-term asset mix of 60% equity funds and 40% bond funds.

If you had tried to improve on this outcome by adjusting your asset mix to 80% equities when stocks in the previous year rose 24% (which happened 13 out of the past 50 years) and reducing your equity weighting to 40% in years you lost money (14 out of the past 50 years), the average return on your portfolio would have been 7.1%.

You might also have taken a contrarian view: A one-year rise in equities of 24% would signal an overheated stock market, prompting you to reduce your equity weighting to 40% for a year while a negative return would be regarded as a buying opportunity causing you to increase the equity weighting to 80%. Your average return over the 50 years would have been 6.8%.

If varying the asset mix based on recent stock market performance has no significant impact on returns, then what does? The answer is your choice of advisor. And I don't mean that some advisors are more prescient than others - in reality, no one knows what the markets will do in the near future - I mean some of them are more expensive.

Consider how you would have done had you invested your savings in low-cost index funds instead, such as ETFs with an MER of 40 basis points. If ETFs had been available for the last 50 years, you would have enjoyed an average annual return of about 9.0% after fees, or 2% a year more than with the 2.4% mutual funds. That differential can easily translate into thousands of dollars.

An account with a current balance of $100,000 earning 9% a year would grow to $862,000 in 25 years. If that account earned 7% a year, it would grow to just $542,000 over the same period.

The above example assumes that the mutual fund returns before fees are the same as the returns on ETFs. Some investment advisors will suggest that the actively managed mutual funds they sell will do better than the benchmark indices. It is one thing to say this but entirely another thing to prove it. Don't accept this argument without seeing an apples and apples comparison, after fees.

Does this mean that talking to an advisor is a waste of time? Not at all, but you do want to pick the right advisor. The time with your advisor should be spent discussing matters where they can provide real value such as how your asset mix might change as you get closer to retirement, what insurance coverage is appropriate and what strategy is the most tax-effective.

An advisor who simply discusses what the markets have done and how you might adjust your asset mix is adding little value. In addition, you might want to consider a fee-only advisor so you don't have to worry about whether the commissions payable are affecting the investment recommendations made.

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