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SHELF LIFE

Thinking small can yield big payoff for Sprott

IPO TIMING GOOD

Money manager's investing style all the rage

By Hugh Anderson

Rookie brokers quickly learn the score on new issues of stock. In the nature of things, some initial public offerings will be in hot demand and make clients happy if you can only get some to sell.

Other IPOs will face a cool reception and clients will not thank you for selling them a dog. The trouble is that to get any of the hot stuff you have to build a record of taking down the cold and clammy product.

It seems there is little likelihood of that dilemma surrounding the coming IPO of Sprott Asset Management.

It's probably going to be hot and much in demand as investors recall once-controversial predictions of founding guru Eric Sprott that have come true.

What's odd about this is that while IPOs mostly thrive on optimism about the future, Sprott, 63, is best-known for predictions of doom for the financial system.

A recent sample: "We're in a systemic financial meltdown. There are probably 10 companies that are broke that are still trading." Another prediction: Gold is going to US$2,000 an ounce in this cycle.

These opinions could be written off as those of a maverick contrarian if the record did not show a series of big-picture and highly profitable timing calls such as on uranium around US$10 in 2003. Recent price: US$71. A closer look at the investing style of his flagship Sprott Canadian Equity Fund reveals, however, that the fund's standout 28% return over the past 10 years was very much the result of successful bets on tiny unknown speculative stocks.

> "Sprott is best known for predictions of doom

Big-company stocks don't turn Sprott on. Indeed, they are often the targets of his short-selling prowess.

For many of us this performance might be viewed as the triumph of hope over experience, like a second marriage, according to that old curmudgeon Samuel Johnson. Certainly, it required a lot of optimism. Such bets and timing calls don't always work out, of course, even for Sprott.

A look at individual annual returns shows that buying into this style provides a bumpy and nerve-wracking ride. The fund's best year recorded a 100% gain. The worst served up a 39% plunge.

This is something to keep in mind when you consider which of your clients to pitch the IPO to. Note also that this is strictly a secondary offering by company insiders of a minority stake at a time when the Sprott investing style is all the rage. Good timing again, perhaps?

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▮ Hugh Anderson is a freelance financial journalist and a former retail investment advisor

ARLEN REDEKOP / CANWEST NEWS SERVICE

Dylan Reece, left, and David Chalmers, of Rogers Group Financial, are the new breed of advisors transitioning to a fee-based compensation model.

COMMENT

Rogers team seeks right mix

Fee-based model focuses on asset balance

Jonathan Chevreau
Well advised

Vancouver-based Rogers Group Financial has been around the financial-advice business long enough to take seriously the transition from older advisors to their successors.

Two years ago, this column described Jim Rogers' personal five-year transition to exiting the financial-planning business he founded in 1973: Apart from continuing as chairman, he now spends his semi-retirement as an industry ambassador as president of the Million Dollar Round Table. But even Rogers' successors are having to deal with their own succession issues.

A good example of how the torch is being passed to the next generation is the team of Dylan Reece, 33, and David Chalmers, 57. Chalmers has 35 years industry experience and Reece almost eight.

Together, they quip, they are the "old fart and the whippersnapper. I don't want to stop working," Chalmers says. "I love what I do but want to work less, travel more and smell the roses."

Increasingly, Chalmers will be eating his own cooking, since the focus at the Rogers Group has long been on generating income in retirement.

The firm's clientele consists chiefly of affluent business owners, executives, professionals and academics who are either retired or on the cusp of retirement.

As one of the few remaining independent financial-planning groups in Canada, Rogers Group offers a combination of mutual funds, insurance products and IDA-sold individual stocks and bonds.

Like other "new-breed" advisors profiled in this series, Chalmers and Reece are transitioning to a fee-based model and away from the older transaction or commission model of advisor compensation. Chalmers started to move in this direction five years ago and Reece joined him a year ago. A decade ago, Chalmers decided he no longer wanted to sell mutual funds with deferred sales charges (DSC) but would instead sell funds with a zero front load. Thus, the annual trailer fees that went with front-load funds meant that portion of his practice had already become asset-based.

The problem was clients always have legacy positions, such as DSC funds sold by previous advisors, which can constrain rebalancing because of redemption charges. "If a brand-new client came with cash and no legacy positions, it would be 100% F-class mutual funds, individual stocks, ETFs (exchange-traded funds) and GICs," Chalmers says, "There would be no embedded compensation at all. The optimum is to get entirely to that fee-based approach."

The pair believe clients gain five benefits from this model: product recommendations are revenue-neutral, so in the client's best interests; accounts can hold any kind of investment product while maintaining the advisor's target revenue, reducing conflicts of interest; they can exploit pricing anomalies between front-load and F-class mutual funds; and a combination of active and passive investments minimizes the impact of fund management rxpense tatios (MERs) on sustainable withdrawal rates and long-term returns.

Clients receive an investment policy dtatement (IPS), net eorth snalysis and portfolio management report, with the combined impact of portfolio product costs and advisory fees summarized at the end. In a sample report for a hypothetical $1-million portfolio, the total cost of investment products is estimated at 0.84% and the total advisory fee at 0.53% (including GST), for a total of 1.37% — half what an all-mutual-fund portfolio might charge in MERs. The revenue target for clients with less than $1-million is 0.9%.

Because of anomalies like hedge funds that charge performance fees, "it's not fair to say a lower MER always produces a better result but it is fair to say across the broad spectrum of a practice a lower MER probably will produce a better result," Chalmers says.

"You need to separate the cost of a product in a portfolio from the cost of the advice you're getting," Reece adds, "For most it's all bundled together in one MER."

The pair build custom portfolios for clients after first assessing individual risk tolerance, time horizon and requirements for investment returns. The starting point is to determine overall net worth: how much cash, fixed income, precious metals, real estate and equity a client holds. This is followed by specific investment recommendations and tweaks to the asset mix.

For clients with employer-sponsored defined benefit pension plans, the commuted value is calculated. Since this is considered the equivalent of a fixed-income asset similar to a bond or a GIC (guaranteed investment certificate), the investment portfolio may contain relatively less fixed income and more equity.

At the other extreme, a business executive will have considerable equity exposure through holdings in the firm (whether public or private). This would count as "equity" in the overall net worth statement, so the portfolio might contain more fixed income and less equity than a client with a rich employer pension.

"From a portfolio-construction perspective, generally the older the client the more the fixed income," Chalmers says. The "fundamental building block" of the fixed-income component is a ladder of GICs or government bonds.

Fifteen years ago Chalmers decided to separate equity and fixed income in client portfolios, which meant not using balanced mutual funds. In years when the stock market is rising, clients draw RRIF income by selling some equity positions; when markets are down, they draw down from fixed-income reserves. "We want to structure it so we can outlast an equity downturn for several years."

Generally, they steer clear of some of the newer financial products that charge a premium to shelter clients from market volatility. Instead, they prefer a lower-cost asset-allocation approach to risk management.

Next week we'll profile one of Canada's pioneering fee-only firms. Despite the similarity in terms, fee-only is quite a different approach from fee-based. For this next phase of the "new breed" series, I'd be happy to hear from other fee-only advisors.

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