

Recent Changes To Our ETF Strategies

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We have made changes to our index fund strategies ("ETF Strategies") to incorporate our latest long-term forecasts for stock and bond returns and to utilize new ETFs covering investments previously unavailable through index funds. The objectives of the strategies remain the same.

Given these changes, it is important to review the objectives of our ETF Strategies, describe the process we follow to develop them, and summarize the changes we have made.

OUR ETF STRATEGIES

We currently manage five different ETF Strategies for our Canadian clients. We implement the strategies by primarily purchasing shares/units of exchange traded funds (ETFs), which are generally index funds that are traded on stock exchanges (we will discuss the pros and cons of ETFs in a forthcoming note).¹

By providing a range of strategies that differ by degree of risk and potential return, we can better address the varying needs and objectives of our clients.

Strategy	Risk Benchmark	Latest Allocations		
		Equities	Corporate Bonds and Preferred Shares	Government Bonds
Short-Term Bond Alternative	DEX Short-Term Government Bond Index	0%	43%	57%
Conservative	S&P/TSX 60 Index	9%	22%	69%
Moderate	S&P/TSX 60 Index	21%	30%	49%
Balanced	S&P/TSX 60 Index	38%	31%	31%
Aggressive	S&P/TSX 60 Index	63%	19%	18%

OBJECTIVE OF THE STRATEGIES

Our ETF Strategies are designed to manage the volatility of periodic returns relative to a specific benchmark that tracks the stock or bond market.

The variability of a portfolio's returns from one period to the next (weekly, monthly, annually, etc.) has a pronounced impact on investors who are either trying to accumulate wealth or living on the income their portfolios generate. As we will show in an upcoming article, investors are usually better off earning a series of seemingly modest returns from year-to-year (less volatile returns) when trying to accumulate wealth or fund retirement.

The variability of returns can be managed by systematically mixing investments that differ in their sensitivity to different economic factors, such as corporate profits, long-term interest rates, and exchange rates. Our ETF Strategies are mixes of distinct investments (asset classes) that are managed by following a systematic investment process.

OUR INVESTMENT PROCESS

The process we follow in managing our ETF Strategies is as follows:

Step	Procedure
1	Select the types of investments (asset classes) to use in the strategies.
2	Forecast long-term returns (10 year returns) for each asset class.
3	Characterize the relationships between asset classes, i.e. the behavior of assets classes relative to one another in different market conditions.
4	Analyze all possible discrete mixes of asset classes under varying market conditions to determine mixes that meet our return and volatility targets.

It is important to emphasize that we change our strategies infrequently and changes are generally prompted by shifts in our long-term return forecasts and the availability of new ETFs.

RECENT STRATEGY CHANGES IN THE CONTEXT OF OUR INVESTMENT PROCESS

The Selection of Asset Classes

We selected eight asset classes to include in each of our ETF Strategies based on our long-term return forecasts and our research regarding which asset classes work well together to control the volatility of a portfolio.

Short-Term Bond Alternative Strategy	Conservative to Aggressive ETF Strategies (Varying degrees of equity exposure)
<ul style="list-style-type: none">• Canadian Money Market Securities	<ul style="list-style-type: none">• Canadian Equities
<ul style="list-style-type: none">• Canadian Short-Term Government Bonds	<ul style="list-style-type: none">• U.S. Equities
<ul style="list-style-type: none">• Canadian Medium-Term Government Bond	<ul style="list-style-type: none">• International Equities
<ul style="list-style-type: none">• Canadian Long-Term Government Bonds	<ul style="list-style-type: none">• Emerging Market Equities
<ul style="list-style-type: none">• High Quality International Government Bonds	<ul style="list-style-type: none">• Canadian Preferred Shares
<ul style="list-style-type: none">• Canadian Retractable Preferred Shares	<ul style="list-style-type: none">• U.S. Corporate Bonds (Hedged to Canadian Dollars)
<ul style="list-style-type: none">• Canadian Straight Preferred Shares	<ul style="list-style-type: none">• High Quality International Government Bonds
<ul style="list-style-type: none">• Canadian Convertible Bonds	<ul style="list-style-type: none">• Canadian Short-Term Government Bonds

We have eliminated exposures to inflation protected bonds and sectors of the stock markets (REITs and Income Trusts). We have added exposures to international government bonds and U.S. Corporate Bonds (hedged to Canadian Dollars). In large part, these changes are implications of our long-term return forecasts.

Implications of Our Long-Term Return Forecasts

Given low long-term interest rates, below average earnings yields on stocks, the potential instability in consumer prices, and the prospects of below average corporate profit growth, the potential return on stocks in developed countries over the next ten years is relatively low - just over 5% in Canada according to our equity forecast model, for example. In contrast, lower risk fixed income corporate securities (preferred shares and corporate bonds) are expected to produce attractive returns - many in excess of 5%.

Given the relative attractiveness of corporate fixed income investments, our equity oriented ETF Strategies have shifted moderately toward these lower risk investments in lieu of higher allocations to equities in developed markets. Allocations to emerging market equities have increased slightly owing to their more attractive valuations and higher long-term potential returns. We have not reduced exposures to government bonds nor substituted corporate bonds for government bonds, rather we have generally altered the way we gain exposure to equity oriented returns in our Strategies (increased exposures to preferred shares and corporate bonds).

In an upcoming article, we will present our long-term forecast for equities and discuss their implications on asset mixes.

Selection of Asset Mixes for Our Strategies

Our process to analyze potential asset mixes for the ETF Strategies (Steps 3 and 4 of our Investment Process) has evolved over the years. Currently, we follow a process whereby we evaluate all possible combinations of asset classes under varying market conditions given a discrete limitation on weightings between asset classes.

For example, in selecting an asset mix for our Aggressive Strategy, we created all possible portfolios (in excess of 3,000,000) to the eight asset classes we selected for inclusion in the strategy to determine which asset mixes had higher probabilities of achieving our objectives.²

This approach allows us to evaluate how different combinations of asset classes behave relative to benchmark indexes in various market conditions, enabling us to identify sets of asset mixes that have a high probability of achieving our strategy objectives. This aspect of our process is quite involved, so we will discuss it in an upcoming article.

FINAL THOUGHTS

The changes we have made to our ETF Strategies are the result of a systematic decision-making process. There are many factors that we evaluate in making strategy decisions, a few of which have been highlighted in this note. However, given the many questions and concerns regarding the economy and the financial markets, we feel it is important to address important issues that impact our ETF Strategies in greater depth. Thus, we will be writing a series of notes in the coming weeks to address these issues, beginning with our long-term return forecasts for the equity markets.

¹ In our Short-Term Bond Alternative Strategy, we purchase individual securities to gain exposure to asset classes where an ETF does not exist (Canadian Convertible Bonds, Canadian Retractable Preferred Shares, and Canadian Straight Preferred Shares).

² The number of portfolios analyzed represents all possible combinations of the eight asset classes where allocations to any one asset class were allowed to vary from 0% to 100% by increments of 4 percentage points, i.e. 0%, 4%, 8%, 12% ...100%, and the sum of the allocations equals 100%. For example, there are 593,775 possible portfolio combinations for the eight asset classes when 4% is allocated to Canadian Equities and the allocations to the other seven asset classes range from 0% to 96% and are multiples of 4 percentage points.