Fund Follies: Watch your Weight!

Robert MacKenzie

Being overweight is not only dangerous to your physical health, it can be just as damaging to your retirement nest egg. But it's not food I'm talking about in the latter case — it's industry obesity.

You may recall that in the late 1990s advisors were warning people about the danger of investing in the high-flying Toronto stock market index. At that time, technology firm Nortel formed about 35% of the index, meaning that, in effect, people were buying a single stock with 35% of their money and the index with the remaining 65%. When that stock tanked, index funds tied to the TSE collapsed with it, and great was the fall.

Similar problems are cropping up again. This time the vehicle is dividend funds. As in the case of heavily weighted Nortel being "hidden" in a stock index, this time it is financial services firms that are buried in what are labeled dividend funds.

A quick check of the sector-weighting page in the GlobeAdvisor listings revealed that the majority of the major dividend funds had about 40% or more invested in this single sector (and double-digit percentages invested in the energy sector as well). The Guardian and Bank of Montreal (BMO) funds checked in at 53% each, just behind the most concentrated Philips, Hager and North (PH&N) fund at 54%.

You don't need a lot of math skills to realize that any weakness in that sector will mean big losses in value for these dividend funds. They, in fact, have become "sector funds" focused on financials, even though they are not labeled that. (Perhaps they should be!)

Investors can hardly be blamed for having large bank and financial holdings. Their performance has been spectacular for over a decade. But at some point the growth that they have undergone means that a portfolio becomes overly risky because of its concentration on too narrow a base in that one sector. That means it's time to cut back, to sell and to re-balance to something less vulnerable.

I wonder whether the warnings about this problem will be ignored this time as they were 7 years ago? Back then, investors/advisors to their detriment had all sorts of excuses for not selling and diversifying:

1 "It has done so well in the past!" There's a good reason that fund literature puts a disclaimer at the bottom of its ads that past performance is no indication of future returns. Not only does it get the fund sales people off the hook, it warns us again about the inevitable ups and downs of the market. Just because a fund or an industry sector has done well does not mean that it will maintain its current price level. Don't be afraid to take profits when your investments are successful.

2 "The tax would kill me!" I know of a number of people who had hundreds of thousands of dollars in Nortel stock but were afraid of paying tax on their capital gains if they sold. They don't have a problem any longer, of course, ever since the stock lost 97% of its value. Bite the bullet and pay the tax.

3 "I don't know where else to invest the money!" For some reason, many investors think that they must be fully invested at all times. Holding cash is seen as a failure. I like the smart fund managers who usually have over 20% of their portfolio in cash, and even more when the market is high. That way they may deploy it when a market downturn occurs and lessen the volatility risk of their funds. My advice: Be patient and hold cash if there is nothing attractive to buy.

4 "You may be wrong about this sector and it'll go up!" This is a criticism that advisors dread hearing. The primary role of good financial advisors is not to try to pick funds and sectors that will soon go up, it's to grow capital at a fair rate with a minimum risk of loss. Picking stocks or funds that will go up soon is largely a game of chance. Research such as that in David Dreman's book *Contrarian Investment Strategies* demonstrates that professional analysts actually fare poorly over time with their near-term recommendations.

More important than leaving investing to chance is to have a strategy that minimizes risk and selects well-managed funds, thus avoiding big losses. As the advisors' advisor, Nick Murray said, "An advisor should above all help his clients to avoid 'the one big mistake' that will put their financial health in jeopardy." In this case, avoiding dangerous sector concentration is more important than missing out on future gains in that sector.

So, what is an investor to do? Check over your holdings from time to time to see what your sector allocations are. For mutual funds, that means a check of the Morningstar or GlobeFund websites or a review of printed fund info sheets, if your advisor does not do the work for you.

The TSX had weightings of 36% in financials and 32% in energy at mid-year, but I think that any concentration over 20% in an investor portfolio is probably too much. Cutting back on dividend funds so that their dominant sector is balanced by others in your overall portfolio is one way to go. Or pure Canadian equity funds may fit the bill as better-diversified substitutes for dividend funds, knowing that they may not have as many dividend-paying stocks in them.

If you really want dividend payers, it may be time to add one of the new global dividend funds offered by several fund companies, some of which offer the option of currency hedging. Canada has fewer and fewer stocks to buy, whether they pay dividends or not—another reason to look to non-Canadian investments for appropriate diversification.

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