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ADVISOR'S EDGE REPORT

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Investors Rule

Upstart firm, owned and operated by investors, says it values advisor feedback

INTERVIEW BY MARK NOBLE

There are only a few new players in the Canadian mutual fund industry, and even fewer who've made an immediate impact.

Since its inception—by a trio of former star fund managers—the industry has had its eye on upstart EdgePoint Investment Group. The firm's founding partners and primary money managers, Tye Bousada and Geoff MacDonald, could have easily rushed into the market with a firm focused on gathering assets. Instead, the former Trimark managers took their time to build a business intensely focused on working with clients serious about long-term investment performance.

Their motto—Owned and Operated by Investors—tells the full story. Investing is all that matters for MacDonald and Bousada, and they refuse to institute anything into their firm's model that will undermine that philosophy even if it costs them assets. And by doing so, EdgePoint

is already challenging the underlying fabric of the Canadian mutual fund industry.

Q Describe the transition from being portfolio managers employed by a large mutual fund company to running a larger business.

TYE BOUSADA It was interesting. Initially, it was a blend of both managing money and managing the business. But fortunately, we're back to being money managers. Patrick Farmer, EdgePoint's CEO, will focus on the day-to-day operation of the business.

One of the most common mistakes portfolio managers in the mutual fund industry make is to

You can't control what the markets are going to do in the short term but you can build a good culture for this business.

Tye Bousada (right)



assume that because they understand businesses, they'll be able to manage a company as well [and do so unsuccessfully].

We've watched people make those mistakes in the past, and didn't want to be one of them. That's where Pat Farmer fits in. He put all of the infrastructure in place, and everybody apart from the investment department

reports to him. This lets us focus on managing money, which is exactly what we used to do.

We were also fortunate because initially we had Bob Krembil's [former Trimark founder] backing and capital, which allowed us to really sit back and figure out how best to approach this business. We weren't forced to come

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Investors Rule

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out of the gate with a product right away. We were able to spend the first nine months of the operation determining how best to approach the market.

We went across the country—quite literally from Halifax to Vancouver—talking to a number of financial advisors who have built successful businesses, and asked them what they wanted to see in the industry; what they liked in the marketplace; what they didn't like; where they thought the industry was going to be in five years; and what product attributes they thought attracted assets.

The feedback we received was remarkably consistent and in line with our beliefs about what the industry needed.

We also spent a lot of time thinking about the people we'd like to bring on as partners. You can't control what the markets are going to do in the short term but you can build a good culture for this business.

Q How big is your firm now?

GM We are a team of 21 now. Just recently, we brought on a lot of sales and operations people.

Q Have you found this a good market to hire?

TB We mostly hired people we've worked with in the past. Out of the 21 people we hired, we worked with about 15. That's actually a real luxury because you're able to eliminate the risk of not knowing what you're getting. That's a hurdle we've been able to avoid [as a new business].

Q Pat Farmer was a well-respected money manager in his own right. Do you think it helps to have someone with an investment background run the company?

GM He managed a lot of people as the CIO of AIM Trimark for eight years. He was actually our boss. He was the CIO for all of North America by the time he left, and oversaw something like \$120 billion in assets with a couple hundred people reporting to him.

Q Did you have any unforeseen challenges as a start-up?

TB The markets. Although in hindsight it proved to be a good thing.

GM There are always challenges, but knock on wood, things have been good so far. We were advised by a lot of people that there was no room for another mutual fund company in Canada. For one, it's capital-intensive. People told us

we don't know anything about managing a business. But we knew how to manage money, and we're sort of Monday-morning quarterbacks because we study businesses for a living. We can give a lot of valuable input, but we don't necessarily have the skill set to run the business.

The key was to bring in the right people who have an incredible amount of experience and have done this before. We have other people take care of the nuts and bolts, while we manage the money.

It also did not cost nearly as much money as people said it would. This is actually not a very capital-intensive business, that's for sure.

Q From a stock market perspective, do you think it ended up being a good time to launch new funds?

TB Absolutely. We're actually very excited to start the funds at the current market valuations. We're a blend of value and growth investment styles and that made us even more excited because we're able to buy great businesses that grow over the long term at pretty depressed prices. Those types of stocks were not in short supply.

We launched on November 17, 2008, and thought the possibilities were pretty exciting, but we didn't know how low the markets could go. By the time March 9 rolled around they plummeted even lower and frankly we became more excited about the long-term possibilities.

This stems from the fact that we tend to focus on longer time horizons to make an investment. We're not focused on the next month or the next quarter. We realize a disproportionate number of managers have a short-term focus—one month, three months or a year. We've partnered with advisors who understand we're trying to build wealth for investors over a five-year time period. Three- to five-year returns are what we focus on.

GM One of our [definitions of success] is to be at the top of our peer group over a 10-year timeframe. There are no asset targets within that definition of success. You see fund companies operating a business and they are talking about asset targets and how big they want to be.

That's not one of our key success factors; it's not one of our goals. Our goal is to create value for our clients over the long term. With that goal in mind, starting out where we did [in the market cycle] puts us in a pretty good

situation to achieve it.

Q You were veterans of the Trimark part of Invesco Trimark, where the "Trimark Discipline," is still practised rather reverentially. Assuming you would have been students of that discipline, can you tell advisors how your management style would be different?

GM The term we've been using around here is the "Krembil Approach" (named after Trimark co-founder Bob Krembil). Tye and I are going to invest the same way we've always invested—the same investment approach we learned from Bob. I don't see why any of that would possibly change.

We're lucky to have a small asset base, which allows us to put that investment approach in very flexible formats, and in companies of all sizes around the world.

TB I don't think Bob would have partnered with us if we said we were going to change our investment format. And nothing speaks to the fact more that we will follow the "Krembil Approach" than the fact that Bob Krembil is one of our partners.

Q So will this be a complete departure from what Trimark does?

TB I wouldn't say what we're doing is a conscious departure from what Trimark does. As far as managing money goes, there's no change at all to what Geoff and I have done in the past.

EdgePoint has a different culture and a different environment than what existed at Trimark. That should be expected because we're looking at different groups of people.

Q What sort of feedback did advisors give you and how have you responded to that?

TB A lot of what we've done reflects the comments of advisors. There's nothing preventing senior management of fund companies from going across the country and asking advisors their opinions. The problem is many senior managers don't want to hear the feedback.

They're actually afraid of the feedback because they won't be able to implement it.

For example, some of the feedback we heard involved higher minimum [investments].

Another big piece of feedback we got from advisors is they don't really care about going golfing with you. What they care about is good investment performance. Some even suggested spending more money on the investment department rather than the marketing department.

Q As investors, where do you see the market going over the next 12 months?

GM We rarely answer questions like that definitively. We piece together a global portfolio, for example, with about 25 to 30 ideas. There's no overall theme. Let's say we love [the outlook] for orthopedic companies, we still don't buy them all. We buy one stock, and that will be one idea. If we love the oil and gas sector, there will be one oil and gas company in the portfolio and we have the whole world to choose it from.

One of the things we learned from Bob is to piece together a proper portfolio and diversify it, not just make one or two big bets on one or two sectors.

There's a possibility banks will resemble regulated utilities a few years from now

Geoff MacDonald

I don't think there are any themes. The general theme we talked about since we launched six months ago is where the market is today and the valuations associated with that.

There are a couple of traps we have warned investors about. One of them is the flock-to-safety mentality. The place to hide in the market was not the place to be. It's going to take a long time to get your money back owning the Campbell Soups of the world.

There's a wonderful opportunity to dig beneath the [companies] everybody knows are going to survive. You have a once-in-a-generation opportunity to buy great companies at silly prices. That was one theme we've talked about.

The other theme is to be careful of value traps. In an economy that's shrinking, we're not growing. There are a lot of low-quality businesses that will decline. Those sub-par businesses with weak competitive positions may look cheap but stay away unless you know when the economy's going to turn.

Q What are your long-term earnings expectations for return on equity considering leverage has been taken out of the market?

GM Banking is the main industry that will have its return on equity prospects affected. It's reasonable to say many banks around the world will hold on to a lot more capital than they have in the past. In some cases, they'll be forced to. There's a possibility banks will resemble regulated utilities a few years from now. We don't know at this point. In terms of broader returns on equity I don't see a big change in other industries.

Q What's the earnings potential of

corporate bonds versus equities over your three- to five-year time horizon?

TB Looking back, they were both very attractive in November and December. That was reflected in our growth and income portfolios, where we were 70% invested in equity and 30% invested in fixed income. The fixed income was all in corporate bonds because that is where all the opportunities were. We weren't hiding anything in governments, like the majority of the world seemed to be doing.

GM Simply put, I think there were a lot of people excited about corporate bonds and the yields that were there. You could see a lot more talk in the industry about high-yield bond climbs. We took some advantage of that.

We avoided government bonds. Not many balanced funds across the country did that. Not sure why.

Q Do you have any asset targets in mind? Is there a point where you would close off mandates to new investors in order to preserve performance?

TB We are going to have to be true to our objectives. We'll close off if size impedes our ability to be at the top of our peer group or have strong relationships with our advisors. If it means we have to hire so many employees that they can't think and act like owners, we'll stop.

The nice thing is we have a track record of doing it right. The process is in place to make tough decisions that are right for the investors. It's an example of something we're going to have to be held accountable for as an investment-led organization versus an asset-gathering organization.

GM You have two fiduciaries as a public mutual fund company—the public shareholder who wants to see asset growth, and the unitholder that wants returns. You have the shareholders demanding asset growth. The professional management team with limited investment background will want to satisfy the demands of those shareholders.

The ownership of our fund is pretty strong, and we've set it up so that it will be employee-controlled forever. We have a shareholder agreement that makes it impossible to sell your stake to anyone other than another employee. I think if you can keep the employee ownership intact, you can keep the investment ownership intact, and consequently you can keep the investment-focused model in place longer. We've seen that. We've seen private employee-owned firms maintain an investment culture longer and stronger.