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Wealth Insights

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Active management and investment success

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The long-term returns of active management compared to passive investments have long been debated. However, returns are only part of the picture.

Members of both schools of thought perennially argue that their way is better than the other. Even though the approaches of both styles of investment management are quite different, each has their unique benefits. To set expectations, it is important to understand that the advantages of active management can quickly erode if one fails to adopt a long-term perspective.

In a February 2017 study, DALBAR, a financial services market research firm, examined active and passive investing of U.S. investors and how both affect the returns investors earn. The report found that actively-managed portfolios outperformed over the longer-term (5+ years). Its data also showed that patience is required. In other words, generating returns in excess of a benchmark tends to be about as exciting as watching a Bonsai tree grow.

One reason for this "lack of excitement" is related to an active manager's calculus on the degree of risk needed to generate a unit of return.

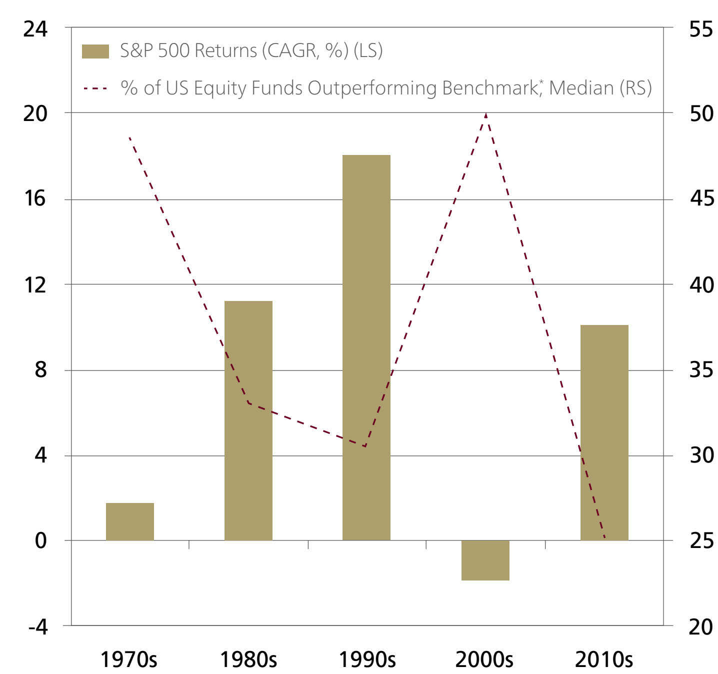
Take for example a runaway bull market like the 1990s. Surging markets are often accompanied by an increasing number of participants throwing caution to the wind, a tough situation to add value. On the other hand, in the U.S. we see much better performance from the active management industry during periods of sluggish equity index returns (Figure 1).

The case for active managers

Take both the 1970s and the 2000s, two decades when elevated equity market valuations in the U.S. sowed the seeds for weak future equity index returns. In our view, stock pickers with a focus on the fundamental merits and intrinsic valuation of individual companies were better able to navigate this landscape and reward their investors relative to neighbouring decades.

Active managers also seem to collectively add value through periods of heavy selling pressure. Figure 2 shows the percentage of active managers who outperform their benchmark materially increases with the size of the market drawdown, while a lower percentage outperform when returns are rising materially (Figure 2).

Figure 1: More active managers outperform when markets are sluggish



* S&P 500 prior to 2000 and S&P 1500 after.
Source: John Bogle, SPIVA, Morgan Stanley, 1832 Asset Management L.P.

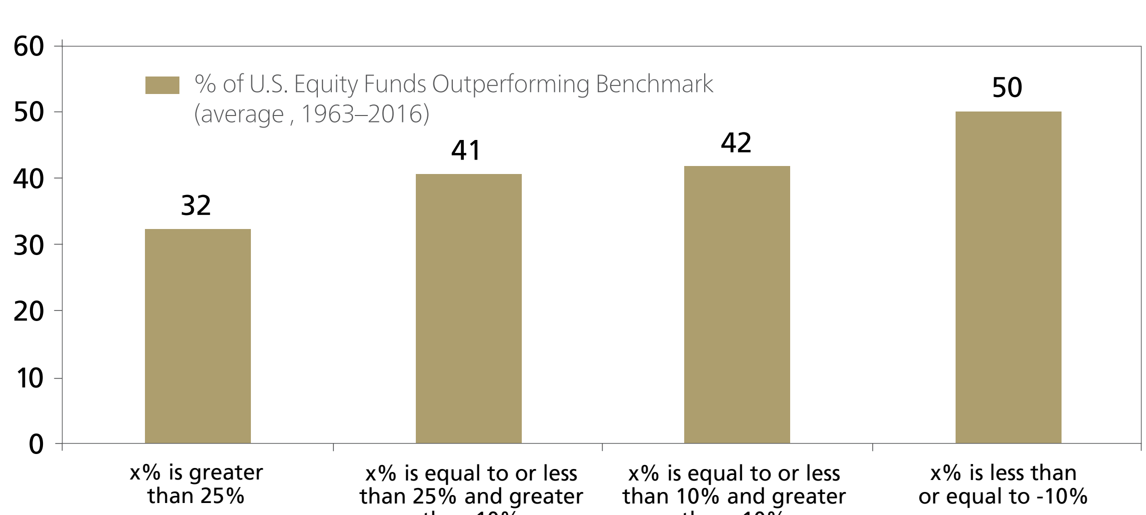
Based on S&P 500 Index daily performance (1928- 2016), data has shown that most U.S. market drawdowns have been small (less than 7%), but every once in a while—usually in concert with an economic and earnings recession—they become very large. The past two U.S. recession-related equity market drawdowns were the 49% slide into the 2002 low and the 57% meltdown on the back of the 2007–09 financial crisis. Cash, options, futures and other investment tools are often employed by active managers to soften the blow.

One does not have to be a market doomsayer to support the merits of an actively managed mandate. Falling correlations between securities, diversity in investment segments (i.e. small-cap vs. large-cap), and increasing performance differentials between the best and worst performing stocks generally creates more opportunity and distortions which a skilled investment manager can take advantage of. Imagine, for instance, how difficult it was for a Canadian equity manager to outperform the S&P/TSX Composite Index back when Nortel represented more than 30% of the index. Prudence alone would not have allowed anywhere near a 30% position in a single name. While Nortel offers an extreme example, in more general terms we find that active managers tend to be biased towards companies that are smaller than the average capitalization weighting in their respective benchmark. This is not surprising because the largest stocks are often the most crowded, overanalyzed, or expensive stocks in the market—places where active managers are unlikely to have an edge.

The bottom line

To be successful, investment managers must possess the skill to identify excellent investment opportunities, the judgement to choose prudently among those opportunities and the ability to implement ideas with few obstacles. Some of the more important contributions by active managers have been their ability to navigate challenging investment landscapes while offering a differentiated return stream relative to a cap-weighted benchmark. Given enough time, these contributions can make a critical difference in the long-term success of a diversified portfolio.

Figure 2: Adding more value when selling pressure is heavy



x = Annual S&P 500 Index Returns
Source: John Bogle, SPIVA, Morgan Stanley, 1832 Asset Management L.P.

Scotia Wealth Management™

Enriched Thinking®

Understanding the difference: time-weighted vs. money-weighted rates of return

Investment Solutions, The Bank of Nova Scotia

Many investors use asset performance to track their investments but there are a number of ways to calculate a portfolio's rate of return.

While the standard in performance reporting was traditionally a time-weighted calculation, as part of the new Client Relationship Model II (CRM2) financial industry regulations, investors now receive an annual report that includes a rate of return determined using a money-weighted calculation.

Although both methods are accurate and correct, each calculation can produce distinct results. It is important that investors know the difference to have a more thorough understanding of how these two calculations may affect their portfolio strategy and goals.

Time-weighted rate of return (TWRR)

TWRR eliminates the effect of cash flows into or out of a portfolio. It's ideal for comparing the performance of portfolio managers and measuring them against a benchmark. However, a shortcoming of using TWRR is that it is generally impossible for individual investors to calculate on their own. They would need to know the value of their portfolio on each day a cash flow occurred and remove it—information that's not typically readily available. It can also be argued a TWRR calculation is not the most appropriate performance methodology to individual investors because the timing of cash flows can have a big impact on personal rates of return.

Money-weighted rate of return (MWRR)

MWRR, for its part, does not eliminate the effect of contributions and withdrawals. On the contrary, it specifically adjusts for them. Therefore, it can differ substantially from the time-weighted rate of return when cash flows occur during the same period being measured. MWRR is ideal when investors add or withdraw funds from their portfolio right before a large move in the market. In this case, MWRR better reflects the investor's personal investment experience. Nevertheless, a shortcoming of MWRR is that it is highly dependent on the timing of cash flows. For example, MWRR is not ideal for comparing and benchmarking portfolio managers or investment strategies, as a lump-sum contribution or withdrawal can cause the portfolio's MWRR to outperform or underperform its benchmark, which could be misleading.

How actions matter

To illustrate how an investor's actions can affect a portfolio's return, we produced the table below illustrating what happens when contributions, withdrawals or no action is taken within a portfolio over the course of a year. Each portfolio began the year at the same value, held identical holdings and earned the same rate of return over a 12-month time frame. The only difference between the three scenarios was the investor's cash flow activity. The differences are striking.

TWRR and MWRR both offer valuable insight to investors. While time-weighted return calculations are useful for assessing the performance of your investment managers relative to each other or market benchmarks, money-weighted calculations can help assess personal performance relative to individual financial plans and goals.

	SCENARIO 1	SCENARIO 2	SCENARIO 3
Portfolio Value *(as of January 1)*	$1,000,000	$1,000,000	$1,000,000
Market Activity ↓3% *(January 1 to September 5)*	$970,000	$970,000	$970,000
Investor Cash Flow Activity *(September 5)*	$150,000	$(150,000)	No action taken
Portfolio Value *(as of September 5)*	$1,120,000	$820,000	$970,000
Market Activity ↑10% *(September 6 to December 31)*	$1,232,000	$902,000	$1,067,000
TIME-WEIGHTED RATE OF RETURN	6.70%	6.70%	6.70%
MONEY-WEIGHTED RATE OF RETURN	7.83%	5.46%	6.70%
Results	Cash flow decisions led to a positive impact on performance. The investor in this scenario made a large contribution right before a positive period.	Cash flow decisions led to a negative impact on performance. The investor in this scenario made a large redemption after a decline in the market and needed to sell investments at a lower price.	This investor did not make any contributions or withdrawals so their decisions did not impact performance. As a result, both return figures are identical.

Enriched Thinking® at work

The Bank of Nova Scotia

Age: 75 years old

Family: 2 grown children, widowed

Business: Retired

Lifestage key need: Wealth preservation and legacy planning

After building a successful professional career and raising two adult children with her husband, Peter, Sonia continues an active lifestyle in retirement. She spends her time between her home in Calgary and her vacation home in Los Cabos, Mexico.

As Sonia enters a new chapter of her life without her husband, who recently passed away from dementia, Sonia focuses on preserving her wealth, Peter's legacy and the family's future in every way possible.

For over 20 years, Sonia and Peter worked together with their Wealth Advisor to build and manage their wealth. Today, Sonia and her relationship manager have a new plan in place that provides thoughtful advice for all her deepest concerns:

< Wealth preservation strategies

< Estate, trust and legacy planning

< Support for the administration of day-to-day financial affairs

< Incapacity planning

How we structured Sonia's wealth

Sonia's relationship manager worked closely with her and introduced her to our specialists: an Estate and Trust Consultant, a financial planning expert and insurance specialist to review her financial plan and her estate and trust needs. Together, they implemented key ideas to address all of her concerns.

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Enriched Thinking... cont'd

Investment management services

After reviewing her situation with her relationship manager, Sonia continues with a discretionary investment portfolio. Handing over this discretion allows Sonia to spend more of her time with family and abroad with peace of mind, knowing her advisor is managing day-to-day investment decisions in accordance with the guidelines and goals they established together.

Estate and legacy planning

The Estate and Trust Consultant on the Scotia Wealth Management team met with Sonia to review her Will and Powers of Attorney to ensure they continue to reflect her current wishes, and that her assets are properly managed and transferred if she becomes incapable during her life and upon her death. Her Estate and Trust Consultant also recommended that she have a separate Will in Mexico to facilitate the timely transfer of her property located there when the time comes. To relieve her children of the burden of responsibility that comes with being Executor and Power of Attorney at a very difficult time, Sonia decided to appoint Scotiatrust as her Corporate Executor and Attorney for Property. Now her children need not worry about the time, work and complexity involved in administering their mother's estate and finances.

Wealth preservation and incapacity planning

Working with the Scotia Wealth Management team, Sonia was able to establish an alter ego trust. This will allow her to reduce future probate costs and to transfer much of her wealth privately and tax-efficiently to her children upon her death from the trust while taking care of all her financial needs during her lifetime.

In naming Scotiatrust her co-trustee, Sonia also ensures that the ongoing management of the trust will not become an administrative burden to her while traveling or to her family in the event she becomes incapable during her lifetime.

Support for administration of day-to-day financial affairs

Having recently managed the details of her family's financial affairs during her husband's illness, Sonia prefers to have the administrative side of her financial affairs taken care of by Scotiatrust through a Personal Office account. Personal Office provides day-to-day management of finances and financial reporting for clients. Sonia worked with her Scotia Wealth Management team to set up Personal Office, giving her peace of mind that all of the details of her day-to-day financial affairs will be smoothly, securely and efficiently handled by her Scotia Wealth Management team. With Personal Office, Sonia will no longer spend time or worry about collecting all of her pension and investment income, charitable donations, handling her tax preparation and monthly bills. This solution gives her professional support and provides her with a convenient, detailed, consolidated monthly report that complements her discretionary investment portfolio.

Philanthropic planning

It was important to Sonia for her to preserve her husband's legacy and to give charitably. Working with her Wealth Advisor and a Scotiatrust philanthropic expert they developed a strategy using the Aqueduct Foundation to establish a tax-efficient, personal charitable foundation in memory of her husband. Using Aqueduct allowed Sonia to create a personalized foundation with practical administration and flexible gifting options. Sonia was able to fund the foundation by converting a portion of her RRIF each year to a non-registered portfolio using her charitable foundation and significantly reduce her tax burden. More importantly, Sonia created a lasting legacy for her husband through the foundation that is personalized in name and purpose, which their children can give to now, and carry on after her death to preserve their parents' memory.

Insurance planning

As part of her estate planning process, Sonia's Scotia Wealth Management insurance consultant developed a personalized insurance strategy so that her estate meets her tax liabilities at the time of her death, thereby preserving the overall estate value she leaves to her family. Knowing that Sonia gifted her vacation home to one of her children in her Will and that she wanted to make sure her other child receives an equal benefit after her death, the team structured insurance for her now so that at the time of her death, the proceeds would be used to even out the estate gifts between her children, preserving family harmony.

Contact a Scotia Wealth Management professional to learn more on how these services can be customized for your financial goals.

Each year, the ***ScotiaMcLeod Charitable Foundation*** encourages and rewards community engagement through our ***Share the Wealth*** program. Together with our clients, we're immensely proud of our advisors' volunteering and fundraising efforts which raised ***over $800,000*** this year.

At Scotia Wealth Management, we believe strongly in enriching the places where we work, live and play. ***Because when communities prosper, we all do.***

How to determine the value of a business

Business and Family Advisory Services, Scotia Capital Inc.

Determining a value for the shares you own in a public company is simple—the stock is listed on an exchange (like the TSX) at a price which reflects the current market value of that individual share at that point in time. Arriving at a value for your private company shares however, is much more complex.

Why do you need an accurate value?

A valuation of the shares (or assets) of a privately held business may be required for a variety of reasons aside from an impending sale. Such reasons might include: debt or equity financing or re-financing, corporate reorganizations, tax and estate compliance or planning (e.g. estate freezes, final returns on death), and personal or business disputes.

Arriving at an estimated value for private company shares is not an exact science; it involves both mathematical analysis and the application of professional judgment. Despite this, the estimated value is required to be "reasonably" accurate according to the Canada Revenue Agency (CRA).

Common approaches to valuing a business

There are several ways to value a business. Each method uses different financial information and assumptions and hence leads to different values. The valuator will typically select a single approach after analyzing the financial performance and understanding the operations of the business.

Asset-based techniques

Asset based approaches determine a business' value based on the market value of all its net assets (total assets less total liabilities).

1. The *adjusted book value method* adjusts the net worth or equity of the business as shown on the financial statements to market value. Book to market adjustments are made to assets and liabilities including investment portfolios, equipment and real estate. Market value determinations for equipment and real estate are determined by management or a qualified appraiser. The valuator may account for certain costs, such as trapped in corporate tax. This technique is used for investment holding companies. It is also used in valuing operating business where the earnings are not generating a sufficient return on the invested capital (asset base). That is, for companies where there is no commercial goodwill.

2. The *liquidation value method* determines the value of the shares as the net proceeds to equity holders after a liquidation of the company's assets, and satisfaction of claims on those assets by creditors (including tax authorities) and higher ranking share classes. This method is typically only employed if the business is not a going concern.

Earnings and cash flow-based techniques

Earnings and cash flow approaches determine a business' value based on an ongoing anticipated stream of future earnings or cash flows.

1. The *capitalized earnings or capitalized flow approaches* apply a multiple to expected cash flow/earnings to arrive at business enterprise value. This methodology is used when valuing operating companies where forecast future cash flows are not available or not reliable. The selected estimate of maintainable earnings/cash flow are based on analysis of current and historic financial results and are normalized to adjust the amounts shown in the financial statements to results that

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Value of a business...cont'd

can be expected by a notional purchaser of the business. The business valuator applies a "capitalization rate" or "multiple" to this single period earnings/cash flow amount to arrive at business value. The capitalization multiple is selected based on a variety of inputs and considerations, the most impactful of which are the risks associated with the cash flows/earnings and the growth potential for future period results.

2. The *discounted cash flow method* determines the value of a business by taking forecast future cash flows and applying a "discount rate" that reflects the return an acquirer would accept to compensate them for the risk associated with the forecast cash flows. Unlike other methods, this particular technique takes into consideration the unsteady pattern of revenue and cash flow over a period of time and is particularly useful for companies where historic earnings are not indicative of expected future performance.

Market-based techniques

Applying a market approach involves using benchmark data (typically public company trading or public/private transaction data) to establish a value for the business. For private companies the most commonly applied market approach attempts to establish a range in the value of the business by comparing it to similar businesses within your industry that have recently sold. Of course, this method is reliable only if there are a sufficient number of similar businesses within the same industry that have sold and reported the sale data.

Other considerations that impact business value

The values arrived at using earnings/cash flow techniques may be adjusted by the valuator to account for items such as one-time significant planned capital expenditures, as well as assets which are redundant to the core operations (real estate, personal vehicles, marketable securities) and apply reductions for items like shortfalls in working capital.

Fair market value vs. price

The business value arrived at using the above referenced techniques is prepared in the context of a notional (hypothetical) transaction. Actual value (price) received in a transaction will often differ from fair market value for a number of reasons, including strategic (synergistic) buyers and a competitive sale auction process as well as forced sales and imbalance of negotiating skills on the seller's side.

Who can provide a formal business valuation?

The Canadian Institute of Chartered Business Valuators (CICBV) is the only professional body that is recognized by Canadian courts to provide formal valuations. Its designated professional members have either the CBV (Chartered Business Valuator) or EEE (Expert en évaluation d'entreprises) designation and must meet the requirements of the CICBV. Valuations by these certified professionals give credibility to the process undertaken and the actual value that is established.

Conclusion

Whether you are considering a sale, re-financing, or just looking for some guidance, determining a value for your business is not an easy task. For further information and guidance, please contact your Scotia Wealth Management Advisor.

Celebrating Canada's rich history

The Bank of Nova Scotia

CANADA 150

2017 marks the sesquicentennial (150-year) anniversary of the confederation of Canada. From the signing of the British North America Act to the final game played by #99 Wayne Gretzky, the last 150 years has seen Canada not only persevere but also prosper through good times and bad, while—as a nation—staying true to who we are and where we came from.

What follows is a highlight from confederation onwards of some of the most significant social, economic, political and territorial events in Canadian history over the past 150 years.

1867 British North America Act divides the Province of Canada into Ontario and Quebec, joining them with New Brunswick and Nova Scotia to create the Dominion of Canada (confederation).

1870 Manitoba enters confederation.

1871 British Columbia enters confederation.

1873 Prince Edward Island enters confederation.

1885 Canadian Pacific Railroad completed, becomes longest in world.

1905 Alberta and Saskatchewan enter confederation.

1910 Royal Canadian Navy founded.

1914 Canada enters World War I.

1918 Women gain the right to vote.

1920 Canada is admitted into League of Nations, result is de facto independence.

1931 Canada attains legal independence due to Statute of Westminster.

1939 Canada declares war on Germany, enters World War II.

1945 Canada joins United Nations.

1949 Newfoundland and Labrador enter confederation.

1960 First Nations people are granted right to vote without losing status.

1967 Expo 67 opens Centennial anniversary.

1981 First Shuttle Remote Manipulator System, also known as Canadarm, goes to orbit aboard Space Shuttle Columbia.

1982 Canada signs Constitution Act, attains total independence from Great Britain. It also includes Charter of Rights and Freedoms.

1984 Marc Garneau is first Canadian in space.

1989 One dollar bills replaced by iconic loonie.

1992 Roberta Bondar becomes first Canadian woman in space.

1994 North America Free Trade Act (NAFTA) enacted.

1999 #99 Wayne Gretzky plays final game in New York.

2005 Civil Marriages Act legalizes same-sex marriage.

2016 Canada becomes a signatory to Paris Agreement.

2017 Happy 150th Birthday, Canada!

Scotia Wealth Management™