Halton Hills WEEKEND

Money Matters.....

Think again before abandoning mutual funds

By BRETT WORBY

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Tempted to abandon mutual funds for the seemingly greener pastures of GICs? Think again. Over the past 17 years, or about four full market cycles, mutual funds have outperformed GICs.

By how much is revealed in the brand new Equion All-Fund Index. It's a composite of all mutual funds in Canada, weighted by each fund's size. Dating back to Jan. 1, 1977, the index reveals that mutual funds have enjoyed, on average a 2.6 point a year advantage over GICs. Since 1977 funds as a whole are up a cool 3 per cent compounded annually vs only 10.7 per cent for five-year GICs.

In dollar terms, that translates into a dramatic difference over time of $2,700 on a $1,000 initial investment thanks to the magic of compounding. A $1,000 investment in the All-Fund Index at its inception would have grown to about $8,300 by December 94, compared with only $5,560 for the average five year GIC. Updated weekly, the index level is reported in dollars to represent the value today of a $1,000 total investment in all mutual funds in Canada at the start of 1977.

From the index's 17-year history, investors can glean three important lessons. The first is that mutual funds collectively deliver excellent value. They not only do better than GICs, they also beat out the TSE 300 stock index including dividends, and clobbered inflation. Not just over some lucky period when things were going well, but over a long time. Through periods of inflation, deflation, war, recession, referendums, 20 per cent interest rates and boom times.

The second key point: a balanced portfolio is the best way to go for long-term conservative investors, offering the best blend of risk and return. The All-Fund Index is representative of such a portfolio because it's made up of all funds — some equity, some bond, some resource, some international. (The index excludes money market funds, because they're just another way of holding cash).

International equity funds have been the best place to be. A $1,000 investment in 1977 is now worthy some $13,000. But that came with more risk. Specifically, they were about as volatile as the Canadian stock market and about twice as volatile as Canadian bonds.

A balanced portfolio, however, manages to capture much of the extra return offered by equities without much of the risk. Magic? Nope, just plain math. Because some asset classes zig when others zag, balanced investors enjoy a smoother ride.

As the All-Fund Index proves, investors who diversify earn higher returns, with lower risk. The index has a standard deviation of 2.6, about a third less risky than say, the TSE 300 total return index, but it shows a higher rate of return the TSE. (Standard deviation is a widely used measure of risk.)

The third lesson of the All-Funds Index's 17-years history: don't time the market. Even during the severe recession of 1980-82, contrary to what you might expect with the benefit of hindsight, the All-Fund Index did well. It rose 35 per cent over that three-year period.

Instead of moving in and out of the market, hang in and put the market to work for you; the All-Fund Index has made money in 15 of the past 17 years, and beaten five-year GICs in 10 years out of 17.

These types of results aren't an exaggeration of the merits of mutual funds. If anything, the Equion All-Fund Index is a conservative growth yardstick. Because it includes all funds, it's a reasonable indicator of how much you should be able to make without taking big risks, picking strong-performing funds or adding value in any other way.

The index's makeup avoids some other biases, such as survivorship bias, which happens when poorly performing funds out of business. So you look at the worst balanced fund over 10 years and see that it's up 6 per cent annually.

The fact is, bad funds did exist. But they've been folded, or merged with another fund. When that happens: poof! The poor record vanishes as the merged fund adopts the record of the better fund. The All-Fund Index includes those poor funds, thus avoiding the upward bias of the monthly fund averages.

An index composed of every fund also avoids other selection biases. It doesn't just pick the good performers, or restrict itself to the big funds, which tend to do a little better than the overall fund universe.

In short, the All-Fund Index provides a snapshot of the big picture, something that investors often lose sight of. Especially at difficult times like now.

Which brings us to the looming question of how to invest your RRSP. Lately it seems like mutual funds just go down. After all, 1994 was a dog year, with pretty well everything doing poorly. And with five-year GICs now offering 8.5 per cent or so, mutual funds may seem like a poor deal. It's no wonder that many observers have been predicting a massive inflow of new RRSP dollars into GICs this season.

What you should do? My advice: Take a little risk because it's the only way your money will really grow above the ravages of inflation. Besides, if you're a long-term investor, it doesn't matter if your portfolio's value fluctuates somewhat. The end result is what really counts.

Brett Worby is a financial planner at Money Concepts in Georgetown.

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