Structured for long-term investment success

Have you ever wondered what it takes for an investment management firm to be successful? You're not alone, because a great deal of research has been conducted on this very question. This research finds that there are some very specific structural and investment approach attributes that successful investment firms have in common. Here is a checklist of those key attributes to help you determine if your fund companies are structured to succeed.

STRUCTURAL ATTRIBUTES

1. Investment led

Several well-known mutual fund firms spend more on marketing expenses than all the other costs of managing your money[i]. *(Source: Investor's Dilemma, Louis Lowenstein)*

> The focus of sales and marketing-led firms is asset gathering and creating products that will sell. This results in a supermarket selection of funds for every taste, some of which are not in the best interest of investors. In contrast, investment-led firms are guided by professionals who have a background in investing, not sales and marketing. This fosters a supportive organization that focuses on long-term returns rather than short-term sales targets. It's important to partner with investment-led firms because they base decisions on what's in the best interest of investors. While most firms ask "will it sell?" investment-led firms ask "should we be selling it?" Investment firms run by investment professionals – it just makes sense.

2. Privately held

Employee-owned firms have a better chance of avoiding the pressure that leads other firms to focus on increasing assets rather than managing money.[ii] (*Source: Barclays Wealth white paper: The Science and Art of Manager Selection)*

> Publicly traded fund companies have to balance the needs of the investor with the demands of the shareholder, and these inevitably clash. If we simplify the demands of the shareholder, it would be maximizing shareholder profits. This is achieved by having high assets and charging high management fees. Neither of these is good for the investor. EdgePoint is a private company owned and operated by employees. With no shareholders to answer to, we are able to align our interests with those of our investors to create what we believe is a mutually beneficial relationship.

3. Size matters

A fund's performance is inversely correlated with its assets under management.[iii] (*Source: Does fund size erode mutual fund performance white paper by Chen, Hong, Huang and Kubik)*

> While greater assets benefit the fund company, this is less positive for investors. The smaller the fund, the more flexibility it has to buy a substantial stake in smaller companies, which can often be more attractive than larger ones. Our Portfolios remain flexible in size which allows us to make meaningful investments in our best ideas. Choose a quality investment firm that knows how to manage growth while remaining flexible.

4. Experience

Funds managed by experienced fund managers outperform by 1.5% per quarter[iv]. *(Source: The value of experience for mutual fund managers white paper by Kempf, Manconi, Spalt, 2013)*

> If experience didn't matter, we would all be market-made millionaires, but we aren't. We know that experience matters because it gives managers the discipline, skill and

experience needed to filter out the market noise. Our investment management team of five has a cumulative experience of 76 years. More importantly though, we don't just hire portfolio managers, we hire owners, and we believe owners don't leave. So that 76 years of experience we just talked about, it isn't going anywhere.

5. Co-investment – eat your own cooking

Managers who have a minimum of $1 million in the funds they manage outperform the majority of their peers over a five-year time frame[v]. Out of the 7,700 funds tracked by Morningstar, nearly half are run by managers who don't have a single penny in their own funds[vi]. *(Source: Morningstar Research Inc. and U.S. Securities and Exchange Commission)*

If you're at a dinner party and notice the host hasn't eaten any of the food, you'd probably be a little wary of trying it yourself. With the same logic, you probably shouldn't trust a fund manager with your personal savings if they don't have the confidence to invest their own money in the same products. Managers who do create a community of shared interests and mutual goals with their investors. EdgePoint internal partners have some $78 million invested in their own investment products, for many of us, the lion's share of our investable assets. To learn more about our thoughts on co-investment, read: Invested interest.

INVESTMENT APPROACH ATTRIBUTES

6. Collection of your best ideas

Funds that concentrate their holdings in their best ideas outperform the market by 4 to 10% annually[vii]. *(Source: "Best Ideas" white paper by Randolph Cohen, Christopher Polk and Bernhard Silli)*

A concentrated fund is made up of a relatively small number of businesses which reflect the high conviction ideas of portfolio managers. These ideas are developed through exhaustive research to build in-depth, company-specific knowledge and expertise. In addition, concentrated funds outperform without added risk because the benefits of diversification weaken significantly as you increase the number of holdings.[viii] The average U.S. equity fund holds around 160 stocks[ix]. In contrast, EdgePoint Portfolios are concentrated on a few, well-researched ideas which allow our managers to move beyond familiarity to expertise.

7. It pays to be active

Funds with the highest active share outperformed their index by 3.64%[x] annually. *(Source: The Mutual Fund Industry Worldwide white paper by Cremers, Ferreira, Matos, Starks April 2011)*

Active share	Annualized out/under performance (after fees)
Less than 60%	-0.13%
60-90%	1.63%
Over 90%	3.64%

Active share: *the percentage of a fund's holdings that differ from the benchmark index.*

Paying for active management doesn't make sense if your fund just mimics the index. Unfortunately for investors, there are a lot of closet indexers out there charging management fees for active management but in fact look a lot like the index.

Active share	Definition
0 – 20%	Pure indexing[xi]
40% – 60%	Closet indexers
80% – 100%	Truly active

Are you getting what you pay for? Active fund managers' investment decisions are based on specialized analysis and typically overlap little with the benchmark index. Today, active managers comprise only 20% of mutual fund assets compared to about 60% in the 1980's[xii]. And the growth of closet indexers has increased from almost 0% to 50%. EdgePoint Canadian Portfolio's active share is 84% and EdgePoint Global Portfolio's is 98%.[xiii] We're always told to be more active, it's a shame more people don't do it.

8. Low turnover

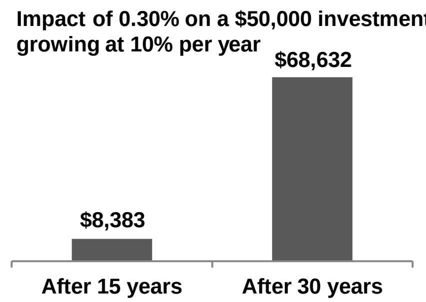
Underperforming funds are more likely to have higher portfolio turnover[xiv]. *(Source: Interaction between mutual fund performance and portfolio turnover white paper by Ching Wu, 2014)*

> How often your fund turns over its holdings each year speaks volumes about the investment professionals managing your money. Funds with low turnover are managed by people with conviction in the businesses they buy and a temperament to cope with market swings. With a long-term outlook and commitment to staying the course, their investment approach is about buying businesses rather than renting stocks. The industry average holding period is approximately 1.4 years[xv]. EdgePoint's investment horizon is typically 3 to 5 years. Stick with a firm where their managers think and act like business owners.

9. The lower the fees, the higher the returns

Fees are unavoidable, but you need to pay attention to them because they eat away at your investment savings. *(Source: Check your fund company's website)*

Here are two fees that you, as an investor, should be concerned about - MERs and TERs.



The MER (management expense ratio) is what you pay each year to own a fund, whether it makes or loses money. The chart[xvi] highlights the impact 0.30% has on an investment growing at 10% per year. On average, our MERs are approximately 21% below our competitors.[xvii]

A lesser known cost, the TER (trading expense ratio), is the cost associated with buying and selling investments inside your fund. A portfolio manager with a long-term investment strategy will have lower turnover which helps keep TERs low. At EdgePoint, TERs are on average 0.05%. Compare that to a cross section of the largest fund companies who have an average TER of 0.16%.[xviii]

What you initially thought was pocket change can add up to substantial savings in the long run. Can't get enough of MERs, check out: [The big deal about smaller MERs.]

10. Investing based on business values, not computer algorithms

Funds focused on stock selection had better returns than those that made market timing calls. These calls are not rewarded in the market and actually tend to destroy value for fund investors. *(Source: How active is your fund manager? White paper by Cremers, Petajisto,2006; Investor's Dilemma by Louis Lowenstein)*

> Cremer's research and Lowenstein's book emphasize the idea that fund companies should be focused primarily on investing. Specifically, bottom-up stock selection based on fundamental analysis. No market timing. No black-box, mechanical investment strategy based on formulas alone. You want a fund company that views stocks as ownership interests in businesses.

Resources:

[i] The Investor's Dilemma, Louis Lowenstein
[ii] The Science And Art of Manager Selection, March 2012 Barclays White Paper
[iii] Does fund size erode mutual fund performance White Paper by Chen, Hong, Huang and Kubik
[iv] *Source: The value of experience for mutual fund managers White Paper by Kempf, Manconi, Spalt, 2013*
[v] Morningstar Research Inc. "Want Fund Managers on Your Side? Pick Those That Walk the Line" January 2011
[vi] U.S Securities and Exchange Commission (SEC) with data aggregated by Morningstar's FundSpy tool.
[vii] "Best Ideas" Randolph Cohen, Christopher Polk and Bernhard Silli http://personal.lse.ac.uk/polk/research/bestideas.pdf
[viii] How many stocks make a diversified portfolio? White Paper by Meir Statman, Journal of Financial and Quantitative Analysis
[ix] Independent Investor Institute https://educatedtrader.com/monthly_reports, March 2013
[x] The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees, and Performance, Cremers, Ferreira, Matos, Starks, April 2011
[xi] Active share statistics from "*How Active is Your Fund Manager?*" Cremers & Petajisto (Yale School of Management, 2007).
[xii] Active Share and Mutual Fund Performance by Antti Petajisto, December 15, 2010
[xiii] As at June 30, 2014
[xiv] Interaction between mutual fund performance and portfolio turnover by Ching Wu, 2014
[xv] Industry turnover rate source: Morningstar database US
[xvi] Returns show the effect of compounded growth and aren't intended to reflect the future returns of any EdgePoint investment product.
[xvii] Source: PalTrak, As at December 31, 2013. Category average is MERs of actively managed deemed competitor funds in relevant categories.
[xviii] Average of EdgePoint's four funds. Industry TER: Fund Company Reports, Hollis Wealth – James Gauthier. More than 200 funds were analyzed with an average TER of 0.16%. Most of the $300-million plus funds from 16 of Canada's biggest load fund companies were considered as at July 2014.

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