

Notes

Nexus Investment Management Inc.
Portfolio Management & Financial Counsel

Inside Articles

THE VUVUZELA AND OTHER DISTRACTIONS

RISK VERSUS RETURN

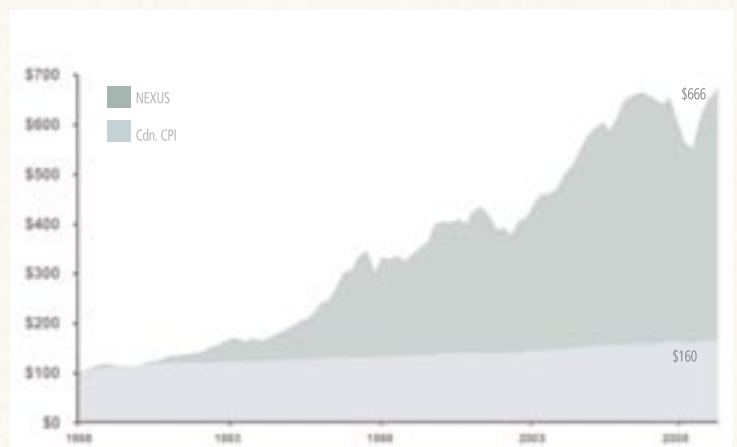
THE LIFE BALANCE SHEET

PEARLS OF WISDOM

Building Value for Clients

Since its establishment in 1988, Nexus has pursued an investment approach which concentrates on real growth in client wealth over the long term. The chart illustrates the impact of this long-term investment thinking – a \$100 investment in a balanced portfolio in 1989 has grown to \$666 at March 31, 2010.

\$100 Investment with Nexus in 1989



The Vuvuzela and Other Distractions

June means summer is upon us but, for soccer lovers, June 2010 also means World Cup season. Every soccer fan is out and about supporting their teams with enthusiasm. There is much going on in the city this summer. Not only do we have the hoopla around the G20 and the sudden deluge of construction around the city, but there is also the Shriners' Parade, Caribana and the Beaches Jazz Festival, to name a few.

Despite all this activity, I am not sure even a vuvuzela can truly distract from the undercurrent of worrisome news in the world at large. The financial stability of the global markets remains precarious and it's not just the economic news that is worrying. There is the oil spill in the Gulf, the standoff between North Korea and South Korea and the continued problems in the middle east – the list goes on.

How does one relax and enjoy the World Cup and other summer festivities without worrying about the economy, one's portfolio and these troubling times? Understanding your financial circumstances and having a plan in place will allow you to worry less and enjoy the summer more. Nearly every Canadian felt the impact of the financial crisis over the past two years. However the severity of the damage was different for everyone. Some portfolios were just bruised while others suffered permanent damage. Now is the time to review your financial plan, update your will and review your insurance coverage so that when the next market downturn hits, you won't be apt to panic.

Planning is not meant to focus on the short-term. It is meant to provide a framework to understand objectives, analyze your current situation, identify barriers and explore options to achieve your objectives. The key to any solid plan is to ensure the underlying assumptions are realistic. Realism is a function of the various vulnerabilities in the financial plan. Vulnerabilities fall into two categories: those within an individual's control and those outside their control. The former includes lifestyle costs, asset mix and the management of assets - factors that are different for everyone and reflect choice. The latter includes inflation, investment returns and, of course, changes in government policy affecting pensions and tax rates. These are the factors that we have to try and forecast.

In this issue of Nexus Notes, we examine two topics related to these vulnerabilities. The first article looks at the concept of a life balance sheet as a way to help with financial decisions. The second article examines the volatility of investment returns and how this relates to risk.



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Risk versus Return

Risk and return are the “yin and yang” of the investing world. Everyone understands that they go together. And investors recognize that with higher return comes higher risk.

But after paying lip service to these two “truths”, most people are captivated by the more attractive and accessible of these two - return - and give little further thought to risk. After all, return is what an investor is really after, and information about historical returns is widely available. Risk, on the other hand, isn't something most of us go looking for, and it's not quite as easy to gauge.

Nevertheless, risk mustn't be ignored. It is, in essence, the price an investor “pays” in exchange for return. In the same way that the price of a good or service is a key factor when deciding whether to buy, so must risk be taken into consideration when pursuing investment returns.

But what is “risk”? In simple, qualitative terms, we think of risk for Nexus clients as the chance that they may not achieve their financial objectives: the likelihood that they live longer than their money, or that they will not be able to afford to do the things that they had been planning to do. This definition, while appealing in its simplicity, is unsatisfyingly vague.

A more quantitative measure of investment risk is the degree of variability – or volatility – of future rates of return. Consider two investments. The exact return on each of them is uncertain. Both are *expected* to earn a return of 5% in total over the course of a year. But the return on the first one is anticipated to vary between 3% and 7%, while the return on the second could vary between a 10% loss and a 20% gain. Neither one is “risk free”, as it is possible for each to fail to live up to the 5% “expected” rate of return. But, clearly, the second investment is the riskier one because of its much greater range of possible outcomes.

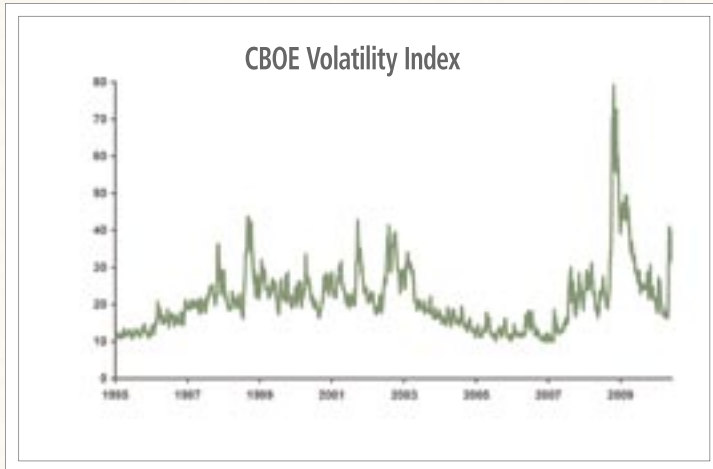
This simplistic example illustrates a few important things about risk. First, every investment has some degree of risk. While cash hidden under a mattress appears to be “risk free” over short periods of time, over the longer term there is a very real risk that the hidden cash won't buy as much in the future as it does today.

Second, there is uncertainty about both the *level* of future returns and the degree of *variability* of those returns. Today, investors may anticipate that a portfolio will generate returns over the next 5 years that range between 4% and 8% annually, with a “best guess” or “expected” rate of return of 6% on average each year. But it may turn out that not only is the return different than expected, but the ups and downs in between are much greater than originally envisioned.

Third, risk, being a measure of uncertainty, is necessarily a forward-looking concept. How an investment has performed in the past – both its rate of return and the variability of that return from one period to another – is interesting, and perhaps provides a clue about the future. But it's almost guaranteed that the future will be different than the past, and possibly *very* different.

Fortunately, there are some forward-looking indicators that signal how uncertain the markets are about the future. The most widely followed such indicator is the “VIX”, often referred to as the “fear index”. VIX is the symbol for the Chicago Board Options Exchange Volatility Index, which is a measure of the implied volatility of index options on the Standard & Poors 500 Index. What's important for our purposes is that it is a distilled measure of the *anticipated* variability of future returns of a broad equity market index. Simplistically, the higher the level of the VIX, the more uncertain are market participants as a whole about the future rate of return on the S&P 500 – the more investors collectively fear or worry about the future. This can be seen in the graph.

Risk versus return cont.'d



You can see the dramatic “spike” in volatility in late 2008 when anxiety about a possible financial collapse was at its peak, followed by the powerful calming effect thereafter of the coordinated rescue efforts by central banks around the globe. Similarly, the growing complacency from the beginning of 2003 until late 2006 is also quite visible. Today, the index is at an elevated level – in the mid-30s – consistent with current worries about weak government finances - especially in Europe - and the resulting potential for an economic setback.

If risk is an unavoidable companion of investment return, then the portfolio manager’s challenge becomes one of managing and minimizing that risk. One of the primary tools for dealing with portfolio risk is diversification.

However, it is not enough to diversify simply by holding lots of different stocks, or, in the extreme, building a portfolio of index funds from various countries around the globe. First of all, the stock markets in the major countries move, if not in lockstep, then in a much more synchronized way compared to 10 or 20 years ago, such that losses in one national market are much less likely to be offset by gains in another. Second, many of the major stock market indices are not themselves well diversified. For example, nearly 75% of the S&P/TSX Composite Index in Canada is comprised of companies in just three sectors - financial services, materials, and energy.

Rather, effective diversification to reduce risk in a portfolio is a multi-dimensional undertaking. An intelligently diversified portfolio will not be inappropriately exposed to weakness in a particular asset class, to adverse economic performance in one geographic region, to regulatory developments or commodity price weakness that cuts

across an entire industry, or to a damaging setback at an individual company. The objective is to have a portfolio that is exposed to only as much risk as its owner/beneficiary can tolerate, and that earns a return which is at least commensurate with that level of risk. This is the approach at Nexus.

HOW HAVE WE FARED?

Does this approach to diversification actually reduce risk? Consider the Nexus North American Equity Fund. When looking at the Fund’s performance, we focus on long-term rates of return – over periods of 5 to 10 years. That tells us how “far” we’ve travelled. When assessing how “bumpy” the ride has been over those long-term periods (i.e., how risky the road travelled was), we look at how much the month-to-month returns have jumped around. We can compare both measures to the Fund’s benchmark, which is a blend of 50% of the return on the S&P/TSX Composite Index, 45% of the return on the S&P 500 Total Return Index (measured in Canadian dollars) and 5% of the return on the DEX 91 Day T-Bill Index.

Over the 10 years ended May 31st, 2010, the Fund’s month-to-month returns have been 20% less volatile than those of the benchmark. In other words, the Fund has been 20% less risky than its benchmark. Despite being *lower* risk, however, the Fund has produced significantly *higher* returns: 5.2% annually on average over that same 10 year period, as compared to 0.7% for the benchmark (in each case excluding management fees).

Results for the Nexus North American Balanced Fund have been very similar: 21% less volatile than its benchmark, while producing average annual returns of 6.1% versus 3.2% for its benchmark. The Nexus North American Income Fund, despite holding up to 20% of its portfolio in equities (which are riskier than bonds), has been 2% less volatile than its bond-only benchmark, and has produced benchmark-beating returns of 6.3% annually compared to 5.4% for its benchmark over the 7 year period ended May 31st.¹

With the usual caveat that there can be no assurance that future performance will be like the past, we can say that the Nexus strategy of keeping both return *and* risk in sharp focus has worked: risk has actually been lower, but without any commensurate sacrifice in return.



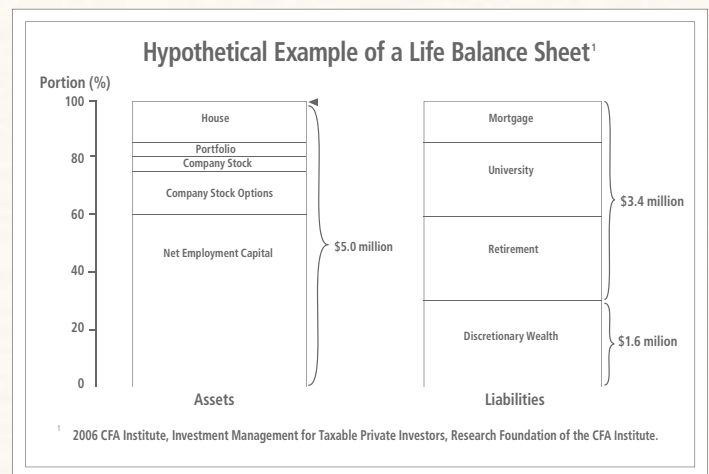
¹ The Income Fund does not have 10-year performance numbers as it was only established in September, 2002.

The Life Balance Sheet

I recently attended a conference put on by the CFA Institute on wealth management. One of the topics that particularly resonated with me was the idea of including human capital on the balance sheet. Human capital represents an individual's earning power at a point in time.

The idea is that human capital is created throughout one's career, 'liquidated' over time to meet that individual's financial needs and converted into financial capital. Understanding its value provides an individual with a more comprehensive assessment of their financial circumstances and it is an important factor in making financial decisions. It helps an individual assess savings and consumption requirements over their life cycle, make better investment choices and determine insurance needs.

Consider a total "wealth equation" where economic wealth equals financial capital plus human capital. Human capital for most people is their largest and most valuable asset. This is obviously true for the recent university graduate in their 20's but it can also be true while you are in your 30's, 40's and 50's, too – when earning power is the greatest. Most people first spend time paying off their life liabilities – like a mortgage or children's education. Then they start accumulating financial capital for retirement. In the life balance sheet to the right, we can see that total potential lifetime assets equals lifetime liabilities. If you have a clear idea of your human capital value then it is easier to see how best to allocate resources. Including human capital on the balance sheet helps address three key areas.



The first benefit to including human capital on the balance sheet is that it acts as a guide to choosing an appropriate level of consumption. The lifetime consumption model says that people consider both current assets and future earnings in order to smooth lifetime consumption. An individual who expects future earnings to increase considerably will likely consume more today. It also helps individuals identify a level of consumption that can be maintained for the foreseeable future and therefore avoid overspending today.

Second, understanding the value of human capital for an individual is important in determining optimal asset allocation. If an individual's career has a high level of job

The Life Balance Sheet cont.'d

insecurity, they have a short career life or their compensation is undiversified because a large portion is tied to company stock, there are risks to the value of that individual's human capital. Therefore, their financial capital should be invested in such a way to take into account these risks. This individual might want a conservative portfolio with fewer stocks and more bonds because they can not afford to suffer a significant loss in the financial part of their wealth equation. In contrast, an individual with a high level of human capital that is considered secure can afford to take more risk with their financial investments. If the investments perform poorly, then the losses are less significant relative to one's life assets. In addition, that individual has the ability to offset losses by either working harder, working longer or spending less. The value of human capital and equity allocation are directly related.

Third, human capital provides a basis for hedging and insurance strategies. A more comprehensive balance sheet helps a client see the approximate financial loss that can be suffered if he or she dies or becomes disabled. This doesn't mean that one should purchase insurance based on the value of their human capital. A needs approach is preferable for determining the appropriate amount of insurance. The benefit is that an individual can see how their financial picture can change if there isn't a hedge against the human capital part of the equation.

The biggest challenge about including human capital in the balance sheet is how to value it. It is actually similar to valuing a stock. Basically, expected future cash flows (employment income, after-tax) are discounted to the

present. The present value of these cash flows can change significantly based on modest changes to the discount rate and the projected growth rate of future earnings. The value is also impacted by the individual's health, age, job security, mortality rate and household consumption. While different financial planners might calculate different values for an individual's human capital, each approach could be well justified based on the assumptions used. While the forecast may not be precise, the value of undertaking the exercise and learning the effect of different assumptions encourages the thoughtful consideration of the material contingencies that can occur over one's lifetime.



Pearls of Wisdom

Reading is one of the principal occupations in our profession. As the group of us digest a wide range of material, interesting ideas and surprising facts – some serious and some light-hearted – rise to the surface. We attempt to share a few of those with you in each of our issues of Nexus Notes.



- At a time when world economies are drowning in debt, the European Union has declared that vacations and tourism is a human right and that governments should subsidize vacations for those who cannot afford them. Antonio Tajani, EU Commissioner for Enterprise & Industry recently declared: “Travelling for tourism today is a right. The way we spend our holidays is a formidable indicator of our quality of life.” Under his plan there would be special subsidies for young people, the disabled and the elderly. (*Forbes*, June 7, 2010).
- For those who are confident the U.S. is on the road to recovery, Barron’s suggests a sobering read of a recent piece by David Rosenberg. Rosenberg points out the following inconvenient facts: One in every 10 Americans missed a mortgage payment in the first quarter of 2010 – a new record. One in 10 American’s credit-card debt is being written off – also a new record. One in six Americans is either unemployed or underemployed. Over four in 10 of those jobless Americans have been out of work for at least six months, and there are five unemployed workers competing for every job opening. One in four Americans with a mortgage has negative equity in his or her home. Only one in 50 Americans plans to buy a home in the next six months. Finally, only one in eight Americans feels the current government policy is actually helping the economy. (*Barron’s*, May 24, 2010).
- When one looks around the world at precarious levels of sovereign debt, one is struck by the relative strength of our federal government’s balance sheet. As well, our banks have withstood the credit crisis better than banks in just about every other nation. However, we may not yet be out of the woods. A new survey ranks Canada as having the highest ratio of consumer debt to total financial assets. Over the past year and a half, consumers in many countries around the world re-trenched, while Canadian consumers have kept spending. Much of this debt has been in the form of mortgages, as our housing market has remained incredibly resilient through the downturn. However, this is not the only area in which consumer debt has expanded. In 2009, 75 cents of every dollar spent on cars was borrowed. This is up from 39 cents in 1999. Bank of Canada Governor, Mark Carney, has been warning everyone who will listen about the risks our country faces from the rapidly escalating consumer debt. (*The Financial Post*, May 12, 2010).
- A survey by Investors Group revealed that 60% of Canadian parents aged 43 to 63 helped their adult children financially. The average amount of this help was \$3,675 per year. Help was also provided in ways outside the simple transfer of money. The survey described parents in a number of different ways. “The Venture Capitalist” – 44% invested capital in their children (i.e., paying for post-secondary education) to get their children to the next stage (or first?) of self sufficiency. “The Service Provider” – 70% assisted children by providing babysitting services, home maintenance and repairs. “The Funding Agency” – 22% provided lodging and/or financial relief to adult children with insufficient funds. “The Universal Coverage Provider” – 10% were providing support both for their own parents and for adult children. (*CA Magazine*, April 2010).
- Wealthy western countries are at the forefront of the revolution in technology. Or are they? In a recent report by Accenture, it was determined that consumers in emerging markets are twice as likely to purchase and use consumer technology in the next year. In the past year, emerging market consumers were more than twice as likely as those in developed countries to have bought a smartphone or computer, or connected on social networks. (*CA Magazine*, April 2010).



NEXUS

Portfolio Management & Financial Counsel

Nexus Investment Management Inc. provides discretionary investment management and financial counselling services to private clients, trusts, estates and foundations.

- Exceptional client service and objective advice:** tailored to the client's individual needs.
- Superior investment performance¹:** long-term record of superior after-tax returns and capital preservation.
- Disciplined investment approach:** "Growth at a Reasonable Price" philosophy, using research and patience.
- Alignment with clients' interests:** as the Firm is wholly owned by its principals, we are committed to your financial success.
- Cost-effective management:** our services are accessible directly, without the costs of branding and distribution.

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¹ A composite of Nexus accounts, managed to a balanced mandate, has earned 6.9% per annum, pre-fees for 10 years. A composite of notional returns from a weighted average of the following indices: T-Bill (5%), Bonds (35%), TSX (35%) and S&P 500 (25%) earned a return of 3.3 % over the same period.