Liberty International Investment Management
111 Peter Street, Suite 621 Toronto, ON M5V 2H1
o: 416-304-9510 f: 416-304-9900
toll-free: 1-844-304-9510
www.libertyiim.com

20 Questions To Ask An Investment Advisor

The most daunting task for an investor is finding the right advisor who can fulfill all their needs.

Some of the keys would be to find someone who is a good personality fit, has high moral standards, who will always work in your best interests and who can provide the long-term returns that will let you live a comfortable lifestyle that takes you to the finish line (death).

Beyond those keys, there are more things to glean when interviewing advisors, or even discussing with your current advisor.

Here's a list of 20 questions (in no particular order) that should be asked during every interview. Hopefully, it will help you make the best choice.

1. How long have they been in the industry?

The longer the advisor has been in the industry, the better experienced they are to handle the difficult times. Anyone under the age of 35 (born in 1980), probably has not experienced the difficult periods of the last 3 bear markets (the 2000 tech crash, the 2001 terrorist attacks and the 2008 financial crisis).

2. What are their qualifications? Are they an actual registered portfolio manager or just a bona fide sales representative?

There's a pecking order in the industry based on qualifications and experience that determine what the advisor may offer you.

A stockbroker may have their CSC (Canadian Securities Course) but this is a very basic qualification, based on a 6-month program and one exam. Stockbrokers new to the industry may only sell mutual funds, GICs or money market products before they move up the ranks to offer instruments such as individual stocks and bonds.

A financial planner may hold the PFP (Personal Financial Planner) or CFP (Certified Financial Planner) designations (two six-hour exams) and be registered to sell mutual funds or exchange-traded funds (ETFs). Their focus is more on retirement planning and taxation and not toward actual individual investments such as stocks and bonds.

A portfolio manager would hold the highest of designations with either the CIM (Chartered Investment Manager) and/or the CFA (Chartered Financial Analyst). These exams are more focused on actual investments and portfolio management. The CFA program is a series of 3 exams of 6 hours in length. Some have referred to it as similar to a Master's Degree in Finance. They also

© 2016 LIBERTY INTERNATIONAL INVESTMENT MANAGEMENT INC – VOLUME 2 NEWSLETTER 1

need up to four years work experience as an associate portfolio manager before applying to become a portfolio manager.

Portfolio managers would be at the top of the pecking order as they make all the decisions regarding an investor's plan and their goals. They also need to be fluent in tax and retirement planning. Portfolio managers are registered through a provincial securities commission.

3. What types of investments does the advisor offer?

Mutual funds and ETFs would be sold by stockbrokers and financial planners. They tend to have the highest fees and investors need to be aware of all the charges involved with owning mutual funds.

Pooled funds may be sold by investment counselling firms. They are similar to mutual funds as the tax efficiency is weak but the fees may be lower. Many investment counselling firms may offer a few different types of pooled funds based on different investment models (i.e. all-Canadian, all-US or all-international).

Other investment counselling firms may offer customized portfolios which are more tax efficient because they are built for one person or family, not for the masses. The portfolio manager (or their sales rep) would sit down with the prospective investor and create a portfolio just for them, built to achieve the investor's goals and needs.

4. What's your investment style or philosophy?

There are many types of investment styles and philosophies and they should fit your personality. Some examples might include:

- Value investing or bottom-up investing where earnings or discounted cash flows determine the "value" in a stock and is the reason for owning it.
- "Top-down" investing where investments are made based on macro-economic events. This could also involve advisors rotating sectors based on these events.
- Quantitative analysis that only considers financial statement metrics but no intangibles are considered (such as pricing power, goodwill, management's abilities, competition, etc.).
- Technical analysis whereby stocks are traded based on technical charts.

5. What has the performance been like after all fees have been paid? What has the performance been during the worst years? How has performance compared to the benchmark?

It's one thing to be shown a chart of performance numbers. It's quite another to be able to reference it to the fund or portfolio to measure if it has outperformed the market consistently over time. That's why benchmarks are necessary. That way, an investor can compare performance on an apples-to-apples basis.

© 2016 LIBERTY INTERNATIONAL INVESTMENT MANAGEMENT INC – VOLUME 2 NEWSLETTER 1

For example, if a portfolio is fully invested in just the Canadian stock market, then the benchmark index would be the S&P/TSX Index.

Observing one, three five and ten-year returns are important so investors can see not only how the manager performed during the bad years but also when all the performance occurred. Perhaps one of the funds made big returns while it was small and gathering new injections of capital. But it may get to a certain size where the performance returns weaken because the fund is more correlated to the market.

When considering performance during the worst years, it's important not only to compare the fund performance versus the benchmark in that particular year but also to determine how long it took to make the money back.

In 2008, the stock markets were down 35% to 40%. For most mutual funds, it took 5 years to get back to break-even.

Or, consider below the returns of two hypothetical funds (A & B):

Year	Fund A return	Fund B return
2008	-30%	-45%
2009	+10%	+30%
2010	+15%	+10%
2011	-5%	-10%
2012	+15%	+20%
2013	+15%	+20%
2014	+10%	+15%
2015	+10%	-5%

Now, take $1 in 2008 and calculate the returns. At the end of 2015, Fund A (a more consistent performer) was worth $1.34. It took Fund A five years to make back the original $1 investment.
Fund B was worth $1.11. It, too, took five years to make back the original $1 investment but despite the higher annual single-years returns, the performance of Fund B was hurt by three bad down years. That's why investing is about avoiding the big loss, not about the big returns in the good years.

6. What's the Alpha of the fund/portfolio?

Alpha is the performance of a fund over and above the benchmark returns. Generally, if a portfolio manager can beat the benchmark by 2% annually (after fees), then they're deemed to be a good performer. Compounded over 20 years, a 2% outperformance on $1 million invested is an extra $400,000 in return.

More importantly, creating alpha during the down years is the true test of a portfolio manager. In this context, if the index fell 10% but the fund only fell 7%, the difference of 3% is the alpha. For example, say a manager was 20% cash in 2008 and the other 80% was invested in stocks. The cash

© 2016 LIBERTY INTERNATIONAL INVESTMENT MANAGEMENT INC – VOLUME 2 NEWSLETTER 1

portion would be considered a "synthetic short" as the money was not invested in the stock market. The net "long" position would be 60% (80% invested less 20% cash).

In 2008, if the market fell 40%, the above portfolio would be down 24%, a difference of 16 percentage points of alpha earned by the portfolio manager. What's important here is that if they made 30% in 2009 (some did), they'd be back to break even in one year, not five years. That's the importance of alpha and protecting the downside.

7. What are the risk-adjusted returns?

Risk-adjusted returns are also important for investors to understand. Finance specialists rely on 3 different ratios to judge performance: The Sharpe Ratio, the Treynor Ratio and Jensen's alpha (discussed in Question 6).

The Sharpe ratio is a measure of stock performance. It measures the reward per unit of risk. By definition, it is the ratio of an asset's excess return compared to its volatility. In other words, for every dollar of risk incurred, what dollar amount of reward is earned? A number greater than one should be achieved.

The Treynor ratio measures the performance of an asset compared to a risk-free asset (typically Treasury bills). The higher is the Treynor ratio, the better is the performance of the portfolio.

8. How is the advisor managing the risk in client portfolios? Are they making similar mistakes as outlined below?

It's not just do-it-yourself investors who make the common mistakes below; some advisors do, too.

- ***"Diworsification"*** is a term used to describe a portfolio that has too many stocks in it – no more than 30 should suffice.

  That's because if an investor owns 100 names with an average 1% portfolio weight, and one of the stocks doubles or triples, it won't have any material impact on performance. The bet size isn't big enough.

- ***High turnover*** - If the advisor trades too much and gives away too much money in the form of costs from commissions, bid/offer spreads and taxes, the returns will suffer.

- ***Quality of company*** - If the portfolio quality is sacrificed for owning "flavour-of-the-day" stocks that are always in the news (Valeant Pharmaceutical's extreme rise and fall is one example), returns could suffer.

- ***There's no international exposure*** – Long-term evidence has shown that international returns add an extra 2% compounded annually compared to just North American investments.

9. Is the portfolio re-balanced? How often is it done? What conditions apply that cause portfolio re-balancing?

Over a 10-20 year time frame, portfolio re-balancing may enhance long-term returns by about 2% a year. If an investor has a 30-stock portfolio, the average weighting should be 3%. When a stock becomes 6% or more of that portfolio, half the position should be sold and the proceeds allocated to those stocks that make up less than a 3% weight.

10. How correlated is the portfolio?

There are two types of risk: Systematic risk and Non-Systematic risk.

Systematic risk is the risk of being in the market (stocks, bonds, real estate, commodities, etc.) and exposed to macro-economic events. The only way it can be reduced is to keep all your money under your mattress and own a gun (or keep it in a panic room or vault).

Non-systematic risk is unique risk. This risk can be reduced through prudent diversification by having investments in different countries, different industries and by owning different sizes of companies where the blue chips offer steady income and the smaller ones provide capital appreciation.

11. What is the portfolio's turnover rate?

In 2010, the average turnover rate of Canadian equity mutual funds was 120%, meaning that by October of that year, every stock in the portfolio had been bought and sold. For the investor, this led to poorer performance and higher capital gain taxes payable.

The higher the turnover rate, the higher the costs and, therefore, the lower the returns. This question will quickly differentiate a firm or advisor's investment philosophy from other companies.

12. When do you sell a holding? What are the red flags that cause you to sell?

Advisors should be consistent with their answers. It will illustrate just how disciplined they are. The greater the discipline and pragmatism being shown, the better your chances to make money.

And if they're constantly selling stocks because of perceived red flags resulting in higher turnover, this could be an indication of poor judgement or a lack of due diligence when doing investment research.

13. What are the *overall* fees?

There will be a management fee to manage your portfolio but what other fees involve the day-to-day management of the portfolio? They may include:

- Management fees
- Performance fees

© 2016 LIBERTY INTERNATIONAL INVESTMENT MANAGEMENT INC – VOLUME 2 NEWSLETTER 1

- Custodial fees
- Trading commissions for each trade
- Foreign exchange commissions or spreads
- Soft dollar charges
- Hedging costs

Only when you consider the totals costs can you then begin to decipher what the overall management fee will be and how that will affect your performance over time. A 2% to 3% overall fee compounded over 20 years reduces your inherent gains by half.

For example, if you compound $100,000 over 20 years at 10% a year, you'll end up with $800,000. If the return is just 7% (10% return less a 3% fee), you'll end up with only $400,000. Half your gains will be lost to fees.

14. What's the dividend history of the stocks in the portfolio?

Companies that generate consistent free cash flow (money that's left over after all the bills are paid) have the capacity to raise their dividends each year. If the historical norm of dividend increases for the stock markets has been 6% to 8% annually, how does this compare with the dividend growth of the stocks in the advisor's portfolio?

What is the dividend payout ratio compared to a firm's free cash flow? For example, if one-third of the free cash flow is paid out in dividends, this leaves plenty of room for further dividend increases.

This is important as dividends make up roughly two-thirds of all investment returns and it goes a long way to determine if retirees can live off the income without having to eat into the capital to make ends meet. Given that people are living longer and the money has to last longer, this is an important discussion point with the advisor.

15. What's the biggest investment loss or experience the firm or advisor has had during their career? What did they learn from this experience?

The more honest and candid they are, the better that trust can be built between the client and the advisor. Nobody is perfect. Everyone has made mistakes during their careers. If they say they've never lost money, they're lying.

Even Warren Buffett has lost money on investments. To paraphrase one of his favourite adages, "I love airlines but I lost all my money in US Air. Now, when I get the compunction to buy an airline stock, I have to pick up the phone and say, "Hello, my name is Warren and I'm an air-aholic. Please stop me from buying an airline stock."

16. What happens if the advisor gets hit by a bus? Who will then look after your money?

It's important to learn what the advisor's career plans are, when they plan to retire and what their succession plan is if they do get hit by the proverbial bus.

© 2016 LIBERTY INTERNATIONAL INVESTMENT MANAGEMENT INC – VOLUME 2 NEWSLETTER 1

17. Are you interested in my kids' or grandkids' accounts?

Many advisors have little or no desire to look after legacy accounts (kids and grandkids). That's because by the time the legacy group has money to invest, the advisor may be close to retirement and, naturally, they'll never make any money off these investments. Also, the accounts tend to be smaller and too time consuming to manage.

A good advisor would deem the legacy accounts important for these reasons:

- It keeps family money in the advisor's hands for multiple generations.
- It gives the family peace of mind that their best interests are aligned with the advisor.
- It gives the advisor an opportunity to teach the kids and grandkids so they can learn to save and grow their money faster, reducing the needs of the parents to supplement the legacy lifestyle.

18. Is the advisor involved in soft dollar activities? What are they?

Soft dollars are a little-known phenomenon in the industry that lets the advisor/firm reduce costs or transfer some of the costs of the firm to the clients.

For example, a firm may get free investment research advice from an institutional broker in return for directing trades through that broker. Instead of a commission cost of 1 or 2 cents a share, the commission on the trade may be much higher, say 7 or 8 cents.

Or, a firm may take a spread when converting currencies. For example, an advisor buys a US stock for a client but has to convert Canadian dollars to US dollars to complete the purchase. Instead of booking the foreign exchange conversion at the spot rate, say $1.33, they may charge a spread of 25 basis points and charge the client $1.3325, with the spread going to the firm.

19. How many client complaints has the advisor had during their career? How did they handle the complaints? What resolutions did they provide?

Client complaints should be handled immediately and not allowed to fester. You can get a good idea of how client-centric the firm is when discussing client complaints. Is the relationship going to be firm first/ client second (the bad business model) or client first / firm second (the good business model)?

20. Is the firm independent or owned by a third party? What happens if they are acquired? How will the business be run? More importantly, will the client atmosphere change or stay the same?

If the firm's employees are equity partners, there's some reassurance that things should be run consistently and with a similar message.

© 2016 LIBERTY INTERNATIONAL INVESTMENT MANAGEMENT INC – VOLUME 2 NEWSLETTER 1

If a company is purchased by another firm, the philosophy may change and so may the products and advice being offered.

Always remember, it's your money, not theirs. They should be working for you and it should be a privilege for them to manage your wealth, not some God-given right to play with other people's money (known as OPM in the industry).

Final Thoughts:

If at any time during the interview you believe you are:

- Not getting a straight answer
- Not being asked about your circumstances and goals
- Not having your questions answered

Either make notes about their lack of openness and compare it against other interviewees, or just end the interview and walk away.

Remember, everybody on Bay Street and Wall Street can talk the talk but very few can walk the walk. Even fewer can do it with humility. It is the humble portfolio manager who you should hire to manage your money.

© 2016 LIBERTY INTERNATIONAL INVESTMENT MANAGEMENT INC – VOLUME 2 NEWSLETTER 1