ACTUARY MY DEAR I DON'T GIVE A DAMN.

This paper serves to bring focus to why and how the fund industry evolved to its current state, what investors are paying for and the potential solutions to these problems.

James Wanstall

Chief Executive Officer, BluMont Capital Corporation.

WHAT IS MONEY MANAGEMENT FOR?

As far as we are concerned the only job of managing individual wealth is to preserve and grow spending power for some date in the future. This date is often unknown and variable so managing risk is an essential part of the equation. The question then becomes what are the risks? From our perspective at BluMont, the primary risks are permanent loss of capital, interest rates, inflation and human emotion. Those are the risks that we try to manage.

You can manage the risk of loss through not overpaying and diversifying (not putting all your wealth in Nortel for example). You can manage interest rate risk through strategies that are positively linked to interest rate changes such as equity market neutral. You can manage inflation risk through owning infrastructure, commodities, i.e. real assets. Real return bonds categorically do not protect against real inflation these days and are possibly the most tragically mis-priced asset on the planet in our humble opinion! But the biggest risk is human emotion.

If we look at human emotion in investing, there are numerous issues that drive this, but the outcome is always a lack of discipline. How many investors sold bonds to buy more stocks at the end of 2008? Very few, even though this was and always will be the right thing to do.

How many investors would have sold a risk asset such as managed futures that is designed to pay off to maximum effect in times of stress such as 2008, to buy more stocks? A lot more.

How many investors would prefer an equity manager be allowed to raise cash and use other strategies such as short-selling and options to protect capital in a period like 2008? All of them from what we can tell.

DO INVESTORS GET WHAT THEY PAY FOR?

Oscar Wilde defined a cynic as someone that knew the price of everything but the value of nothing. This attitude would explain the surge of interest in Exchange Traded Funds (ETFs) as many investors have focused on cost as the issue. As evidence, see the plethora of commercials from ETF providers solely promoting their "lowest fees" and never discussing their net returns. It is hardly surprising that the Mutual Fund industry has created a lot of cynical current and former investors, but that does not mean that the original concepts behind active money management don't make sense.

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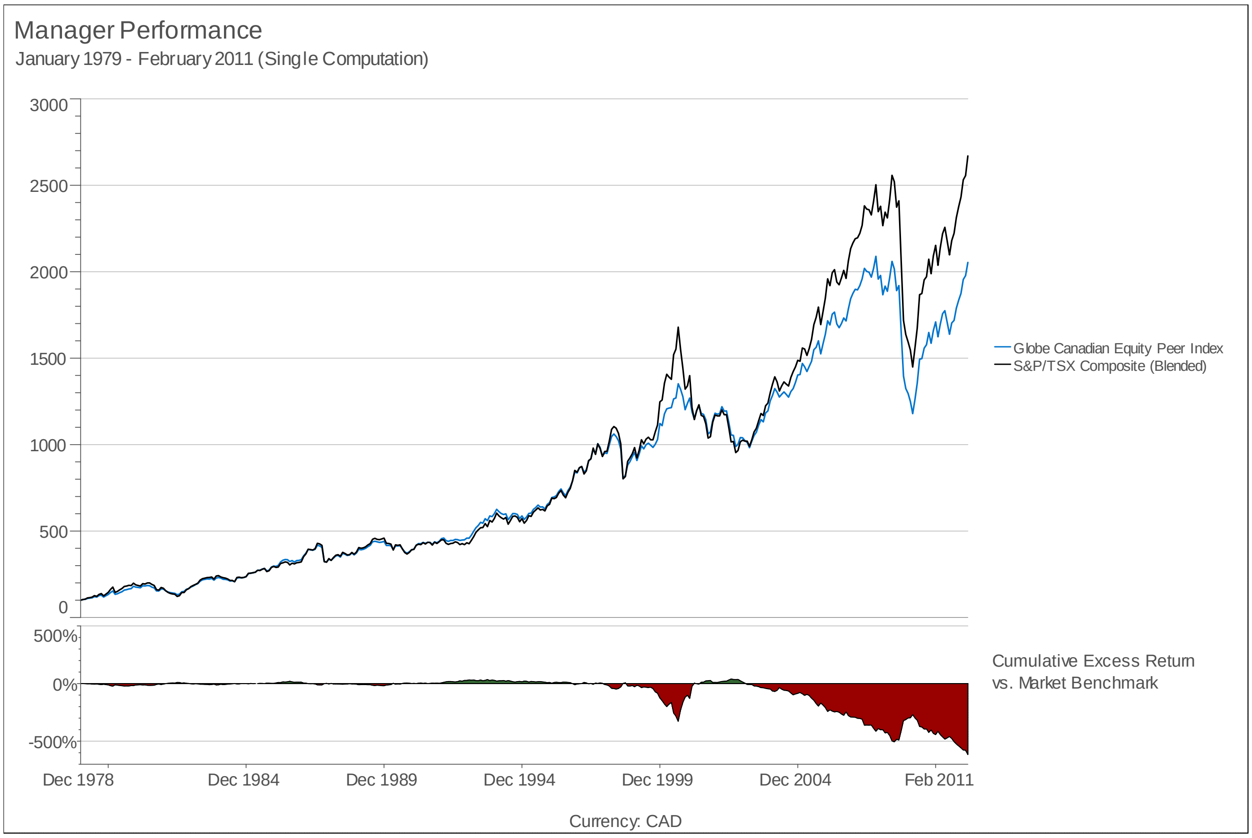
Can it really be true that professional money managers can't pick stocks any better than a monkey equipped with a dart? Think about it. The fund industry hires smart, driven people, gives them superb training and education and puts in place incentive schemes for performance. Their inability to perform makes no sense and in fact it's not true. Sir John Templeton said: "If you want to have better performance than the crowd, you must do things differently from the crowd." The real issue is that the average Mutual Fund has stopped doing things differently.

The industry has grown to the point of becoming a commodity. The industry is not growing overall but has rather become a business of growth at a competitor's expense. With that has come a win at no risk (to their business) rather than a win at all costs (again to their business) approach that has led to marginal differentiation – no-one is prepared to stand up and be counted.

It is not the absolute level of fees that Mutual Funds are charging that is the issue, it is what the investor is paying for that is the issue. Since 1980 the Globe Canadian Equity Peer Index (all the Canadian Equity Funds) has had a beta of 0.81 to the S&P/TSX. Beta is the measure of how much of the return has come from the underlying index.



This means that about 80% of the return has come from being exposed to the market. If you assume that you can replicate that exposure for 0.2% via an ETF then what are you paying 1.5% for?

BluMont Capital
70 University Avenue, Suite 1200 P.O. Box 16 Toronto, ON M5J 2M4 T: 416.216.3566 1.866.473.7376 F: 416.360.1102 blumontcapital.com

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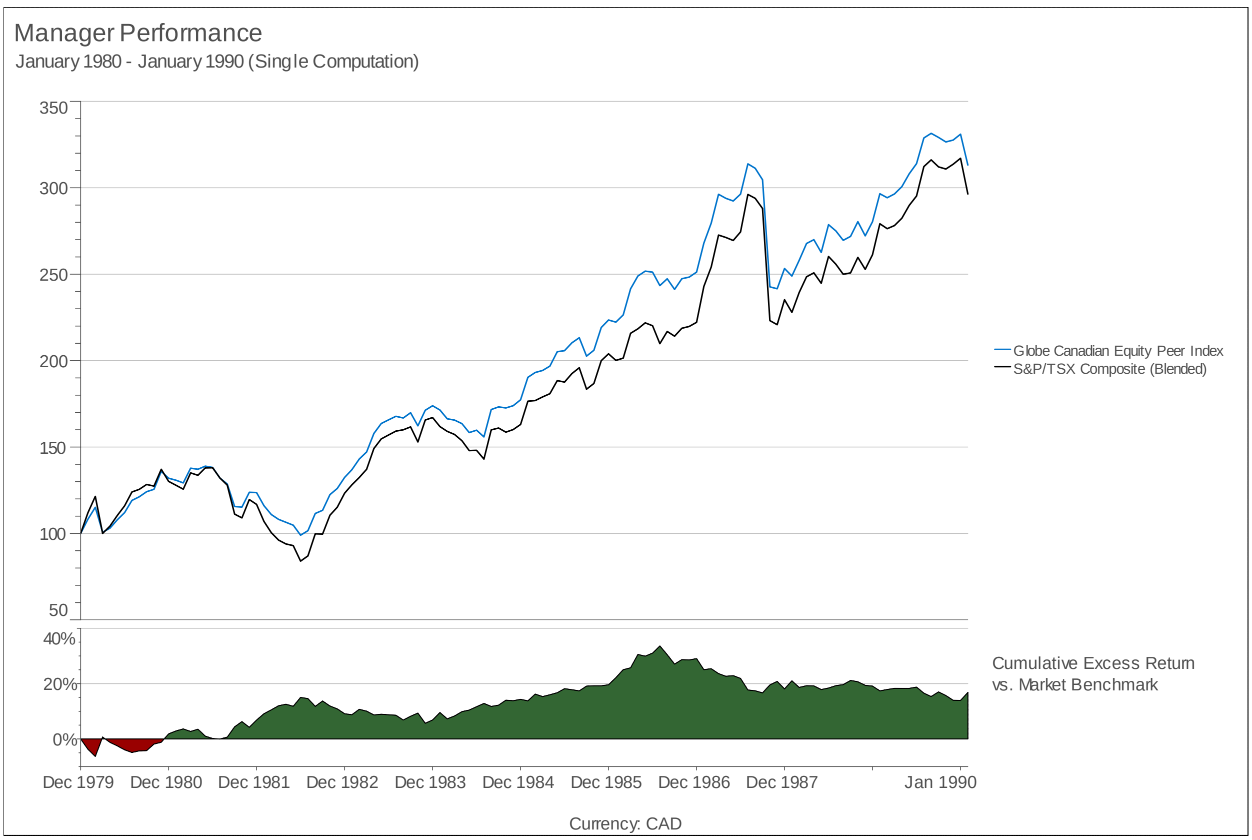
If you have $1,000 in a fund charging 1.5% or $15 per year and you can run $800 of it for 0.2% or $1.60, then you are paying $13.40 for $200 of active management – 6.7%! No wonder they don't perform, they are too timid and the best ideas get diluted. It really is time the fund industry put the active back in active management.

Unfortunately Mutual Funds will not take the risk of straying too far from the crowd as they have billions of dollars to manage that prohibit them from actively managing the money that is entrusted to them. Frankly, their investors have become victims of the industry's success, as a $5 billion Canadian equity fund is too big to be anything other than the market, and the fund has no incentive to change that while it earns 1.5% fees. Sadly, that fund and the $600 billion industry behind it needs to shrink dramatically in order to be incented to try to actively add value for its clients. Ironic that once the ETF industry has taken over the fund management industry, it will start to perform again isn't it? Reversion to the mean truly is a perverse and powerful force in money management!

WHAT HAPPENED?

Interestingly it wasn't always this way. In the 1980s Canadian Equity Fund Managers delivered 12.72% per annum with standard deviation of 14.66% versus the S&P/TSX at 12.23% and 18.39% respectively.



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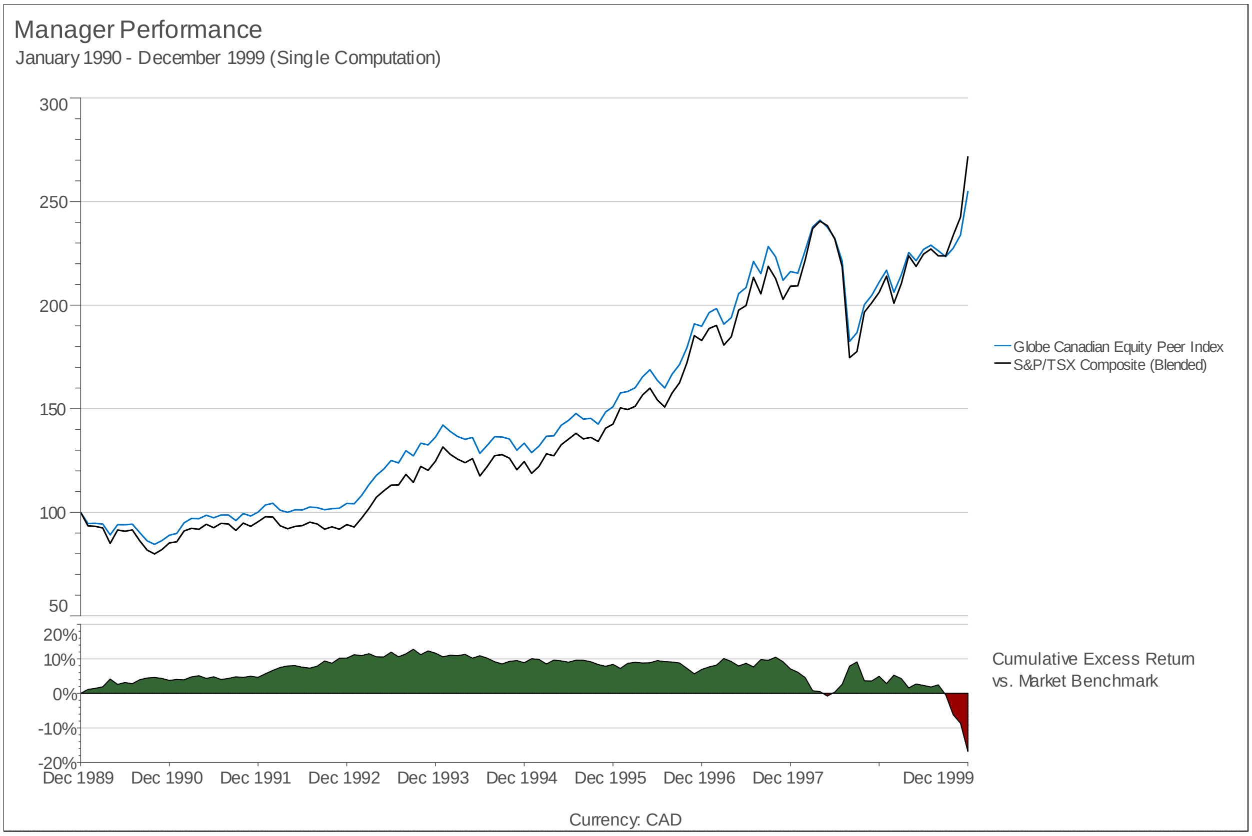
The average fund beat the market with less risk. These numbers do not account for the funds that did really poorly and folded (survivorship bias), but that makes little difference as by the end of the 80s the best managers survived and had the majority of the assets so surely this would continue in the 1990s.

No it didn't! It leveled off and started to deteriorate in the mid 1990s. The average manager delivered 9.81% versus 10.51% for the S&P/TSX with slightly lower standard deviation (12.05% vs. 14.65%).



They did worse than the market and didn't manage risk as well. What changed?

Bob Krembil stated: "Managers have all become closet indexers and not just in Canada. The whole industry has become about how far you are from the benchmarks under or overweight (certain sectors). It's a stupid way to run money." It wasn't always this way, but it started to dramatically change in the early 1990s thanks, ironically, to positive changes for some of the largest pension plans. The following excerpt from http://www.referenceforbusiness.com/history2/99/Ontario-Teachers-Pension-Plan.html gives a brief overview of those changes:

"A pension plan for Ontario teachers was created in 1917 and for the next 70-odd years acted as a government agency. As required by law, contributions from the teachers and matching funds from the government were put into nonnegotiable provincial bonds. The system came under stress in 1975, following the indexing of benefits to the cost of living. The level of government and teacher contributions

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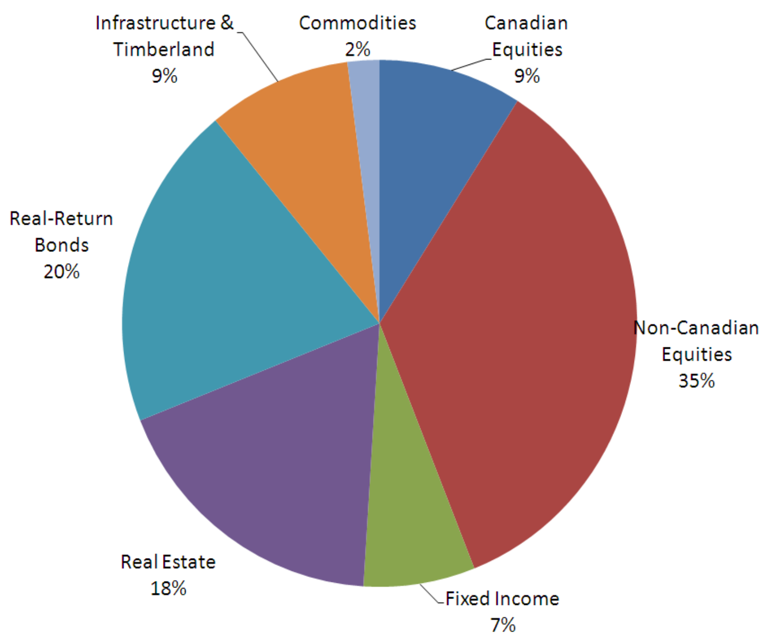
and rate of return on nonmarketable Ontario debentures could not keep pace with inflation. The plan was running a multibillion-dollar deficit by the end of the 1980s.

An outcry for change rose up, and a committee representing the province and the Ontario Teachers Federation was formed to address the problem. They determined the best route was to convert the plan to a nonprofit private corporation and allow for flexibility in its investment options. In addition, the government would boost its level of contributions to the reconstituted organization. The Ontario Teachers' Pension Plan Board was established on December 31, 1989, replacing the Ontario Teachers' Superannuation Fund."

This was great change for Ontario Teachers (OTPP), OMERs and the other huge pension funds, as it freed them to pursue more beneficial and sophisticated strategies. In fact OTPP has evolved over the past two decades to one of the most respected investors on the planet with an asset mix that looks nothing like the market.

Ontario Teachers Pension Plan (OTPP) Actual Asset Mix
(as of December 31, 2009)



What were less sophisticated trustees and investment committees to do? This was a significant problem as they were not equipped to make complex decisions. Thankfully, actuaries who just that morning had engaged their clients by looking at their shoes, arose en masse, mounted war horses, put on armour and became the shining white knights of investment consulting.

A new industry was born and the mutual fund industry rapidly followed. Former actuaries, now consultants started telling us that we should divide our equities into different style boxes, generally distinguished by growth, value and core on the "y axis" and large cap, midcap or small cap on the "x axis"—nine boxes in total. Then, for a fee, they would identify the "very best" manager in each box who had the potential to beat the specific index. Of course, if the manager didn't they would fire and replace them. This approach is flawed in both its underlying assumption—that having money in all of the boxes is the best way to beat the market—and its implementation— that the consultants are going to be able to identify the managers most likely to beat their assigned indexes.

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Starting with the wisdom of allocating assets to all the style boxes, Craig Callahan and C. Thomas Howard published a study in 2005 that looked at the characteristics of stocks held by some of the most successful long-term investors. They concluded that the one common denominator of successful long-term investors is that the companies they own did not conveniently fit in one style box, and that had they been constrained to a single style box as many institutional managers are today, returns would have suffered by 300 basis points annually over long periods of time.

Randolph B. Cohen of MIT's Sloan school of finance has published numerous studies of what maximizes manager performance and how to select those managers. He has found that some of the critical factors are better fee structures, concentration, illiquid or inefficient markets and staying within capacity. Very few fund companies pay attention to these factors, let alone embrace them.

As to the ability of consultants to consistently identify managers who are able to outperform their "style box benchmark", even if the end game was to find nine managers who beat their style-box benchmarks, this approach has failed in the past and will likely continue to fail. If consultants had been successful in identifying such managers, their lists of recommended managers would presumably be similar to their lists five years ago. But if you were to ask your current consulting (or wealth management) firm if you could see its list of recommended managers from five years ago, you'd be lucky if 20% of the names were the same (many having likely turned over multiple times since then).

Not only does this categorically not work for pension funds, it is a nightmare for individual investors. Individual investors are not pension funds – they have a limited time horizon and do not have constant funding obligations. In fact at the points when adding new money makes most sense (end of 2008) the average investor cannot, emotionally or financially.

At the end of the day most investors would like alternatives to the roller coaster ride of long-only, constrained investing if they were readily available and helped to smooth the ride. Just don't count on the largest groups in the mutual fund industry to go there any time soon as their business models just aren't designed to allow that. It really is a shame.

It comes down to a few fund managers who are prepared to constrain the size of their funds, align their fees with investors and march to the beat of the drum of real investor risk to try to make a difference. We are proud to count BluMont among that group.

James Wanstall
Chief Executive Officer, BluMont Capital.

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