

The Emperor's New Clothes

Northern Trust Global Advisors

The wealth market faces increasing competition and declining product differentiation. The wealth industry is responding to these emerging trends with “new” and “unique” investment vehicles promising enhanced features, lower risk and low correlation to traditional stocks and bonds. The quest for something “new” and “unique” is driving investment strategies, service delivery models and new asset classes.

The one thing these opportunities have in common are layers upon layers of complexity - challenging investors to exercise additional due diligence. While some of these “new” opportunities are revolutionary, others are simply old ideas repackaged into a different layer of clothes. Linked notes, private placements, income trusts and structured products are all examples of investment opportunities promising something new and exciting while delivering higher returns. Exercising due diligence and asking the right questions is the only way of evaluating “the emperor’s new clothes”.

It is important to acknowledge that new opportunities, platforms and investment vehicles are constantly appearing. Some even change the investment landscape. The impact of the Internet as a delivery vehicle for investment platforms, and the impact retail hedge funds on asset allocation, are just two examples of how our environment has changed. At the same time, new ideas, new vehicles and new platforms also expose us to the unfamiliar. It is easy to feel overwhelmed listening to the “experts”. In those situations we face a critical fork in the road. We can either ask questions at the risk of feeling awkward, or we can follow the herd. Historical examples of herd mentality plague the investment industry. Remember the gold-rush? Or the more recent tech boom and subsequent bust? Or perhaps a U.S. example such as Long-Term Capital Management’s collapse will illustrate the ease in which we become trapped in the euphoria of “the latest thing”. However, as opportunities become more complex, the danger of lack of due diligence grows. What might be a recognizable warning signal in context of the familiar can easily be overlooked when buried underneath a new investment platform, delivery vehicle or investment structure.

Exercising due diligence and asking the right questions is the only way of evaluating “the emperor’s new clothes”. ... What might be a recognizable warning signal in context of the familiar can easily be overlooked when buried underneath a new investment platform, delivery vehicle or investment structure.

The following are some key points to consider when evaluating new ideas:

1) Selling the sizzle or the steak?

Ensure you understand the fundamental nature, characteristics and risk of the underlying investment. Do not become distracted by “packaging” (capital guarantees, glossy marketing material etc).

2) What are the basic characteristics of the investment?

It is easy to get distracted by features, especially if the product promises tax efficiency, regular income distribution or some other desirable attribute. But the risks associated with a product are tied to its basic characteristics. Does it represent an equity or debt interest in something tangible? How stable is that interest? How reliable is the underlying asset? What recourse is available to you if things go wrong?



3) How suitable is the strategy?

If you don't clearly understand the strategy and process behind the investment vehicle you cannot gauge whether it is suitable for you. Warren Buffet once stated that "he would never invest in something that he did not understand". Throughout his business activities, it would seem that Buffet remained true to this principle.

4) What are the primary risks?

Under what conditions will the product underperform? Every strategy has downside risk. If you don't clearly understand the risks you need to ask more questions.

5) Who are the people?

Who are the individuals that are managing your money? What is their education and experience? Is the firm that they work for a credible, reputable organization? Are the individuals stable and cohesive, invested emotionally and financially in the success of the firm? Is the firm independent, answering only to its clients, or is it part of a larger conglomerate?

Most of the financial debacles of preceding years have been due to an entity or individual getting into trouble and trying to correct and/or cover up the problem. If you have doubts about the reputation, presence, ethics and quality of the personnel, talk to their competitors.

6) Process


Ensure there is some credible and repeatable process for adding value to your portfolio. That is the difference between an investment and a gamble. Investment is a process leading to a well-diversified portfolio, gambling relies on luck.

Do your homework and don't follow the herd. Your savings take a lifetime to build, but momentary lapses in due diligence can do a lot of damage. Due diligence is your protection. Most of us don't have the time, knowledge, skill nor resources to conduct adequate due diligence on our own.

Many wealth management platforms combine advice from an advisor with the due diligence resources of an independent, unbiased organization. Trustworthy organizations use "due diligence managers" to assess and monitor products before they receive the necessary blessing to be placed on their wealth management platforms. The due diligence manager should be an expert at evaluating products and investment opportunities to determine if the "emperor has any clothes". The quality of the due diligence manager is your protection from the "emperor's new clothes". They should be independent and objective. Ask about the quality, reputation and qualifications of the respective due diligence manager in order to find out how they evaluate and monitor products.

Do your homework and don't follow the herd. Your savings take a lifetime to build, but momentary lapses in due diligence can do a lot of damage. Due diligence is your protection. Most of us don't have the time, knowledge, skill nor resources to conduct adequate due diligence on our own.





To help meet the ever-growing need for sound due diligence, ScotiaMcLeod's Summit and Pinnacle Programs are supported by the capabilities of Northern Trust Global Advisors (NTGA), a leading investment management consultant. NTGA identifies candidates from a universe of over 5,000 managers using a disciplined, multi-step process that leverages sophisticated quantitative and qualitative analysis. Only after passing rigorous standards may a manager be invited to join the ScotiaMcLeod Summit or Pinnacle Programs. Once a manager has been selected, NTGA will conduct quarterly due diligence on managers to ensure compliance with the investment mandate's benchmark, weighting guidelines, investment restrictions and risk/return expectations.

The involved manager research, risk categorization and due diligence process used by NTGA takes much of the guesswork out of the otherwise difficult and complex task of manager selection.

For more information on our due diligence process, or for specific information on your investment managers, please contact your advisor.

This publication has been prepared by ScotiaMcLeod, a division of Scotia Capital Inc.(SCI), a member of CIPF. This publication is intended as a general source of information and should not be considered as personal investment, tax or pension advice. We are not tax advisors and we recommend that individuals consult with their professional tax advisor before taking any action based upon the information found in this publication. This publication and all the information, opinions and conclusions contained in it are protected by copyright. This report may not be reproduced in whole or in part, or referred to in any manner whatsoever, nor may the information, opinions, and conclusions contained in it be referred to without in each case the prior express consent of SCI. Scotiabank Group refers to The Bank of Nova Scotia and its domestic subsidiaries. TM Trademarks of The Bank of Nova Scotia.

