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Establishing the right asset mix, changing the asset mix and good security selection are the key determinants of successful investing. To be frank with you, I have never been particularly successful in making big asset mix changes. If I could do this consistently and successfully, I would not have to work for a living, and right about now I would be dropping anchor at Monte Carlo in my yacht.

I have been in the business for quite a number of years, however, and I have learned a few things. I am going to make some assumptions: first, that most charitable organizations intend to have a long life—they are not going to liquidate themselves in the next few months; secondly, these organizations need a regular, dependable income to finance their projects; and thirdly, trustees of these organizations, being human, do not like huge swings in the market value of their funds on a short term basis.

What is the main problem these institutions have? It is almost a truism these days but, of course, it is inflation. Under stable price conditions, all you had to do was to buy a nice long term Government of Canada bond and you would receive a steady stream of income every year to finance a stable level of services. But under inflation, this does not work. If you have a fixed income stream and costs are rising, you have only two alternatives. You can dip into capital if that is possible, or you can reduce the level of services.

Under inflationary conditions, there is a constant temptation that you will have to fight, that is, to maximize current income. Costs are going up and you will want to get more income out of the portfolio. What you will be tempted to do is to shift more into long term, fixed income investments (assuming that there is a yield curve) or, which is worse, to downgrade in quality to increase current yields. These temptations occasioned by inflationary conditions should be avoided. What is the solution?

Well, there is no such thing as a free lunch. If you are going to protect against future inflationary cost increases, then you have to sacrifice some current income. You must make that sacrifice in the hope that you realize higher income levels and higher capital values in the future. You can do this in one of two ways, or by a combination of methods. For example, you can invest in investments which produce a high current income, spend part only and keep part in reserve by capitalizing it. In other words, do not spend all your current income. Alternatively, you can invest at least part of the funds in equity investments, sacrificing current income to produce higher income and capital values for the future. Thirdly, you could try a combination of the above.

You will notice that I have stressed the dangers of maximizing current income and spending it all. I am not a believer in investing all of a charity's investment funds in very low yielding securities to provide higher yields and maximum

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appreciation in the far distant future. Charitable institutions that hold their money for long periods and do not do anything with it do not impress me. Some compromise is necessary. What you need is an asset mix that will first provide a reasonable level of dependable income to finance ongoing projects; secondly, take into account the need for rising income levels if inflation continues; and thirdly, a minor consideration but it may be important, protect against violent swings in market values on a year-to-year or cycle-to-cycle basis. If you are going to establish an asset mix, you really have two main asset classes: fixed income—including short-term investments, mortgages, bonds; and equities—including common stocks, convertible preferred shares and debentures, warrants, real estate and gold (practically anything that has evidence of ownership attached to it).

For a moment I am going to diverge from the opinions of my colleagues. I think that capital markets are pretty efficient over the long-term, in the sense that returns from various asset classes tend to cluster around a norm. This is what you would naturally expect. Investors are not completely stupid and will tend to emphasize those assets perceived to have the best prospects, thus driving down returns from those assets. Conversely, they will shun unpopular assets, thus driving up returns. There are many participants in the capital markets acting reasonably independently and it would be very unusual if, in the longer term and allowing for a few structural inefficiencies, the returns from various asset classes were not very close together. I have some figures prepared by MacLeod Young Weir giving rates of returns for various asset classes over five and ten years.

It is intriguing to note the various returns: for ten years—8.17% for finance company paper, 8.73% for mortgages, 7.56% for bonds, 10.08% for Canadian equities; for five years wider discrepancies appear—finance company paper 9.28%, mortgages 9.38%, poor old bonds 8.06%, and equities 21.74%. Now, before you all start slavering after equities and stomping your mothers to buy them, remember that in measuring investment returns the choice of starting and ending dates for the period examined can make a tremendous difference. If at the beginning of 1979 your investment manager had shown you these returns: ten years—mortgages 9.1%, long bonds 7.6%, equities 6.1%; five years—9.6% for mortgages, 7.8% for bonds, 6.6% for equities, I wonder how many of you would have begged your investment manager to buy more equities? If you had seen those figures for the five and ten years ending in 1974 or 1975, and if your investment manager had suggested buying equities, you would probably have taken him out and lynched him right on the spot. All I am saying is that you should not react too quickly to recent events, because they tell you nothing about what is going to happen in the future.

Now, look at a balanced fund that had a fixed mix of 40% equities, 25% bonds, 20% mortgages and 15% short term: over the last ten years, that fund would have produced a return of 9% a year and 14% a year over the last five years. The rising returns stem largely from increased dividend income and the

roll-over of the fixed income investments at ever-increasing yields. That is the do-nothing mix: get a good one and stick with it.

Big asset shifts are intriguing. I have mentioned that, although I think capital markets are reasonably efficient over the long term, they can be very, very inefficient and erratic over short, three to five year periods. The profits made from asset shifts at the right time are enormous. And unfortunately (no such thing as a free lunch here), the losses from inappropriate, ill-timed asset switches are equally large.

Let us take as an example the crafty investor who made two basic investment decisions in the last ten years and the rest of the time went off sailing. He would have been 100% in short term investments in the five-year period 1970-1974, and then from 1975-1979 would have switched to 100% Canadian equities. He would have realized a ten-year return of 14% which is good.

Let us consider another fellow who did the wrong thing: 100% in Canadian equities from 1970-1974, then, because of the complete panic after the market disaster in 1974, 100% short term for the next five years. If he was lucky, he realized 3-4% for the ten year period.

The above illustrates that successful asset mix changes can be extremely profitable. The point I am really trying to make, however, is that only two decisions were made in ten years. You do not have to worry about the asset mix every day. When clients want to discuss the asset mix at enormous length, I really worry because there are very wide cyclical moves in the securities markets and rash changes can be disastrous. For asset mix changes to be successful changes should not be made every week or even every month. Substantial change should only be necessary every two or three years, and radical changes are not required to substantially improve the return.

You should consider strategy and tactics. Significant changes in asset mix are strategic decisions of a longterm nature that are made infrequently. Tactics are the short term moves and are best left to your investment manager. Do not fiddle with the asset mix too frequently, please. The problem with asset switching is that it sounds great—switch from equities to bonds, short term to long term and so on. However, the problem is that successful switching generally means selling popular securities (ones that everyone tells you to have a lot of) and buying unpopular securities. Fighting the crowd is easier said than done and requires skill.

If you are a disciplined investment manager, you are going to be battling your clients and your peers much of the time. But that is where you earn your keep—by buying straw hats in the winter. Anyone can buy a bathing suit in May, but buying one in December is a little off-beat.

Another problem you have to face is that changing the asset mix will often change current income quite considerably. If you have $1 million in 10% bonds, you will realize $100,000 a year in income, which you might well be

spending. If you were listening to me before, of course, you will not spend it all, but will keep some of it. If you switch to equities yielding 4%, your income will be chopped by $60,000 to $40,000. That may well inhibit you from making really massive switches in assets. It may mean that you have to retain some of your income in high income years to keep your programs funded in low income years.

In summary, operating a charitable endowment fund is not any different from operating any other fund in a fiduciary capacity. You have to establish a disciplined investment policy with your investment manager right from the beginning so that you both understand what it is, and you have to stick to it. Do not veer with every tempting market fluctuation. If you are going to change your policy really think it through as a long-term approach, not something that is a reaction to what happened in the bond market or the stock market last week. Do not be obsessed with high current income, inflation will kill you. You will have to sacrifice some current income in order to get more income in the future and to protect your capital base. You have to accept some volatility in income and in market levels. I do not say that you have to have tremendous swings, but you must steel yourself to fluctuations. I hope you will not have a 30% decline in one year, that is a bit steep, but a 10-15% decline should not be a cause for worry. If you are a long-term investor, you can put up with it.

As an aside, I think we must get away from the idea that charitable foundations are not taxed. They are taxed and very heavily. There are two ways in which governments can tax a charity. One, they can come out and say "we are going to slap a 20% (or whatever amount) tax on the charity's income" or, secondly, they can impose the hidden insidious tax-inflation. If inflation is at the rate of 10% then charitable funds are being taxed at 10%. Much is made of the fact that pension and charitable funds have difficulty in securing investment returns that even match the inflation rate. This always surprises people, but it is not in the least surprising to me. Government-sponsored inflation is intended to take money from savers and give it to spenders. Since pension funds and charitable institutions are big savers, naturally they get clipped by inflation. If you are keeping up with inflation or are above it, you are doing a good job considering the odds against you.

As an investment manager, I would like to put in a plea for a hard-working, under-paid group of suffering, nervous souls. If you are ever thinking of giving your investment manager a really hard time, even if he deserves it, have pity.

I would like to end with a little story about the mouse in the jungle who was having an awful time because he was so small. Animals were always trying to eat him or tread on him, or both. Finally, he went to the wise old owl and said, "Wise Owl, I am having an awful time—everybody is against me—what can I do?"

And the wise owl looked at him and said, "Your problems are caused because you are so small. Turn yourself into an elephant and no one will bother you."

The mouse said, "Wise Owl, that is a terrific idea, but how do I do that?"

And the wise owl said, "Do not bother me with administrative detail—I just set policy".