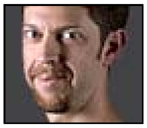
PORTFOLIO STRATEGY / Rob Carrick's ideas for managing your investments

The right balance: Low fees, high returns

Mutual funds that offer a mix of stocks and bonds are often safer than equity funds, but they can be more expensive



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Four words of advice coming out of the latest mutual fund sales statistics: Don't be a sucker.

Figures issued this week show balanced funds led all categories in sales in August, just as they've done since June. Balanced funds are safer than equity funds, and there's a huge variety of choices suited to different risk tolerances. But this is also a category that features some of the lamest, overpriced products the fund industry has to offer. Worse, there are billions of dollars sitting in these funds.

Quality balanced funds are certainly available, but investors (and, let's be honest, their advisers) are obviously having trouble telling the difference. The Portfolio Strategy column is here to help with a look at both the bad and the good in balanced funds.

Let's start with an overview of the category, which is based on the idea of balancing the risk of owning a portfolio of stocks by adding bonds.

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There are Canadian balanced funds that hold stocks and bonds in roughly equal proportions (neutral balanced), and that tilt toward stocks (equity balanced) and bonds (fixed-income balanced). There are also global versions of these funds. Expect to find some U.S. and global stocks in the portfolio, but mainly Canadian bonds.

The problem with many balanced funds is that they charge investors too much for the kind of work they do.

A strange fact about balanced funds is that they can, in some cases, charge more in fees than both bond funds and equity funds. So, bottom line, you could well be paying a fund company for the service of mixing stocks and bonds in a single fund. This is unjustified, unless you think a fund company should be rewarded for being able to do the investing equivalent of walking and chewing gum at the same time.

The average management expense ratio (MER) for all six kinds of balanced funds - that's the ratio of fees to the total amount of money in the fund - is 2.37 per cent. This brings us to a practical reason to watch those balanced fund fees, which is the low yields to be had from the bonds that, by definition, these funds hold.

The yield on a five-year Government of Canada bond - that is, the annualized return from the interest you receive - is about 2.5 per cent right now. A five-year provincial government bond yields about 2.9 per cent. Subtract the average balanced fund fee from these yields are you're not left with much. Those same fees will grind down your returns from the stocks in your balanced fund, though not quite so dramatically.

RBC Balanced is an example of a fund that charges a lot, hasn't performed especially well and yet has attracted very close to $8-billion, which makes it the largest fund in the Canadian neutral balanced category. Fees are undoubtedly part of the problem with this fund.

The MER is 2.25 per cent, which is a little below average but still high for a fund where the huge asset base suggests the opportunity to reap economies of scale. Weak returns reflect the heavy fee load. Over the 10 years to Aug. 31, this fund made a compound average annual 4 per cent, while its peers averaged 4.6 per cent. RBC Balanced would look a lot more competitive with an MER of, say, 1.5 per cent.

Or, better yet, how about an MER of 1.14 per cent? That's what you pay if you invest in RBC Monthly Income, another Canadian neutral balanced fund from the RBC family and an outstanding example of one of the good balanced funds available to investors.

RBC Monthly Income and RBC Balanced are not interchangeable. RBC Balanced is designed as a conventional portfolio building block while RBC Monthly Income is for investors seeking monthly income derived from bonds and dividend stocks (it's unavailable for registered accounts). Still, the two funds do provide an example of how the good and the bad in the balanced category are to a fair degree distinguished by the fees they charge.

This explains why fees were one of the criteria used in compiling our list of top balanced funds. The maximum MER in our screening process was set at 2 per cent, a threshold that allows for the inclusion of a very solid fund called Mackenzie Saxon Balanced. Its average return since it opened for business in December, 1985, is 7.3 per cent, which is right around what you'd hope to make from a portfolio of stocks and bonds combined. Note: The SI series of this fund for DIY investors is referred to here, not the more expensive SA series that advisers sell.

All the other top balanced funds have MERs below 1.5 per cent, and several are right at or below 1 per cent. Unfortunately, some of these low-fee funds require a minimum initial purchase of $5,000 to $25,000. Dealing only with larger accounts is one way for a fund company to keep expenses down.

In addition to fees that are well below average, funds needed strong medium- and long-term returns to make our list of top choices in the balanced category. Specifically, we looked for three- and 10-year annualized returns that ranked in the first or second quartile. Quartiles divide funds in a particular category into four groups - first quartile is best and fourth is worst.

Over the past 10 years, the best performers on the list were TD Monthly Income and RBC Monthly Income, with annualized returns of 8.4 and 8.2 per cent, respectively. BMO Monthly Income was somewhat behind at 5.5 per cent, but it's clear that big bank monthly income funds in general are worth a look for investors who want a regular flow of income and the security of knowing this money is coming from a balanced mix of stocks and bonds.

Don't be put off by the less familiar Beutel Goodman, Leith Wheeler, Mawer and McLean Budden names on the list. All of these companies specialize in managing money for pension funds, endowments, foundations and/or high-net-worth individuals and they offer retail mutual funds as a sideline. These funds are available through online brokers or directly from the companies themselves.

The cost of buying these funds should in most cases be nil, which is in keeping with their low-fee, high-return profiles. Now that's balance.

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Some good and not so great balanced funds

A Six-Pack of Lame But Still Popular Balanced Funds

	Assets ($	MER	3-Year	10-Year	Min. Upfront Purchase

Fund	million)	Category	(%)	Quartile	Quartile	($)
AGF Cdn Balanced Value	781	Cdn Neut Bal	2.38	3	4	500
CIBC Balanced	615	Cdn Neut Bal	2.34	3	4	500
Mackenzie Ivy Growth & Inc.	1,773	Cdn Eq Bal	2.1	4	3	500
RBC Balanced	7,858	Cdn Neut Bal	2.25	4	3	500
Scotia Canadian Balanced	2,153	Cdn Neut Bal	1.98	4	4	500
Trimark Select Balanced	1,306	Cdn Eq Bal	2.33	3	3	500
Top Balanced Funds						
Beutel Goodman Balanced	1,057	Cdn Eq Bal.	1.07	1	2	10,000
BMO Monthly Income	4,762	Cdn Neut Bal	1.49	1	2	500
Caldwell Income	12	Cdn FI Bal	1.5	1	2	500
Leith Wheeler Balanced	57	Glo Eq Bal	1.18	1	1	25,000
Mackenzie Saxon Balanced IS	267	Cdn Eq Bal.	1.99	2	1	5,000
Mawer Cdn Balanced RSP	168	Glo Neut Bal	1.03	1	1	5,000
Mawer Cdn Diversfd Investmt	80	Glo Eq Bal	1.02	1	1	5,000
McLean Budden Bal. Grow D	184	Glo Neut Bal	0.95	1	1	10,000
PH&N Balanced D	753	Glo Neut Bal	0.87	1	1	5,000
RBC Monthly Income	6,610	Cdn Neut Bal	1.14	1	1	500
TD Monthly Income	3,922	Cdn Eq Bal.	1.4	1	1	100

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