



## **A quick primer on pooled vs. non-pooled investments including topics such as embedded capital gains.**

As an Investment Advisor to clients with above average net worth, I am frequently asked to differentiate between pooled and non-pooled investments. Are there any advantages to placing your investible assets with institutional money managers over using more retail focused companies whose ads we are accustomed to seeing in both print and televised media?

First off, what do we mean when we refer to pooled funds vs. non-pooled? Well, pooled investments are those in which your funds are placed (co-mingled) in a large “pool” of capital along with a myriad of other investors looking for the same focus and management company. Investors are only apprised at the end of each quarter of the largest holdings within the pool and oftentimes have a difficult time determining the true style focus of the manager. Mutual funds, closed-end funds, hedge funds and ETFs fall into this category. With the non-pooled managers, investors actually own every security in their account with the purchase price exactly what they paid for it. There are no embedded capital gains or losses (we will talk about them later) and the list of the current holdings can be seen at any time by just looking at the account. Since every investment in non-pooled is known, it is very easy for the owners to confirm the investment viewpoint the manager has. An example of a non-pooled product is CIBC Wood Gundy’s Investment Consulting Service (ICS)™.

While on the topic of transparency, investors in both types of investments pay the costs associated with managing the money. It can be quite difficult to determine exactly what the costs are for all of the services provided, which can include transaction commissions, manager salaries, custodial, reporting, accounting and auditing, sales fees, advertising etc.. I often find clients have no idea of the magnitude of “hidden” costs. For pooled funds, these fees are embedded into the structure of the fund as the Management Expense Ratio (MER). With non-pooled products, fees are broken out and paid directly by the investor, so investors in some cases are able to use them as a tax deductible expense.

One amazing fact is the number of individual items many of the pooled products hold. In Canada, one of the most popular funds is reported by MorningStar as holding 341 different securities. How can one outperform the market when they are the market? On the other hand, the non-pooled institutional money managers hold far fewer securities, often numbering in the range of 40 to 60. Considering the average investor generally will have more than one fund in each category, with the pooled variety, they likely will have a significant overlap, further restricting performance.



Furthermore, since the standard mutual fund managers are required to hold cash balances that are fairly high to meet investor redemptions, less investors' dollars are at work. For non-pooled investments, redemptions are met with sales of the assets actually owned in the client account, eliminating any need by the manager to keep a high cash reserve should he desire to be fully invested. In this light, imagine a sharply declining market where investors are panicking and sending continuous sell orders. The manager will be forced to sell into the falling market in a much more aggressive fashion and perhaps have to chase the more liquid issues at prices far below their relative value. On the other hand, the non-pooled account sales would be client specific and likely not on so large a scale.

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Another difference between the two is around manager style and style drift. Since there is very little transparency with the pooled products, determining specifics such as manager investment style is difficult because the full security list is seldom reported and if it is, its from a date in the past. Consequently, since this type of investment attracts "hot" money chasing the most recent returns numbers, the managers need to focus on the hottest stocks in hopes of outdoing their peers with little regard to long term disciplined structure. On the other hand, the non-pooled managers typically attract more sophisticated investors such as pension funds and so forth, who are more inclined to review the returns in the context of the manager's peers for his style and mandate and judge instead relative to only his own space. A more sophisticated investor knows styles go in and out of vogue and a manager who outperforms versus his peers will add significant alpha (outperformance) over time.

No comparison of the two main types of managed assets would be complete without some comments on the tax ramifications in non-registered accounts. An investor in a pooled product will book a capital gain or loss when he sells, amounting to the difference between the purchase cost and the proceeds of the redemption. Also, he cannot use any management, sales costs etc as expenses along the way. Surprisingly, one tax often overlooked is that related to embedded capital gains and losses. In fact, I have had clients purchase a pooled fund in November which has declined for the balance of the year and who have subsequently received a capital gain slip for the first two months of ownership. How can that happen? Well, since your funds are comingled with those of all the other investors in your pool when you purchase, all paper gains or losses the fund holds become yours so when any internal sales are made, guess what?

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In fact, a 2006 study in the U.S. by the Securities and Exchange Commission



## Are Pooled Mutual Funds The Best Solution?

estimated embedded gains can rob investors of 2.5% of their gains each year! By way of comparison, investors in non-pooled products own the individual securities outright so there is no way they can be responsible for anyone else's capital gains or losses. In fact non-pooled investors can prune individual winners or losers from their portfolio every year through tax loss/gain selling to be even more tax efficient. Finally, as I mentioned above, in non-registered accounts investors are often able to use the fees as a tax deductible expense.

When an investor is faced with the task of deciding where to place his investible assets, using non-pooled products is clearly the way to go. Considering the significant tax advantages including fees broken out and potentially deductible as expenses, no chance of embedded capital gains/losses affecting returns, more focused managers and portfolios and so forth, it is certainly worth an investor's while to do their homework.

For more information or to have a complimentary review of your current holdings, please contact me.

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