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Case Study on Avenue vs. The Index

Avenue's Equity Portfolio is designed to accomplish consistent compounding in a diversified mix of assets and not simply to replicate or beat an index. The fundamental reason for creating a portfolio this way is to drive down the overall risk or volatility as it is called in the financial industry. We address this issue occasionally in this part of the letter because there are times that our portfolio does not reflect what is happening in the broad market indexes and we get questions as to why this is the case.

The first question we ask of the Market is can we compound in bonds or income generating securities and receive an 8% to 10% rate of return with as little risk as possible. Right now we own Yellow Media Bonds and Timbercreek Mortgage Investment Corp which fit this description. This is all we can find at this time but we are patiently waiting for an opportunity where we would like to have at least 20% of the portfolio invested this way. As a reminder, in 2009 the Avenue equity portfolio was over 35% invested in bond and other bond like securities. There is no exposure to these types of investments in the TSX index.

After building in some consistent income streams, we always look for consistent income generating companies. Many of these public companies fall into sectors like Real Estate and Utilities. We think these are quality hard asset investments to have over the long term so we will try and have roughly 10% invested in Real Estate and another 10% invested in Utilities. However, the TSX index only has 3% exposure to Real Estate and 2.4% exposure to Utilities.

To summarize, Avenue likes to first build the Equity Portfolio with 20% invested in higher yielding bonds and another 20% in Real Estate and Utilities for a total of roughly 40%. This makes a big difference to how our portfolio moves when compared to the TSX Index where only 5.4% is invested in comparable securities.

We would also like to be clear that we are not always fully invested in these sectors. Right now we are underweight in high yield and Utilities given where we are in the interest rate cycle. Our preferred investment while underweight will usually be cash not another asset class.

There are also big differences between the major Canadian and US indexes. The TSX index is 23.8% in energy stocks and 31.3% in financial stocks. Whereas the S&P500 index in the US is 10.2% in energy stocks and 17.5% in financial stocks. Avenue's Equity Portfolio lives in between these two indexes with currently 17% in energy stocks and 23.2% in financial stocks.

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The point we are trying to make clear is that Avenue's equity portfolio's performance is derived often very differently than the returns of the established indexes. Why we go out of our way to do this is to lower the volatility or risk of the overall investments and increase the consistency of the compounding within the portfolio.

Over the last ten years Avenue's equity portfolio has had volatility of approximately 11.5% vs. the TSX index which has had volatility of 18%. We have compounded at times with roughly the same rate as the index but Avenue's equity portfolio was compounded with 36% less risk.