

# No such thing as a free lunch

By Dan Richards

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*In investing, if the returns are too good to be true, then they are.*

Over the past 20 years, the expression “There's no such thing as a free lunch” has gained broad currency. The “no free lunch” phrase was popularized by economist Milton Friedman, winner of the 1976 Nobel prize in economics, who used it to describe instances where there were hidden costs for government programs portrayed as free.

You don't have to delve into the field of economics to find examples of people looking for something for nothing.

Imagine that you're on holiday with your family at Disney World; the first day you see a sign in the lobby of your hotel offering free tickets to Disney World in exchange for taking in a short breakfast presentation on a new vacation concept.

Those free tickets are anything but. You pay a big price for them – typically an overlong pressure-packed sales pitch, and an unpleasant tone at the end if you don't buy.



Consider the Canadians who invested in non-bank asset backed commercial paper (ABCP) in 2006 and 2007. Backed by assets such as credit card debt or mortgages, these promised a small premium – well under one percentage point – above government paper, and with no added risk.

When credit markets seized up in August, 2007, those ABCP investors couldn't access their funds. In this case, the free lunch of a slightly higher return without risk became a serious case of indigestion, as individual investors who owned this paper were only recently able to get their money.

A recent example of the quest for a free lunch is the search by many Canadians for investments that participate in stock market increases while still being entirely safe, so money is not at risk.

That has fuelled the rise in sales of hybrid investments, including principal-protected notes (also known as PPNs); guaranteed investment certificates (GICs), where your return is not a fixed interest rate but is tied to stock market performance; and segregated funds. These all promise investors the chance to participate in a rising stock market while guaranteeing their capital.

In some cases, these offerings can serve investors well, as some provide favourable tax

treatment and insurance protection; they can also give people the peace of mind to hang in through volatile markets. It's worth noting, however, that many of the PPNs in particular have been marketing successes, drawing in large amounts of money, but investment failures, registering poor returns.

The key when buying a hybrid product that combines greater safety with upside potential is to understand the price you're paying – problems arise when investors fail to understand the tradeoffs they're making and believe they're getting something for nothing – that the guarantee of their principal comes at no cost.

Depending on the offering, these costs can include high fees that reduce returns, a cap on the upside, a high degree of complexity, lack of liquidity (the inability to convert these investments quickly into cash) and counterparty risk (the chance that the institution guaranteeing your money runs into difficulty). Just because there's no free lunch doesn't mean you can't find lunch at a bargain price – in fact many money managers spend the bulk of their day looking for cases where the market has mispriced risk and, as a result, there are bargains to be had.

The bond and stock markets in early March were a classic example. The share prices of some Canadian banks had been driven so far down that their annual dividends exceeded 9 per cent of the stock price – effectively, the market was forecasting profit woes and an almost certain dividend cut.



At the same time, the difference in interest rates between Government of Canada bonds and investment grade corporate bonds (what the industry calls the “rate spread”) had risen to record levels, essentially pricing in the risk of defaults that would normally only come in an economic depression.

Since then, bank shares have bounced back and the spread between the interest rates on government bonds and quality corporate issues has narrowed sharply. Money managers and investors who decided that the market was overestimating the level of risk did well – the key to their success was that they dispassionately analyzed the downside priced into these investments and concluded, correctly, the market was wrong.

For any investment, there is a tradeoff between risk and return. As a general rule, the greater the potential return, the higher the risk; conversely, the lower the risk, the lower the likely return. What great money managers do is consistently find instances of mispricing where the potential return is out of proportion to the risk, getting good upside while maintaining a reasonable level of safety.

So while you can certainly find “safer” investments on the risk-return spectrum, “safe” investments are another story. Any time an investment is held out as absolutely safe while promising a return above that guaranteed by the government, remember that there truly is no free lunch. And bear in mind another investment axiom: “If it seems too good to be true, chances are it is.”

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