# THE HOT POTATO

**August 2021**

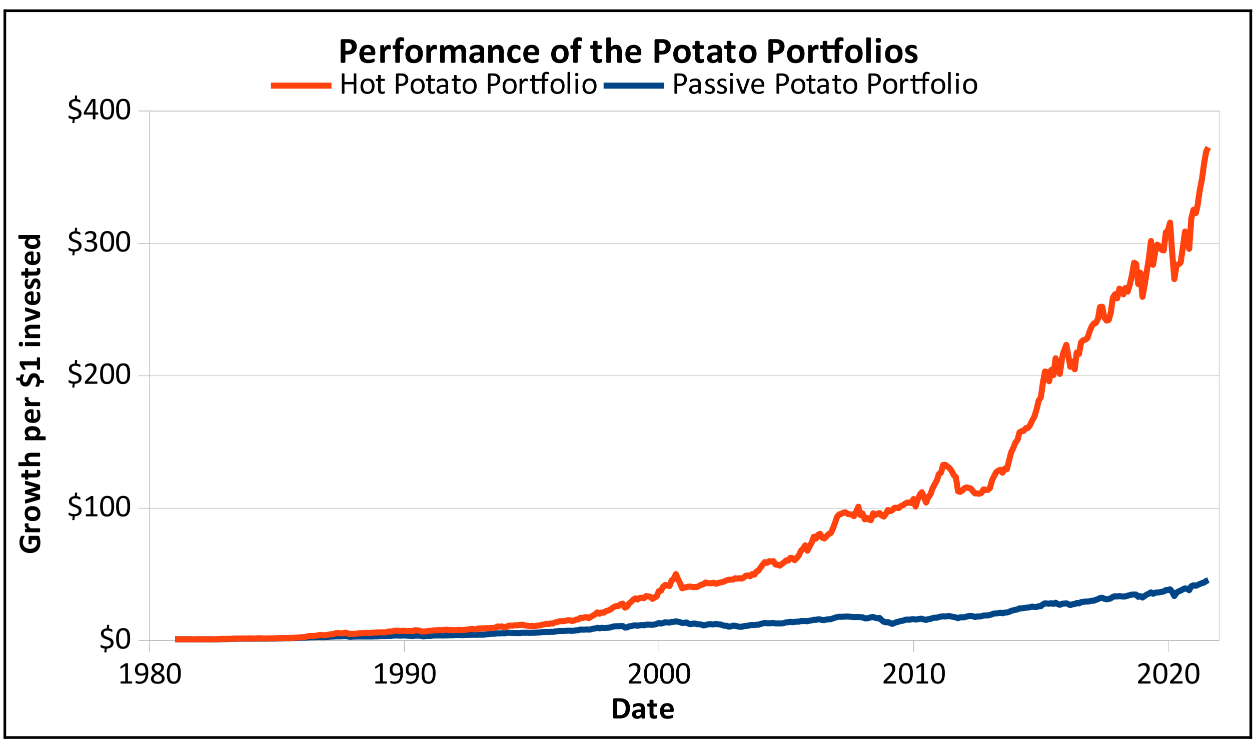
The humble spud lends its name to two investing strategies. The passive couch potato portfolio is standard fare for index investors. But more adventurous individuals might opt for the hot potato portfolio and its sizzling returns.

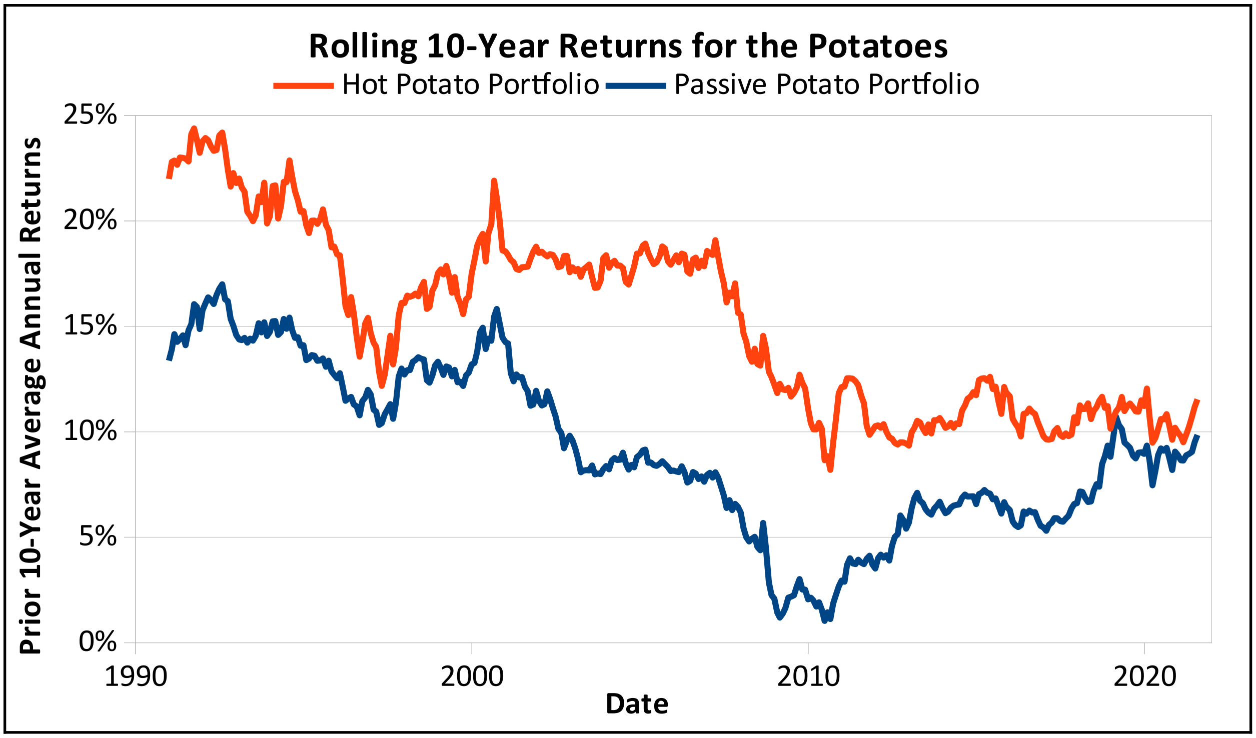
I'll begin with a quick review the passive potato portfolio because it represents a solid option for investors who like diversified low-fee index funds. The passive portfolio invests an equal amount of money in four major asset classes including Canadian bonds, Canadian stocks, U.S. stocks, and international stocks. Here the idea is to take a largely hands-off approach to the market.

The passive portfolio produced average annual gains of 9.9 per cent from the end of 1980 to the end of July 2021. (All of the return calculations herein are based on index returns for the asset classes using non-hedged versions of the FTSE Canada Universe Bond Index, the S&P/TSX Composite Index, the S&P 500, and the MSCI EAFE Index. They include reinvested distributions and assume monthly rebalancing but do not include fees, taxes, commissions, or other trading frictions.)

The passive portfolio served up solid returns over the years and it can easily be altered to lean more toward stocks, or bonds, depending on an investor's risk tolerance.

The hot potato offers a more aggressive active strategy using momentum. Be warned






that it is not well suited to passive investors and it should be avoided by novices in particular. It also requires more work to implement in practice.

But the hot potato approach is pretty straightforward. Each month it moves all of its money into the single index (of the four used by the passive portfolio) that climbed the most over the prior 12 months. That means the hot potato portfolio might change monthly depending on market conditions.

The extra effort paid off because the hot potato portfolio climbed at an average annual rate of 15.7 per cent from the end of 1980 to the end of July 2021. It beat the passive potato portfolio by an average of 5.8 percentage points per year. You can examine the return history of both portfolios in two accompanying graphs.

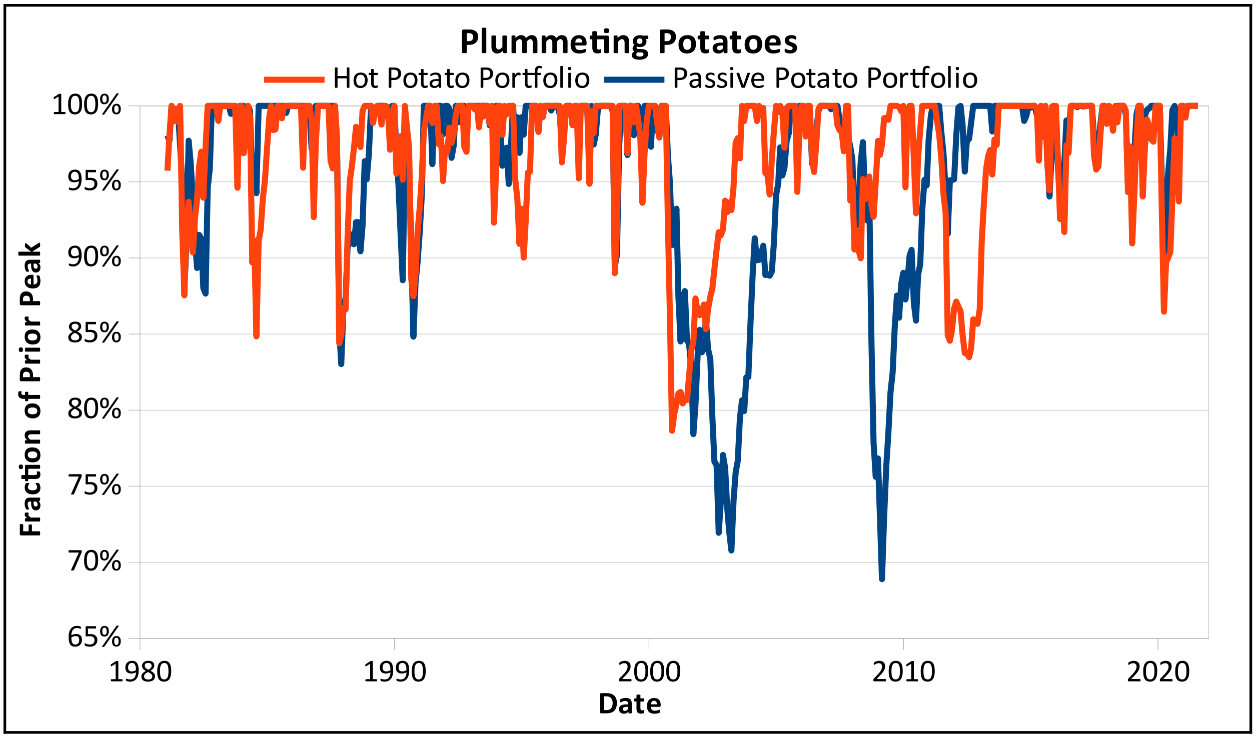
The hot potato generated succulent returns and it didn't suffer from extreme plunges that often accompany high-performance strategies. You can examine down periods for both portfolios in the third graph.

The passive portfolio suffered from two big downturns in recent times. It dipped 29 per cent when the internet bubble deflated in the early 2000s. It also fell 31 per cent during the financial crisis of 2008.

The hot potato portfolio fared better. It lost 21 per cent after the internet bubble burst and recovered rapidly. It also sidestepped most of the 2008 crash when it fell 10 per cent thanks to a quick switch to bonds.

As previously mentioned, the hot potato requires more trading because it made an average of 1.7 large trades a year since 1980 and some of those trades were money losers. In other words, there is a cost to trying to time downturns and the hot potato can be overly active in some cases.

It is also worth remembering that the returns mentioned above do not include extra costs incurred by the hot potato. These come in the form of trading costs and taxes. The




later can be a big factor for taxable accounts because the hot potato tends to trigger capital gains taxes fairly frequently.

As a result, more aggressive and experienced investors can dine on what the hot potato has to offer, but others should probably stick to the passive portfolio to avoid heart burn.

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