Exchange Traded Funds (ETFs)

I have followed passive investing and Exchange Traded Funds (ETFs) since my pension fund days in the 1980s. I don't own any ETFs myself but I am not doctrinaire about it. I am happy to discuss them in any level of detail and to have them in your account if you like. If you want to use ETFs, please call and arrange some time to review with me and I'll be happy to see how we can fit them in.

Q: The financial media say ETFs are the key to success, and are 'growing significantly faster than traditional mutual funds'. What are they and should I have some?

A: **Short Answer**: An Exchange Traded Fund is very similar to a mutual fund in that it is a share in a pool of individual investment securities such as stocks or bonds. The difference is that an ETF is traded on a stock exchange, as the name implies, whereas mutual funds are bought from and redeemed to the fund company directly. It is a small difference, since being traded on an exchange has no impact on the investment characteristics of the fund. It is the holdings of the fund (stocks, bonds, real estate etc.), not the way it is traded, that determines how the fund behaves.

ETFs were initially designed to mimic a stock market index at low cost. These 'passive' ETFs hold every stock in the index, so their performance tracks the index[1]. With no portfolio manager or investment analysts to pay for, passive indexing can reduce costs. Lower costs are not to be dismissed, but are exaggerated in the media by apples to oranges comparisons.

ETFs are today's media darlings; they have become popular with speculators who want to be able to trade throughout the day. Many ETFs are held for less than 30 days, according to industry data.

Passive investing may have a role to play in long-term investment portfolios, but only *if* the investment characteristics of the entire index are what you want. Indexes are flawed by their construction algorithm, which leads to increased volatility at crisis points in the market – exactly the wrong time – making the crisis worse. Resolving the flaw leads to increasingly complex and costly algorithms, which quickly lead you back to the judgment and fees of active management.

[1] More specifically, index ETFs hold a statistically representative sample of stocks in the index so that the ETF behavior mimics the index closely; the difference is called 'tracking error'

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The most important determinant of investment returns – by far - is asset mix. Passive vs. active management and fees are minor factors. Autopilot may be effective most of the time; but in a crisis you want experienced pilots at the controls. It's the crisis that kills you.

A: **Longer Answer**: ETFs have morphed from their initial passive index focus to include all kinds of assets, from gold to junk bonds. They now include active management just like any fund, and leverage, where derivative contracts multiply the daily market moves by as much as 2 or 3 fold – (nasty critters, as many dilettantes have discovered).

These ETFs will likely be seen by history (possibly quite soon) as another industry invention designed to allow inexperienced people to lose large amounts of money quickly.

Fads aside, the fact is that the long term returns from indexes compare well to active money managers. Indexing is a reasonable strategy. However, the story is more complex and nuanced than financial journalism lets on.

Costs/Fees

Let's deal with the fees straight and up front.

The main potential benefit of ETFs is the lower cost of passive indexing. Note that a mutual fund can follow a passive index strategy too. There is nothing unique to ETFs that lends them to passive index investing. Since passive investing can reduce cost in both mutual and exchange traded funds, my comments below can apply to both.

Passive ETFs in Canada have management fees of about ½ of 1% (0.5%). This compares to a management fee of about ¾ of 1% (0.75%) for an actively managed mutual fund in an account over $1 million[2]. When you add the advisor compensation of 1%, the ETF cost is 1.5% vs. an active fund of 1.75%. So you are saving about ¼ of 1% (0.25%) apples to apples.

Financial journalists love to exaggerate the fee difference by comparing ETFs which do not include advisory costs with average mutual fund fees which in Canada usually do include the advisor's compensation.

Comparing an index investment that has no advisory fee with an actively managed investment that does have an advisory fee is obviously an apples to oranges comparison that precludes any meaningful information. You can compare index vs. active management, or you can compare do-it-yourself investing vs. using an advisor, but mixing the two together demonstrates either the financial illiteracy or the intellectual dishonesty of the journalist … but it exaggerates the fee difference and makes sensational copy.

A quarter percentage point is worth thinking about, but it is not earth-shattering in the context of hoped-for portfolio returns of say 5% - 10%. When we look at the difference between active and passive management below, you will see that the fee reduction may not be worth it.

[2] For a more complete and easily readable explanation of fees, please email me and I'd be happy to send you a 1-pager.

Not a silver bullet

It may sound surprising but costs are never the difference between investment success and failure. Your asset mix, and avoiding large capital losses from 'Big Mistakes' are far more important, accounting for over 90% of the differences in portfolios' returns[3].

Most individual investors fail to achieve even the returns of the investments they hold because they tend to put the most money into whatever has recently gone up the most, and they tend to sell whatever has recently gone down the most[4]. Experienced and professional investors do the exact opposite.

Individual investors tend to destroy capital in 6-figure chunks, not by fees.

So if I sometimes seem dismissive of ETFs and passive investing, it is because having a fee that is ¼ of 1% lower than your neighbor has absolutely nothing to do with whether you survive a crisis such as the tech stocks, or the panic of 2009, or whatever the 'crisis du jour' happens to be. In fact, the stress of market crises such as 2009 is worsened by a passive strategy, as we will see below.

Nevertheless, the question remains: given equal behavior, reduced fees for index investing might benefit long-term investors. So, do you want the index, or a professionally managed portfolio? Turns out that index investing has some important flaws.

Capitalization weighting

Most indexes are capitalization weighted, which means that companies with higher total market value (or capitalization[5]) have a greater weight in the index formula. As the share price of a company rises, it has more weight in the index, so the ETF buys more of that stock. As a stock like Nortel goes up and up, the index ETFs buy more and more of it, so it continues to match the index. If this sounds like 'buy high', you are right.

A professional manager adds incredible value in times like the Nortel craze – by avoiding it. Clients will recall Danny Bubis of Tetrem Capital, manager of the United Canadian Equity Value Fund and CI Canadian Investment Fund, resisted huge pressure to hold Nortel, and saved his investors' fortunes in the subsequent implosion. Danny's 15 year performance in United Canadian Equity Value is still better after fees than the index is with zero fees!

It's the crisis that kills you.

Weight limit formula

Some index funds try to get around the market cap problem by limiting the amount in any one stock to 10%. While this 'caps' the Nortel problem at 10%, it leaves you exposed to a related problem: indexing locks you in to whatever market sector – or group of stocks - is dominating the market, because the index fund will still have to buy them.

The tech and growth stocks *as a group* dominated the US index in 1999 for instance, and collapsed *as a group*. Capping Nortel at 10% would not have helped much, because Cisco, JDS Uniphase, Amazon, EBay, and Global Crossing all collapsed, taking the broad S&P500 index down almost 50% in 2003, while value stocks went up.

Active management therefore has a critical effect mitigating the sense of panic and reducing the susceptibility to a Big Mistake.

[3] Brinson, Hood, and Beebower, Financial Analysts Journal, July-August 1986 is the definitive study.
[4] *Quantitative Analysis of Investor Behaviour,* Dalbar Inc., March 2011, as reported in Nick Murray, July 2011.
[5] Market capitalization is the price of the stock times the number of shares. The Dow Jones Industrial Average is weighted by market prices of the 30 stocks. This means that a $60 stock has more weight or influence on the index than a $20 stock, even though the total market value of the $20 stock could be greater than the total value of the $60 stock if there were more shares outstanding.

These crisis situations are rare, but the consequences are so disastrous that missing just one pays a lifetime's management fee. The loss of 50% over 13 years in the NASDAQ index will never be recovered by low fees.

Sector exposure

Not only does indexing lock you into a crisis, it forces you into the sector composition of the market. For instance, the Canadian index (TSX) has about 40% in the resources sector, and another 40% in banks and financials. Indexing in Canada means you are locked in to a 2-sector portfolio.

Gold alone comprises a significant weight in the Canadian index; as the gold bubble blows off, you are locked in. I submit, based only on a hunch, that the pain of underperformance in the Canadian index will be as severe – and unmanageable – as the pain suffered by NASDAQ index investors after 1999. You save on fees though.

Similarly, the last time indexing was popular was the 1980s, when the global index looked like a no-brainer strategy. Unfortunately, the index was powered by Japan, whose market peaked in 1989 and languishes today at a little more than 1/3 that level.

The point is that indexing is a very specific investment decision, subject to its own risk tradeoff: in Canada you are deciding to invest 80% of your portfolio in financial and resources stocks, and exclude consumer, industrial, manufacturing, health care, food services and others. Is that a decision you want to make?

To get around the sector valuation problem, some funds will use a formula to avoid high-priced stocks, others use a formula to select high-dividend stocks, while still others invest in a single sector, such as banks or health care.

The difficulty is that with each mutation of the index concept into a more specific formula, the simplicity and low cost are driven further away. The iShares Fundamental Index Fund, for example, has a management fee of .75%, which is the same as the fee on an actively managed equity fund (over $1 million).

The crippling drawback is that indexing is too simple a formula. Successful investing cannot be resolved into a simple formula.

Dangerous shift of focus

Not only do the formula-based funds lose any cost benefit, they also have the important effect of moving the security selection decision away from a professional portfolio manager, and over to you.

Your attention is drawn away from strategic decisions such as what your savings or withdrawal rate should be or how much of your portfolio to have in global equities or bonds, as you focus more on the P&G dividend, the export mix of H J Heinz, or the question of whether the index is being dangerously dominated by a sector.

What's the matter with that?

In almost 30 years in the business, I have learned that flying the plane is not the same as building the plane. For sure you want your pilot to know a lot about how the engines work and what they can or can't do, but you don't want your pilot staying up late at night working on engines. It's a different job. You can't do a good job at both.

Trying to manage the strategy as well as the client is a complex job. It requires focus on variables that are out near the horizon: what asset mix is best for the client's personal goals, history, perceptions, and emotions. Individual security selection involves focus on many variables that are down near your toes: how are natural gas prices going to affect DuPont's profits over the next 5 years, or what will a stagnant housing market do to Royal Bank's return on equity?

Questions out on the horizon are totally different from questions down near your toes. Look at one and you quickly lose sight of the other.

Sideways markets opportunity

There is one more important reason that I do not have index investments in my own portfolio.

Index investing compares favorably to active professional managers when all stock groups move together in unison. Over this last 5 years, for instance, in the crash of 2008/9 and the immediate rebound, (if 5 years can be called immediate) all stocks moved together. When everything goes off a cliff at once, there is less a manager can do to capture opportunities or mitigate a decline. So indexing looks pretty good in the rearview mirror today.

However, when a market moves sideways, or the different sectors within the market behave differently, there is much more opportunity for a professional portfolio manager to add value by weighting the portfolio to the sectors and individual companies that are doing well, and avoiding the laggards. Bob Krembil, one of the founders of Trimark, got his start managing small company stocks at Bolton Tremblay in the 1970s, where his portfolio reputedly increased several-fold over the decade while the indexes did zero.

A sideways market with dangerous currents is the ideal time for active management with the flexibility and the courage to capture opportunities and avoid danger.

We could well be in one of those markets today, where the global economy is bound by slow-growth conditions, yet individual sectors and companies can do quite well. We are already seeing the resources sector becalmed, while companies such as Ford Motor recover strongly.

Personally, I have my money with active managers. I'm one of my own top ten accounts. I may change my mind one day. If I do, you will know about it.

Have a great summer!

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Book Review – Trust Me I'm Lying

Ryan Holiday
Penguin Group 2012

This disturbing book is about the grey zone between the blogosphere where anyone can say anything, the established print media where there is supposed to be at least a kernel of journalistic ethics, and web advertisers' insatiable need for viewer clicks.

Holiday describes in detail, from personal experience, how to begin a 'story' with a malicious posting on a minor local blog, have it picked up by a news blog like Gawker or Drudge Report, which is then reported on by major media such as the New York Times, and suddenly you are at centre stage in a national presence.

By the time someone figures out that the story was totally fabricated, the public eyeballs have moved on and nobody cares if it was true or not.

For instance, Holiday's marketing campaign for the movie 'I hope they serve beer in hell' involved defacing the movie posters - which he had paid for and placed - then sending a photo of the defaced posters to two blogs with a comment 'Saw these last night. Good to know LA hates Tucker Max (the director) too'.

The publicity storm worked so well, and the recipe was so simple, that he repeated it for a US politician, and has made a career out of it (he is now director of marketing at American Apparel). The book has dozens of examples, most from Holiday's own experience.

The technique works so well because 'hyperlocal' blogs have very high trust with their followers, and very few resources to verify facts (or settle libel claims). The established media outlets are starving for salacious news, and are clear of libel and reporting standards because they are simply reporting something posted somewhere else. The Globe and Mail is not breaking any laws by reporting that Gawker says a Star reporter claims to have seen a tape of Rob Ford …

The dozens of examples of fabricated stories getting national media coverage is disturbing. The movie 'Gasland', which shows tap water being lit aflame, is still used endlessly in antifracking propaganda, even though the tap water has been shown to contain naturally occurring methane from a nearby swamp and has nothing to do with fracking.

I know that some of my clients actually hate Ford to begin with, but you should still feel a little creepy tingling at the back of your neck when a person – who doesn't meet popular standards of handsome physical appearance and smooth talk – is shredded in mainstream media without evidence.

A reporter claiming to have seen a video is not evidence.

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