

CAN'T BEAT 'EM?

PASSIVE INVESTING IS GOOD FOR BOTH CLIENTS AND ADVISORS.

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Beating the stock market is a challenge that motivates many investors and their advisors to follow an aggressive active-management strategy. But as historical performance statistics have forever demonstrated, few active money managers are actually able to outperform the market.

Indeed, fewer than 9% of actively managed Canadian equity mutual funds outpaced the S&P/TSX Composite Index during the five years ended 2007 on a compound annual return. While foreign funds fared somewhat better, 85% of U.S. equity funds and 87% of international equity funds still underperformed their respective benchmarks, according to Standard & Poor's most recent SPIVA report comparing active and passive management.

Long-term strategies based

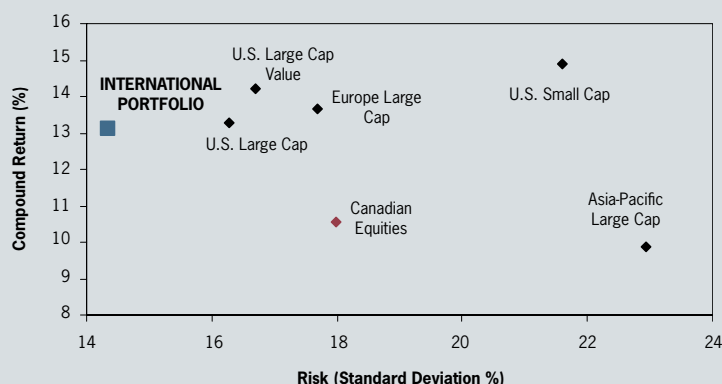
on low-turnover passive investing, such as PWL's approach that utilizes ETFs and "tilted" index-based funds, have almost always resulted in a superior after-tax

return as compared to actively traded accounts.

As of March 2008, actively managed funds in the Canadian, U.S. and International equity

Spreading Out

International stock diversification = Better risk-adjusted returns;
International Equity Diversification (1980-2006).



Source: Ibbotson Associates, PWL

categories underperformed their benchmarks in every traditionally compared period (three, five, 10, 15, 20 and 25 years), according to the Morningstar Fund Indices, which provide weighted average compound annual returns for the various fund categories, corrected for survivorship bias, so that they include all funds that were in existence at any time during a specific period.

For example, Canadian equity funds lagged the S&P/TSX Composite by more than two percentage points during the five years ended March 2008. There was a similar gap between international equity funds and the MSCI EAFE Index during that period, while U.S. funds fared somewhat better, lagging the S&P 500 Composite by a mere one percentage point (see “Performance Comparison,” page 15).

Advisor Benefits

So, as the markets continually prove, passive investing produces better results, and without the angst and uncertainty that characterizes the active alternative. That’s better for the investor, but could it also be better for the advisor? The answer, we believe, is yes.

Of course, you might ask why you’d want to tell clients that all they can do is mirror market returns. It makes it hard to justify the fees they pay you. And, why would you want to forgo the opportunity to grow a client’s portfolio faster, and at the same time command higher fees for greater assets under management—or through transaction fees accruing from a commission-based account?

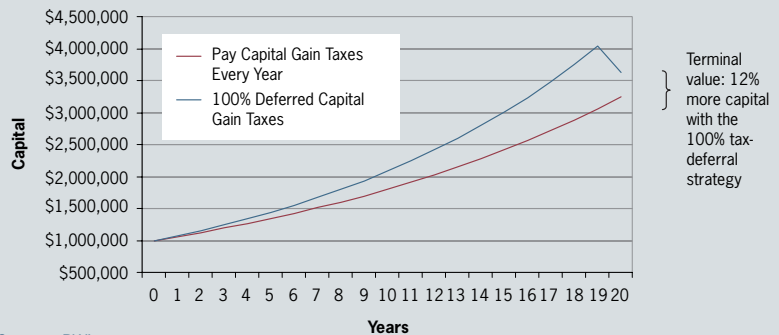
All valid questions. The answers lie in the realities of passive investing. As historical performance shows, the long-term market return is likely to be better than what’s achieved through active investing. What’s more, a passive invest-

ment program increases wealth by minimizing investment turnover, which is a major source of transaction costs. This in turn creates tax efficiency, as capital gains are realized less frequently than in an active portfolio.

Clients will also be happy to pay your fees because their returns will probably be better than published active returns (those of mutual funds and wrap programs). And, they’ll be pleased to pay you because they’ll **continued on page 12**

Deference Pays

Put off portfolio taxes as long as possible;
\$1,000,000 Invested Over 20 Years.

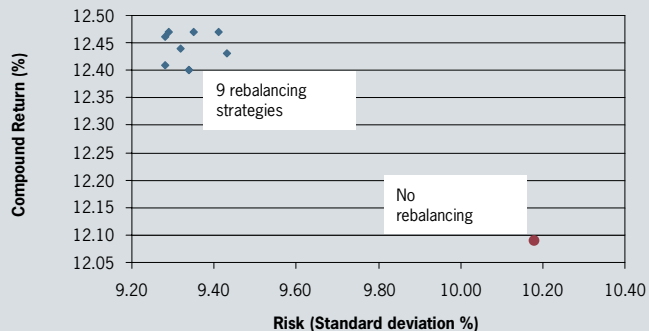


Source: PWL

Assumptions: Equity returns are 8% per year, constant. Dividend return = 1.5% per annum; Capital gain return = 6.5% per annum. Marginal tax rate on capital gain = $(46\% \div 2) = 23\%$. Marginal tax rate on dividends = 30%. All investments are liquidated at the end of the period.

Balancing Act

Buy and Rebalance = Better risk-adjusted returns;
Rebalancing vs. No Rebalancing (1980-2005).



Source: PWL and Ibbotson Associates

Index composition: 30% Scotia Capital Short-term Index, 10% Domestic High-yield Index, 10% FTSE-NAREIT Equity Index, 17% S&P/TSX Composite Index, 6.6% S&P500 Index in CAD, 6.6% Fama-French Large Value Index in CAD, 3.3% US Small Stock Index in CAD, 6.6% MSCI EAFE Index in CAD, 6.6% MSCI EAFE Value Index in CAD, 3.3% DFA International Small Cap Index in CAD

continued from page 11 be content with their relationship with you. All of this combined can lead to a more loyal client base.

A passive investment program also minimizes emotional turmoil and the accompanying mistakes brought on by market timing, such as selling low and buying high. Further, it gets rid of hindsight bias. It's an approach that keeps clients off the market roller-coaster created by the daily financial press.

A key contributor to the success of passive investing is a lower fee. William Sharpe, Nobel Prize winner and author of the Sharpe Ratio, says passive and active managers together represent the market. As a group, passive managers mimic the market's return (gross of fees). Active managers, who make up the balance, must also match the market's return (gross of fees). Therefore, due to lower fees, Sharpe concludes the passive managers will always outperform as a group. And better performance in client portfolios translates into higher advisory fees because assets under management are greater.

Certainty is Welcome

Clients love certainty. So why do so many advisors ignore the well-known and easy-to-implement factors that can help them build better client relationships and superior business? The unfortunate answer is that most advisors use the aura of stock-picking (or fund-manager, or wrap-picking) to justify what they're paid. But once they admit to themselves and their clients that no one can successfully predict the future, the door is open to more rewarding relationships.

Indeed, there are advisors who will, during certain periods, help their clients outperform the market. But they can't achieve this all the time. And when they fail, their clients leave them in search of another advisor who can help them outperform again. It's basically impossible to successfully manage the transitions that happen when a portfolio moves from overperformance to underperformance. So the switch to a passive strategy helps ensure you're getting paid for services you actually can provide and control, and which truly help the clients.

For example, fee levels are a constant issue for clients. This doesn't mean you should offer to work for free, but it does suggest you should minimize the fees they pay on the investments you manage on their behalf. Never forget, it's their money.

The median Canadian equity mutual fund's management expense ratio is 2.34%. The least expensive way to buy the S&P/TSX Composite Index—the iShares Canadian Composite Fund—is 0.25%, which, added to a 1.25% advisor fee, totals 1.50%. With active investing, your client is already behind by 84 basis points even before the portfolio begins to make, or lose, money.

Clients also dislike the lost opportunity cost of high taxes. Put your clients in a low-turnover passive portfolio and they will pay fewer taxes each year. Tax deferral is a powerful investment booster (see “Deference Pays,” page 11).

Common Misconceptions

In our industry we’re bombarded with marketing messages and media stories about undervalued stocks and successful fund manager picks.

Many advisors are unaware the average investor would benefit from an increased return if he or she switched to a passive strategy. This is the case because you are eliminating the possibility of buying high and selling low, and simultaneously reducing transaction fees dramatically because investment positions are being maintained rather than frequently changed.

It’s also important to diversify internationally. An investment in a well-diversified portfolio of U.S., European and Asian equities over the past 25 years has produced a significantly higher return at considerably less risk, including currency fluctuations (see “Spreading Out,” page 10). Of course, market movement will alter portfolio content, so one can’t simply sit tight and make no changes. Advisors need to rebalance a portfolio to maintain diversification and asset mix in order to stay on course (see “Balancing Act,” page 11), and there are rebalancing strategies which allow an advisor to handily outperform a portfolio that employed no rebalancing and at much less risk.

Advisors and the investing public strive to beat the market. But how can this be practical in an age of instantaneous global communications? How can a portfolio manager get a scoop on a stock and buy or sell it before the news is out? Moreover, how possible

is it to make use of such information without running afoul of compliance rules? Even if a manager is able to realize this advantage, what are the chances this particular transaction will be more successful than what a competing, similarly qualified manager is up to?

Kenneth French, professor of fi-

nance at Dartmouth College, stated in a March 2008 study, “The Cost of Active Investing,” that overconfidence is a major reason investors are willing to incur the extra fees, expenses, and transaction costs of active strategies. “Investors who are overconfident about their ability to pro- **continued on page 15**

Performance Comparison

Compound annual returns as of March 31, 2008.

FUND CATEGORY* OR INDEX	3 YR	5YR	10YR	15YR	20YR	25YR
Canadian Equity funds	12.3	16.4	6.8	9.3	8.3	9.1
S&P/TSX Composite TR CAD	14.2	18.5	7.8	11.3	9.8	10.3
US Equity funds	-1.0	2.6	-1.6	5.1	6.9	7.7
S&P 500 TR (Bank of Canada) CAD	0.3	3.6	0.2	8.0	9.9	11.0
International Equity funds	5.2	11.5	0.9	5.6	5.2	6.9
MSCI EAFE GR CAD	7.7	13.4	3.1	6.9	5.5	11.2

* Fund category data are Morningstar Fund Indices, which are weighted averages and corrected for survivorship bias

Source: Morningstar Canada

continued from page 13 duce superior returns are unlikely to be discouraged by the knowledge that the average active trader must lose,” he wrote.

Don't Over-Promise

Advisors need to set their egos aside and pave the way for their clients to feel confident that portfolio returns will, at the very least, keep pace with the capital markets. If keeping pace with the market won't fulfill their goals, educate them and help them determine a plan to save more or need less.

Teach your clients to realize the folly of counting on the market to make them rich. As an advisor, your role is to be a good steward of capital. So ensure there is a disciplined and achievable method that sees to it clients' capital keeps pace with inflation on an after-tax basis. Let them know you will work with them to boost returns through proven means: tax management of family accounts, asset allocation, structured diversification using academically proven research on value and small factors, the efficient-frontier models proving that international diversification produces better risk-adjusted returns, and reducing the risk through disciplined rebalancing.

It's also important to remember the

big picture—financial planning. To contribute to the best net wealth improvement for a client, you must provide advice on such factors as paying down debt, splitting family income, capturing cash flow excesses, and risks like disability and death.

Active = Expensive

The market volatility of recent months has created considerable stress in advisor-client relationships. But it's been a test that has proven the mettle of our investment approach. Our clients, while disappointed at the market's performance during the past year, have continued to be satisfied with their long-term investment plans.

This is not to say there's no stress when markets decline. But the difference is that by not promising to beat the market, and by having educated our clients accordingly, we can easily demonstrate that we are following the disciplined strategy that's stated in our investment policy. Markets are always doing what we expect—experiencing a reaction to economic or media information. As advisors, our role is to focus on the client's life, family, goals and factors that, together, we can demonstrably influence. ^{AE} **LAYTON**