EPISODE 42:

IPOs, Indexing and Market-Linked GICs: Weighing Up Their Worth

[INTRODUCTION]

[0:00:05.3] Benjamin Felix: This is the Rational Reminder podcast, a weekly reality check on sensible investing and financial decision making for Canadians. We are hosted by me, Benjamin Felix and Cameron Passmore. So today we tried a new format which I thought was pretty good. We talked about two current topics, portfolio management topic, a financial planning topic and the worst advice that we heard last week. So I, I felt good having structure actually.

[0:00:30.0] Cameron Passmore: Yeah, I think we've been looking for that structure just to help us prepare, I think it helps people understand where we're going with each different episode. And there's some good stories that came out this week. Lawsuit against closet index funds, all this talk about IPOs lately and we did a good discussion around account, which accounts to use in what situations.

[0:00:51.2] BF: Yup. Feel free to give us feedback. Let us know what you thought of the episode. As always, we appreciate people sharing the podcast with other people that they think will find that interesting. It it blows my mind. We're getting per episode around 1,300 downloads now, which is a lot.

[0:01:07.4] CP Even going back right to episode one last August, which I find amazing.

[0:01:11.6] BF: The fact that people are listening is a –

[0:01:13.9] CP I think we're almost up to 3,000 downloads a week. 3000 a week.

[0:01:16.1] BF: 3,000 a week?

[0:01:17.0] CP Yeah, 3,000 a week, we're closing in on, yeah.

[0:01:19.5] BF: Wow. I didn't see that point. Anyway, we, we very much appreciate people listening and we obviously hope the content is useful to you.

[0:01:26.3] CP I love the feedback.

[0:01:27.4] BF: Yeah. Feedback's been great. Thanks.

[INTERVIEW]

[0:01:37.9] BF: Welcome to Episode 42 of the Rational Reminder Podcast, just Cameron and I today, no guests.

[0:01:44.1] CP: We got the system down now. Every other week we have a guest.

[0:01:46.4] BF: Yeah, that's going to continue.

[0:01:47.8] CP: However, you do want to adjust the format a bit you were thinking going forward.

[0:01:50.7] BF: Yeah, so for the episodes where it's just us, we're just going to make a small, a small tweak to sort of try and keep it relevant to people.

[0:01:58.6] CP: And less factors.

[0:01:59.7] BF: Yeah. We're going to take a break from talking about factors. We’ve become known as like the factor podcast, which isn't necessarily what we want to be.

[0:02:06.5] CP: Sort of stop using the F word as much.

[0:02:09.4] BF: I used it in an in a non-investment context in my notes and I was thinking like, oh Geez, people are going to get upset. I said, factor. So for the format we're going to try doing two current topics, which is less, we've usually been doing sort of like five.

[0:02:23.5] CP: Yup.

[0:02:23.4] BF: And then one portfolio topic. So portfolio management, investing topic, one, financial planning topic. And then we're going to finish off each episode with the worst, the worst advice that we heard in the previous week.

[0:02:36.9] CP: I love that one because there's so many that come up in our day to day world that uh, it's going to be fun to have that one added in.

[0:02:43.1] BF: Yeah. Uh, so one of the things that happened, and this isn't one of our – I'm breaking the format already, but it's not one of the stories we're going to talk about. But the Ontario budget came out and one of the things, one of the items that was in there was a protection for, title protection for financial planners and financial advisors. They didn't specify what that means. Like, what are they actually going to do? It said that they still have to work on the framework.

[0:03:05.5] CP: Right. And it will take a number of years, but the point is to make it more in line with I think Quebec, right? Which is the only province now that does have protection or standards for using the title financial planner or financial advisor.

[0:03:17.6] BF: Yeah.

[0:03:18.5] CP: I think it's a good thing.

[0:03:19.5] BF: It is a good thing. It won't affect us at all because I think the, they're, they're trying to make the title line up with credentials, but here we are, most of us that face clients are financial planners or are CFPs or a CIMs or CFAs. Yup. So it shouldn't affect us at all. But for the industry as a whole and for consumers, I think it's definitely a good thing

[0:03:37.0] CP: Yeah, because now you can just call yourself a financial planner and you're in business, right? That's right. It's that easy.

[0:03:41.1] BF: Or financial advisors even. Yeah. Even worse, arguably. Okay. So the couple of stories we're going to talk about. First one is closet index funds, which is an issue that's been known in Canada for a long time. Uh, but right now there's a class action lawsuit that's been put forward again by two different law firms against two funds. Specific funds.

[0:04:01.9] CP: Yeah. I was really surprised by this actually. I mean we've known there's been closet index issue, especially when you're managing a big fund in Canada, but to actually go and file a class action lawsuit, I wonder what their real motivation is?

[0:04:13.2] BF: Well, they want to make money, the law firm wants to make money.

[0:04:16.9] CP: But are you trying to make a statement like, do you really think they can win? They think they can pull this off? And like, where does it stop? Do you sue the initiative for promoting active mutual funds over reasonably low fee index funds?

[0:04:28.0] BF: Well, with active share, right. That's the whole thing. Active share is the – it's a measure of how different are you from the index?

[0:04:35.0] CP: Yeah, I get that for sure.

[0:04:37.4] BF: So the funds got low active share. There is a pretty reasonable argument to say, well, you're just charging active fees to be the index. And that's, that's not right. And that's not good for consumers. But I think that the main issue, especially for the Canadian bank mutual funds, which are massive, and this is what the lawsuit is proposed against, is uh, the RBC and TD Canadian Equity Funds. But you start talking about the Canadian market, which is relatively small and these are big portfolios, 2.5 billion and 5 billion. Yeah. So where do you go? Like at some point you're going to be the index because you have so much money to invest and Canada is a relatively small pool of opportunities.

[0:05:13.1] CP: Yeah.

[0:05:13.4] BF: Hard to be different from the index and be diversified. So yeah, what, what's worse? But then it creates the argument of, okay, so you just index, so charge –

[0:05:21.7] CP: Their raw MERs, I guess pre any sort of advisor compensation is 1% for TD and 0.77 for RBC. So I guess the argument is you can go buy an index fund for a fraction of that

[0:05:33.7] BF: And buy XIC for whatever it's at, 10 basis points or something

[0:05:36.3] CP: It's that spread that is really being overpaid.

[0:05:39.3] BF: I think fund managers, like the people who are managing those funds, when you think about what their incentives are, they don't, they don't want to underperform the index and they especially don't want to dramatically underperformed the index.

[0:05:51.7] CP: Therefore, they can't be different, too different from the index. Otherwise you have, you know, career risk I would guess.

[0:05:56.8] BF: Exactly. There was a research done on this in 2016 I didn't actually like the paper very much because I didn't like their – the paper was saying that active share actually predicts outperformance. If you find high active – you remember that paper? You find high active share funds are actually going to do better anyway. I didn't like that conclusion of the paper because it was, it was later disproven by somebody else very quickly.

[0:06:20.2] CP: But is used often to promote active funds in Canada by advisors.

[0:06:24.2] BF: But one of the outcomes of the paper that's interesting in the context that we're talking about is that they looked at the Canadian market and found that 37% of Canadian equity mutual funds are closet index funds. Meaning they've got low enough active share that they're basically the index.

[0:06:37.2] CP: Yeah. It's really interesting cause I'm not sure they are closet index funds deliberately. It's just a function of size and the Canadian marketplace like what else could they be? So I guess the point of the lawsuit is, well you better come clean and therefore say you're an index fund and revamp it, which would dramatically cut profits in those funds for the banks. That’s a huge profit margin.

[0:06:57.1] BF: This is a lot of money.

[0:06:58.6] CP: A lot of money.

[0:06:59.5] BF: On a fund that size.

[0:07:00.4] CP: You know, we need to see what happens.

[0:07:01.9] BF: I looked at the regression coefficients. I know we're not supposed to talk about factors, but different context. I did look at the, how different are these funds from the market from a factor perspective, and they're both pretty much perfect market exposure, market beta of one and minimal exposure to other factors. And they've got large negative alphas, which you'd expect from exactly what you'd expect across the board.

They looked at it from a factor perspective, they looked a little bit different from the index but not that much different, but maybe different enough that they're not a closet index fund. Like they both had value tilts. So who knows. It'd be interesting to see if it gets certified and if it does get certified, what the uh, what the outcome will be.

[0:07:40.1] CP: So a friend of ours shared an article from the Wall Street Journal about the perks that are really fueling up this IPO frenzy that's happened lately.

[0:07:47.9] BF: Yeah.

[0:07:48.5] CP: So much talk about IPOs now. Yeah. And I think you said you had a stat here that shows the IPO volume could be as big as it was back in 1999.

[0:07:56.0] BF: Yeah, that's from the, the paper that we're talking about here or the article that at least spurred us to have this part of the conversation showed that, if the proposed or the IPOs that we think are going to happen end up happening in 2019, that this could be the biggest year for fundraising. Yeah, like you said since 1999.

[0:08:14.1] CP: I think Lyft is already gone and then Uber maybe coming up Airbnb.

[0:08:19.4] BF: Uber filed the rest one. So Uber's coming.

[0:08:21.1] CP: Yeah, I've had a few people ask about Slack, so at the same, as soon as it goes, I want to participate.

[0:08:25.9] BF: Pinterest is another big one. The question is, should people invest in an IPO? Obviously IPO isn’t a new thing, but people definitely get excited about them. People want to get in on the IPO allocation or they want to buy as soon as it starts trading. Yeah, you're right. The question is should you invest? Like what does the data say on IPOs?

[0:08:44.0] CP: Yeah. So many people just want to invest based on the story of that company and have no idea about the metrics or evaluations or anything

[0:08:50.1] BF: Which arguably don't matter anyway. But yeah, I agree. I think that the, one of the things that people should is that if you own index funds, you will get an allocation, well not the, not the initial allocation, but you, you will get a IPO stocks in the index fund eventually.

[0:09:05.6] CP: Eventually.

[0:09:06.5] BF: It depends on the index.

[0:09:07.5] CP: Usually it's in the first year though, right? Depends on the index.

[0:09:10.9] BF: Depends on the index, yeah. So I looked at the methodologies for a few different indexes. S&P Total Market Index, which is tracked by XEU and ITOT. They add IPOs quarterly. So it's not, I mean it's not infrequent.

[0:09:23.9] CP: Yeah, it’s pretty fast.

[0:09:24.9] BF: And they don't look at any liquidity restraints or anything like that. For the S&P/TSX Composite, which is a committee based index. S&P Total Market is not committee based, it's rules based. That's maybe a conversation for another day, talking about how indexes work, but anyway.

The S&P/TSX Composite adds about 12 months, that's it. They wait a year. Then the FTSE Canada All Cap. So S&P/TSX Composite, that's like XIC, FTSE Canada All Cap, That’s VCN those ETFs attract those indexes. They add IPOs after three months, but they have to meet a liquidity requirement. And if they don't meet that requirement then they wait a year as well. So anyway, the point is getting excited about IPO is was fine. You will get them in your index fund eventually. It just depends on which index or tracking.

[0:10:07.3] CP: But sure is a lot less demand now than there was back in ‘99 so it is a very different time I think.

[0:10:12.6] BF: Yeah, I hope so, I hope it is. And we start talking more broad data on IPOs, it's fine to look at, you know, I want to get on the Uber IPO. What IPOs actually look like in a broad sense, like what's the data on IPOs. There’s a paper that I've found from a 2017 called “The Long-Term Performance of IPOs, Revisited”. Pretty telling title. It does answer the question we're asking.

They looked at 7,487 US IPOs, they found that they tend to be high beta stocks with negative exposure to the value factor.

[0:10:46.3] CP: Which is what you'd expect, their growth characteristics.

[0:10:48.1] BF: Yup. The paper also found that using the, the Carhart four-factor model, which includes momentum, explains all of the underperformance of IPO stocks for the first three to five years. You'd expect that, I guess it's a good model. Of course it explains it. IPO firms continue to underperform over the first two years after going public, even when differences in size, book to market and momentum are accounted for, underperformance gradually declines becoming insignificant beyond two years after going public so that's, that's interesting.

[0:11:18.3] CP: So they kind of take on the more normal characteristics.

[0:11:21.1] BF: For the first two years, you would expect on average IPOs to underperform, after that, they would be explained by the regular characteristics.

[0:11:27.4] CP: Or normal type performance expectations.

[0:11:29.9] BF: Yep. So they concluded that there is a statistically significant and economically meaningful underperformance of IPO firms over time horizons of up to two years, even accounting for the usual risk factors. So that's definitely an interesting finding. Basically it means on average with IPOs, it's probably not going to be that great. They do also talk about though the on the initial allocation, IPOs do tend to pop.

[0:11:53.6] CP: If you can get it.

[0:11:54.4] BF: If you can get in on the initial allocation on the first day, they tend to pop.

[0:11:59.9] CP: I love to know how you get those allocations in today's world.

[0:12:02.9] BF: You can get them, you ask a broker, they'll try and get you an allocation, but you have to have –

[0:12:07.1] CP: But it's who gets that allocation, which broker gets that allocation? Do you have to buy a bunch of junk and other times to get access to the good stuff? I mean that's the stories we used to hear back in the 90s.

[0:12:17.8] BF: Interesting.

[0:12:18.6] CP: So if you were persistent buyer of IPOs, no matter what the quality was, you'll get the good ones, but you had to take some of the bad ones. I have no idea if it's like that today or not.

[0:12:27.7] BF: We've had clients that have gotten some initial allocations but you have to put up, you have to want to buy a lot and you're not going to get the amount that you want.

[0:12:34.9] CP: You must have to have money there as well. Managed money on the books and that for sure.

[0:12:39.5] BF: And you get a pro rata allocation, like you're not going to get the amount that you want. You're going to get proportionally, the amount that you want relative to everybody else based on the amount of that broker gets allocated.

[0:12:47.8] CP: Not a lot of experience there.

[0:12:49.6] BF: But people like IPOs because lottery effect, obviously, people are willing to accept the probability of losses for the small potential of a very large gains.

[0:13:00.3] CP: Plus, it's a great story, to be able to say you got, I got to draw down of the Slack IPO.

[0:13:05.9] BF: Yeah. Move on to the portfolio topic for this week? Yep. So that was the two stories we just talked about though is the IPOs and closet indexers we mentioned, we mentioned the financial planner titles as well, but that's it for the current topics. So for, for the portfolio topic, I thought we'd talk about the arguments against.

[0:13:24.0] CP: Now you're working on a paper for this?

[0:13:25.5] BF: No, not a paper. I just did a – I wrote the script for a video that we'll do in the next few weeks. That's where I got some of this a, talking points came from. I think that I –

[0:13:35.0] CP: I find it quite amusing actually to work on making arguments against indexing.

[0:13:40.3] BF: I think I boiled it down, it wasn't as clear in my script, so maybe I need to revisit the script, but when I wrote the notes for this discussion, I think it comes down to three main arguments. The first one is index funds are risky because there's no downside protection. We'll dig into more of these, each of these more in a sec. You got no control over your holdings, which may be another expression of the first one, but it's different enough that it's worth talking about separately. And then the last one is that a skilled active manager will always be an index fund. So those are the three reasons and obviously –

[0:14:10.0] CP: We hear this all the time. So when clients transition to us from where they are now, this is often the arguments that they will hear from the advisor that's losing the business.

[0:14:19.5] BF: Oh yeah.

[0:14:20.8] CP: And quite forcefully. And it causes often a lot of stress for people and they go through this.

[0:14:24.8] BF: So let's dig in to each one of the, each one of those reasons. Uh, index funds are risky. Like I mentioned before, you have to infer from that, that there's an alternative index or risky relative to something. And the idea would be that they're risky relative to an active manager who can do stuff like protect your downside. So that's been studied. Of course, Vanguard looked at it and in a 2018 paper, and they looked at US mutual funds, found that, they looked at a handful, I can't remember how many, a handful of historical bull markets and bear markets I looked at – in each bear market, what percentage of active managers outperform the index. Same thing for bull markets.

And they found, there was nothing statistically significant. There's nothing obvious, but they've found that in some bear markets, more than 50% of active managers outperform, but in other bear markets, more underperform.

And they're – like I said, nothing statistically significant.

[0:15:17.1] CP: Which is kind of what you'd expect.

[0:15:18.0] BF: It's just random.

[0:15:19.0] CP: But if you were that good, there should be a significant difference in returns.

[0:15:22.8] BF: Significant difference. But it's also the skill thing where if you're that good, it should show up in subsequent bear markets. So the Vanguard looked at that too. They took the funds that did well in bear markets and said, how did they do in the next bear market?

Zero relationship, which is again what you would expect based on what we understand about financial markets and so anyway, no merit to that. The idea that index funds are risky and I've heard financial advisers would be very passionate about this, like tell their clients you know, while index funds so that they're, you've got to understand they're very risky.

[0:15:54.2] CP: Because they own everything.

[0:15:55.0] BF: All the stocks.

[0:15:55.7] CP: All the bad stuff too.

[0:15:57.0] BF: Well that takes us to the next, the next argument against index funds. You get no control over your holdings, which is obviously true.

[0:16:04.2] CP: And think of the emotion behind that. Everybody wants control. I mean that's the main driver I think for having active management. You want to control what you can. Index funds, you have no control, which I totally disagree with.

[0:16:15.8] BF: But again, it comes back to what is, what is the alternative? If you don't want to own all of the stocks because you want to avoid the bad ones and buy the good ones, the question becomes what is a good stock? And I think that the, the most interesting way to think about that is that there's a huge difference, huge difference between a good company and a good stock.

Because a good company may not have good stock returns, and that happens. There's one data point that I found that from 2010 through to 2017, so this is just speaking to the quality of a company versus the quality of a company's stock returns, from 2010 through to 2017 Google, Apple, Amazon, and Netflix over that time period, explosive growth, as everybody knows. And over that same time period, Domino's pizza destroyed their stock returns.

[0:17:06.0] CP: Amazing.

[0:17:06.8] BF: Didn't just do a little bit better, like dominated them, barely even comparable on a chart. Yeah, that speaks to that point. Uh, and then there's all the data around the number of stock cars that drive market returns. So you look at the – there’s a study from a couple of years ago that looked at the, all of the stocks that had ever been included in the crisp index. So send it for research and security prices. 26,000 stocks that had been at some point in the index from 1926 through 2017 I think it looked at, 2015, so only 1000 of those 26,000 stocks were responsible for all of the return in excessive T-Bills.

[0:17:41.7] CP: And that's kind of the data point we've talked about two weeks ago, I think.

[0:17:44.4] BF: It is.

[0:17:44.8] CP: That so few stocks were responsible for all of returns and you never know which ones are going to be and you think about intuitively all the stocks in the market are traded so actively every day, all day by all similar participants, all the information's priced in there.

Why would you expect necessarily one to outperform the other or anyone to have that ability to find that one.

[0:18:06.5] BF: So there's really no merit to that argument either that you get control over your holdings by not being in an index fund. That's true. But there is zero benefit to that. And I think that the other, the other aspect of that point is that you end up with, well this maybe be better to talk about with the first point with index funds being riskier.

When you introduce active management, you're introducing a whole other level of risk. Because now you're not just taking on the risk of the whole entire market. You're saying we think this subset is going to do better, which statistically based on the data we just talked about is extremely unlikely, but now you're taking on that risk that this subset is going to be better even though statistically it's much more likely to be worse and that's active risk.

Now, you're taking market risk but you're also taking active risk

[0:18:49.5] CP: The other risk you're taking too is, will that manager be there for the long term? We've seen managers, I even poked through a couple of fun companies this morning that I used to use years ago. With all the star managers, we used to meet at the luncheons. I couldn't find one manager that I recognize the name of from you know, 15, 20 years ago, not one. Well how would he do with your business? How do you manage client's money in that kind of environment? Yet those website is still full of people that are being touted as a star managers today.

[0:19:19.7] BF: Wild. Well, there's a couple of data points that we have, that apply directly to what you just said. I think the other thing, last point on active risk, market risk is a priced risk. You expect a positive return over the long term for taking that risk. Active risk, no positive expected return, statistically much more likely to underperform and you wouldn't expect on average any added benefit from taking on active risk and that's the whole zero sum game argument.

On average, you'd expect active managers to underperform because of their higher fees.

[0:19:46.3] CP: And the last one you have, the last argument you have is a skilled active manager will always beat an index fund. That argument you hear all the time.

[0:19:52.9] BF: Especially when we start talking about the data. You start talking about mutual fund data. People will always say, well, you can't talk about mutual funds because no one's going to invest in the average fund. You're going to find a good manager. Um, and we've talked about, we've talked about these –

[0:20:06.3] CP: But the loaded word in there to me is ‘skilled’.

[0:20:09.0] BF: Yeah.

[0:20:09.6] CP: And humans are pattern seekers. And if you show someone a fund that has, has 10 years of great performance, they're going to automatically assume it was skill.

[0:20:18.9] BF: For sure.

[0:20:19.3] CP: But statistically we don't know that that’s skill.

[0:20:22.1] BF: It's very hard to know that it's skills statistically. And we've talked about these papers in the past, so hopefully it's not repetitive for people, but mark our heart in 1997 studied mutual fund performance found the results do not support the existence of skilled or informed mutual fund portfolio managers. 2010 Fama and French also looked at U.S. mutual funds with more recent data, obviously. They did find superior and inferior skill in the, in the tails of the, of mutual fund returns. But they also found that, that that's before costs, after costs even the skilled managers don't, they're not skilled enough to cover their cost.

[0:20:57.5] CP: It’s just a whole distribution left.

[0:20:59.0] BF: There are skilled managers but not skilled enough to cover their costs. That's interesting. And then speaking to your, your anecdotal examples that you're just talking about when we're talking about skill, one of the questions is like you were saying before, at what point, like how long is long enough, what's a long enough track record before you can determine someone's skilled and we know statistically that data point is 36 years with 2% alpha with a 6% standard deviation of alpha. That's the statistical definition of skill at a 95% level of confidence. But then you start looking at actual managers who've had long-term success. So, David Baker with the 44 Wall Street fund, top performing US Equity Mutual Fund for the decade in the 1970s, I believe? Not only beat the market beat every other fund and then the subsequent decade, which was the 1980s, I believe he, the fund lost 73% of its unit value over the time period over the, over the decades.

[0:21:51.4] CP: But Jeunesse example is the best ones. The class at the Bill Miller example, 15 years in our old beating the S&P 500 and I can remember getting a book from the company, I think we may have talked about this on a prior podcast, got a book from the company that introduced the Bill Miller Fund in Canada and we got the book and you know, years after that, whatever it was, a five, six years out that it was just terrible performance. And I think they got just obliterated in the crisis, right. Cause he was, you know, had a huge position in Fannie Mae.

[0:22:20.0] BF: Wow. I didn't find all those details but like you said. Ending 2005, 15 year track record, phenomenal. Starting 2006 pretty much every year, it was terrible performance and they get one year we'd beat the market in there. Um, and then after, after that he gave up.

[0:22:34.5] CP: To his credit, he said that a lot of it was luck in the road show. I can remember him saying that back in the in the - whenever it was, but the fun company spun this around to look at how great this is and that was the message to us as cause I buyers of this fund to look at how great it's been, but he did downplay, hey look, there's a lot of luck in this. And I recently listened to a podcast with him. He's quite modest about it.

[0:22:59.3] BF: Interesting. That’s not how it would be sold for sure. Even if he's modest.

[0:23:04.3] CP: No, no.

[0:23:04.6] BF: Okay. So that was really the three arguments that we hear about counter arguments for indexing and I don't think any of them have any merit at all whatsoever. If anyone has, if anyone has better arguments that we should address in an episode, be happy to hear them. Shoot, us an email, I guess. I'd actually be pretty curious if, if people do have good counter arguments to indexing, love to talk about that.

[0:23:26.3] CP: Okay. Planning topic for this week. I thought we'd talk about the cascading order of when to use what sorts of accounts.

[0:23:32.9] BF: Yeah, so account type planning. I guess I would, I would call it, but it's just obviously in Canada we have RSPs, we have TFSAs, we have RESPs, we have our RDSPs. In some cases, we have taxable investment accounts. We have corporate accounts which we're not going to talk about today. That's a whole other discussion. So we'll exclude corporate from this conversation, but I think that the, the very first thing to think about when you're deciding should I allocate to which account is, what's the goal for the money. If it's short term, probably not going to use the RSP, unless it's for buying a house or paying for education.

[0:24:07.0] CP: Or if you're going to be at a much lower tax bracket on the sell side.

[0:24:10.6] BF: But I'm talking about if you - you don't want to pull out a RSP.

[0:24:13.6] CP: Well it depends on the situation, right? If you really cast track, you might do an RSP at a high tax bracket now and if going to be a low tax bracket and a couple of years, just say an extreme situation.

[0:24:22.7] BF: In an extreme situation.

[0:24:22.7] CP: The point being, you got to be aware of what your tax bracket is going to be and what your needs are.

[0:24:27.7] **BF:** Yeah. And the point you just made, might address the opposite side of it where for short term needs, the TFSA is probably better just because when you put money in, you use up your room. When you take money out, you get the room back the following year.

[0:24:40.2] CP: Absolutely.

[0:24:40.8] BF: With the RSP, you put money in, you use of your room. If you take it out, even if it's in a lower tax bracket, the room is gone.

[0:24:47.8] CP: It's only extreme situations. And I'm not sure I've ever recommended that. But the point is to be aware.

[0:24:52.7] BF: Yeah. And so like I mentioned, I think that the only exceptions for short term needs with the RSP are home buyers plan. So if you know you're going to be buying a house, it can be a good idea to use the deduction. If you're in a high tax bracket and then knowing you, you're going to pull the money back out to buy a home.

[0:25:07.7] CP: Just watch your limit on that, which is down 35,000 and try to get it between you and your spouse.

[0:25:12.1] BF: It's got to be in there for 90 days.

[0:25:13.3] CP: It’s 35, 000 each.

[0:25:14.1] BF: That's true. 35,000 each. That's 70,000 total.

[0:25:19.9] CP: That's real money. Right? So.

[0:25:19.9] BF: But even then for home buyers plan, if you can avoid using it, like if you can come up with the cash in, uh, in other, in another savings account, use your RSP, get the deduction, great. But if you can come up with the cash elsewhere, that's better because the longer the money can be in the RSP growing tax free –

[0:25:35.3] CP: But if you got the cash and you need a bit more to get that down payment, you might as well cycle it through the RSP, trigger the refund, then use it. Again, situational issues come up.

[0:25:45.2] BF: That's the - lifelong learning plan. I've never actually seen someone use it but you can. Similar to the home buyers plan, just paying for education, slightly different amounts, similar rules.

[0:25:54.0] CP: But the best long-term account is a TFSA.

[0:25:56.2] BF: Which is confusing because it's also the best short term account.

[0:25:59.3] CP: Right. Cause that was a lot of people say, well he used my TFSA for short term cash flows and leave my investments and my trading account long term. It's like no, you got that upside down. For many people they'll never touch their TFSA or if they do is the last thing they'll ever touch.

[0:26:11.8] BF: Yeah, you're 85 years old, you're only asset’s, your TFSA, you take money out, you're not affecting your government tested benefits, you die, you can name a beneficiary so it passes outside of your state.

[0:26:20.8] CP: And you avoid probate.

[0:26:23.7] BF: It's pretty clean. But yeah. The TFSA, it's really good as a shorter term vehicle because of the flexibility around withdrawals, recreating new room. But it's also, it's also pretty great for being the longest term asset, which makes it, I think a little bit confusing for people to think about.

[0:26:37.5] CP: Yeah. Let's talk about the cascading it, the normal order of accounts that you would fill up. So generally speaking, it's the RSP first.

[0:26:44.9] BF: We'll depends on your income, on your tax work.

[0:26:46.2] CP: Sure. It depends on your income.

[0:26:47.4] BF: If we ever assuming someone's got a high taxable income, I would go RSP first, then I would go RESP because you get the matching grants, assuming you have kids. And then I would go TFSA if you have to choose. Obviously the best, the best case is you just max everything out and it's a non-issue and then you're investing in your taxable account. But if you have to make a choice and you have a high income, I'd go RSP RESP taxable. And if there's an RDSP in there too, that would fall in this, say, what did I say? RSP, RESP.

[0:27:15.0] CP: Because you get the grant.

[0:27:17.2] BF: TFSA

[0:27:17.1] CP: TFSA. If you have a mortgage?

[0:27:21.6] BF: Well yeah. If we're talking about the mortgage as a bucket, that starts to get pretty tricky. It starts to get pretty tricky because it depends on your asset allocation. Like if you're putting money into your, RESP or your TFSA, that's 50% stocks, 50% bonds, I might say pay off some of the mortgage or pay off more mortgage to be aggressive with the mortgage as opposed to buying bonds in your accounts. If you're 100% equity, I would go, well, it still depends on your asset allocation. If you're okay being more than a hundred percent equity through leverage, then you invest in a hundred percent stocks.

[0:27:53.2] CP: It also depends on your motivation too. Some people are very motivated to pay down debt. So if you're more motivated to pay down debt then to accumulating your TFAS, hammer the debt.

[0:28:02.1] BF: That's a behavioral decision.

[0:28:03.5] CP: Some people are extremely motivated to get rid of debt.

[0:28:06.1] BF: But if we're, if we're just talking about what is the most rational thing to do. The answer to your question depends on asset allocation, right? What is your asset allocation? But yeah.

[0:28:15.1] CP: But it's not irrational to allow your behavior motivations to drive you.

[0:28:19.7] BF: That's true. You're right. I have to make it a case from the behavioral side. Yep. So we talked about taxable income. I think something that people don't maybe understand all the time is that if your, if your tax rate stays identical, if it does not change between now and when you withdraw from the RRSP, your after tax result from using the RSP and the TFSA ignoring withholding taxes, which we'll talk about in a second, your after tax result will be identical.

[0:28:48.0] CP: What about the refund? The refund on the RRSP?

[0:28:51.3] BF: You have to think about it a certain way. This only, it makes this make sense, but you have to think about it a certain way for the math to work. So if you take the, if you're 50% tax rate, if you take $10,000 and put it in your RRSP, you cannot compare that to $10,000 that you put in your TFSA. You have to compare it to $5,000 that you put in your TFSA because the RSP is a pretax contribution. And I know in reality people contribute with after tax dollars and get a refund. You can't think about it that way.

You get the refund, you can use that for other stuff. But you've got to think about whatever goes into the RSP as a pretax contribution. And if you think about it that way than the example that I just say –

[0:29:27.6] CP: 10 grand of the RSP is really five.

[0:29:29.5] BF: at a 50% tax rate.

[0:29:30.7] CP: It’s really 5,000 in a TFSA.

[0:29:32.4] BF: Correct.

[0:29:30.8] CP: Like your net costs at the same.

[0:29:35.1] BF: Correct.

[0:29:36.1] CP: And then in that case, well that’s logical.

[0:29:39.4] BF: Yeah, it is. You can use that as a decision tool where if you, if your tax rate's going to stay identical, which you can't know obviously. But if it is going to stay identical, then you're indifferent but completely different between an RRSP and TFSA.

[0:29:50.7] CP: In that case a TFSA will blow it away cause you're paying tax in the RSP on the withdrawal side down the road.

[0:29:55.6] BF: If the, if your tax rate stays the same, it's the same if your tax rate stays the same beginning and end the after tax dollar amounts you will have available to you from the RSP and the TFSA is identical. If your tax rate stays the same, 10,000 the RSP 5,000 the TFSA, say it grows over time and in the future if you're still taxed at 50% and mean think it will just one year. There’s no growth.

[0:30:18.2] CP: But you take the money out of the RSP or it's going to be after have to pay tax and that withdrawal.

[0:30:22.1] BF: But you have $10,000 not five.

[0:30:24.1] CP: Of course, 10 is in there. Now I get you. Okay.

[0:30:27.8] BF: So that's it. That's it. So tax rate’s the same, equal result. As soon as you are in a lower tax bracket or paying low tax at a lower rate in the future than you are now, the RSP starts to have an increasing advantage depending on that differential. So again, you can use it as a decision tool. It depends on unknowns like, what is your future tax rate, but the, the point is I guess if you're in a higher tax bracket now relative to what you expect in the future. Unknowable. I get it. RSP makes more sense.

[0:30:55.9] CP: But I'll make the behavioral argument again, which is the limits that come out from CRA. For many people are really motivating just to maximize, just keep your head down to maximize everything.

[0:31:05.4] BF: Maxing everything, then our conversation is irrelevant. This conversation is only relevant for people that have limited cash and a have to make a decision. I think that it's pretty intuitive that if you, if you have, if you have ruined your RSP and TFSA, there's really no reason to invest in a taxable account with one exception. Know what the exception is?

[0:31:24.8] CP: I'll let you tell us.

[0:31:27.6] BF: If you're speculating on individual stocks, I would, I would rather see people do that in a taxable account than in their TFSA or RSP. The reason being if you put 10 grand in your TFSA and it goes to zero because you lose on the stock, or it goes to 60% of its original value, that room –

[0:31:45.7] CP: But if it happens to become a 10 bagger.

[0:31:47.7] BF: But, statistically you are way, way more likely to –

[0:31:50.6] CP: Look who's talking about but irrational stuff now?

[0:31:53.4] BF: What do you mean? That's not irrational.

[0:31:54.2] **CP:** All the speculating on stocks is not rational.

[0:31:57.4] BF: No, I agree. It's not rational. But if someone is going to do it, the numbers are stacked against them that they're going to win. So you're more likely to lose, therefore you should basically plan to lose rather than plan to win.

[0:32:07.3] CP: In doing your trading account. Using capture the capital loss and use it against future gains.

[0:32:10.5] BF: Exactly. Capital loss and you're not going to evaporate your registered account room.

[0:32:14.4] CP: Because those losses can be carried forward.

[0:32:16.4] BF: And on the flip side, if you do make a 10 bagger, it's at the capital gains rate. So on the off chance that you do win, it's going to be relatively tax efficient anyway and you haven't https://www.pwlcapital.com/wp-admin/profile.phprisked your registered account room, that's the one exception RSP and TFSA for long-term as long as you have room, unless you're picking stocks, in which case taxable account I would say is better.

[0:32:36.2] CP: Lesson points on withholding tax.

[0:32:38.5] BF: Yeah. So the last bit for this, once we've decided, okay, we're going to put x amount of RSP x amount to TFSA. The next question that follows that is how much of what are we going to buy? It's that whole asset. It's not even asset location because we can assume the same asset mix across all account types, but you can still decide to buy a US listed or a Canadian listed ETF in those accounts. And so for in our RSP, US listed, US or international or emerging market ETFs are going to be more tax efficient. In the RSP.

[0:33:13.1] CP: US listed.

[0:33:14.3] BF: US listed. Listed on a US stock exchange. The reason being, there is no withholding tax from dividends paid from a US stock or ETF to an RRSP account.

[0:33:25.0] CP: Whereas a Canadian listed, there's a withholding tax that goes in the US that Canadian Fund and you don't get that back in the RSP.

[0:33:32.8] BF: Right. So with US listed ETF of US stocks, there's no withholding tax. The really interesting one is with international and emerging market stocks, you're still losing withholding tax from the international and emerging markets countries because they're paying their, they're withholding tax on the dividend is paid to the US listed ETF. The reason it's interesting is because of the withholding tax with the treaty rate, the withholding treaty rate is on average lower for foreign countries to the US than it is foreign countries to Canada. So you're better off getting the US withholding rates and then eliminate in the US withholding tax.

[0:34:06.3] CP: We can make a whole section of the show on this topic alone.

[0:34:09.7] BF: Yeah, probably it is kind of interesting and I think the other big red flag, so you a US listed in the RSP for US and international and emerging markets saves you a bit of tax but obviously there are implications like you've got to pay currency conversion costs, you've got to rebalance between currencies, all that kind of stuff. But barring that, if we ignore those costs, it's more tax efficient. And then the other, the other one we'll keep an eye out for is with the TFSA. If you have US listed, you're going to lose two levels of withholding tax because TFSA, you don't get that preferential US withholding treatment. So you lose two levels of withholding tax using a US listed ETF of international or emerging market stocks or a Canadian listed ETF that owns a US listed ETF. So in the you a say, the best thing that you can do is Canadian listed ETF that holds stocks directly.

[0:34:57.3] CP: Once again, I can hear listeners' heads exploding now. The point is you've got to watch the withholding tax carefully on these things.

[0:35:04.6] BF: Yeah, well it's not, it's not that bad. In a TFSA. If you hold a Canadian listed ETF that owns international stocks directly, you're only paying the withholding tax rate for the international stocks paying the dividends to the Canadian ETF. Whereas if you hold a US listed, you're getting two levels of withholding tax.

[0:35:20.2] CP: Well, I know that. I'm just saying the listeners. That's okay. They'll get it now, we said it twice.

[0:35:23.8] BF: Okay, cool. And one of the challenges is for emerging markets, there are no, there's, there's one from Bimo, but it's not, not, not great. Most emerging markets, ETFs hold a US listed ETF. So the TFSA for emerging markets, you’re kind of, you're kind of out of luck. You're going to pay two levels of withholding tax.

[0:35:41.9] CP: Which is a meaningful amount of cash. It's like 60 70 basis points at least.

[0:35:45.9] BF: Okay. So that's it for the financial planning topic. I hope that was useful for people.

[0:35:50.6] CP: So the worst advice we heard last week: market linked GICs. This came up, haven't heard about, it's been a long time, but it came up recently.

[0:35:59.1] BF: Talk about terrible stuff. Terrible stuff.

[0:36:02.2] CP: Yeah. So someone owns a bunch of them and didn't really understand, but when they looked into them, they realize that there's a whole lot of complexity here. I don't really get it. And they surmise that it's probably better for the bank that it is for them to, which I said that's a pretty fair assessment. And the ones that I've looked at, and there's a ton of these out there, but there is liquidity on it's, we're going to look into it and see.

[0:36:21.8] BF: There is liquidity?

[0:36:21.9] CP: There is liquidity.

[0:36:23.3] BF: Is it reasonable liquidity?

[0:36:24.4] CP: I'll have to find out. I think each one has different rules that you have to follow. I remember we had some way back that you had certain times a year you could sell them and it was a certain percentage of NAV. So net asset value. So I'm going to have to look into it. I don't know even which series this is, but a lot of them have this promise that you get this beautiful potential return with no downside. And I've seen all kinds of combinations over the years. You know, we'll give you whatever, 7% of the upside each year, but if you have any one of the years is bad, that's rolled into the average, but there's no downsides. Ends up becoming is very complicated and all people really hear is I get some upside with no downside and then she was a good enough to make the decision.

[0:37:06.1] BF: I think the key is you eliminate downside in most cases, but you cap upside. That's basically the essence of the product, structured notes and market link GICs, you're giving up potential upside for eliminating downside.

[0:37:18.6] CP: And it locks in the money for the bank and it pays nice commissions for them. I think there's like a 4 to 5% offered as a commission rate on these things.

[0:37:25.2] BF: Which obviously hurts you as the investor. But I think that the lock in period that you just mentioned, that's, that's the biggest key to these products. Over one year, I might even say it's not that bad of a deal, but over five years there's about a 70% chance that markets are going to be positive. So over five years in more cases than not, you're going to lose by capping your upside more than you would have gained on average from protecting your downside. And I looked at it, it was a few years ago that I looked at this, I went to one bank's website that published all their structured note data and I went and did over the life of each of these products historically. How did they do relative to a balanced portfolio of index funds.

[0:38:04.0] CP: I didn't know you did that.

[0:38:05.6] BF: I couldn't - when we migrated our website, I think the blog posts was, it wasn't carried over so I couldn't find it, which is a shame because there was some good data points in there, but basically the, the vast majority of market link GICs underperformed.

There's like a few specific ones that like they were linked to gold stocks or something and that happened to be a good period for gold stocks and those outperformed. But anyway, the point is the, these products play to loss aversion for ambassadors. Well, I don't want to lose money, but I don't want to give up upside. Well this solves both of those problems. The reality is using these is you're being hamstrung by the upside cap.

And the downside protection shouldn't mean anything to you as a long-term investor anyway. So I don't, I don't think that there are any – well, we don't use them, so no, I don't think there are any situations where I would say yes, a market linked GIC or a structured note is a good idea. You agree?

[0:38:50.7] CP: I agree 100%. Anything else you'd add

[0:38:53.3] BF: No, I think that's good for today. Obviously the, we have video today, so if you're listening, you could have been watching.

[0:39:00.3] CP: Why, I'm not sure, but you could have been.

[0:39:02.6] BF: And if you're watching, I mean, let us know how we look, I guess. And if you have a feedback on the format of this every other week show, let us know.

[0:39:11.8] CP: Of the just us. I think that I like the new us format. I thought it was good. We'll see. We'll see what the listeners think though. Feel free to let us know.

[END]