EPISODE 82:

The Rational Reminder Podcast Episode 82: Sustainable Investing, Retiring on Index Funds, and Fee Location

[INTRODUCTION]

[0:00:05.7] 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.

[0:00:14.6] Cameron Passmore: Exciting week this week. We have new microphones.

[0:00:16.7] BF: I was going to say that. Yup. I hope we sound better.

[0:00:20.6] CP: I think it always sounded originally good, but these are nice new mics. It's our first small step towards our studio, hopefully in the next few months. Anyway, this is a long episode so we'll make the intro quick. Big focus was on ESG investing.

[0:00:33.7] BF: I think that's it. Let's fire up the episode.

[0:00:35.4] CP: Fire it up. Let it go from there. Some interesting things on fees too that came up from a recent article. Yeah, but it's a long one. We went slowly, so that you could appreciate all the research that Ben has done on ESG investing. With that –

[0:00:47.0] BF: Well at least at the very end, we had a pretty interesting discussion about where you should pay your fees from. Hopefully you can get through to the end, because there's a good discussion there.

[0:00:54.3] CP: Thanks for listening.

[EPISODE]

[0:00:59.5] BF: Welcome to episode 82 of the Rational Reminder Podcast.

[0:01:02.5] CP: It sure is number 82.

[0:01:04.5] BF: Yeah. Yes, it is.

[0:01:06.4] CP: Off the top, I just finished a book by Michael Lewis, *The Undoing Project*.

[0:01:10.9] BF: You've mentioned this book before, I think as you're reading it.

[0:01:13.3] CP: It's a phenomenal story in a way that really only Michael Lewis I think can tell a story like that. I'm sure you've read maybe his past books, like *Moneyball*, or *The Big Short*, or *Flash Boys*. We take these events and ideas and stories and just weaves them into an incredible, incredible book about the impact that these two behavioral psychologists had, Amos Tversky and Daniel Kahneman. I know we've talked about for sure Kahneman in the past. He wrote the book *Thinking Fast and Slow*. It was an amazing story about how these two guys came together in the 60s in Tel Aviv, I believe. Over time, they just became – He describes it – Michael Lewis describes it almost like a love affair. They were together all the time, like six hours a day every day for so long. Did you know that Kahneman spent time at UBC?

[0:02:00.0] BF: Oh, I did not know that.

[0:02:00.8] CP: Didn’t know that. Yeah. Between there and Michigan, as well as time in California. Yeah, it's an amazing – What these guys discovered and how they worked off each other to discover these biases that we all suffer from and heuristics that we have. I saw a recent interview with Kahneman. Even he said – well, it was with Shane. He’s with Shane on the knowledge project talking about even he after being a so-called expert on this for so long, he still falls prey to these issues and these biases.

[0:02:29.0] BF: Does he catch himself at least?

[0:02:30.7] CP: I don't think he does actually. He doesn't think he has any greater insight than anybody else. Some of the examples that they talked about representative bias and people misjudge the odds of a situation all the time. Your judgments are totally distorted. You make serious errors. Availability and all the systemic biases that are caused by our judgment being distorted by the memorable, things that we saw recently, or we remember conditionality that

people don't know what they don't know. They also don't factor their own ignorance into their judgments.

One of my favorites is the anchoring bias and we've done this in a seminar a while ago, where if you spin a wheel that has between one and a 100 as an example and depending what that number comes up, that will often guide people into how the answer a question such as what percentage of African countries are in the UN? If you happen to have spun a higher number, you're going to guess a higher number for the membership level.

[0:03:20.5] BF: Fascinating.

[0:03:22.0] CP: The book is loaded with examples. How they discovered – I mean, I think it's fair to say they discover this entire field of behavioral psychology. Kahneman won a Nobel Prize for that. How they worked off each other to develop ideas and questions and tests, there's all kinds of risk profiling type questions, loss aversion questions that that they came up with. It's just how they interacted that just created this incredible body of research.

[0:03:48.9] BF: Once in a lifetime relationship thing.

[0:03:51.9] CP: To tweak the interest of Michael Lewis, for him to actually go ahead and write the book, quite something.

[0:03:57.6] BF: You read way more than I do and probably way more than most people. I know you always say it's because you don't have kids at home. It's true, because I spend a lot of my weekend playing with the new Hot Wheels track that we got with my kids.

[0:04:13.0] CP: I'm bringing my kids Hot Wheels track to Value Village.

[0:04:16.3] BF: Oh, you still have it?

[0:04:18.4] CP: Yeah, help yourself.

[0:04:19.3] BF: You got the Hot Wheels track?

[0:04:21.4] CP: We'll have to negotiate with James, but yeah, we're loaded with stuff.

[0:04:23.4] BF: I'm going out and talk to James after this. Carrying on, what I was going to ask you was – so you read all this material. How do you think about applying it to the stuff that we do with clients every day? You go and take in this amazing story about Kahneman and Tversky and you reiterate to yourself all these biases that you already were aware of, but now it's fresh in your mind. Do you take that and apply it in any way?

[0:04:44.0] CP: I think it gives me greater appreciation for all these ideas came from. I think we do at some level something I've thought about a lot lately is as you consume, we all consume so much material. How do you archive this and how do you recall this that can be useful in these client meetings, or even just day-to-day life. I listened to a fabulous podcast yesterday with Tim Ferriss interviewing Bob Iger of Disney. Incredible story, how he got to where he is.

What do you pull out of that? He gave a famous quote by Theodore Roosevelt. It's the how to recall it, how do you organize it. Actually, that's a question Tim asked him. He says, "I'll actually e-mail stuff to myself." There's a whole e-mail folder. I'm trying to save ideas in my Evernote system and try to categorize them there, but it does become a challenge to organize and recall all this material.

[0:05:33.3] BF: Absolutely. Huge challenge.

[0:05:35.2] CP: Then I've got so many books and ideas backed up to read that it's crazy. I need more time. Anyways, onto the next news story?

[0:05:41.7] BF: Yeah. I thought this one was good. It was from December, so it's not super timely I guess. It was about CalPERS, the big California state pension fund, California Public Employee Retirement System. CalPERS.

[0:05:54.4] CP: CalPERS, a massive 380 billion dollar pension system. Largest in the US.

[0:06:01.2] BF: Yeah. The interesting thing about it is that they have made – and they've been pretty vocal about this over time. I think they've just done another round of firing, but they're

getting rid of a bunch of their external active equity managers and bringing a lot of those assets in-house. When they bring assets in-house, a good portion of that goes into index strategies.

[0:06:20.9] CP: It's incredible. The most recent cuts, they cut the number from 17 mandates to just three external managers. Cutting that allocation from 33 billion down to 5 billion out of a 380 billion dollar pension system.

[0:06:35.7] BF: It's crazy. They're citing underperformance and they're citing high fees and those things obviously go hand in hand. It is interesting, because they're – and I don't remember which one, but there was a pension fund that I read an interview from, or the pension fund manager that I read an interview from a while ago. They were talking about how active has been the best thing ever for them and they've totally smashed the market. You just think with the distribution of outcomes, CalPERS happens to be on one side.

Imagine just the impact on the investing community in general if CalPERS had happened to fall on the good side of the distribution and had a great experience with active managers. That could shift a whole needle in terms of this wave of indexing. If a more vocal market participant, or a larger market participant happens to have a good experience with indexing, that could shift the whole dialogue. Statistically, that's unlikely and that's where – we're seeing this statistically likely.

[0:07:23.2] CP: It goes out a portfolio of that size.

[0:07:24.8] BF: Right. We're seeing this statistically likely outcome. It is just interesting to think about. There are some pension funds out there that have done well, or at least say they've done well with active management. They're maybe just not as big, or not as vocal.

[0:07:36.1] CP: According to Morgan Stanley, there's been about a trillion devices that have left active managers. They say the long-term picture is also grim. As in the past decade, only 12% of managers have outperformed the broader stock according to –

[0:07:48.2] BF: According to SPIVA report. You know what I'm really excited for? If it happens and I don't know if it's going to happen. I got an e-mail from somebody who's in our business a while ago and they were just saying, "Hey, I've checked out your videos and I think they're

great." They're an active manager, but they wanted to say, "What do you think of the SPIVA report using A class funds?" Which they do and I've asked them about that in the past to confirm that's what they're doing.

[0:08:09.4] CP: A class. Having the trailer fee built in.

[0:08:11.4] BF: Correct. If the fund, the F class fund without the trailing commission costs 1.5% just to manage the fund, there's an additional 1% cost that's designed to pay a financial advisor.

[0:08:21.9] CP: Did you say F class at 1.5?

[0:08:24.0] BF: Yeah. Just say you take an F class fund at 1.5%.

[0:08:26.4] CP: Could they be that expensive? I guess they could be. Yeah.

[0:08:29.2] BF: Yeah. Well, you're used to the F class funds that we see that are 30, 40 basis points. Actively managed F class funds are still going to be 1%, 1.5%.

[0:08:36.5] CP: Done any of those in so long.

[0:08:38.7] BF: Yeah. The challenge with the SPIVA report using the A class funds is that you have – you're comparing the index, which has no fees to active funds which not only have active fees, but they also have trailing commissions for advisors built into them. It's not a great way to do the comparison. Anyway, so I e-mailed them and said like, "Hey, we're an indexing firm in Canada and we would love your report. It'd be awesome if you could run it like this just to see how it changes the distribution of outcomes." Because those numbers, like that 12% of active managers beat the market over a decade wherever. People always cite that, but it's using A class funds. How does the story change if we use F class? Shouldn't change a ton, but it should change a bit.

[0:09:15.4] CP: As the article goes on as you know, some analysts believe that this has to turn around. Another active management says they've been unjustly vilified. That's so sad.

[0:09:25.5] BF: I can see that you're feeling sad about it.

[0:09:27.9] CP: The thing is it's more a testament to how bright these people are. That's the whole point. They're fighting – the weak competition is being driven out, so you're left with the best competitors. It's a tough game. A lot of very smart people.

[0:09:40.2] BF: Yeah. What you said is extremely true. That 1 trillion dollars that have left active managers, which active managers has it left?

[0:09:48.1] CP: Likely the weakest ones, right?

[0:09:49.5] BF: Probably the weakest, the least skilled. The most skilled active managers are keeping more of their clients at least, which means the remaining active managers competing with each other for alpha are the skilled ones. Which means that the skilled active managers no longer have unskilled active managers to exploit degenerate alpha.

[0:10:04.4] CP: Exploit. That's right.

[0:10:05.5] BF: Now they're battling with each other, these two ultra-skilled managers. Then you've got the whole paradox of skill problem where those two ultra-skilled active managers say equally skilled, if they're competing for alpha, who's going to win on the trade on average? It's going to be determined by luck, by pure luck.

[0:10:20.1] CP: I also like the article that we dug up from the Financial Times on January 12th. Vanguard to become the first asset manager to break the 6 trillion dollar mark. I thought these are some interesting stats in there. Their net sales in 2019 were 268 billion dollars. 16% increase over last year. However for the first time in seven years, Blackrock had greater sales than they did. Based on the sales, the first nine months of 2019 at 300 billion dollars they're expected to break the all-time sales record of Vanguard, which they said in 2017 to be above 371 billion dollars.

What is interesting to me is can you believe where Vanguard sales went? Only 20% went to long-term equity funds. 60% went to long bond funds and 20% went to money market funds. The CEO of Vanguard said that many of their 30 million clients became defensive after the rough patch in the fourth quarter of 2018, which many people will remember was a rough time.

[0:11:20.7] BF: Of course. It was a good time to take a defensive position.

[0:11:23.5] CP: Ain't it amazing though? A group who you would think would have selection bias in their clientele with much more discipline –

[0:11:30.5] BF: Well, we know that index fund and ETF assets are being used. We don't know actually. We know to an extent, they're being used for active management purposes. I don't know what the proportion is of how much is being passively held versus actively traded. I think you had a stat a while ago though showing that a lot of these total market ETFs, their average holding period is less than a year or something like that.

[0:11:51.1] CP: Oh, way less than a year. I think some of them are in the matter of weeks or days. We looked at that.

[0:11:56.2] BF: It's not like people are on average just passively buying and holding these things.

[0:12:00.5] CP: No. Anything else in the news front?

[0:12:02.6] BF: No. I think that's good for the current stuff.

[0:12:05.2] CP: Onto the portfolio topic, which is socially responsible investing.

[0:12:09.0] BF: Yeah, this ones come up – well, it comes up all the time. We've talked about it a little bit here and there in the past, but it's becoming an increasingly big deal. We can see that just by the assets. When you look at US domiciled assets under management, at the start of 2018, it's a bit old now, it's probably higher. At that time that started 2018, 25% of all US professionally managed assets were in sustainable strategies. That being a very broad term that describes all sorts of socially responsible, environmentally friendly, all that stuff.

[0:12:42.2] CP: On that, announcement last week by Blackrock was huge, I think.

[0:12:46.3] BF: Yeah. It was a big announcement, because Blackrock is a big company. We'll see how it actually shakes out. I think there was a lot of negative pushback on –

[0:12:54.7] CP: Was there?

[0:12:56.5] BF: Yeah. I mean, the things that he was saying were not fact-based a lot of them. Saying that which we're going to talk about, sustainable strategies tend to do better. False.

[0:13:05.8] CP: There's the teaser.

[0:13:07.1] BF: Anyway, we'll talk more about that in a second. In Canada, the sustainable assets are about half of them managed market, which is that's a lot.

[0:13:15.9] CP: It's a way higher than it would have guessed.

[0:13:17.3] BF: Yeah. 2.1 trillion dollars in Canadian dollar terms. That number is up 42% since 2016. That’s professionally managed funds in sustainable strategies.

[0:13:26.9] CP: In a sustainable strategy, not just holdings that are deemed to be sustainable.

[0:13:30.8] BF: Right. You look at ton of the big Canadian pension funds have done things similar to what Blackrock has done, where they've said publicly, we're going to make sustainability an important part of our investment process. This idea of social responsible investing or sustainable, let’s call it sustainable for the rest of the podcast. That concept is growing in terms of the assets under management. That fact is extremely important, which we're going to talk about as we go through this segment.

As an investor when you're thinking about should I build a sustainable portfolio, or should I put sustainability at the forefront of my investment decisions, I think that there are a couple of main things you've got to think about. One of them is what is the impact on your expected returns, which is maybe an obvious consideration. Then the other one which is probably more important and probably less obvious is how sure are you that the thing that you're investing, which may have an effect on your expected returns, a negative one. I spoiled it. How sure are you that this portfolio with a lower expected return by definition, how assure you that it actually reflects your

views and values? Because you can go and buy this sustainable portfolio that's got the sustainable label on it, but there's a pretty good chance that it's not going to meet your definition of sustainability. We're going to talk about why that's true. Sorry, I keep giving teasers.

[0:14:46.2] CP: Yeah, and how much impact it's really going to have.

[0:14:48.8] BF: Well, yeah. The impact thing is interesting and I've got notes on that too. Maybe just to set the discussion, there are two main types, the two most common types in terms of assets of sustainable investing strategies, one is negative screening.

[0:15:03.2] CP: Taking out what you don't like.

[0:15:05.0] BF: Totally taking it out. Then the other one is ESG integration. ESG is Environmental Social Governance. The integration, the integration strategies opposed to totally excluding stuff. An integration approach changes the weight of companies. The highest ESG ratings, the most sustainable companies or whatever you want to call it, they get a higher weight in the portfolio and the worst companies get a reduction.

[0:15:29.0] CP: More of which you want. Less of what you don't.

[0:15:31.0] BF: Right. Most ETFs, like if you look at a sustainability ETF, there's a good chance they're going to be using both strategies. It might be an ESG integration approach, but they've completely eliminated tobacco, or weapons or whatever. In a lot of cases, it'll be both strategies going on.

[0:15:45.4] CP: Are most companies using a similar type scoring system?

[0:15:49.2] BF: Oh, Cameron. Good question. We'll cover that in a second though. It is a really good question and it's a really important question. No is the answer. I guess I really thought through this topic, so I have it all structured in my head. That’s why I keep getting these –

[0:16:00.6] CP: Yeah. I don’t want to rush you. I know there's – we’ve got a lot to cover here.

[0:16:03.3] BF: That's why I keep giving these teasers by accident. Okay, so if we talk about the effect unexpected returns and this is one of the most important pieces. Well, it's those two pieces together I guess that are jointly important.

[0:16:13.0] CP: When we're dealing with clients, how often does that consideration come up compared to the desire to have an impact, or reflect our values?

[0:16:20.7] BF: Well, I think it doesn't come up because people don't have the knowledge to even ask that question. What client that is worried about climate change is going to say, "Cameron, will this affect my expected returns?" That's literally the last question they're going to ask. I guess, what I'm saying is that you're right. That's not what they're thinking about. I think that's because there's a lack of knowledge. That's why understanding the trade-off between expected returns and reflecting your values is important. I just want to throw in there, I'm not anti-ESG. I think it's fine if you want to do that, but you've got to understand the trade-offs, which is the point of –

[0:16:48.9] CP: Well, you're just bringing the facts. You've dug through the papers, so fire away.

[0:16:52.7] BF: Okay. If we think in broad terms of the effect on ESG scores on stock returns, that was examined in quite a bit of detail in a 2019 paper by Rocco Ciciretti, Ambrogio Dalò and Lammertjan Dam.

[0:17:07.9] CP: Look at you. You pulled off all three names.

[0:17:10.4] BF: Thank you. They controlled for common risk factors. I wanted to say this too. This is another really important point. If you don't control for common risk factors, an ESG portfolio can actually look really good compared to the market in terms of returns. That's important, because if you take say just a regular market cap weighted index and compare that to an ESG index, the ESG index may have outperformed the market. Why though? It's because it has excess exposure to certain types of risks.

[0:17:38.0] CP: Luckily, all our listeners get that.

[0:17:40.0] BF: That's right. At this point, probably a lot of them do. You'll often see a loading to the profitability factor if you invest in an ESG index.

[0:17:48.2] CP: Reinvestment as well, perhaps?

[0:17:49.9] BF: I can't remember. It's been a while since I looked at the – I wrote a blog post a while ago on doing a five-factor regression on an ESG index, because somebody had written an article saying, “Look, look. ESG index has beat the market.” I was like, “Hold on. Hold on. Did you run a five-factor regression?”

Anyway, so in this paper the paper that I mentioned, they controlled for the common risk factors. They looked at 5,972 firms globally and they looked at the data for 2004 through 2018. They found that companies with higher ESG scores tended to deliver lower average returns. There we go. There we have it. Lower historical returns. They found a statistically significant negative premium for the ESG characteristic in a traditional Fama French factor, five-factor regression. They also did a si- factor aggression including momentum. They did a seven-factor regression including an ESG risk factor, which we're going to come back to in a second, because it's important in a different context. In all cases, they found that better ESG ratings and stocks produce lower expected returns.

[0:18:47.1] CP: They included momentum.

[0:18:48.6] BF: In one of their regressions, they did a bunch of different ones.

[0:18:50.7] CP: Really curious to just as an aside thing, the momentum going into these stocks now if there's a momentum fact that may be happening.

[0:18:56.7] BF: Yeah, it's a good question. One of the papers that I read did talk about that actually. If there becomes a quick, strong preference for ESG products, that can drive the prices of those securities up, which can make the returns look good, but only for a short period of time. Because once the prices jump based on the interest, their future returns are now lower.

[0:19:13.6] CP: Higher the price, lower the expected returns going forward.

[0:19:15.5] BF: Correct. Which is a theme all the way through this whole ESG conversation. In that, in the paper that we're talking about, they found that a one standard deviation decrease in the ESG score was associated with a 0.13% increase in monthly expected returns. It was meaningful. When they controlled for all the common risk factors that I mentioned in those different regressions, they found the lower historical returns of the ESG risk, no the ESG characteristic, which is different from the ESG risk factor. The reason that the ESG risk factor is important is that they used exposure to that factor to try and determine whether the ESG negative premium is coming from an ESG risk factor, or an investor preference. That distinction is very important in thinking about this.

If it's an investor preference and Fama and French did a paper about this in 2007 called disagreements, tastes and asset prices. They basically said that if investors have a taste is what they call it, but if they have a preference that's not related to risk and expected returns for a certain type of assets, they'll be more willing to hold those assets regardless of their risk return profile.

[0:20:21.9] CP: That makes sense.

[0:20:22.9] BF: If enough wealth is controlled by investors that have that type of taste and this is why at the beginning of this discussion, I said that the magnitude of assets going to these strategies is important, if enough investors have a specific taste like we're seeing with the sustainable investing movement, that can have a meaningful effect on prices.

[0:20:40.0] CP: Driving them up you're saying.

[0:20:41.6] BF: Driving them up reducing expected returns.

[0:20:43.6] CP: That may be okay with those investors.

[0:20:46.0] BF: That's an important part of this whole thing. Another way to think about this is that – well, it's like what you just said. The investors that have a taste for sustainable investments, well, this is the inverse of what you said actually. Investors that have a taste for sustainable investments require higher expected returns to be convinced to invest in an unsustainable company. Now we've got just say for argument's sake, half the market.

[0:21:06.0] CP: Is that necessarily true?

[0:21:07.5] BF: Is what true?

[0:21:08.3] CP: Well, you're saying that if the sustainable investors are pushing up the prices of these securities they want, are they then setting the other non-sustainable investments, prices lower saying we're demanding a higher rate of return for us to invest in those just by them not going there? Or could you have a whole cohort of investors that say, “I just don't want them. Regardless of the expected returns.” Therefore, leaving an opportunity set for other investors, of the non-ESG investments.

[0:21:34.8] BF: Those are two different things. There's exclusion and there's investor tastes. Exclusion leads to an actual risk premium, because neglected stocks that a large portion of investors will invest in like you just said, they actually become riskier. One of the main academics, I can't member who it was. Maybe it was Miller. Anyway, or maybe it was Robert Merton. Somebody wrote a paper on that, on neglected securities having a risk premium.

If they are neglected, then it's still the same effect. The risk premium increases on the less desirable companies. If it's an effective investor tastes, so half the market is willing to invest in the bad companies, but only if the expected return is high enough that drives down the prices of those types of companies. I guess on the flip side of that, the sustainable investors are more willing to invest in sustainable companies, even if their expected return is lower, which drives up the price of those companies and drives down their expected returns. Yeah.

I think based on that little bit there, we might have a bit of an understanding that based on investor tastes, it's reasonable to expect lower returns for companies that are sought after by the sustainable investing group movement, whatever you want to call it.

Then I looked at another paper from also from 2019 by a guy named Olivier David Zerbib, and he developed an asset pricing model and he included an ESG. He included premiums for exclusion and investor tastes. When you made that comparison a second ago, this is why I had an answer, because I read a paper about it. He looked at distinctly what is the effect from exclusion. What is the effect on securities that are completely excluded from ESG strategies

and what is the effect of investor tastes? He is looking at it in the context of differences in expected returns.

He said that the premium for exclusion was related to the increased risk of stock, which are neglected. That's the thing we were just talking about based on that paper by the guy that I can't remember the name of. Then the premium for investor tastes is – and this is very specific language that came from a different paper that this guy cited, but it's interesting language. The premium for investor taste is related to the cost of externalities that sustainable investors internalize to maximize their welfare, instead of the market value of their investments.

[0:23:42.9] CP: Okay. Let’s run that one again.

[0:23:45.2] BF: The premium for investor tastes is related to the cost of externalities that sustainable investors internalize to maximize their welfare, instead of the market value of their investments.

[0:23:55.2] CP: Right. It's the amount they're giving up to feel good about their investments.

[0:23:58.1] BF: That's a very concise way of putting it.

[0:24:00.5] CP: Which is totally okay.

[0:24:02.1] BF: Like we said before, I have nothing against ESG investing. You just have to understand what the implications are. In this paper, the guy found, Zerbib found that the exclusion effect and he looked at US stock data from 2000 through 2018, the exclusion effect, so the difference in expected returns between stocks are neglected in stocks that are not, I guess, was 2.5% per year.

[0:24:22.5] CP: That doesn't factor in any of the other factors in the Fama French model.

[0:24:26.9] BF: No. All of these papers looked at multi-factor. Yeah, they're controlling.

[0:24:30.6] CP: It’s how much you're leaving on the table by excluding them.

[0:24:33.4] BF: Correct. If you go –

[0:24:34.6] CP: Wow. That’s a big number.

[0:24:35.6] BF: - deep down the path of ESG investing, I can exclude all the companies that I don't like. In this paper, they found it to be about a 2.5% per year opportunity cost, I guess. Then the effect of investor tastes, which is associated with the idea of an ESG integration approach, that was 1.5% per year.

[0:24:51.9] CP: So much you're giving up by focusing on that slide of the –

[0:24:54.1] BF: Correct. By weighting more towards ESG and less –

[0:24:57.9] CP: Amazing numbers.

[0:24:59.2] BF: Yes. Now one of the other really interesting things about this whole discussion and it again speaks to the importance of the size of the ESG industry, but it's that the dispersion in ESG preferences is extremely important. What that means is if everybody, all of the investors in the market had the same ESG preferences, the same willingness to own bad companies if the expected returns are high enough and the same willingness to hold sustainable companies, even if the expected returns are low. If everyone had the exact same preferences, there would be no ESG industry. Their products wouldn't exist, which means there's no dispersion of preferences, the industry doesn't exist. The differences in expected returns don't exist if there's no dispersion in preferences. This is from a paper by Pastor, Stamba and Taylor. They've written some other fantastic papers in the past.

They took a theoretical approach, the other papers we talked about were empirical. They found with their theoretical approach that firms with higher ESG scores have lower expected returns. No news there from the empirical stuff we've talked about. Those expected returns get lower when risk aversion is low and ESG sensitivity is high. If risk aversion is low, sustainable investors are more willing to hold riskier stocks despite lower expected returns, which changes that difference in expected returns between sustainable and non-sustainable companies. Anyway, so that, the dispersion and the strength of the dispersion is an important component of the differences in expected returns.

[0:26:25.4] CP: Whole lot to think about.

[0:26:26.8] BF: Yes.

[0:26:27.5] CP: I mean, this is going to be a longer topic than normal, but I think it's worth all to go through slowly and I know we've had a lot of feedback from people that don't just rush through a in-depth topic. I think we're going to try to keep going through this carefully.

[0:26:39.4] BF: I think we've been careful enough so far.

[0:26:41.0] CP: I think so, but it –

[0:26:42.2] BF: Try and backup anything?

[0:26:43.3] CP: No, it's going to be longer than normal. I think we're good. Unless, someone really doesn't like it, they can hit the little fast forward –

[0:26:48.0] BF: The 30-second thing. Yeah.

[0:26:48.7] CP: 30 seconds faster.

[0:26:50.3] BF: Now the other piece that I – We talked would expected returns, the other piece is social impact. We're going to touch on expected returns one more time, but social impact for a second. In the Pastor, Stamban, Taylor paper, they found in their theoretical model that sustainable investing does lead to positive social impact by encouraging sustainable firms to invest more, which makes sense. We're talking about the cost of capital for these sustainable firms declining. Their required rate of return for investors to invest them is lower, because people are internalizing the positive externalities, while discouraging unsustainable firms from investing for the same reason. Their cost of capital is getting higher and higher, so now for an unsustainable company to invest in a project, they've got to have a really high expected return to make that investment.

[0:27:33.6] CP: Naturally.

[0:27:34.2] BF: Right, which if you own that company, that's not necessarily a bad thing because your expected returns are higher. If you're running the company, it sucks. Which is the point, that's creating positive social impact.

Now where it gets tricky is that based on what I just said, you can affect social change with your investments, which is good. The important part is that you are doing so at the expense of your expected returns. I think that has to be true. It has to be true, because if there's no dispersion in ESG preferences, the thing that we just talked about with higher cost of capital for unsustainable companies, if there's no dispersion in ESG preferences, that effect is not going to exist. For sustainable investing to work the way that you wanted to in terms of social impact, it has to be true that you accept lower expected returns on a risk-adjusted basis. If that's not true, if you don't accept lower expected returns, then the social impact piece mechanically can't be functioning, can't be working.

[0:28:31.1] CP: I can see everyone scratching their head.

[0:28:33.3] BF: Okay. Well, you try.

[0:28:34.4] CP: No, no. Keep going.

[0:28:35.8] BF: Well, how would you explain what I just said?

[0:28:37.3] CP: No. No better than that. I'm just saying it's so counterintuitive.

[0:28:40.7] BF: I mean, for the whole thing to work, like why are we doing socially responsible investing? Maybe you want to feel good about ourselves? Maybe you actually want to have an impact. If you actually want to have an impact and if that impact is going to work, it is going to work because you're getting lower expected returns.

[0:28:54.9] CP: More demand for the securities means lower cost in capital, easy to raise money, lower expected returns, positive impact change should come.

[0:29:02.5] BF: Right. You're encouraging good companies by giving them your capital. If everybody is doing that –

[0:29:06.0] CP: Right. There's less demand for these so-called bad companies, their cost of capital has to go up. Therefore, higher expected returns.

[0:29:12.2] BF: Positive social change.

[0:29:14.1] CP: Which is why I've heard some people said, “Oh, I want to own those things and take those higher expect returns and go and make a donation to make an impact,” because someone has to own all the stocks all the time.

[0:29:24.2] BF: As I was going through this research, that's one of the things that popped into my head is if you decide that I'm going to be the sustainable investor and you accept that you're going to have lower expected returns, which I think must be true, both theoretically and empirically. If you're willing to do that, you're knowingly giving the people who by definition don't share your beliefs, higher expected returns. If we assume just from an economic perspective, that means they're going to have more wealth.

[0:29:46.4] CP: That assumes those companies survive.

[0:29:48.4] BF: Fair enough. Yeah. I mean, if the portfolio is diversified enough, it should be all right. If we if we assume that the people investing in the unsustainable companies are going to ultimately have more wealth, then they may also have more control to do things that maybe by definition of the difference in preferences, you would disagree with. Maybe they take their wealth and go buy another SUV and you paid for that. Maybe I'm pushing that too far. I don't know.

[0:30:10.1] CP: Yeah, maybe.

[0:30:10.9] BF: I don't know. Okay, so difference in expected returns is a big piece of ESG investing, or sustainable investing I said I was going to call it. The other piece is that it must be less diversified in the market. That's a requirement. That hurts from two perspective; it hurts from the perspective that you own the part of the market that has lower expected returns, so

you're giving up on a portion of the market that has a higher expected return and you also have a fewer number of securities.

[0:30:35.4] CP: Therefore, reducing the reliability of your outcome.

[0:30:38.5] BF: Not only do you have lower expected returns, you also have a less reliable outcome. It's a double whammy of pain. Then fee is the other one, where if you look at iShare has a suite of ESG products in Canada and you could build a portfolio, like a globally diversified index portfolio for 28 basis points.

[0:30:56.3] CP: Which is still remarkably cheap.

[0:30:57.9] BF: That’s cheap. Super cheap. Well, we'll talk about those products again in a second. People might shake their heads a little bit. To do the same thing with an iShares ETF portfolio that does not have the ESG screen, you're going to pay 12 basis points. It goes from still pretty cheap to ridiculously cheap. You're right, the difference is not –

[0:31:14.8] CP: Negligible.

[0:31:15.8] BF: Yeah, not huge. Now the other piece and this comes back to that reflecting your values idea, is that these things exist on a continuum, where to get more hardcore ESG preferences, you must give up more diversification and you're probably also going to have higher fees. Now the big piece is that trade-off between views and values. Then you ask this question about do they use the same –

[0:31:37.4] CP: Filters, the same ESG filters or framework.

[0:31:40.7] BF: The answer is no. This is again a 2019 paper. There was a bunch of papers on this, I guess last year by Florian, Berg, Julian, Kölbel and Roberto Rigobon. They looked at the ESG ratings from five prominent ESG ratings agencies, so these would be the agencies that index providers are using to build their index products. They found an average correlation of 0.61 for ESG ratings, which is low.

[0:32:04.6] CP: I’d say that sounds low.

[0:32:06.7] BF: Yes. For context, I can't remember if this was from the – Yeah, I think it's from the paper. For context, Moody's and Standard & Poor's for their credit ratings have a 0.99 correlation. There's a lot more subjectivity it looks like in the ESG ratings than there is in something like a credit rating. The range, so the average correlation 0.61 with a range between 0.42 and 0.73.

Now if we look at the MSCI Canada IMI extended ESG focus index, which is the index at one of those iShares ESG Canada ETF tracks, as I said we're going to come back to that product. The index takes an integration approach, combined with total exclusions for tobacco, controversial weapons and producers of where ties with civilian firearms and businesses involved in severe controversies. You got the integration and you got some exclusions.

One of the largest holdings of that index and therefore the ETF tracking it, is Suncor, which is a Canadian energy company specializing in synthetic crude production from oil sands. Suncor aside, more than 16% of that index is made up of energy companies.

[0:33:08.3] CP: I know sometimes you show that to clients who want to have this preference and they're shocked by the holdings.

[0:33:13.0] BF: Right. You look around and say, "Well, that sucks." You look at FTSE, which is a different index provider that Vanguard uses and FTSE's ESG index do exclude oil, gas and coal companies. They don't exclude downstream companies, like pipelines, but still better than no exclusion at all if that's your thing.

Now energy specifically is apparently based on that paper I mentioned about how different companies rate stuff. Energy is one of the biggest points of disagreement, which on average, rating correlation of only 0.29. I guess no surprise that the indexes are treating it differently based on how the ESG rating agencies are treating it.

Now this poses two major problems; one of them is that what we've been talking about is that you as the investor might be investing in a product that you think aligns with your views and values, but it actually doesn't if you didn't look at the holdings. That sucks. That's too bad. You're accepting lower expected returns for something that you would have been sad about

owning anyway. Then the other big problem is that we talk about that social impact piece, are you really having a social impact? If companies don't know which ESG behaviors are going to be rewarded in terms of what ESG rating agencies are going to say –

[0:34:18.8] CP: How interesting.

[0:34:20.1] BF: - then right. If I'm a corporation and I do. Maybe my company does want to improve our ESG rating for whatever reason, maybe because we want our stock price to go up, maybe because we're altruistic, whatever. If that corporation is using ESG ratings to try and improve themselves –

[0:34:37.1] CP: They're getting mixed signals in the marketplace.

[0:34:38.4] BF: They’re getting mixed signals, right. Now investors are allocating their capital, or if companies realize based on what we've been talking about, companies realize that there's a market impact of these sustainable investors so they want to align with them, but they don't actually know what to do, because the rating agencies are all giving mixed signals.

[0:34:53.1] CP: So interesting.

[0:34:53.9] BF: That gets pretty messy.

[0:34:55.2] CP: Or you go back to the Suncor example, maybe they're the best of the worst in some people's eyes. You don't know perhaps what caused them to be included in that rating selection.

[0:35:03.1] BF: Yeah. Sure. That actually speaks to the way that I wrap this topic up is that approaching sustainable investing, it's all about precise management of the trade-offs between the implicit and explicit cost we've talked about and your specific set of views and values. It's all about managing those trade-offs. I've spent some time talking to Tim Nash a while ago and I have no idea what he's going to think for this episode. I don't know if I like it or not. He’s explained to me that his role as a fee-only consultant for people that want to invest this way, his role is 100% about managing trade-offs. He takes his knowledge set and he tries to figure out how severe are your biases against these certain things.

Okay, if they're extremely severe, that means your portfolio is going to look like this. It's going to be three stocks or something. That's the obviously an extreme example. Then someone like Tim would be saying a three-stock portfolio is pretty undiversified. We might want to shift a little bit. It's all about managing that continuum of what are your views and values? How closely do they need to be matched and how can you do that in a way that is still diversified and still has a reasonable expected return that's going to let you meet your goals.

[0:36:10.5] CP: Some reliability and reflects your preferences.

[0:36:13.7] BF: Yeah. I know that was a big topic, but I think it was – I think it was worth discussing. It comes up a lot.

[0:36:19.2] CP: Comes up a lot, especially now after the big announcement last week.

[0:36:22.7] BF: I don't know what other context you could have to think through that question of should I be a sustainable investor? I think we gave all the context. Maybe all is –

[0:36:30.6] CP: We gave enough for now, I think it's safe to say. On to the planning topic?

[0:36:34.4] BF: Yeah. Another one that you chose for this week. Spending from an index fund portfolio, which is again another question we get quite often. How should I structure my portfolio when it comes time to actually start living off of it?

[0:36:47.9] CP: Yeah. I think there are two million things that it speaks to. One is asset allocation. I think when people ask this question, they are may be partially thinking about how should my mix between stocks and bonds change over time? Or even how should my mix between total market and dividend stocks change over time? I'm not saying that's what you should be thinking about, but that's what some people might be thinking.

[0:37:05.2] CP: Again, listeners know your point on that.

[0:37:08.1] BF: Maybe. Some of them.

[0:37:09.0] CP: Also some rules of thumb that I know drive us all crazy.

[0:37:12.5] BF: Yeah. I think people are thinking about, “What should my asset allocation be?” Then they're also thinking about, “How do I actually get the cash out of my portfolio?” Which I think speaks to that mental accounting capital versus income discussion. On the asset allocation piece, I think like you said Cameron, the rules of thumb are pretty brutal, like reducing your equity exposure over time based on your age, like a 100 minus your age whatever it is.

[0:37:34.8] CP: Now having said that, if you follow that, you did keep yourself out of trouble. I know some people that did follow that in 2008. It's better than not. Better than getting in over your head with an equity allocation that you can't live with.

[0:37:47.0] BF: Yeah, for sure. Asset allocation is always going to be somewhat subjective. There's always that risk aversion piece that plays into it. There is some interesting research, some of it's actually come from Graham and our PWL Waterloo office on glide path investing versus constant equity allocation. That research has found that there's no expected benefit to using a glide path, so that's consistently decreasing your equity exposure over time. There's no benefit to that, compared to holding the time-weighted average asset allocation of the target date of the glide path fund. If on average you owned a 60/40 portfolio based on your glide path, you could've just owned a 60/40 portfolio the whole entire time.

[0:38:25.0] CP: Stay 60/40 all the way through.

[0:38:27.5] BF: Been just as well off. Now, it doesn't mean your asset allocation should never change. I think that you can be. We talked about this in the investment with leverage discussion that we had a while ago and in the YouTube video I did, where well, in their suggestion you're using leverage to get your future savings into equities as soon as possible and then you're decreasing your leverage and then you're finally when that's done, adding in your fixed income.

I think equity investors can do something similar, where you have your aggressive portfolio for a period of time and then transition may be near retirement, but just that that glide path concept isn't necessarily what you have to do. I think changing asset allocation should be based on other stuff. Like if you have a windfall, that's a reason to change your asset allocation.

[0:39:05.9] CP: Or if you don't need to take on the risk. If you have enough saved up.

[0:39:08.9] BF: That's what I was getting at.

[0:39:10.2] CP: That preference, right? To be aware. We're going to talk about this, but aware of what your long-term financial plan is and the volatility that you have a preference for.

[0:39:19.1] BF: I mean, if you think about it, once you're at the point where you're making the decision that you're ready to retire, it by definition means that you have enough financial capital to fund your future expenses. Otherwise, you would not be retiring.

[0:39:30.7] CP: Correct. You can make choices at that point to reduce the variability in your portfolio if you wish.

[0:39:34.4] BF: That's what I'm saying. Exactly. Once you reach that point of capitalization, you can do exactly what you're saying. Now, I guess if you have more capital, which maybe speaks to the windfall point I was trying to make, if you have more capital you can afford to take even less.

[0:39:48.0] CP: Or even more. Go both ways, right? We have some clients that have way more than they'll ever need, that have gone all equity, because they can afford to. Even if does fall by half, they're not in trouble. They know over long-term higher expected returns.

[0:40:01.2] BF: That speaks to the point of why rules of thumb are not useful for asset allocation.

[0:40:04.7] CP: Trade-offs.

[0:40:06.4] BF: Yeah. Okay, so the other piece of this question I think is spending policy, where people have this portfolio of index funds and they pay some distributions from dividends and interest, but that's probably not enough to live on. I think this is why income investing in general is so attractive to a lot of people is that you get this fixed amount, or not fixed, but you get this amount of income paid by distributions. If that's enough to live on, cool.

[0:40:27.7] CP: You're not selling stuff to make your payment.

[0:40:29.0] BF: You're not selling stuff. Having a spending policy as a retiree is I mean, it's a key part of retirement. The spending policy should not be dictated by the dividend policy of the companies that you're on.
[0:40:38.9] CP: That's a key line. Although people love dividends. We've talked about that forever.

[0:40:43.8] BF: They're not investment returns.

[0:40:45.1] CP: Don't let that dictate your spending policy.

[0:40:47.7] BF: Right. Dividends are not returns. You've got to figure out how much you can spend from your portfolio. It's not something that we can give you the answer to, because it's one of the biggest problems in finance. I think Merton Miller might have said that. You can use stuff like Monte Carlo, a model to approximate how much you can spend. You can use historical worst-case scenario analysis, like how the 4% rule is developed.

[0:41:06.4] CP: Monte Carlo is basically stress testing your returns with some variability in those returns over your lifetime.

[0:41:12.0] BF: Yeah. If we simulate a thousand lifetimes, how many of the thousand simulations did you not run out of money? That's Monte Carlo. You can do the same thing with historical analysis, so take all the historical time periods using US stock date or something, that you can get for free online. Anyway, so you can use those things to figure out what your safe spending rate is. Then once you know that number, you can spend some combination of income and capital as long as you stay within your spending rule.

[0:41:35.3] CP: Correct. Because what matters is total return and variability to prices.

[0:41:38.6] BF: Right. When a dividend is paid to you that your capital decreases must decrease mechanically by the amount of the dividend that was paid. It's no different. Receiving a dividend is no different from making your own dividend and selling some stock. I just have to

throw this in into this discussion, because it comes up on the dividend YouTube video that I posted a while ago. When you sell shares –

[0:41:58.5] CP: Ferociously comes up in the comments.

[0:42:00.4] BF: All the time. Man, I thought I answered this already.

[0:42:03.8] CP: It's not debatable. It's tautology.

[0:42:06.2] BF: Yes. The thing that comes up that we're talking about being tautology is that people seem to think that if you reduce the number of shares that you own, wish you would do if you're selling shares as opposed to receiving dividends, if you reduce the number of shares that you own, you're shooting yourself in the foot. You're now worse off. You're in a worse off position to accumulate future capital. If you think about an example, so if you started a 100 shares worth $1 each, so you've got $100 in your portfolio.

[0:42:29.1] CP: Of total value.

[0:42:30.1] BF: Total value. The shares pay a 10 cent dividend, you've got a 100 shares and they're worth 90 cents each now.

[0:42:36.4] CP: $90.

[0:42:37.2] BF: $90 portfolio and you've got $10 in cash from the dividend. Now alternatively, if you had not receive the dividend because your shares didn't pay dividends and you instead same value for the shares and you instead sold 10 shares to create a $10 cash flow because you needed some income, you would now have 90 shares. Instead of a 100 shares worth 90 cents each, you've now got 90 shares worth a $1 each. Portfolio is still worth $90. Now in either case, whether you own less shares that are worth more, or more shares that are worth less –

[0:43:04.9] CP: It's the same thing.

[0:43:05.6] BF: - if the future return, like tomorrow there's a 10% return, a 10% jump in the market, the value in both cases increases by the exact same dollar amount. The number of

shares that you own does not have any impact on your returns, especially now that you can trade fractional shares. It really doesn't matter. They used to matter a little bit, because at some point you would have to sell your last share, I guess, but with fractional share is it. It doesn't matter now.

[0:43:30.0] CP: Number of shares times current value, that determines your portfolio value.

[0:43:33.6] BF: Yeah. I think just one more thing to touch on on this income topic is that what a lot of people would do to make it easier to think about is build a GIC ladder. You've got five GICs returning one each over five years. The thinking goes that you can just spend those GICs.

[0:43:49.4] CP: You don't worry about the market. You basically give yourself peace of mind that you don't have to worry about the market for five years, but that's not necessarily true.

[0:43:58.9] BF: Well, it's not true because when your GIC matures, you have to replenish – you have to replenish it to keep your asset allocation the same.

[0:44:05.0] CP: Well, that's just it. As you spend down those GICs, overall your equity exposure all things being equal is increasing because you're reducing your fixed income. I can tell you, very few people look at it that way. They just compartmentalize it, “I'll leave my 60/40 loan over here. I'll have all five years of GICs in this other account.” Therefore, I don't touch, well now you're really at whatever. Some other asset mix.

[0:44:26.4] BF: Now all of a sudden, three bad years in the market and yeah, now you're at 80% equity and who's to say the fourth year is going to be good and not bad? Well, we've talked with this with Alexander McQueen a while ago that the GIC ladder concept is basically irrelevant for that purpose.

Anyway, and then the other piece of this I think people get – people struggle with and this is one of the other questions that I get a lot on this topic is that if you have a balanced ETF, like say you retire with VBAL and that's your only asset, there's this perception that you're required to sell stocks when they're down. If you think about it, if you owned 60% of your portfolio in a stock ETF and 40% in a bond ETF, if stocks are down, you can just sell some your bonds for income to rebalance and that's fine. You end up back with your 60/40 mix. If you own VBAL, you have

to sell stocks when they're down. That's not how it works. If stocks are down, VBAL is rebalancing, which means –

[0:45:12.5] CP: You've been buying all the way along.

[0:45:14.5] BF: Right, which means, say it's happens in a single time period; stocks drop. Inside of VBAL they're selling bonds to buy cheap stocks and then you go and sell your unit of the fund, you're selling the cheap stocks that they just bought. It's not like you're buying stocks low. You're buying them low. Or sorry, selling stocks low. You're buying them low and then selling them low, but you're not losing out anything.

[0:45:36.0] CP: No. In fact, you're going to better tracking to the asset makes you want it all the way along, as opposed to when you decide to take money out.

[0:45:42.6] BF: Yeah. I mean, yeah, you figure out your spending policy, sell your assets as needed, use income distributions to –

[0:45:49.7] CP: Use Monte Carlo to find out the asset mix that's appropriate for you and your own preferences.

[0:45:54.0] BF: The asset mix in the spending policy.

[0:45:55.7] CP: Anything else on that topic?

[0:45:57.5] BF: Nope.

[0:45:58.3] CP: We'll quickly go on to the bad advice of the week. This one came from a Globe and Mail article of December 18th, Why Investors Should Pay For All Investment Fees Out of Non-registered Accounts? This generated quite a bit of discussion around here and we thank a regular listener for sending in the article to us. I know you're listening, Mike. This goes back to a letter I guess from the recent Department of Finance Canada letter to CRA stating that paying investment fees for your registered accounts, your RSP or TFSA out of your non-registered account, so have your trading account pay for your RSP and TFSA fees, does not constitute a tax advantage for investors. Therefore, the article says, "Therefore, you're now free and you

should pay all your investment costs from your RSP and your TFSA out of your trading account."

[0:46:44.7] BF: Right. You're paying fees in your RSP and TFSA, but instead of taking the cash to pay those fees from those accounts, you take them for your taxable account.

[0:46:51.1] CP: If you go back to basics, any fees paid from non-registered accounts for that account are tax deductible, so your trading account if it pays those fees that's a tax deduction for you. Any fees paid from an RSP for the RSP are not tax deductible. They used to be many, many years ago, but they no longer are, right? Same thing for TFSA. However, you are effectively using pre-tax dollars to make that payment. That's the benefit of using the cash in your RSP to make the trustee, or the management fee payments. Those are pre-tax dollars.

[0:47:24.6] BF: If you think about it that we've talked about the RSP in the context of asset allocation. You should use the after-tax value of your RSP for asset allocation. Fees are calculated based on the pre-tax value of an RSP. If you think about it, you have – say your tax rate is 50%, you have twice as much in your RSP account than you actually own, but you're still paying fees on the full amount.

You're paying fees on the portion of your assets that the government owns or is entitled to. If you pay those fees from inside the RSP account, you're paying – the government's paying half your fees and you're paying half your fees. If you pay those fees with after-tax dollars from your taxable account or from wherever, you're paying your portion of the fees and you're paying the government's portion of the fees and you're not getting a tax deduction for it. When you would draw the money from the RSP in the future, you're going to pay tax on the on the full amount.

[0:48:12.7] CP: That assumes that your service provider can partition those fees, so they produce an accurate receipt, so that your trading account fee is deductible, but the RSP fees paid from your trading account are not deductible. I'm not sure if systemically, the industry can do that. Perhaps they can.

[0:48:26.3] BF: I'm sure a keen DIY investor could figure out how to partition their own fees out.

[0:48:30.0] CP: Still, it doesn't make any sense. Now it does make sense for the TFSA, right, to have your trading account pay for the fees as opposed to your TFSA.

[0:48:37.8] BF: Yeah, because in that case, you're paying fees on the after-tax amount, so you're not paying the government's portion of the fees.

[0:48:43.6] CP: Right. It’s after tax on both sides.

[0:48:45.5] BF: The more you can leave in the TFSA to compound, the better. We have to do a little bit more work on this, because I'm not sure if there's some break point where it does make sense to pay RSP fees, like if you have a long enough time horizon.

[0:48:55.9] CP: Yeah, the compound enough for the fees that are left behind, but be a long time if it does work.

[0:49:00.4] BF: Maybe it's a thousand-year time rise in the RSP. It makes sense to pay out of the taxable account.

[0:49:04.3] CP: The article didn't talk about the deductibility to fees and that's the point of this.

[0:49:07.7] BF: If you Google around on this, nobody's talking about that. I actually saw a post on Reddit that I responded to, just because I read it and I was like, “Oh, come on. I can't just let this one go.” Because people seem to think that they could deduct all of the fees. The letter from finance to CRA, which it's called a comfort letter. It addressed Income Tax Act 207.011, which relates to the advantage. This used to be considered an advantage, the advantage of paying fees from a registered account.

They're saying that's no longer an advantage. You can do it. It's a completely different section of the income tax act that relates to the deduction of fees. That's Income Tax Act 2120, bracket 1, bracket BB, which addresses the ability to deduct fees. Then the other piece that’s important is Income Tax Act 18, bracket U, bracket U, which addresses the limitation, specifically the limitation for deducting fees paid for services in respect of the RSP and TFSA. 207.011 which is the thing that's been addressed in this comfort letter and that's been talked about, only addresses where you can pay the fees from.

[0:50:11.1] CP: Not the deductibility.

[0:50:12.5] BF: Correct. The deductibility is a completely different section of the income tax act. Now I'm not that confident in my ability to interpret the income tax act, so I did ask one of our CPA friends and he confirmed that that's the way it is.

[0:50:24.4] CP: Okay. It's the end of the day. Looks like for now, we use the RSP to pay the RSP fees if you can't get a TFSA fees. Typically they're much smaller, but paid for by your trading account. Leave the trading as is for deductibility.

[0:50:35.6] BF: We are doing – we have a couple of our analysts working on building a more robust model, so we can build some parameters around does it ever make sense to pay fees for the RSP or the taxable account? If we find any groundbreaking conclusions that we didn't expect, well, we'll relay them to you, our faithful podcast listeners.

[0:50:51.4] CP: Anything else?

[0:50:51.9] BF: No. Long episode. Sorry, everyone.

[0:50:53.7] CP: Great. Thanks for listening.

[END]