Money Never Sleeps

The Newsletter for the Informed Investor

Wealth Management
Dominion Securities

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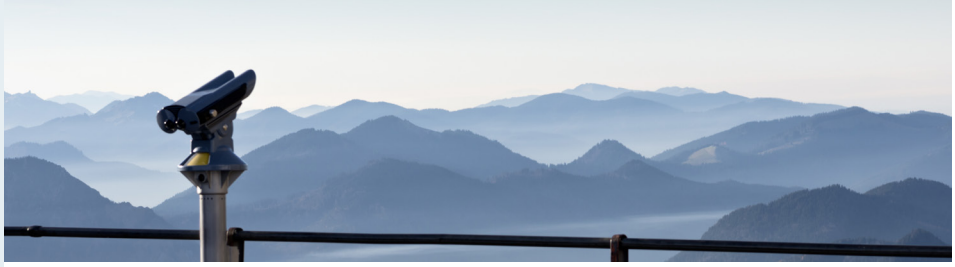


Active versus passive

(The debate rages on)

"If my universe of business was limited, say, to private companies in Omaha, I would… try to buy into a few of the best operations at a sensible price. I certainly would not wish to own an equal part of every business in town."

– Warren Buffett, Legendary Investor

Passive investing has gained in popularity over the past few decades as an investment vehicle that allows broad market exposure at an attractive price point. It has also helped create high speed change in the active management world by flushing out "closet indexer" managers who basically mirrored indices at a higher cost, and it has put pressure on overall pricing with a move to transparency, which are all positives. Hopefully in the next few pages, we can show both sides of the debate.

Indexing is an investment strategy designed to match the performance of a benchmark index by buying (and selling) all of the investments and in the same proportions as the index. Exchange Traded Funds (ETFs) provide exposure to the holdings of the index. For example, the SPY (S&P 500), QQQ (Nasdaq 100), and XIU (TSX) are some that are available.

And while the intent was originally to benchmark the major indices, the proliferation of ETFs has now caused many to question if a bubble is forming. There are now over 2,000 ETFs listed on U.S. exchanges and inflows are now over $1.4 trillion. There are ETFs that are available for any index, any sector, any vice/virtue, currency ETFs, commodity ETFs and even volatility ETFs. Heck, if you really want to get sophisticated, there are leveraged and inverse versions of most of those, with or without leverage.

ETFs have made it possible for everyday investors to invest like Warren Buffett! Or have they?

Active managers use disciplined process in which managers use as much analysis as is available to buy and sell securities based on the fund's mandate. They also can go to cash (which an ETF cannot) to provide downside protection and reduce volatility when it makes sense to do so. They can also allocate assets to areas of the markets which are undervalued and avoid overvalued names. They don't have to hold every name in an index, so can avoid the ones not working.

By avoiding jumping on the bandwagon and buying "hot" stocks, active managers can avoid buying frenzies. There are many examples I could give you (the current "FANG" craze might become one), but most readers will remember Nortel Networks, which at its peak of $124.50 in 2000, represented 45% of the S&P/TSX 60 Index. Investors in that index probably didn't realize that almost half of their investment was in a stock on its way to 0.39 cents by 2009.

Another example would be the latest down cycle in 2008-09. Most North American markets were down 40% to 50%. The average ETF? You guessed it, 40% to 50%. Most decent active managers were down half that amount.

How about a real live example. One of our largest holdings in our entire book is Fidelity Special Situations, managed by the very capable Mark Schmehl. The fund was created in April 2007, about half a year before that incredible down cycle began and so it recently celebrated its 10-year anniversary.

Here's how he has fared versus his benchmark:

(All numbers as of August 31, 2017)	1 YEAR	3 YEAR	5 YEAR	10 YEAR
Fidelity special situations	15.60%	12.63%	19.63%	14.70%
Benchmark	6.08%	3.78%	10.28%	6.04%

And yet, despite many active managers who can boast excellent numbers versus their benchmarks, it seems based on the cash flows that passive is winning over active:

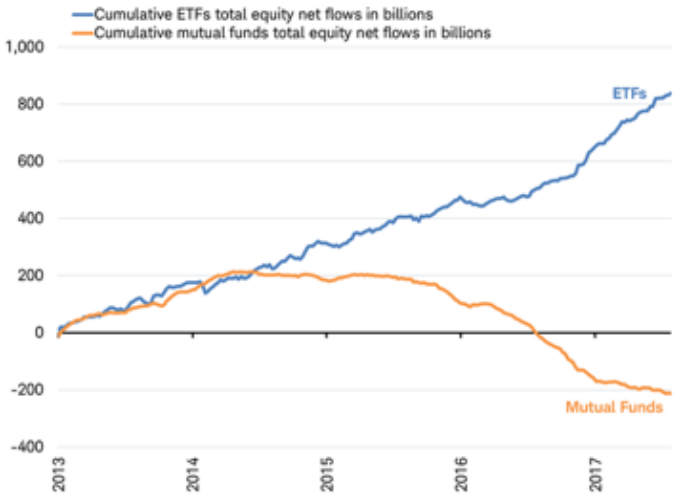
S&P/TSX Index versus Canadian equity funds | Bear markets 1980–2009

Peak month	Trough month	TSX performance	Average fund* performance	Difference
November 1980	June 1982	-38.8%	-27.2%	+11.6%
July 1987	November 1987	-25.4%	-23.0%	+2.4%
December 1989	October 1990	-20.1%	-15.5%	+4.6%
April 1998	August 1998	-27.5%	-24.3%	+3.2%
August 2000	September 2002	-43.2%	-26.9%	+16.3%
May 2008	February 2009	-43.3%	-42.8%	+0.6%
Average		-33.1%	-26.6%	+6.5%

Source: Globe HySales. Based on the average of 569 funds (558 actively managed mutual funds and 11 index funds); calculations are made using month-end figures.

In the first half of 2017, almost $500 billion flowed from active to passive, and now account for more than a third of all assets under management. Once again, I believe this is a case of the crowd "lemming" approach and doing the wrong thing at the wrong time.

In fact, a recent survey by Fidelity noted that one in five buyers believe that stock index funds can protect them



from market ups and downs. A similar survey by Nataxis Global Asset Management found that 60% of individuals using index funds believe that they can help minimize losses. But neither of those surveys can tell you how ETF holders will react on the next big downturn. Will they hold or will they do what the crowd always tends to do: Ride it out until maximum pain at the bottom, then sell right at the bottom only to watch markets rebound.

Proof of this behavior can be seen in inflows and outflows into mutual funds:

S&P 500 Index Performance vs. 12-month Equity Mutual Fund Flows

Sources: BlackRock; Informa Investment Solutions; DB US Equity Strategy; Investment Company Institute (US mutual funds and ETFs). The S&P 500 Index is an unmanaged index that consists of the common stock of 500 large-capitalization companies, within various industrial sectors, most of which are listed on the New York Stock Exchange. Returns assume reinvestment of dividends. It is not possible to invest directly in an index. Past performance is no guarantee of future results. The information provided is for illustrative purposes only and is not meant to represent the performance of any particular investment.

Inflows are always at all-time market highs while maximum outflows are (you guessed it) at the bottom.

There is no doubt the current inflows into ETFs are causing some distortions, and some will argue it has put a floor (for now) on markets and why we haven't had a 5% drawdown in over 15 months. As money has piled into ETFs, "bubble" warnings have been raised. I'm not sure yet, but I do foresee pockets of systematic risk because if money came out during a potential downturn, the liquidity on ETFs collapses. Remember the flash crash where the Dow Jones dropped 9% in a "flash"? Some ETFs traded down 30 to 40% at the same time.

Chasing performance is nothing new in the stock markets. It has been there since markets were formed. Using ETFs as the preferred vehicle to chase, is. It can explain the recent lack of volatility and why all the dips have been bought the past few years. Think about this: if the ETF buyers sell, who will be left to buy? It's an easy argument to make that ETFs and index funds are actually more dangerous in a down (bear) market when it comes.

The other point I will mention is the level of complacency about investing in ETFs. Many banks are now marketing them across the board to the masses, assuming all investment objectives are the same. I would suspect most ETF buyers, or those sellers for that matter, don't even know what's in them.

We are at a juncture in markets where deep, structural changes are taking place. The 30+ year fixed income bull market has come to an end as interest rates rise, and equity markets move much quicker to news than they ever have. When five stocks account for 33% of all the gain in the S&P 500 in 2017 (Facebook, Amazon, Apple, Netflix, Google) to me is an indication of unappreciated risk. It has been a very narrow market.

While the advent of ETFs has been in a positive many respects, the explosive inflows reflecting "crowd think" investing raise flags. While they claim to offer liquidity, they have never really tested when markets go the other way. And trust me, they do. This could become a huge problem for not only ETF investors, but the markets in general.

Even Vanguard founder Jack Bogle was recently quoted saying:

"ETFs have become a marketing and promotional game. Those kinds of things are great for marketers, but bad for investors," says Bogle, in an August telephone interview, on vacation in the Adirondack Mountains. "The ETF has become a heavily traded vehicle used for speculation, often on indexes without much claim to fame except that they have a new ideas some marketers want to test on unsuspecting investors. The proliferation of "fringe elements ETFs" has resulted in "a quagmire of choices – everybody's trying to be more creative than the next guy. So there are ETFs of dubious credit quality, leveraged ETFs, people creating their own investment ideas, their own indexes. All that has led to speculation." (Source: Think Advisor)

The number of ETFs may have surged when high frequency and algorithmic programs have soared, but have yet to truly be tested. And to close off, Mr. Bogle, the creator of indexing:

"ETFs probably have a turnover rate of 700% per year. That is staggeringly high by any measure. The mutual fund industry, in general, has a turnover rate among shareholders of 30% to 35%, a three-year average holding – which I myself think is amazingly short. 60% to 70% of securities that were suspended were ETFs. Of course it can happen again! With high frequency trading, we have a system out of control. We've created a kind of Frankenstein's monster."

(Source: Think Advisor)

Quotes

"A person who never made a mistake never tried anything new."
– Albert Einstein

"Giving money and power to governments is like giving whiskey and the car keys to teenage boys."
– PJ O'Rourke

"Retirement at sixty-five is ridiculous. When I was sixty-five I still had pimples."
– George Burns

"A clever man commits no minor blunders."
– Goethe

Around the globe

Canada (buy)

- Experiencing best sustained growth in some time
- 2017 GDP up 275%
- Participating in global recovery, commodity rebound, and fiscal/monetary stimulus
- Housing remains question mark

U.S.A. (buy)

- U.S. economy on cusp of operating on full capacity
- Difficult to gauge how much of a fiscal reform will get done
- Short-term interest rates to grind higher
- New Fed chair in next few months?

Europe (strong buy)

- Despite Brexit, UK doing well
- Populism on rise (Spain/Catalonia)
- Earnings gaining on positive momentum/real interest rates are low
- Valuations seen to be at a discount relative to other markets

Asia (hold)

- Japan emitting mixed signals but no doubt getting better
- China continues to impress with its resilience
- North Korea huge question mark

Emerging markets (hold)

- GDP growth expected to be in 5.50% range
- India experiencing credit concerns
- I.T. leading way in recoveries

Notes

- The largest holdings in ETFs? No surprise: Apple, Microsoft, Facebook, Amazon, JNJ, Exxon, JP Morgan, Google
- Vanguard, founded by Jack Boyle, created the first ETF in 1976 with a total of $11 million. By 1999, that amount reached $100 billion. Today, the top 10 ETFs alone boast total assets between them of $836 billion. (Source: Gavekal 8-7-17)

ETF cash flows for 2017	
U.S. stock ETFs	$95 billion
Non-USA ETFs	$267 billion (largest were Japan & India)
Biggest out flows	Hong Kong/China

A special welcome to all new clients who have joined us

Thank you especially to clients who have mentioned our name to people they know. As a sign of gratitude, four times a year we'll randomly select a client who has introduced our services to a friend for special acknowledgement via a nice dinner at one of the finer restaurants in London.

C.P., our winner this quarter!

Please don't keep us a secret!

We are very happy and proud of the clients we serve in our practice and we are always open to serve more clients just like you. Should you be talking to someone who is unhappy with their current advisor, or would like a second opinion, we would be grateful if you passed on our numbers: 519-675-2011 or 1-800-265-5911. Thanks for keeping us in mind.

Wealth Management
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Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the fund facts and prospectus before investing. The indicated rate[s] of return is [are] the historical compounded total return[s] including changes in unit value and reinvestment of all distributions and does [do] not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder that would have reduced returns. Mutual funds are not guaranteed, their values may change frequently and past performance may not be repeated. Returns as of Aug. 31, 2017.