Investment Outlook

Wealth Management
Dominion Securities

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Passive investing: A quiet revolution

By the time I became a CFA charterholder 20 years ago, it was clear to me that the academic research on investing had overwhelmingly validated passive management over active management. So, I was perplexed why so much of the industry was still staunchly behind active management ... It may have taken 20 years, but fund flows are now finally validating passive management in a huge way. A recent New York Times article concluded that, in the U.S., Vanguard had brought in $823 billion in new funds over the past three years, which was 8.5 times more than rest of the fund industry combined (4,000 firms).

Vanguard: The catalyst for change

While Vanguard has been around since 1975 and is the originator of the index fund, it still remains an anomaly within the investment industry. I put a lot this down to the culture created by its founder, John Bogle, and its mutual structure. Within a mutual structure, there are no shareholders to report to or pay, so everything is about the unitholders. Vanguard has led the drive for lower investment management fees since its inception and it has saved investors billions of dollars in fees during that time. Fees are important because research has shown for decades that active management cannot consistently beat passive management on an after-fee basis. A big part of that is because passive management focuses on lower fees, turnover and cash balances, which all play to the benefit of investors over time.

History: It has been a long time in the making

While passive management got its start with index funds, it has been the evolution of Exchanged Traded Funds (ETFs) that has been one of the catalysts for change. ETFs were developed in response to the fallout from Black Monday. Their acceptance was slow for the first 15 to 20 years, but they have exploded since. Today, Canadian investors have access to nearly every publically traded asset class right here in Canada. I mention that because using Canadian-domiciled ETFs can give investors all the international market exposure they would want, but without the tax and reporting drawbacks of investing in ETFs traded in the U.S.

There has also been a regulatory shift in a number of countries (e.g. U.K., Australia and Canada) to focus in on better fee disclosure to investors. This has moved the industry to more of a fee-based structure, where compensation for advice is separated

from the underlying product – an area that ETFs lend themselves very well to.

Does passive really mean passive?

While passive investing has taken off since the Great Recession, the use of index funds and ETFs doesn't necessarily mean that investors are using them solely for buy-and-hold strategies. ETFs, in particular, allow investors to make active bets at an asset or sector class level.

Show me the value …

So you might ask, why should anyone pay for investment management advice? It is a relevant question these days and the answers may not be what you think.

First, investing will always be fraught with volatility and emotion. No matter how sophisticated the investor, managing one's own money may not be the best option. Human behaviour dictates that investors look and treat their own money differently than others. Second, invest management continually evolves. I know that my planning and investing models look nothing like they did 10 years ago. I am sure the same will be true in another 10 years. Third, no one can put together a proper investment plan without first understanding the purposes of an investor's wealth and the goals behind them. That is why there has been a movement towards goals-based investing lately. Ultimately, investors should focus on risk and taxes, because they have better control over them than returns. Finally, understanding the concept of reversion to the mean can be a powerful force. Because of behavioural biases with investing, asset class valuations can sometimes see extreme deviations from their long-term valuations (especially during a crisis), which are brought back in line over time.

ETFs Still not sure how ETFs work? This video will give you an overview.

Quote of the Month *"Simplicity is a great virtue but it requires hard work to achieve it and education to appreciate it. And to make matters worse: complexity sells better."* Edsger W. Dijkstra

While I strongly believe financial planning comes before investment planning, investors should also have an advisor who can do both. I find that advisors focusing just on financial planning don't typically set proper expectations on future returns or assess future market risks well. On the other side, advisors focusing just on investment planning have a limited ability to put together the correct investment plan without the financial planning being done first.

The investment industry is going through a lot of change right now. Passive management is one of those disruptions, and is here to stay!

Recommended Reading

NYT: Vanguard Is Growing Faster Than Everybody Else Combined.
Vanguard: Are Investors Looking In The Right Places For Higher Returns?
Bloomberg: ETFs Are Like Politics. The Radical Gets Normalized.

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