



# Active vs. Passive – The Debate Rages On

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Standard and Poor's compiles a report card every quarter that assesses the performance of actively-managed mutual funds versus their indices. Known as the SPIVA Scorecard (Standard and Poor's Indices Versus Active Funds), the report is increasingly making waves in the investment community as its conclusions can often be dramatic – not to mention depressing for active funds.

The latest report (based on year-end 2009 data) concluded: "Over longer periods, we continue to observe indices outperforming the majority of domestic funds. In three-year and five-year periods, only 12.5% and 7.4%, respectively, of actively managed Canadian equity funds have outperformed the S&P/TSX Composite Index."

The findings weren't much different for foreign equities, where the majority of active funds lagged their indices over the last five years. Funds in the Canadian small/mid cap equity and Canadian focused equity categories fared the best, but a high percentage of funds still failed to beat the benchmark over the longer term.

In order to be objective, S&P notes that they: (1) correct for survivorship bias (funds that were liquidated or merged during the period analyzed are included in the opportunity set), (2) compute both equal- and asset-weighted average returns, and (3) make apples-to-apples comparisons (measure funds against appropriate benchmarks). They deserve credit for addressing the first two issues, which can skew data dramatically (survivorship rates can be brutal in certain asset classes). Yet, while S&P compares funds to appropriate benchmarks as best they can, they come up short in a true apples-to-apples comparison as they neglect to address the issue of fees.

The glaring omission in the comparisons is the absence of costs with respect to index investing. S&P makes it clear that there is no deduction of fund expenses from index returns, but this is certainly not the experience of an index investor. Granted, the fees and costs associated with passive products are typically low, but they should not be ignored in any comparison that uses after-fee returns for actively-managed funds, as the S&P study does.

Assuming that an investor uses exchange-traded funds (ETFs) to build an index portfolio, which is the lowest cost avenue to do so, they will pay a variety of costs that are not factored into the comparison. Along with management fees, which typically range from 0.17% to 0.55% for popular asset categories (based on the iShares' suite of products), investors also pay transaction costs to buy and sell ETFs. These can be minimal given the low trading fees offered through discount brokers, but they should not be ignored. As well, ETFs have rebalancing costs and "portfolio optimization" costs, which can lead to notable annualized performance differences between the ETF and the index it replicates.

Consider the popular iShares CDN S&P 500 Hedged to Canadian Dollars Index Fund (XSP). Since November 2005, the fund has suffered from an annualized performance difference of 0.98% (as of the date of this publication) against the index it's designed to mimic due to the costs associated with the fund. In other words, it has lagged the index by 1% per year. The iShares product that tracks the MSCI EAFE Index has an even greater performance difference. The costs associated with the company's ETFs that track large Canadian indices are lower than these foreign equity examples, but the all-in costs of ETF investing are not immaterial. Yet, they are often downplayed, if not completely ignored, in most comparisons of passive vs. active investing.

Management fees, transaction costs, tracking error and other expenses associated with ETF investing can realistically run from 0.2% to 1.5% per year, depending on a portfolio's composition and size. When compared to the cost of the average actively-managed equity fund in Canada, these fees are still very favourable. According to Globeinvestor, the average MER for a selection of popular asset classes is as follows (data as of December 31, 2009):

Canadian equity .....	2.46%
U.S. equity .....	2.57%
Global equity .....	2.74%
International equity .....	2.47%

Contributing to these high fees is the fact that a large percentage of funds in Canada pay annual trailer fees to advisors for the advice they provide to investors. These fees typically make up 1% of the MER of equity funds. Advice, however, is not included in the MER of low-cost ETFs (note: some ETFs pay trailer fees and have much higher MERs as a result). Indeed, many indexers are do-it-yourself investors who do not desire advice. If the trailer fee were stripped out of the cost of active funds, their average MERs would be significantly lower, and a more accurate performance comparison could be made. Unfortunately, most fund companies in Canada do not offer do-it-yourself investors the option of purchasing their funds without the advice component built in. Those that do, including Leith Wheeler, Mawer, PH&N and Steadyhand, typically have much lower fees.

Let's turn to the average returns (equal weighted) of a selection of popular asset classes versus their respective benchmarks, as taken from the S&P report:

**TABLE 1 - ACTIVE VS. PASSIVE RETURNS (AS OF DECEMBER 31, 2009)**

	1 Year	3 Years	5 Years
Canadian Equity	31.29%	-2.38%	4.54%
S&P/TSX Capped Composite Index	35.06%	-0.21%	7.66%
U.S. Equity	9.76%	-11.31%	-4.83%
S&P 500 Index (\$Cdn)	9.34%	-8.80%	-2.23%
Cdn Small/Mid Cap Equity	51.03%	n/a	n/a
S&P/TSX Canadian Completion Index	47.67%	-1.48%	5.81%
Global Equity	15.37%	-8.57%	-0.86%
S&P Developed LargeMid Cap Index	11.43%	-8.14%	0.03%
International Equity	14.51%	-10.38%	-0.58%
S&P EPAC LargeMid Cap Index	13.05%	-8.43%	1.46%
Cdn Focused Equity	29.55%	-3.67%	4.03%
50/25/25 S&P Bench	23.13%	-4.41%	3.64%

Clearly, the numbers favour indexing (with the exception of small cap and Canadian focused equity funds). After all, it isn't easy to beat the index when you've got a 2.5% fee anchor weighing you down. But if a true apples-to-apples comparison were made factoring in the costs of indexing and stripping out the cost of advice in active funds, the numbers wouldn't be as advantageous toward indexing. In fact, by evening the fee playing field, the results can look much different (active management would look superior in the global equity, Canadian small/mid cap equity and Canadian focused equity categories).

S&P also produces a Scorecard for U.S.-based active funds, which have lower fees than their Canadian counterparts. The latest report (year-end 2009) shows that average returns for large cap and multi-cap funds were better than the S&P 500 Index and the S&P Composite 1500 Index, respectively, over the longest time period analyzed. Fur-

ther, the report, which highlights that the average active fund underperformed its benchmark in many categories, also notes: "The conclusions are less unequivocal when looking at asset-weighted averages, which measure the performance of the average invested dollar in active funds. In several equity and fixed-income categories, there is a more level playing field with index returns."

Moreover, if the data set didn't have an abundance of funds that closely follow the index ("closet index" funds), the results would arguably look much different. Low fee, truly active funds (non-benchmark oriented) that are right-sized stand a much better chance of beating the index over the long term. This has been documented in a Yale research paper published in 2007 titled *How Active is Your Fund Manager? A Measure that Predicts Performance*.

The mutual fund industry is heavily marketing driven and has its share of warts. Indexers are quick to point these out. But the indexing business is picking up some bad habits too (think leveraged ETFs and the rapidly growing number of fad-based products). The S&P scorecard exaggerates the outperformance of passive investing by ignoring the issue of fees. National Bank Financial recently completed a more balanced analysis that looked at the difference in performance and risk from holding mutual funds vs. ETFs in a report titled *The Right Tool for the Job: Mutual Funds vs. ETFs*. Although the study still used a high fee opportunity set for mutual funds (i.e., it didn't adjust for trailer fees), it concluded that active funds were the best products in the natural resources, precious metals, Canadian small and mid cap, and U.S. equity categories. ETFs won out in the Canadian equity, dividend and income, financial services, and real estate categories.

Shrewd investors should always look beyond the headlines of any performance-based study. The bottom line is that indexing has merit when it's done right. Active management also has merit when it's done right. Unfortunately, neither camp tends to see it this way. Until they do, the long standing debate, which has increasingly turned into an ugly political campaign, will rage on.

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