Tulett, Matthews & Associates
Portfolio Management

RETHINK THE WAY YOU INVEST

Redefining Investment Execution

Choose Your Investment Tools Wisely

Why Index of Passive Management Outperforms Active Management

Pay Attention to Investment Management Costs and Taxes

CONTENT INCLUDES

- The Power of Asset Class Investment Tools
- Mutual Funds and Stock Pickers are No Longer Sacred Cows
- Fees, Commissions, and Taxes Can Cripple Your Returns

By Keith Matthews
Partner & Portfolio Manger
Tulett, Matthews & Associates Inc.
www.tma-invest.com

An excerpt from the National Best Selling Book,
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by Keith Matthews (www.empoweredinvestor.ca).

Choose Your Investment Tools Wisely

THE POWER OF ASSET CLASS INVESTMENT TOOLS

The great leaders of organizations—whether they be the CEOs of multinational corporations, the coaches of winning sports franchises, or community leaders—all agree on one very important principle when it comes to achieving their winning results: a key component of the success of their plans is paying careful attention to the details and the way they are executed.

The same applies to the execution of the three investment principles. The saying "the devil is in the details" is very much the case in investment management. The methods we use to execute and implement our portfolios are key elements in ensuring success. So much so that we will dedicate this whitepaper to discussing portfolio management execution issues.

Like any chef who has chosen the recipe for a gourmet dinner and is now looking for just the right ingredients, we too are in search of the tools to build, execute, and monitor our investment plan founded on the three investment principles: Invest in Asset Classes + Diversify + Discover the Fama/French 3-Factor Model. Good tools are fundamental in the quest to create a successful investment experience.

Choosing Your Asset Class Investment Tools

Once you have decided which asset classes you want to include in your portfolio, the next step is to decide what tools will enable you to capture the long-term expected returns of your asset classes. Your choices for executing an investment plan built on diversified asset class exposure are as follows:

- individually selecting stocks (stock picking) for each asset class;
- hiring an investment manager (mutual fund or investment counsellor offering) to select stocks in each asset class for you; or
- using precise and transparent asset class investment tools.

Since 96% of the returns come from your asset class and risk factor choices (and not stock picking or market timing), you should only use the first two options if they can demonstrate a consistent performance factor over and beyond the performance of asset class tools. In addition, your tools of choice should deliver transparency, tax-efficiency, and minimal asset class performance drift, and be free of conflict of interest. Above all, your investment tools need to deliver solid long-term performance.

Empowered by Precise Asset Class Investment Tools

The use of precise asset class tools for the average Canadian investor is a relatively new phenomenon. Asset class investment tools can be defined as a diversified basket of securities (either stocks or bonds) that represents an asset class. Access to these investment tools and all the benefits that come with them embodies the brave new world of empowered investing.

Historically, when individual investors or advisors wanted to capture an asset class return, they had to hire an active manager (typically an active manager buys and sells securities, usually within a mutual fund, in an attempt to outperform the asset class returns) or choose some stocks in that asset class on their own. The last decade, however, has seen tremendous growth and innovation in institutional portfolio management tools that track a large variety of asset classes around the world.

The two best types of institutional asset class investment tools available for Canadian investors are:

- **Exchange Traded Funds (ETFs).** Manufactured by institutional money managers such as Barclays Global Investors, State Street Global Advisors, and the Vanguard Group, to name a few. As of 31 October 2007, twenty-eight ETFs were traded on the TSX, with many more traded on the U.S. exchanges.

- **Asset Class Funds.** Offered by Dimensional Fund Advisors, an institutional money manager headquartered in Santa Monica, California. As of 31 October 2007, eight Dimensional funds were available to Canadian investors.

These asset class investment tools track specific asset classes, revolutionizing the way portfolios can be created and constructed. ETFs track commercial indexes such as the S&P/TSX Composite Index, the S&P 500 Index, and the MSCI EAFE Index. Dimensional's asset class funds do not track commercial indexes and do not have managers trying to actively pick and choose the next winners. Dimensional follows a different path, structuring its strategies based on scientific evidence rather than on commercial indexes. It then manages stocks within the structure on a passive basis. Small cap strategies target smaller stocks more consistently, while value strategies target value returns with greater focus. As a result, investors achieve more consistent portfolio structure. Dimensional builds asset class strategies for institutional pension plans and select advisors in the United States, Australia, England, and Canada. Both ETFs and Dimensional's asset class funds follow asset classes with much greater precision than offerings based on active stock picking. They are transparent, tax-efficient, and avoid the risk of human error that can plague professionally actively-managed funds.

Innovation and Evolution of Asset Class Investment Tools

Index or passive management—as opposed to active management—is not a new phenomenon. An index fund or index tracker is a form of passive asset management either in a collective investment offering (usually a mutual fund but it can also be an ETF) that aims to replicate the movements of the commercial index of a specific financial market, or through a set of rules of ownership that are held constant, regardless of market conditions (Wikipedia 2007). A passively-managed fund (Dimensional Fund Advisors is a global leader in this category) typically relies on a set of rules, a screening/filter process, or a set of strict investment guidelines to manage an asset class. Human input is limited to the asset class construction and stock filter level and the fund does not rely on human input to buy and sell individual securities on an active basis.

At the institutional level, the active vs. passive debate has raged for decades. What is new, however, are the innovative asset class investment tools that can now give Canadian investors and advisors a viable and sound alternative to active management.

Ten years ago, if a Canadian investor wanted to get exposure to, for example, international companies, there was very little choice. At that time, only Canadian institutional accounts had the size and the buying power to gain access to institutional managers with expertise in investing in international companies. The only real choice open to non-institutional investors was a limited selection of expensive mutual fund or brokerage firm wrap programs with management expense ratios (MERs) falling in the range of 2.5% to 3.0%. Even Canada's investment counsellor community (servicing Canada's affluent) did not necessarily have the in-house expertise—or for that matter an investment option—to offer their clients in order to get exposure to international equities.

Today, Canadian investors, advisors, and portfolio managers have access to a wide variety of low-fee, tax-efficient, and transparent asset class investment tools designed to track and follow international asset classes and markets. Both Barclays Global Investors and the Vanguard Group have a series of ETFs that track a variety of international commercial benchmarks such as the MSCI EAFE Index or the MSCI Emerging Market Index, with MERs ranging from 0.15% to 0.75% (for more information, see www.ishares.ca and www.vanguard.com). Dimensional Fund Advisors offers three international strategies with a focus on value companies and small companies through their structured asset class strategies, with MERs ranging from 0.6% to 1.0%. (Further information is available at www.dfacanada.com.) If you use a financial advisor or portfolio manager to assist you with the management of your portfolio, remember that you will have to pay their management fees in addition to the fund MERs. Fees for a financial advisor or portfolio manager can average between 0.5% and 1.5% depending on the size of your portfolio.

These new asset class investment tools are empowering and democratic: the little guy (which includes everyone who is not an institution) now has access to Canadian, U.S., and international asset classes in a transparent, pure fashion. The next two sections in this white paper ("Why Index or Passive Management Outperforms Active Management" and "Pay Attention to Investment Management Costs and Taxes") demonstrate why you should consider using these tools to capture the asset class returns in your diversified portfolio, and debunk some of the myths surrounding their use.

What the Experts Say About Indexed Investing[1]

Index funds that are very low-cost (such as Vanguard's) are investor-friendly by definition and are the best selection for most of those who wish to own equities.—Warren Buffett, chairman, Berkshire Hathaway

All the time and effort that people devote to picking the right fund, the hot hand, the great manager, have in most cases led to no advantage. Unless you were fortunate enough to pick one of the few funds that consistently beat the averages, your research came to naught. There's something to be said for the dartboard method of investing: buy the whole dartboard.—Peter Lynch, manager of Fidelity Magellan

Most investors, both institutional and individual, will find that the best way to own common stocks is through an index fund that charges minimal fees. Those following this path are sure to beat the net results (after fees and expenses) delivered by the great majority of investment professionals.
—Warren Buffett, chairman, Berkshire Hathaway

Why does indexing outmaneuver the best minds on Wall Street? Paradoxically, it is because the best and brightest in the financial community have made the stock market very efficient. When information arises about individual stocks or the market as a whole, it gets reflected in stock prices without delay, making one stock as reasonably priced as another. Active managers who frequently shift from security to security actually detract from performance compared to an index fund by incurring transaction costs.—Burton G. Malkiel, finance professor and author of the classic *A Random Walk Down Wall Street*

Index funds decline in bear markets. So do managed funds ... only more so.—John C. Bogle, Sr., former chairman and founder, the Vanguard Group

Index funds should be the core of most portfolios today.—Tyler Mathison, CNBC broadcast journalist and executive editor, *Money Magazine*

When it comes down to how we are performing, we are trailing in the market's wake. People ought to recognize that the average fund can never outperform the market in total.—John Fossel, former chairman, the Oppenheimer Funds

Indexing is a marvelous technique. I wasn't a true believer. I was simply an ignoramus. Now I am a convert. Indexing is an extraordinarily sophisticated thing to do. If people want excitement, they should go to the racetrack or play the lottery. —Douglas Dial, portfolio manager of the CREF Stock Account Fund, the largest pension fund in America

Properly measured, the average actively-managed dollar must underperform the average passively-managed dollar, net of costs. Empirical analyses that appear to refute this principle are guilty of improper measurement.—William F. Sharpe, professor of finance, Nobel Laureate

Most of the mutual fund investments I have are index funds, approximately 75%.—Charles Schwab

Skepticism about past returns is crucial. The truth is, much as you may wish you could know which funds will be hot, you can't—and neither can the legions of advisers and publications that claim they can. That's why building a portfolio around index funds isn't really settling for average. It's just refusing to believe in magic.—Bethany McLean, *Fortune Magazine*

Why Index or Passive Management Outperforms Active Management

MUTUAL FUNDS AND STOCK-PICKING INVESTMENT COUNSELLORS ARE NO LONGER SACRED COWS

It took the bear market of 2000–2002 for many investors to begin questioning the merits of stock-picking mutual funds or investment counsellors. We were told that, in a declining market, active stock-picking strategies would clobber asset class indexing strategies. We were told that smart managers would know how much cash to hold onto and which stocks to sell in the bear market, thus protecting investors from declines in the equity market.

Unfortunately, it wasn't true. Instead, the most recent bear market proved that the average active manager does not perform any better than the broad benchmarks against which they are measured.

Table 1 lists many of the relevant asset classes available to Canadian investors through Canadian

Table 1: Actively Managed Canadian Mutual Funds vs. Index Returns

ASSET CLASS	1 YR.	5 YR.	10 YR.
Canadian Equity Funds (median return)	20.3%	17.1%	7.9%
S&P/TSX Composite Index	22.8%	20.4%	9.1%
Barra Canadian 300 Growth Index	34.1%	19.3%	7.1%
Barra Canadian 300 Value Index	18.2%	22.7%	12.2%
US Equity (median manager)	3.0%	3.8%	1.2%
S&P 500 Index	3.8%	5.2%	3.1%
International Equity (median manager)	9.3%	10.5%	3.4%
MSCI EAFE Index (net div)	11.3%	12.5%	4.5%
Emerging Market (median manager)	36.5%	23.4%	7.5%
MSCI Emerging Market Free Index	41.3%	26.7%	8.3%
Canadian Bond (median manager)	0.0%	4.0%	4.7%
Scotia Capital Bond Total Return Index	1.6%	5.5%	6.1%

Source: Globeandmail.com, Standard & Poor's Index Services Group, S&P/TSX, Scotia Capital Inc. as of 30 September 2007

mutual fund offerings. This ten-year chart covers an interesting period, including the end of the bull market in the late 1990s, the bear market of 2001–2002, and the strong market up to 2007. The returns in almost ALL asset classes demonstrate that Canadian investors would have been better off investing in indexes rather than in actively-managed funds.

Beware of Survivorship Biases in "Median Manager Averages"

In the study and research of mutual fund returns, "survivorship" bias is the tendency to exclude failed mutual funds from the performance studies that determine the median manager averages because those failed funds no longer exist. This exclusion can skew the median manager averages higher because the study only included those mutual funds that were successful enough to survive until the end of the study period.

According to Standard and Poor's, survivorship for Canadian mutual funds over the five-year horizon is 61.9%, 41.1%, and 64.4% for Canadian equity, U.S. equity, and Canadian small cap funds, respectively.[2] Put differently, five years ago there were 205, 163, and 73 mutual funds in the three categories. As of March 2007, there were 109, 92, and 42 mutual funds left. What happened to the disappearing funds? Many of these mutual funds might have been liquidated or merged into another fund during this period. One thing is certain: their performance (and it was most likely poor) is not included in today's median manager averages. So the median manager performance noted in table

1 would be even lower were it to be adjusted for survivorship bias.

The Great Canadian Banks

Even mutual funds distributed by Canadian banks have had a hard time outperforming the indexes. Canadian banks have arguably some of the deepest pockets in the industry, cash which is used to hire the brightest talent. In addition, they have an almost captive client base, ensuring a steady flow of business to support their operations. The banks' management fees also tend to be a little lower than their high-profile mutual fund counterparts, which should make it easier for them to outperform. And, yet, there seems to be no evidence that the active management teams of Canadian banks can consistently add any reasonable performance over the benchmarks.

Table 2 (see page 7) shows the weak performance of Canadian bank mutual funds in their own backyard: Canadian equity, U.S. equity, and Canadian bonds. Although we might assume that out of all potential asset classes, Canadian banks could demonstrate an ability to outperform on their home turf, clearly this is not the case.

Why do active managers underperform the indexes? As a group, active managers tend to underperform their benchmarks due to the combination of two factors:

1. The public capital markets are reasonably efficient and tend to price securities fairly over long periods of time, leaving little room for "outsmarting."

How do the public capital markets become efficient? It is primarily due to the tens of thousands of very smart, hard-working security analysts, investment managers, institutional pension funds, and investors who spend countless hours trying to find and buy incorrectly-priced securities. The active managers themselves and all the other smart security experts make the public markets smart and efficient.

Another way of looking at this is as follows: if an active manager outperformed the indexes because he or she was able to identify and buy mispriced securities, it would mean that the public markets had failed. This may happen on occasion, but finding an active manager who can outsmart the dimensions of risk and return in the public markets—consistently, over a long period of time—is like finding a needle in a haystack.

For these reasons, the data and results show that there are simply not that many *imperfections* or *incorrectly-priced securities* left in the public markets for active managers to identify and buy. The fact that the markets are smart and efficient over long periods of time is the ultimate compliment to active managers.

2. The fees and total costs of active management act as a huge hurdle and leave little room for "out performance."

Active management comes with a price tag. In many consumer-oriented industries, we know that a premium or higher price can often be linked to a higher-quality product—and may represent better value over the long term. We know that many premium products often last longer than cheap, low-cost alternatives and there are many examples of products and services where it pays to spend a little more. Unfortunately, active investment management is not one of these industries—although the industry would like you to think so. The total cost associated with active management

Table 2: Returns of Actively Managed Bank Mutual Funds vs. Indexes

ASSET CLASS	1 YR.	5 YR.	10 YR.
Asset Class: Canadian Equity			
Barra Canadian 300 Value Index	**18.2%**	**22.7%**	**12.2%**
TD Canadian Equity	23.9%	21.4%	10.5%
RBC Canadian Equity	22.1%	18.2%	9.6%
BMO Equity	19.8%	16.6%	9.5%
S&P/TSX Composite Index	**22.8%**	**20.4%**	**9.1%**
TD Canadian Value	18.3%	16.3%	6.9%
CIBC Canadian Equity	19.5%	16.0%	6.3%
Scotia Canadian Growth	20.0%	16.3%	6.1%
CIBC Canadian Equity Value	16.2%	11.4%	6.0%
RBC Canadian Equity	22.5%	17.7%	6.0%
National Bank Canadian Equity	16.8%	15.7%	5.3%
Desjardins Canadian Equity	22.2%	16.8%	4.7%
Asset Class: Canadian Bonds			
Scotia Capital Bond Total Return Index	**1.6%**	**5.5%**	**6.1%**
TD Canadian Bond	0.1%	5.3%	5.9%
Scotia Canadian Income	0.2%	4.3%	5.2%
CIBC Canadian Bond	0.5%	4.5%	4.6%
National Bank Bond	0.1%	3.8%	4.5%
BMO Bond	0.3%	3.8%	4.4%
RBC Bond	0.1%	5.0%	4.2%
Desjardins Canadian Bond	-0.1%	3.5%	4.1%
RBC Canadian Bond	-0.5%	3.4%	3.8%
Asset Class: U.S. Equity			
S&P 500 Index	**3.8%**	**5.16%**	**3.13%**
BMO U.S. Equity	5.4%	4.9%	2.4%
TD U.S. Blue Chip Equity	6.5%	2.9%	1.2%
BMO U.S. Growth	0.4%	1.8%	-1.3%
Scotia American Growth	1.5%	-0.7%	-2.4%

is extremely high and is an impediment for active managers to overcome. The total cost to the investor includes much more than simply the management expense ratios (MERs). Managing diversified pools of capital is associated with many more obscure and behind-the-scenes costs, such as trading

Table 3: Comparison of Fund Ratings by Manager Selection Services

MANAGER SELECTION SERVICE	FUND A	FUND B	FUND C	FUND D
Morningstar (12/00)†	*****	**	***	****
Forbes (12/00)	C	A	A+	D
U.S. News & World Report (12/00)‡	34	50	10	93
Wall Street Journal (1/01)	E	C	A	B
Business Week (1/01)	A	–	B+	C

† Five stars is the highest rating, while one star is the lowest rating

‡ 100 is the highest rating and 1 is the lowest rating.

Source: Dimensional Fund Advisors

commissions and market impact costs. These will be discussed at greater length in the final section of this white paper.

Prior to the last decade, we needed active managers to expose us to a variety of different asset classes. We had no choice and we had to accept all the costs associated with gaining admission to those investment opportunities. Fortunately for investors, times have changed and the options available to us have become much more attractive.

What About the Star Managers?

As we have seen, on average, active managers underperformed their respective benchmarks over long periods. Yet, when it comes to marquee managers who are lauded in the press or in the industry as the "ones to watch," investors remain skeptical that indexes could possibly outperform these high-flyers. Why is this? Why do some investors still believe that star money managers really exist and can be found in advance? And why do they believe that manager selection services at large financial services firms can identify superior managerial skill?

The answers may lie in human nature. When it comes to believing that star performers exist, we are eternal optimists. After all, super achievers and superstars exist in most commercial industries and in sports. We read about them in magazines and they become success stories in our popular culture.

Many of us witness employees or managers who work harder and smarter, and end up with superior results. So why would it not be the case in money management? If superstars exist in other professions, it only makes sense that they should exist in money management. Right? Wrong.

You may think it would be easy to identify the next Tiger Woods or Wayne Gretzky of money management. You may also think that the selection methodologies used by large financial services firms, or even by independent manager selection firms, could consistently identify some of the stars—after all, it is their specialty. Unfortunately, the evidence shows that the manager selection process is spotty at best. Table 3 highlights just how difficult it is to form a consensus on who the current stars are. Opinions from four different leading independent U.S. manager selection services vary greatly on exactly the same funds.

Table 4: Apples to Apples: Comparing Managers to More Appropriate Benchmarks

MUTUAL FUNDS		5 YR	10 YR
Saxon Stock		15.6%	11.5%
CI Canadian Investment		15.6%	11.0%
IA Group Cdn Equity Value		18.4%	10.3%
Renaissance Cdn Core Value		13.4%	10.2%
Dynamic Value Fund of Canada		23.7%	10.1%
BonaVista Canadian Equity		23.1%	10.0%
Beutel Goodman Canadian Equity		17.0%	9.7%
BMO Equity		16.6%	9.5%
Median Canadian Equity Manager		17.1%	7.9%
S&P/TSX Composite Index	Traditional comparison	20.4%	9.1%
Barra Canadian 300 Value Index	May be more appropriate	22.7%	12.2%

Source: Globeandmail.com, Standard & Poor's Index Services Group, S&P/TSX, Scotia Capital Inc. as of 30 September 2007

Furthermore, how do you identify a potential star when they all look identical? All manager commentaries, outlooks, and marketing statements will insist that their group/manager is better and smarter than the rest. If you were to interview a hundred active management firms, you would hear essentially the same positioning statements and jargon. They would all claim to be superior and better than their peers! Here are two points to remember with respect to manager selection:

- past performance does not determine future performance
- risk factors—NOT managers—determine long-term performance.

Smoke and Mirrors: Compare the Stars to the Risk Factors in Their Portfolios

So how do you explain how some managers can consistently outperform the broad market benchmarks (S&P/TSX Composite Index, S&P 500 Index, or MSCI EAFE Index)? This brings us back to the landmark research of Fama and French.

This research showed that three risk factors—stocks vs. bonds, value company stocks vs. growth company stocks, and small company vs. large company stocks—drive 96% of your portfolio returns and that your performance is a function of the investment you, your advisor, or your active mutual fund manager puts into these risk factors. The more you include value and small company stocks in your diversified equity basket (and subsequently increase your risk), the more you will outperform the broad markets over a long period of time.

Table 4 compares some of the stars to a more appropriate benchmark or risk factor. At first glance, it seems that some of these well-known managers have indeed outperformed the broad benchmark. BUT, was the broad benchmark the right comparison? If, for example, their portfolios

Table 10: Tax Efficient and Tax Inefficient Investments

TAX EFFICIENT	TAX INEFFICIENT
Buy & Hold Stocks	Brokerage Accounts (with higher turnover)
Exchange Traded Funds*	Mutual Funds (with higher turnover)
Index Strategies	Investment Counsellors (with higher turnover)
Tax Managed Funds	Hedge Funds (with higher turnover)

* The Price Waterhouse Coopers report "Understanding the Tax Implications of Exchange Traded Funds" (November 2003) states that "both Canadian and U.S. ETFs are structured to operate in a manner that may promote tax efficiency. The major advantage from a tax perspective arises from the fact that the capital gains distributions are minimized."

were constructed with riskier assets (or assets with higher expected returns than the broad markets, e.g., value or small company stocks), comparing their results to a standard broad index is like comparing apples to oranges.

Let's make it more fair by comparing the performance of these managers to more relevant benchmarks that include similar risk factors. This exercise will explain where some of the managers' apparent overperformance is coming from. Table 4 lists a group of funds that have strong ten-year performance numbers relative to their peer group (as compared to the median Canadian equity manager) and the traditional benchmark comparison (S&P/TSX Composite Index). These funds undoubtedly have very good performance relative to the general comparisons. But are these comparisons right? In this case, these managers have stated value biases and value investment philosophies and one would expect slightly higher returns from value companies. In addition, the value effect was very strong during the ten-year period ending 30 September 2007. To better judge performance, we need a more "apples to apples" comparison.

Once compared to their more appropriate risk factors (Barra Canadian 300 Value Index), the star managers in table 5 begin to look more and more mediocre. While this more in-depth type of analysis occurs at the institutional investment level, it unfortunately gets blurred at the retail level by the investment industry, the media, and the mutual-fund marketing machines.

Searching for Stars Can Lead to Chasing Performance

Trying to identify, in advance, star managers who can consistently add value over appropriate benchmarks is more than a challenging task: for many Canadian retail investors, the process unfortunately leads to buying into management styles or sector concentrations at their peak. Trying to identify star managers often leads investors astray and encourages them to chase performance. Instead of buying low and selling high, investors tend to buy high and sell low—and then have to live with disappointing and lagging performance.

Marketing a manager's last few years of performance tends to lead investors to focus on rear-view-mirror thinking and to make decisions based on the past rather than on what will truly have the biggest impact on portfolio returns: their investment allocations to asset classes and the risk factors that drive performance.

Identifying star managers is even trickier for Canadian investors than it is for their American counterparts. Heavily influenced by U.S. investment news and trends, Canadian investors are also subject to trends from our resource-based and cyclical Canadian equity markets, exposing us to an extremely unsettled rollercoaster of star manager marketing that includes investment themes and sector volatility.

Over the past two decades, Canadians have been exposed to several different star manager concepts: the early 1990s included star Canadian junior resources and mining managers; U.S. consumer brand companies boomed during the mid-1990s; and the late 1990s, of course, heralded a new era for managers investing in global Internet and technology companies. The year 2000 saw explosive marketing of managers in sectors such as global pharmaceuticals, financials, and technology, while real estate trust managers came to life in 2002 and income trusts were in full rage by 2004. Finally, in 2007, we were back to where we started, with Canadian oil and gas and resource managers capturing a huge spotlight.

Many star managers are promoted during the late stages of a market sector upswing. Buying into their ideas generally leads to buying stock at heavily-inflated prices, which inevitably leads to poor portfolio construction and disappointing investment returns.

Investors may believe they are selecting a manager carefully but, unfortunately, the process often ends up as too much of a speculative, performance-chasing endeavour. Performance attribution, comparisons to appropriate benchmarks, and risk factors should be examined more closely. Informed investors must not mistake manager performance for risk factor performance.

Is There a Better Alternative to Finding the Stars?

The bad news is that identifying the stars is neither easy nor predictable. The good news is that we have a portfolio construction framework (the Fama-French 3-Factor Model) that can help us create a long-term asset management blueprint. We also have investment tools like asset class investments in the form of exchange traded funds or Dimensional Fund Advisor's asset class funds that provide viable alternatives to traditional actively-managed offerings. These investment tools can give us access to Canadian, U.S., and international equity markets and various risk factors (value company and small company stocks) in a precise fashion. These investment tools can easily compete with the stars and capture the returns of the asset class in a much more transparent, tax-efficient, scientific, and cost-effective manner—and do so with less manager drift and selection risk.

Asset class investment strategies work in up markets, down markets, and sideways markets. Like the tortoise, these asset classes make their gains at a slow and steady rate, easily outpacing sexier strategies where it matters most: in your investment returns.

Pay Attention to Investment Management Costs and Taxes

FEES, COMMISSIONS, AND TAXES CAN CRIPPLE YOUR RETURNS

Do you know your total portfolio costs? Successful portfolio construction must include a review of the *total cost analysis* of your portfolio. You should run your personal portfolio (RRSPs, taxable investments, or investment holding company accounts) like a business. Just as any successful business management group will analyze both its revenues and its cost structure to improve profitability and efficiency, you and your advisor should be doing the same. It only makes sense.

It is vital that you understand the impact of your total portfolio management costs and tax efficiency (or inefficiency). For all intents and purposes, the revenue side of the portfolio is limited to the expected returns from various asset classes or investment choices, and the total cost component is really one of the few things that you and your advisor can control. The benefits of managing your cost structure and tax efficiency include:

- increasing your accumulated wealth over a long period of time;
- improving your total after-tax return. In a low-return environment, this incremental improvement in your after-tax return will represent a higher portion of the total returns. At a time when most financial experts agree that we should be prepared for much lower expected rates of return in the future than in the 1980s and 1990s, every little bit counts;
- allowing you and your advisor to identify and use the most efficient investment strategies and solutions; and
- empowering you and your advisor to actively manage something that is actually controllable as compared to something (like the market) that is out of your control.

Managing Your Cost Structure and Tax Efficiency

The total cost to the investor of any professional investment management program includes much more than meets the eye. These costs include the following:

MERs: The most commonly known annual fee charged by investment counsellors, mutual funds, or portfolio WRAP programs to their investors. These fees can range from 0.5% to 3.0%, depending on the type of service and strategy offered. Typically, the MER consists of fees for a combination—but not necessarily all—of the following expenses: the selling agent, the servicing advisor, and the portfolio manager; TV, radio, and print advertising; all other promotional events; and accounting and record keeping.

Unfortunately, this is only the beginning. In addition to MERs, investors should be aware that there are many more obscure and behind-the-scenes costs associated with managing diversified pools of capital.

Trading Commissions: Possibly one of the largest additional expenses attached to active trading. Trading commissions are the commission that the manager must pay to the brokerage industry for actively buying and selling investments inside the pool of capital being managed. Estimates can range from 20 basis points to 75 basis points, depending on the amount of trading that occurs in the pool.

Figure 1: The Total Cost of Investing

Market Maker Spread: The difference between the bidding and asking prices that the specialist sets for a stock. The specialist keeps the difference as compensation for providing liquidity. For less liquid stocks, the specialist has greater exposure to adverse price movements and likely will make the spread larger.

Market Impact Costs: These costs reflect the change in market price of a security due to a large block trade coming to the market.

Opportunity Costs: The effective cost of security price movements that occur before the trade is actually executed.

Figure 1 illustrates the multiple layers of costs (both direct and indirect) associated with any pooled investment offering (mutual fund, investment counsellor, ETF, or institutional pool).

How Should an Individual Investor Manage the Total Cost?

Individual investors and advisors should be aware of these costs and should seek to find, analyze, and implement the most efficient portfolio management tools in the marketplace. Investor education and awareness are critical to understanding the various costs and their impact on your money.

Asset class investment management tools such as exchange traded funds, Dimensional asset class funds, and some closed-end funds not only have significantly smaller MERs, they also have fewer of the other layers of costs associated with active trading. High total costs are one of the reasons why investment counsellors and mutual fund managers who actively trade securities in the hope of "outsmarting" the market tend to underperform their relative benchmarks.

Managing Your Taxes (After-Tax, After-Tax, After-Tax)

MERs and commissions are the most well-known direct costs associated with investment management, but investors also need to consider other significant indirect costs or inefficiencies. Unbeknownst to many investors, taxes may be the silent killer in their investment management programs.

You may wonder why Canada's investment management industry doesn't talk about tax-efficient portfolio management. If it has such a huge impact, why don't we hear more about it? First and foremost, the mindset of Canada's pension managers is geared to managing money for tax-sheltered pension plans: tax issues are simply not on the radar screen. Second, the industry (manager incentive programs, the media, investor expectations) is generally focused on short-term thinking—which encourages a lot of trading but unfortunately does not support the development of long-term, tax-efficient tools or tax-managed strategies.

Portfolio tax efficiency is a less-than-obvious subject, but nonetheless an extremely important and often overlooked portfolio cost. If you and your advisor manage your taxable investment portfolio in a tax-efficient manner, your after-tax portfolio returns can be increased by anywhere from 0.5% to 1.0% over the long term (ten years and more). The good news is that once you are aware of tax inefficiencies, you can easily improve them.

Studies Support Low-Turnover Index Strategies

In a landmark 1993 U.S. study on managing taxable portfolios, Robert H. Jeffrey and Robert D. Arnott concluded that taxes have a huge negative impact on relative returns and that lower-turnover (stock trading) index strategies are a much more tax-efficient investment option than actively-traded mutual fund or investment counsellor strategies.[3]

This report began the debate on tax-efficient investing within the investment management community in the United States. Prior to this report, no one cared or paid attention to tax-managed portfolios. This study remains highly regarded and is one of the outstanding contributions to the study of tax-efficient investing.

In 1996, Mike Thornfinnson and Jason Kiss published the first Canadian study on tax-efficient portfolio management, coming to essentially the same conclusions as the original U.S. study: over the long term, it is difficult to beat index strategies for taxable accounts.[4] Table 10 lists a variety of tax-efficient and tax-inefficient portfolio management tools based on the findings and conclusions of these and other studies.

The Power of Compounding

Tax efficiency in portfolio management has nothing to do with the federal or provincial taxes that you pay on your employment or business earnings. It involves trying to reduce and defer the taxes payable on the distributions you receive from your taxable investment portfolio (interest, dividends, and capital gains).

In managing equity portfolios for taxable investment accounts, your goal (besides the risk and return goals) should be to minimize and manage any taxable capital gain distributions. By reducing your distributions, you create a deferred capital gain in your portfolio. The simple act of delaying the payment of your taxes produces something quite subtle but *very* powerful.

Over a long period, investors can enjoy compound returns on their deferred taxes and, of course, in turn, keep their share of the gains on their deferred taxes. Added up, all these tiny pieces can represent 0.5% to 1.0% of additional returns over the long term (ten years and more).

Not only are these additional returns real, but they also represent a higher portion of the total returns in a low-return environment—which makes it that much more important to take advantage of tax-efficient strategies.

The studies discussed in this chapter showed that, all pre-tax returns being equal, investors who use tax-efficient strategies will have more money in their taxable trading accounts after all the taxes are paid than investors who use traditional high-turnover mutual funds or trading-oriented investment counsellor offerings.

In fact, both studies concluded that actively-managed pools of capital (with lots of internal trading) would need to consistently outperform their benchmarks (after all their fees) by 100 to 200 basis points just to equal the after-tax returns of the lower-turnover index benchmarks.

The Bottom Line

In this section, we have seen that the tools you use to implement your investment strategies do matter to your bottom line. The active trading of funds and the fees that accompany these services will, over time, have a significant impact on your portfolio's total costs and, in turn, will reduce your returns. No less important is the tax efficiency of your investments, which will allow you considerable savings if implemented properly.

It is well worth your while to pay attention to these seemingly trivial details. Doing so will allow careful investors to be among the fortunate few who reap the greatest potential profit from their assets in the years to come. The good news is that investment tools and winning strategies do exist. These strategies can empower you and give you better control over your total costs and tax efficiencies, enabling you to put more money in your pocket over the long term.

NOTES

1. Quotes compiled by Savant Capital Management Inc. Savant is a member of the Zero Alpha Group, a U.S. nationwide network of seven fee-only investment advisory firms that manage a total of $8 billion in private client assets. Among other strategies, the Zero Alpha Group is a leading proponent of using index and passively-managed investment tools in portfolio management applications.

2. Standard & Poor's, *Index Versus Active Funds Scorecard for Canadian Funds*, 2 May 2007.

3. Robert H. Jeffrey and Robert D. Arnott, "Is Your Alpha Big Enough to Cover Its Taxes?" *Journal of Portfolio Management*, 1993.

4. Mike Thornfinnson and Jason Kiss, "The Overlooked Piranha," *Canadian Investment Review*, 1996.

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Keith Matthews
Partner & Portfolio Manager
Tulett, Matthews & Associates Inc.
3535 St-Charles Blvd, Suite 703
Kirkland, Quebec
514-695-0096 (106)
keith@tma-invest.com
www.tma-invest.com

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