# EBI - Principle #3: Choose Indexing to Implement Your Portfolio

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**Keith:** Welcome to episode 15 of the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host, Ruben Antoine, for today's episode. Welcome, Ruben.

**Ruben:** Thank you, Keith. Always a pleasure.

**Keith:** In our last show, we covered the first and second principles of the evidence-based investment approach. Principle one was to invest in asset classes, and principle two was to diversify those asset classes. In the next few shows, we're going to go into principles three and four to really round out how to think about this exciting way to invest. So in today's show, we're going to introduce listeners to the third principle of evidence-based investing, which is to choose index-based or passively managed asset class investment vehicles. We'll discuss why implementation and execution within an investment approach are so critical for investors. We'll define index management and help you understand the differences versus actively managed strategies. And finally, we'll discuss and review the benefits of index management. So, Ruben, let's start from the beginning. What's behind principle number three?

**Ruben:** Yeah. So, like you said, principle number one was to invest in asset classes instead of buying stocks. Number two was to diversify those asset classes. So now we are starting with principle three. Principle three is really the "how." Now that you need to do that with asset classes, how do you implement these strategies? There is a universe of investment vehicles that investors can use in the marketplace to get exposure to asset classes and to diversify them. So now we want to discuss what products they can use, what are the best products available for them, and the ones they can rely on because execution is key. And the way you implement your portfolio is very key to getting the best long-term result.

**Keith:** You're absolutely right, Ruben. Going back in time, people used to always say, "I got the great investment approach. I got this great way of doing things." But where investors would struggle often would be in execution. It doesn't matter whether you're a charitable organization, a business running and trying to generate profits, or a sports organization. If you don't execute and if you're not careful with the details, you lose your way. So, Ruben, what are examples of great execution that have nothing to do with investment management?

**Ruben:** Yeah. One example that comes to mind is if you want to buy a product, for example, order a product online. Do you have a company that comes to mind, Keith, if I want to buy a product online?

**Keith:** You've got Amazon, which I guess is a big one.

**Ruben:** Yeah, exactly. So you see, if I were to ask that question, many people would answer Amazon right away because we know that we can rely on Amazon. First of all, they have a good catalog of products. And if you want to get a delivery the next day, we can get that. And they made it easy, for example, to return a product if we are not happy. So we know that we can rely on Amazon, but there are a lot of other companies that do the same thing. Like you could order something from Walmart, for example, but we know that we can rely on Amazon. And why is Amazon so successful? It's because they ensure they have the right execution for their customers. So they choose carefully where they implemented their warehouses, for example. They have one of the best inventory management systems in the world, and they ensure that the delivery process is efficient. So similarly, as an investor, we need to find the product or the investment vehicle that we can rely on and that will allow us to have the best execution and, over time, the best result for our portfolio over the long term. And we think that index-based products and passively managed products are the best ones to achieve that.

**Keith:** Yeah, it's very interesting. You used a critical word there which I just heard resonate with me—rely on, having confidence in. And so one of the challenges with running asset allocation models is you used to never be able to rely on active money management to get the exposure you needed because you had all sorts of issues like drift and them doing different things than the mandate, for example. And all of a sudden, you can't rely on getting precise asset class exposure. So yeah, execution is critical. Back in the days, Ruben, we all used to rent videos. Did you use to rent videos like physical videos?

**Ruben:** Yeah, for sure. I'm not that young. I used to go to the video store and rent, not even DVDs. Before DVDs, it was like videotapes. And yeah, I'm a bit old. I remember that time as well.

**Keith:** Another example of an organization changing an existing way of doing things, building a better mousetrap, and delivering an overall better experience, something that people can rely on. And in the old days, that was Blockbuster.

**Ruben:** Yes.

**Keith:** Do you remember how many videos a month would you rent at Blockbuster?

**Ruben:** Yeah, I like watching movies. So I remember, I would say on a monthly basis, I would go twice or even three times, like three weekends in a month with my girlfriend Mary. We used to watch a lot of movies. So we used to rent almost three times in a weekend.

**Keith:** And did you ever find yourself at the office on Monday morning saying, "Darn, we forgot to return the video"?

**Ruben:** For sure. For sure. And then you have to pay those late fees, right?

**Keith:** Yeah. I know my wife and I used to, and our family, Sunday night was video night. So all that to say, between your family and our family, everybody's renting what appears to be anywhere from three to four or five videos a month, maybe one late fee a month. All of a sudden, you're spending $30 on videos. And then along comes Netflix.

**Ruben:** Yes.

**Keith:** It took them a while because they had a mail-in product, but then they went to streaming, and they have completely rebuilt the mousetrap of how you rent a movie.

**Ruben:** And they have precipitated the fall of Blockbuster and companies like that.

**Keith:** So they managed to reduce the cost of actively selecting your video. They improved execution. They improved reliability. You basically, if you want to watch a movie, you knew you could. You didn't have to wait in line and kind of book it. And like back then too, if there was a movie that just came out, you had to put yourself on a list.

**Ruben:** Yes, because sometimes you would go, you would see that movie on the rent, but it's gone. You have to wait until it's back.

**Keith:** That's a great example. I think your example of Amazon and then we look at Netflix, these are two organizations that have changed the way, that have improved. And this essentially is where we're going with this concept of execution. Indexing has essentially improved the reliability for investors to capture exposure in each asset class.

**Ruben:** Exactly.

**Keith:** And there are so many benefits, subtle benefits, that come through. Those are two very cool examples. So let's switch gears a little bit. We've talked about implementation. We've talked about execution. What is index-based investing?

**Ruben:** Yeah. So before defining index-based investing, I think it's important to understand what an index is. An index is basically a basket of stocks that represent a country, a region, or an industry. At first, those baskets were designed and created to be able to assess the performance of a certain market. So when you think about, for example, in the news when they say the U.S. stock market went up or the Canadian market went up, they need to have a way to measure that performance. So some companies decided to design a basket that could represent the U.S. market. They put a bunch of stocks in there, and their valuation would be the proxy. So that's one of the reasons they were created. The other reason was to be able to compare returns with other investment managers. So if you invest in a certain fund, you can see how your performance compares to the general market. So, for example, in watching the news when they say the S&P 500, this is an index. When it goes up, this is an index that represents the 500 largest companies in the U.S. and is a way to represent the performance of the U.S. market because those 500 companies represent 80% of the whole valuation of the U.S. market, for example. So this is the index.

**Keith:** So what you're saying is indexes were first created as a gauge, as a measuring stick, as something that maybe the investment industry could compare themselves to.

**Ruben:** Exactly.

**Keith:** Okay. But now we're talking about them becoming an investment. What does that mean exactly?

**Ruben:** So that's where it gets interesting. It's because that was the main goal. But then once you start comparing different investment products that people were investing in with this index, the market realized that the index was really hard to beat or outperform. So it was really hard to beat the index. You have that investment product, and then you see the index is always outperforming. So you start wondering why not invest directly in the index. So some investment vehicles were created where you can get exposure directly to the index instead of investing in a fund that is trying to beat that index.

**Keith:** Okay. That sounds logical. So how is an index created? What companies end up in indexes and in what ratios?

**Ruben:** Yes. So basically, I will continue from the index I used before, the S&P 500. So S&P stands for Standard and Poor's. This is a company that has some rules. They started off with some rules to include the 500 largest companies in that index, of the largest companies in the U.S., in that index. So it's important to say that it's not a human being, an investment manager, managing that index and deciding, "Today, I feel that Netflix should be included in that index, and tomorrow it's going to be Apple. I'm excluding Netflix." It's rules-based, so it's really objective. It's not based on trying to predict the markets. It's not based on insights and intuition. So that's why we call them kind of a passive investment instead of active. That's why they decided. I'm not sure if this is your question, Keith.

**Keith:** No, yeah, listen, it is. And companies end up in the index by rules-based. The size of the company then typically dictates how much of a weighting there is in an index.

**Ruben:** Yes, exactly.

**Keith:** In most indexes and most of what we call cap-weighted indices. So the thinking behind this approach is you're better off buying this rules-based index, investing money into it, versus trying to identify which manager is going to A, either match the index or maybe even beat the index. This is one of the few examples where we could easily say getting the average return actually is a good thing. Because in our future shows, we're going to allocate about two or three shows to this concept. In our future shows, what we're going to show is that, on average, index money management has done a better job at capturing returns than actively managed strategies. And we're not just going to talk about large-cap indices. We're going to talk about all sorts of indices, large-cap, medium-cap, small-cap, and that on average, value and growth, on average, active money managers, for all sorts of reasons, tend to not get that return of the index. Hence, we think that getting that return of the index not only provides better results but has other advantages.

**Ruben:** You keep saying average, but most people don't want to be average. They want to be superior. So you're saying that the average is better.

**Keith:** They want to be superior. So they bet on an active money manager saying that, "I can beat the index." But what ends up happening when you actually take all the active managers and you review their returns? A funny thing happens. You sit back and say, "Wow, on average, they don't actually meet the average." A small percentage of them do beat the market. The next tricky thing is there's no consistency around if you were a winner, if you did beat the market, will you continue to beat the market? Because all of the data, regardless of whether you're in Canada, the United States, or international markets, suggests that persistence is not part of the active management offering. So just because you're a superstar for five years doesn't mean you're going to be a superstar for the next five years. I guess I got my first insight into this world of active money management versus index returns when I was an institutional bond trader way back in the mid to early 1990s. And I was struck because I used to work with pension funds, and sometimes the managers were quite boastful. You'd serve them, you'd try to bring them ideas, and you'd work your buns off to produce some content that they liked. And after a while, you'd sit back and you'd actually reflect and say, "Okay, of the clients you serve, who's doing a good job for their clients?" I was flabbergasted on average at the lack of returns that the active money managers were providing their end clients. And for me, that's when I personally discovered the power of an index.

So I bought my first exchange-traded fund, I believe, somewhere around '94. So that's 26 years ago now.

**Ruben:** That you bought your first ETF, exchange-traded funds.

**Keith:** I bought my very first exchange-traded funds, and it probably would have been the TSX 35, which back then was called the TIP. We'll get more into that in some of the next shows, but that tracked the Toronto Stock Exchange's top 35 companies. It no longer exists now because it was merged with a product that used to track the Toronto Stock Exchange 100, back then called the HIP, and now you can buy it as XIU, which is the top 60 companies in Canada.

**Ruben:** So that was your first index that you bought for yourself in your personal portfolio.

**Keith:** Correct. In my RRSP, I could have bought, way back then, we had Fidelity, Templeton as money managers, Frank Mersch, Altamira was a massive name.

**Ruben:** Oh, yeah.

**Keith:** In the '90s, there were so many massive names back then because the world was really filled with this concept of active money management. So I was fortunate to have worked in an institutional space where I got a chance to see how things operated. And it was that discovery that kind of led me to buy my first one in my RRSP and then subsequently to start including them in client portfolios when I left in '96 to work in the private client world. And we're going to dedicate an entire show. Our next show is going to be on the history of indexing, and it goes back way before that. It's such a fascinating background. We had a history that led to, for all intents and purposes, a revolution. But let's save that for the next show.

**Ruben:** But how long have you been using indexing and similar products in clients' portfolios?

**Keith:** Oh, for 24 years now.

**Ruben:** Wow. That's amazing. When you think that many people, it's only lately that they are hearing about this type of product, but you've been using them for...

**Keith:** For our clients that are listening, I congratulate every single one of our clients for embracing this process and really being a part of this early adoption because I think they've seen the benefits and they felt it too. They saw it. So let's tie up, Ruben, and talk about general benefits here. What are the benefits that come with index management?

**Ruben:** Yeah. So when we speak about investment, people might think right away about returns. And one thing that is important to say, because we were saying average return earlier, like you said before, many research, many reports have shown that over the long term, one of the key benefits of indexing, so investing in an index, is that they provide better long-term results compared to actively managed peers. So that's one of the benefits. I would say there's a very well-known report called the SPIVA report. So SPIVA stands for Standard and Poor's Indices versus Active. And every year, they show you the data that, on average, active managed investments don't beat the index. So that's one of the key benefits I would mention at first.

**Keith:** That's great. And we're going to bring the SPIVA reports back in a couple of shows from now because it's not just SPIVA in Canada, it's SPIVA pretty much around the world now. And it's across multiple different asset classes.

**Ruben:** Sure.

**Keith:** We're going to go through four right now. What you just gave us was benefit number one, which is solid long-term results. I would even add probably with less risk, better diversification.

**Ruben:** Exactly. Yeah. Good point.

**Keith:** One of the ones that I like is the fact that index money management gives you pure asset class exposure. So what I mean by pure asset class exposure is what you get, what you own. And so in building a portfolio, it's critical that you are comfortable and know what you own all the way through. One of the challenges that sometimes active money managers bring is they bring something called style drift. So style drift is when a manager says, for example, "I will manage this mutual fund or this pool this way, and I will have a tilt towards this sector or this style." They may say, "I'm a value manager." And then all of a sudden, the value manager might, in his own fund, start to drift away from the strategy and start to include growth stocks. And so as a user, if you want to attach value into your portfolio, but when you buy this strategy, you end up buying kind of value and then some growth, you're saying to yourself, "That's not what I opted for. I opted for value, and all of a sudden, I've got a drift into growth," or vice versa. So the bottom line is you end up, by using index or passively managed investment vehicles, you end up blocking away. It's a defensive play away from style drift.

**Ruben:** Not only that, it's a bit misleading because that fund manager, for example, even if the fund is called XYZ Value Fund, if they include some growth, they will maybe lately outperform other value funds. So you will feel like they are doing very well as a value manager. But at the end of the day, it's because they have some growth in their portfolio. So it's a bit misleading, and it's not really transparent. It's funny that you say that because I actually saw another example. I saw a mutual fund called XYZ Canadian Equity. But when you look into it, there are some U.S. stocks. So that's another example where there's a style drift in terms of region. Even if the name is Canadian, they include stocks of other regions. So again, it's not very transparent.

**Keith:** Absolutely. Absolutely. Absolutely. For sure. So there's a couple more we want to cover off here, Ruben. What's another one?

**Ruben:** Another one that I really like in terms of advantages from index investing is, being an accountant, I always care about cost and tax. So when you compare index investing versus other investment vehicles, index investing, if you take ETFs, for example, exchange-traded funds, which is a way to get exposure to index investing, they tend to be very cost-efficient. So their fees, the management fees inside those investment vehicles, are very low compared to, for example, actively managed mutual funds. That's one of the benefits. The other one is tax efficiency.

**Keith:** Hang on. When you talk about cost, let's help the listeners through here a little bit. Why is cost important?

**Ruben:** Cost is very important because the higher the cost, the lower your return because it's a fee. It's a fee that gets deducted from the return that you get from your investment. So one way to increase returns for everyone, one easy way to increase returns is to ensure that you choose a product that has the least cost possible so that there's more money that is left in your pocket.

**Keith:** This is one of the very few industries or services that are a bit counterintuitive when it comes to pricing. Often, people think the higher the price I pay, the more quality and the more premium brand I buy, the longer it will last, the better it will function. And it's intuitive. The challenge, and data shows it now, the higher the cost of your strategy typically leads to worse returns. So this is why cost is so incredibly important. Sorry to jump in there, Ruben. You're about to talk about your favorite subject, tax.

**Ruben:** And it's a good segue because when you think about cost, when you go a bit more general, tax is another cost. When you pay more tax, that's another cost that gets added to your investment portfolio. So you want to try to use a product that has better tax efficiency. We cannot avoid tax, but we can have better tax efficiency. And those products, for example, the index investing. One example I can use is if you use an actively managed investment. That means that there's a manager trying to actively buy and sell stocks. So there's a lot of transactions. The more transactions, not only the more transaction fees, but the more that manager will generate capital gains because they are selling investments, and the more capital gains you pay on a yearly basis, you get taxed on that capital gains. So in contrast, when you use index investing, because it's a long-term and less transaction-heavy investment strategy, there's less capital gains that get generated on a yearly basis, so you pay less tax. So again, as an investor, you need to focus on the money that's left for you. And the money that's left for you is your return after costs and after tax. That's what's left for you, and you want to reduce costs and tax so that there's more money left in your pocket.

**Keith:** We should spend a few minutes on this one because this is really important. The magic behind, Ruben, what you just mentioned is something called unrealized capital gains. In an investment that has low turnover, you get to increase your unrealized capital gains. That's money that otherwise might have been paid out in taxes. So if you get to keep more of the government's money in your portfolio and delay paying that, you get to earn a return on that government's money.

**Ruben:** Exactly. That's a good way you put it, yeah.

**Keith:** That extra return. I've seen reports that suggested somewhere around 50 basis points of additional return over a 10-year period.

**Ruben:** What do you mean by basis points? Can you make it simple for the listeners?

**Keith:** So 50 basis points, 100 basis points is 1%. 50 basis points is a full half of 1%. Point 50%. So if you're able to buy something that doesn't trade a lot internally and doesn't ask you to pay capital gains tax each year, you get to keep the government's money in your portfolio. What you typically owe them, and over time that builds, and then if you get to make a return on their money, it's like the government's lending you money. You keep that in your portfolio at no interest. And that's a powerful concept. And so I remember reading reports by Rob Arnott in the mid-'90s. His point was, boy, pension funds are using indexing all the time for all sorts of reasons—transparency, performance, mostly performance—but he basically, his hypothesis was that it's even more useful for taxable clients because of this tax efficiency. Great point. So that's a really powerful point, Ruben—cost and tax efficiency.

**Ruben:** I'm a CPA, so I have to bring this up. Do you think about another benefit? The last one?

**Keith:** Yeah. So let's round up the benefits of index money management with our fourth benefit: transparency. It is linked to pure asset class exposure a little bit, but it is different.

**Ruben:** You know what you get? That's pure asset class.

**Keith:** Transparency is essentially what you get. There should be no surprises. You may not be happy with what you get. You may not be happy with how it reacts in portfolio diversification because sometimes asset classes lag, but you know exactly what you get. You become the person, the investor, and the investment advisor, if two people working together are in full control of the portfolio. And they see what they own. So those are really what we think are the four main benefits for investors to use that. That's why we like this. That's why we love this as principle number three. So to review, the four main benefits are: solid long-term returns with less risk, pure asset class exposure blocking the investor from style drift, paying less expenses, less cost typically means better long-term returns, and very importantly, having higher levels of tax efficiency as a benefit. And lastly, increased transparency in what you have in your asset class. Those are the four summaries, if you will, of why indexing we feel is such an incredible alternative to actively managed strategies. So, Ruben, as we wrap up the show now, we're going to talk a lot about indexing in the next three or four shows. What's your main takeaway for today's show?

**Ruben:** My main takeaway for the listeners is we spoke about execution. So everyone needs to ensure they have the best execution in their portfolio because it's all about putting the odds in their favor over the long term. It's a call to action. I invite every investor to ask their advisors about indexing and index products. And one thing that they can easily do is look at the fees they pay in their portfolio. If they don't know about the fees, ask the advisor, "How much do I pay?" And if one investor pays 2%, something around that with almost no service or not a lot of service, that investor needs to ask him or herself, "Is there a better way to do things?" So that's my key takeaway.

**Keith:** Excellent. Excellent. Thank you for that, Ruben. I guess I'll summarize by saying, I think when I first wrote the book *The Empowered Investor* in 2004, this was after three years of writing a newsletter around it. Indexing was at the core. It is such an incredible strategy to learn about. It is such a part of becoming empowered. And I encourage listeners to investigate, to explore, to learn more about it. So that's a wrap up for today's show, Ruben.

**Ruben:** That's great. I know we're going to spend a few episodes on principle three. So can you tell us what's going to be on the menu for the next few episodes?

**Keith:** Yeah, the next one is going to be a look down memory lane. We're going to review the history of indexing—when it started, why it started, what were the critical issues happening in the marketplace. The episode after that will include a deep dive in the SPIVA reports and a deep dive in tax efficiency.

**Ruben:** Nice. I'm looking forward to that.

**Keith:** You're going to be the main guest on that one. Followed by, we'll have our first guest talking about the introduction of exchange-traded funds into Canada in the early to mid-'90s, in the participation units, but when they really took off commercially in 1999. We'll leave it for there. So that's it. Thank you very much, folks, for tuning in. We really appreciate you taking the time to listen to the podcast, and we'll see you in two weeks.

**Ruben:** Thank you all. Until the next one.

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