



Active vs Passive: Use SPIVA Scorecards to Make Better Decisions

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Keith: Welcome to the new episode 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: How are you today?

Keith: I'm fantastic, thank you. Looking forward to our discussion. In our last shows, as you recall, we introduced our listeners to index-based or passively managed investment vehicles. We also explored the origins and the history of indexing and we covered the benefits and why investors should consider them in their portfolios. In today's show, we're focusing on indexing, the key benefit of index-based products, and their performance over long periods of time. We're also going to review and discuss the SPIVA reports. That's a report published every year by Standard & Poor's comparing the performance of actively managed strategies versus indices all around the world. So, Ruben, what are the SPIVA reports? Let's start with that.

Ruben: Yeah, so SPIVA is an acronym standing for Standard & Poor's Indices Versus Active. So, Standard & Poor's is the company that created that report. It's an American credit agency that publishes financial research and analysis on stocks and bonds around the world. The SPIVA report is robust research comparing, like you said, the performance of active funds versus benchmarks and indices. It's a free and accessible report online and the listeners can go on spindices.com to consult the report. And we'll put, anyways, all the references and the website in our show notes.



Keith: Yeah, that's excellent. So, when we talk about Standard & Poor's, that's the same Standard & Poor's 500 index that people refer to.

Ruben: Exactly, yeah. It's the same organization here.

Keith: Yeah, it's a huge credit rating agency and it's pretty well-known.

Keith: I remember when the first reports came out many years ago, it was considered a scorecard. And what's fascinating about scorecards is they allow individuals to actually tally up a score, tally up performance. And in a world before scorecards, often people go with hunches and they go with their feelings and emotions and they're not really in tune with the actual performance. I have a rugby analogy on scorecards.

Ruben: You always go back to rugby, eh?

Keith: I've been coaching the sport for, I don't know, 30-40 years, actively coaching for 20 years and coordinating. But there was a period in time, I remember this vividly, when all of our coaches were talking about their players and you have a roster of players and everybody ranks them according to what they feel and their perceptions.

Ruben: Yeah.

Keith: I recall a new coach came in and he quietly kept a scorecard on players' performance.

Ruben: Wow, interesting. So you went from being subjective to trying to make it more objective.

Keith: And he didn't tell us he was keeping a scorecard. He kept the scorecard and he tallied it. He waited for six games. Then he presented the scorecard to the other coaches and he said, "Listen, this is how people are performing during the games."

Ruben: Wow, interesting.

Keith: Yeah, and it would be, "Here's the number of tackles that are made by a person. Here's the number of missed tackles made by a person. Here's the number of proper what we call offloads, passes. Here's the number of poor



offloads." So now we actually had statistics to track player performance. We had a scorecard.

Ruben: Yeah, based on data, not on how you feel about a player.

Keith: Yeah, so what we ended up doing is selections started to be modified based on what we were finding in the data and the scorecards. And what I find fascinating about any of this is it's the same kind of thing with this active versus passive, this debate of are active money managers really adding value versus the indices. And this scorecard is really helpful for advisors and for investors around the world.

Ruben: Yeah, to put some rationale in the debate of which strategy is better, which one is winning, if we can say, in a sense.

Keith: Yeah, that kind of helps describe why scorecards are important. So when people say, "What's important about a scorecard? Why should I care about what's in a scorecard?" It's because it can really provide some meaningful data which can help you make better decisions.

Ruben: Exactly.

Keith: Yeah. So, Ruben, give us some examples here. Let's talk about performance of specific strategies and what we found in some scorecards and then tell the listeners which countries around the world SPIVA now has scorecards on.

Ruben: Yeah, so when you think about the SPIVA report, like we said, it's a comparison between active investing and indices. And they have done that research not only in Canada but in many other regions. They have one every year, actually it's a semi-annual report. But since 2002, we have that report for Canada, for the U.S., for the region of Europe as well, but other countries like Japan, Australia, the region of Latin America, India, South Africa. So it's pretty much global, basically.

Keith: Yeah, so what you're saying is if you think about it, the markets that are in these scorecards represent almost 95 to 98 percent of all stock markets around the world.



Ruben: Yeah, exactly. And when you see a pattern in a certain region, you want to see if that pattern will repeat in other regions and it makes the research more robust.

Keith: Yeah, that's amazing. And so at the core of the report, what is the percentage that they're trying to determine?

Ruben: They want to see when you take all the active funds in the world in different regions on average, when you think about that, an active fund is when you pay a high fee for a manager that's going to use a strategy to actively try to deliver you as an investor a higher return than if you were to invest in the market by buying the indices. And when you look at the data, on average, they tend not to outperform the indices. So, for example, in 2019, if you look at the Canadian active funds, 92 percent of them for the year of 2019 underperformed the indices. So that means that you could basically buy an ETF and invest in the indices and you have put the odds in your favor instead of buying an active fund. That's for one year. But even if you go for a longer period, if you look at the decade, so 10 years ending 2019, 86 percent of Canadian active funds underperformed the indices. So again, by investing in active funds, you don't put the probability in your favor to actually have a good performance over the long term.

Keith: That's amazing. This is exactly what, when we go back to some of our previous shows on the history of indexing, this discovery was made in the 1970s. This discovery of active managers not being able to outperform an index that is an investable index.

Ruben: Yeah, we discussed that in one of our last shows.

Keith: Yeah, so fast forward 30 or 40 years, SPIVA came out with these scorecards and in each country, they break a country into a variety of strategies, whether it's large company stocks, small company stocks, bonds, whether it's their version of international markets, but each scorecard has a series of asset classes where they rank the percentage of managers that can outperform. And we'll talk about the rankings a little later, but that's essentially the essence of these scorecards.

Ruben: Oh yeah, yeah. It's amazing. And to be clear, I know we are repeating ourselves to the listeners, the scorecard is actually showing us which party is the loser and which one is the winner on average so that the investors can



have a better idea where they should allocate their money. It's amazing to see. I invite the listeners to go and check the scorecard. It's not what you would think.

Keith: So let's cut to the chase here. On average, when you looked at all the reports, I have a number in my head, but on average, when you look at all the asset classes, all the different countries, all the different locations, on average, what percentage of actively managed strategies beat the benchmark?

Ruben: Yeah, so on average, like you said, different countries, different regions, and even different time periods, one year, five years, 10 years, on average, 80 to 90 percent of actively managed funds tend to underperform their benchmark. So that means you will have 10 to 20 percent of the thousands of active funds you have available in the marketplace that will outperform the index, which is small compared to what you would think when you just listen to your advisors or ads on TV about where to invest your money.

Keith: Yeah, that's a remarkable statistic when you think about it. Essentially, it's saying 80 percent of the strategies that are being promoted, discussed, sold are not matching the benchmark.

Ruben: Yeah, yeah. And this is basically saying that the idea of having a human portfolio manager who will claim that you have some skills to know what's coming and actively manage your money, it's maybe a myth. I'm going a bit intense here, but yeah, it's maybe a myth because that's what people will think. I often hear people asking me, "Oh, you're a portfolio manager, so you can see what's coming, like what we should do with our money." And when you tell them, "No, no one can do that," sometimes people tend to, that's the job of a portfolio manager.

Keith: Yeah, absolutely, for sure. And it's a good setup here, Ruben, because we're going to go into what I think are the three "yeah, but"s. And these are the "yeah, but active money management still works here."

Ruben: Oh, okay, I see. The way they will defend themselves, yeah.

Keith: Yeah. The first "yeah, but" is in a bear market, actively managed strategies will do better. And we've been hearing that for years. And it's predicated around the idea that actively managed stock funds will somehow know in advance, the managers will somehow know in advance that we have a



correction coming and we'll keep a lot of cash so that when we get the correction, they can buy stocks at better values and then actually add value to those strategies.

Ruben: Or if they don't keep enough cash, they will say, even if we are invested, we will know when it's coming and we'll get out in time. So there's that as well.

Keith: Yeah, absolutely. So those are the two big ones. And so that's what the active strategies have been marketing for decades now. So what does the data show?

Ruben: Yeah, that's a good point because that's a sales pitch, right? Many active managers will say that. And this is, I've been outperforming in the last 10 years before 2020, yeah, because it was a rising market, right? But the data shows that it's not necessarily true because basically, I think the COVID crisis, what we just lived through right now and we're still living through, has tested that rationale because as the listeners may know, the market went down close to 35 percent between mid-Feb and mid-March. And you would expect that an active manager would have outperformed during that period because they would manage around the crash. But the data shows that the one-year period ending June 30th, 2020, so including that crash, 88 percent of Canadian equity funds underperformed their indices. So it's still a big majority of active funds that still underperform when you included a period where there was a crash. So this is amazing. Their sales pitch doesn't work, basically.

Keith: And so that's just the recent period that we're living in. What happened in 2008-2009 in the financial crisis? What were the results that came out in that period?

Ruben: It's very similar. If you remember a few shows, I spoke about my experience when I used to work in the hedge fund industry in the Virgin Islands. And that was during the 2008-2009 crisis because I moved to the Virgin Islands in 2008. And I saw it as well. Active funds, hedge funds included, they couldn't manage around the crisis and they went down as much as the market.

Keith: You're absolutely right. That's a great personal story. The data from SPIVA shows the same thing.

Ruben: Exactly.



Keith: And incidentally, I think it was the crisis of 2008 where investors just took notice and realized that we're paying all these high fees for these fancy strategies where they're supposed to try to avoid problems. People can't see this in advance. It's just not possible. So that was really, I think, the genesis that really pushed indexing ahead around the world, was that crisis.

Ruben: Yeah, indexing was around already, but it was a big wake-up call for many people, definitely.

Keith: All right, Ruben, that was a great discussion around the first "yeah, but". Here's the next "yeah, but".

Ruben: Oh yeah, you often hear things. Yeah, but indexing works only in large company stocks, only in, let's say, the S&P 500, which are large U.S. company stocks because the market is very efficient. There's a lot of people playing in that market. There's not enough room for stock pickers to craft and use their skills. And so in less efficient markets, you have an opportunity for money managers to outperform. What are we talking about here? And what did the data show?

Ruben: Yeah, this is a very interesting argument because, like you said, the market, like the U.S. market stock market, for example, there's so many analysts, stock traders, institutions trading that market, the Canadian market as well, and some other developed countries, and also the large companies in those markets are really followed by a lot of investors. So they will say that those markets are already crowded, they are really efficient, it's really hard to try to outperform because there's so many participants. But other areas, like small companies in those markets or other regions, like the emerging market, where there's less cover by investors, that's where an active manager can find opportunities and actually outperform the market and deliver that performance. But the S&P 500 also did reports that cover different styles, like different capitalization, different styles like value stock, capitalization like small companies, and also for emerging market. And the data is consistent. Even in those areas, when you look at large companies, yes, but small companies as well, value companies, emerging markets, all their asset classes, REITs, real estate investment trusts, it's consistent. On average, 80 to 90 percent of active managers will not outperform the related indices. So in this, it's the same conclusion. It's better for investors on average to invest their money in the indices because they put the odds in their favor.



Keith: Absolutely, 100 percent. And the same thing could be said about fixed income.

Ruben: Yeah, exactly.

Keith: You know what these SPIVA reports show, let's just wrap up a little bit, is that by country and then within each country by asset class, managers manage to fixed income, their local equity markets, U.S. equity markets, the largest market in the world, by style, growth versus value, by capitalization, large versus small, by REITs, which is a slightly different asset class. Regardless of any of these situations, we have the same conclusion.

Ruben: Yeah, no matter how you cut it, how you look at it, it's back to the same conclusion.

Keith: Yeah, and that's what these report cards show. It's amazing.

Ruben: Yeah, and different time periods. Yeah, it's crazy.

Keith: It is amazing, actually. It's amazing. No wonder so many parts of the world are pushing forward using indices and passively managed investment vehicles in their portfolio construction. We're still lagging in Canada. The opportunity is moving forward, but the scorecards show that the results are there.

Ruben: Yeah, and it's public information.

Keith: So we've covered two "yeah, buts." This is the last one that I could think of anyway. "Yeah, but I only pick the winning investment strategies."

Ruben: Oh yes, yes. I often hear that.

Keith: Yeah, I only pick, of course, the first quartile managers. It's obvious, right? If you're looking at the last five years of results, you would say, "I'm only going to pick the winners."

Ruben: Yeah, because like we just said, we said 80 to 90 percent will underperform. So someone might think, "What about if I pick the 10 to 20 percent that outperform? Then I'm okay. Like, all what you guys just said doesn't matter."



Keith: Exactly. So that's exactly the thinking. I'm not going to be in that category that picks the sort of the ones that don't do well. I'll pick the winners. So what does the data show about winning strategies?

Ruben: Yeah, because if this was a strategy to pick the winners, that means that your investment advisor knows who is the winner right now and is going to stay the winner in the future.

Keith: Hang on, and that's a great point. But before we even get there, what do people use to pick their winners? How do they traditionally pick their winners?

Ruben: Yeah, that's common, right? They will look at the past performance and they will say, "Oh, this strategy has been winning in the past year, past five years." Usually, people will look at the past recent performance, not necessarily the 30-year or the 20-year performance. And they will say, "Oh, this is winning right now." And that's the one to pick. So that's the data that we rely on.

Keith: Yeah, so that's the premise, is people look at the data and they say, "Oh, I really like what this strategy is doing. So it's the winner. It's got a better performance. It's beaten the index. It's beaten other managers. It's a top 20 percent manager." So therefore, I will buy that strategy thinking and feeling confident that it will continue to have outstanding performance.

Ruben: Exactly, exactly. And to be honest, it seems like the right thing to do. The problem with that strategy is that it's assuming that because you were the winner in the past, you're going to stay the winner in the future. And remember, when you are an investor, a long-term investor, you're not investing for the next five years. You're investing for the next 15, 20, 25 years. So you're assuming that investment manager will continue having outperformance for many decades. And the data shows that when you look at the S&P, they do another report called the persistent scorecard, where they show that the top quartile managers, so the ones that are winning right now or in the past few years, do they still stay the top quartile managers? So are they still outperforming in the future? And it's really surprising because what they show, what the data shows and the research shows, and again, it's public information, the ones that were in the top quartile, they don't tend to outperform in the future. They tend to actually drop in the lowest quartile.

Keith: Wow, so what you're saying is the winning horses can't continue to win.



Ruben: Yeah, they tend to become bottom-performing funds. It's crazy.

Keith: It just reminded me of when I was a bond trader back in the mid-'90s. You're trying to figure out how to buy strategies. And this is before I discovered indexing. Just before, I was selecting mutual funds. And what did I do? I went and bought the mutual funds that had the best performance in the past four years, thinking this is easy. This is before your time, Ruben, and believe it or not, there used to be books that you could buy at Chapters, which would say, basically, here are all the top mutual funds to buy. And people used to line up and buy these books. And it was all about crafting, how do you look at these managers and how do you buy them? This would have been in the '90s. These were top-selling books back then.

Ruben: Yeah, yeah.

Keith: It's human nature to think that you can study something, look at the data, say, I try to identify the winners and then invest in those winners. It's human nature to do. What's not human nature is to realize that what you're really investing in is underneath our kind of asset classes, and asset classes go in and out of favor. So managers will go in and out of favor.

Ruben: Exactly, exactly. And then there's another aspect as well. If your fund has been performing well, chances are that you will be buying that fund when things are expensive. That can play into it as well. You're not necessarily buying low, depending on the strategy.

Keith: Yeah, you tend to be buying the high strategies at the time. So a couple of points left in the show and then we're close to wrapping up here, but let's answer a couple of key questions here. Why do active funds underperform? What's the main hypothesis around why they underperform?

Ruben: I think we just covered that they underperform and we just provided some response to the arguments people tend to hear. But yeah, the why is there's different reasons. One of the reasons is we touched on that as well. It's the fact that the market is very efficient. So we discussed that in a past show. The stock market, it's millions and millions of participants trading, buying and selling securities, and incorporating any information about the company in their decision. So it's really hard for any active manager to find an opportunity, meaning that to find a stock that has a certain price, but they buy it before everyone else, before that stock starts going up in price. So this is very hard to



do because everyone is looking at the information at the same time in the market. That's one of the reasons. The other reason is because this active manager, their sales pitch is to say that they have a skill, they are very smart people, they can see what's coming, they can move in and out and know what to do before, let's say, a crash. Those managers want to be compensated, so they will require a certain fee. So those funds tend to have high fees in there. And each time you put a fee in a fund, basically you are eating in some of the return you will get, where the indices, the other alternative, the way you can invest, the fees are really low because there is no manager trying to have a certain active strategy. So just by having a low fee, you are not eating out in your return. So the fee is not helping in outperforming the benchmark, basically.

Keith: Yeah, those are absolutely the two critical points. And thank you, Ruben, for sharing those. That's amazing. The only other thing I might add in there is active managers might have a bit of cash drag in there, and that overall rising markets, that doesn't help the return. There's no point holding three, four, five, six percent cash on average all the way through. But that's pretty much why active managers underperform long-term versus indices. So the next question, Ruben, I would have for you is why do people still invest in active funds?

Ruben: Yeah, there's many reasons of that. In some of the last shows, we discussed that. We talked about that earlier as well. Since 2008-2009, there have been some kind of bigger than the past, bigger wake-up call. So investors are becoming more aware. There is a shift to passive in the world, a bit slower in Canada. Still in Canada, even if it's slower, relatively speaking, there have been, for example, 22 billion of inflows in index-type strategies. So it's coming. But the why they still tend to favor active funds is, first of all, they tend to look at the past performance, and that's what is being sold to them. Many investors, when they sit down with an advisor, that advisor would show them some funds. And obviously, that advisor will pick up the funds that were performing at that time, and that's what they will sell to the investors. So a lot of investors still don't know about the alternative. So that's one of the reasons.

Keith: Yeah, those are great points. And I think even within the advisory community, there are advisory firms, there are a lot of the large banks will do it, a lot of the firms will do it. They will suggest that the value-add that they bring to the table is their ability to identify the winners.



Ruben: Exactly.

Keith: And they should be hired so that they can put together a portfolio of winning managers. So the model that we propose and that we've been talking about for two decades now is it's not about picking the managers. It's providing clients with a whole series of services around planning, retirement planning, investment management, keeping the discipline around an investment program, tax estate...

Ruben: Managing their emotions.

Keith: Managing emotions. This is the advice business. When it's time to populate a portfolio, it's not about trying to identify the winners in this very elusive group of managers that come and go. It's about getting solid returns in each asset class.

Ruben: Yes, and again, it's not an opinion the way we do it. It's based on the data, right? It's not our own opinion of what works or not. We rely on what research shows us what's best for investors.

Keith: Yeah, and I think that we're getting closer to a tipping point in Canada. We're not there yet. In the United States and in Europe, they're past the tipping point, but the tipping point is definitely coming where people are going to say, "I need to have this," and advisors will be moving forward with this. It's a very exciting time to be an investor. And the scorecards that we're talking about in today's show are critical. Just like it helped my rugby coaches make better decisions around who to select as the starters, how to put together the best team, it's critical in terms of helping investors figure out how do you manage money? And what should you do? How do you select the right components in your portfolio?

Ruben: Keith, just to spice it a little bit, I have a "yeah, but" for you. Some will say, "What about Warren Buffett? This is an active manager that has been outperforming, so you guys are saying all that, but there is this one that is consistent."

Keith: Oh, that's not even on the script, Ruben. That's very good. I like that. Warren Buffett, I think, has made his fame by having very concentrated positions, using his insurance company to generate loads of cash and reinvesting. And he's done a wonderful job at doing it. That said, the most



amazing thing about Warren Buffett is his... He has been a proponent of indexing for the past 30 years. So if you go into his shareholder meetings that he's been holding in Omaha for decades, it's pretty much in every meeting. He's talking about the fact that indexes really need to be used more by investors and advisors around the world. So he's fully embracing this proposal. In fact, he's the one that had the bet, if you recall, about hedge fund managers not being able to beat the market anymore.

Ruben: Exactly, yeah. I'm going to borrow an example from one of our peers, Ben Felix. In his blog, he said that it's like smoking, right? We all know that, on average, smoking is bad for you. We all know that, and it's been proven by data. But someone might say, "It's not because you have an uncle that smoked all his life and lived to when he's 95 that you can use that as an example to say smoking is good. On average, people still die from smoking, so you should try to avoid smoking." I think it's a very good example.

Keith: That's a great example. So, Ruben, let's wrap up now. What's your takeaway for today's show?

Ruben: Yeah, so my takeaway, I want to be a bit blunt. I want to say that investing in active funds, in general, in the majority, it's literally taking your money from your pocket and giving a bonus to some manager on Wall Street and on Bay Street that, on average, they are not really skilled, they cannot outperform the market. To defend your own interest as an investor, you should try to invest in something that has a better chance to give you a better performance over the future, which is to choose indexing.

Keith: Wow, that's fantastic. My takeaway would be, like you said bluntly, I would say invest in asset classes, not managers. So when you're building your portfolio with today's investment vehicles, go directly to the asset class, bypass the manager. You can work with an advisor because there's a lot of value still, but the advisor and you can go directly and get the asset classes.

Ruben: Yeah.

Keith: What a fabulous show, Ruben. We were talking about this before. It's a show filled with data, these scorecards. It's all database. And so for the listeners, we've tried our best to make data a bit interesting. And we threw in the "yeah, buts." I hope you've enjoyed it. Please stay safe, be well, and we'll see you in two weeks from now.



Ruben: See you all.

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