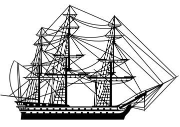

Vanguard®

The case for low-cost index-fund investing for Canadian investors

Advisor brief

April 2018

The cost advantages of index investments can translate into a long-term performance advantage for your clients.

This paper is based on research by The Vanguard Group, Inc.[1]

A passive investment strategy such as an index mutual fund or an index-based exchange-traded fund (ETF) seeks to track the performance of an index by mimicking its holdings. Primarily because of their low-cost structure, well-managed index investments have generally offered long-term outperformance relative to higher-cost investments.

Advisors who index a solid portion of their clients' portfolios often provide their clients lower costs, broader diversification, minimal cash drag and, for taxable investors, the potential for tax efficiency. The sum of these parts can translate to a long-term performance edge.

Understanding the zero-sum game

In the aggregate, market participants are playing a zero-sum game. That is, half of investor dollars outperform and the other half underperform the market average. A bell curve can illustrate the game (see **Figure 1**), with the market return shown as a solid black line. In reality, however, investors pay commissions, management fees, bid-ask spreads, administrative costs and, where applicable, taxes—all of which combine to reduce realized returns over time.

The aggregate result of these costs shifts the curve to the left. A portion of the after-cost dollar-weighted performance continues to lie to the right of the market return, represented by the tan region in Figure 1. But a much larger portion is now to the left of the solid black line, meaning that, after costs, most of the dollar-weighted performance of investors falls short of the aggregate market return. Given the difficulty of selecting an active manager who may consistently outperform the market, we believe many investors are better off using a passive approach, minimizing costs so that, over time, they can achieve a return close to the market average.

The zero-sum principle holds regardless of a market's efficiency. Even in areas traditionally considered inefficient, such as international stocks, our research has shown most active managers fail to outperform their respective benchmarks.

1 *The case for low-cost index-fund investing* (Rowley Jr., Walker and Ning, 2018).

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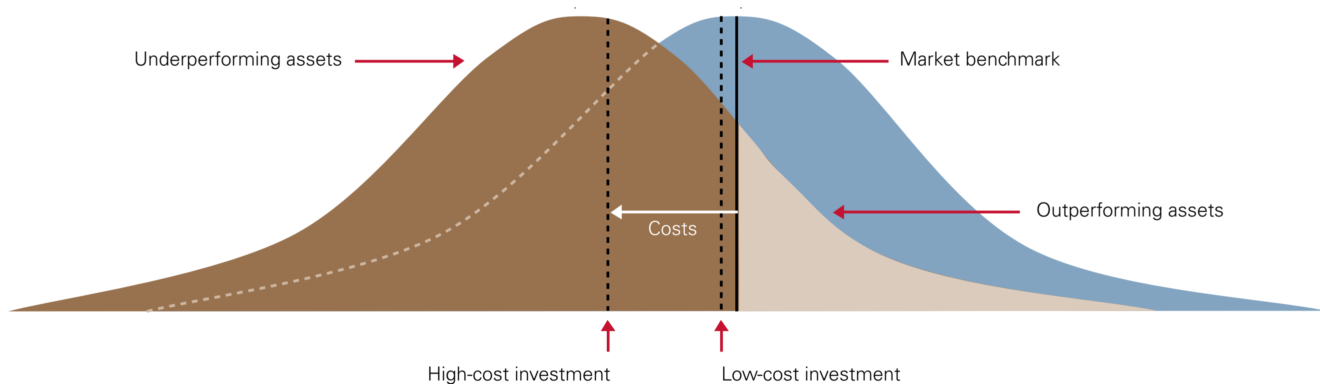
Figure 1. Investing is a zero-sum game

Half of all dollars invested will outperform the market return before costs (blue curve). After costs (brown curve), a much smaller portion (tan) outperforms the market return.



Source: The Vanguard Group, Inc.

Notes: For illustrative purposes only. This illustration does not represent the return on any particular investment.

Active managers frequently underperform

After accounting for funds that merged or closed during the observed time period, it is clear that Canadian actively managed funds, on average, fared poorly versus their benchmarks over the past decade. **Figure 2** shows the relative performance of actively managed Canadian funds when evaluated against their benchmarks.

Note that this relative underperformance has been consistent across asset classes (both equities and fixed income), sub-asset classes (large-cap, mid-cap, small-cap, as well as short- and intermediate- duration fixed income funds) and time period.

Excess returns provide additional insight

A simple percentage can tell you the ratio of active managers who outperform a benchmark; however, it is blind to whether the outperformance was 0.01% or 10%. Figure 2 also displays the median excess returns for active managers in both equity and fixed income segments.

It bears emphasizing that market cyclicality will alternately favour or impede various market segments. As the time period lengthens, excess returns should converge around the average cost drag of active managers.

Benefits of including indexing in client portfolios

If you have clients who are primarily interested in obtaining the market return or who wish to reduce a fund's volatility around a benchmark, you should strongly consider index mutual funds and ETFs for their portfolios. Index funds have three key traits that make them appealing to investors who may have tired of the vagaries of active approaches.

Diversification. Index funds typically are more diversified than actively managed funds, a by-product of the way indexes are constructed. Except for index funds that track narrow market segments, most index funds must hold a broad range of securities to accurately track their target benchmarks. The broad range of securities dampens the risk associated with specific securities and removes a component of return volatility. Actively managed funds, on the other hand, tend to hold fewer securities with varying degrees of return correlation.

Style consistency. An investor who desires exposure to a particular market and selects an index fund that tracks that market is assured of a consistent allocation. An active manager may have a broader mandate, causing the fund to be a "moving target" from a style point of view. Even if a manager has a well-defined mandate, the decision to hold a higher or lower proportion of a security than the index will lead to performance differences.

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Figure 2.	A closer look at data weakens the appeal of active approaches

The percentage of actively managed mutual funds versus their prospectus benchmarks

Actively managed Canadian equity

	5 years	10 years
Large	63%	82%
	0.17%	–0.53%
Medium	40%	66%
	2.91%	1.57%
Small	69%	81%
	0.65%	–0.41%

Actively managed Canadian fixed income

	5 years	10 years
Short	92%	93%
	–0.79%	–0.76%
Intermediate	90%	89%
	–0.93%	–0.73%

- Percentage underperforming prospectus benchmark, adjusted for survivorship bias*
- Median fund excess return, survivors only

Sources: Vanguard calculations using data from Morningstar, Inc. and Thomson Reuters Datastream. Fund classifications provided by Morningstar. Benchmarks reflect those identified in each fund's prospectus. Data as of December 31, 2017.

Fund universe includes funds available for sale in Canada from the following Morningstar categories: Canadian equity, Canadian small/mid Cap equity, Canadian short-term fixed income, and Canadian intermediate-term fixed income. Fund performance is shown in Canadian dollar terms, net of fees, gross of tax withholding, with income reinvested, based on closing NAV prices. Past performance is not a reliable indicator of future results.

*Survivorship bias is introduced when funds are merged or liquidated, and so are not represented throughout full time period examined. See *The case for low-cost index-fund investing,* Rowley Jr., 2018, for more information.

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Taxes. Broad index funds may provide a tax advantage over actively managed funds because they generally realize and distribute lower capital gains to shareholders. This after-tax efficiency is particularly beneficial within taxable accounts.[2]

Low-cost ETFs can add value to client portfolios

Primarily because of their low-cost structure, well-managed index investments have generally offered long-term outperformance relative to higher-cost investments.

Investors have embraced ETFs over the past decade as an efficient means to gain exposure to a broad range of asset and sub-asset classes. ETFs offer the added advantages of increased trading flexibility and potentially even lower costs than traditional index funds. Vanguard ETFs can provide pure, low-cost exposure to investment areas important in setting and maintaining your clients' overall asset allocation strategies.

Please contact your Vanguard sales representative or visit **vanguardcanada.ca** to obtain additional research on indexing to help you build lasting relationships with your clients.

2 Changes to the composition of an index will require the index to sell or buy shares, and the fund may be required to realize capital gains.

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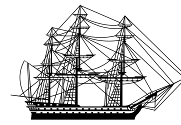

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