# Monthly Market Snapshot – September 2016

## An Important Birthday and an Important Take on Fees

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For clients who have regular investment-related conversations with their advisor, there's a good chance the topic of passively-managed index mutual funds or exchange traded funds has come up. There's also a good chance that an investment product linked directly to the performance of a market index is in your portfolio. For the unfamiliar, an index fund is a passively managed product with a portfolio is constructed to match or track the components of a market index, such as the S&P/TSX Composite, and in turn, replicate the performance of that index (before fees, of course). Contrast that with an actively managed product, where the individual running the portfolio aims to select the securities that best meet the fund's objectives. Of course, active managers always want to outperform the market over time.

A quick reflection on index funds is relevant today because just a few weeks ago, the 40th birthday of the world's first index fund – the Vanguard 500 Index Fund – was celebrated. From very humble beginnings, total index fund assets have mushroomed to more than US$4 trillion south of the border. The index fund also helped spawn the idea behind the exchange traded fund, or ETF.

An ETF is like a mutual fund in many ways, with a key difference being that ETFs can be traded throughout the day, just like a stock (mutual funds can only be bought once daily). As it turned out, the ETF was an ideal vehicle for those looking to get direct index exposure, and global ETF assets now stand at US$3 trillion (most of that is indexed). ETFs have also become incredibly popular. Consider that at the end of 2008, worldwide ETF were less than a quarter of what they are today.

Passive ETF and mutual fund strategies have been sucking huge sums from actively managed products. Over the past year alone, U.S. investors moved more than US$400 billion into passive offerings. Over the same period, US$300 billion was pulled out of actively managed funds (we keep mentioning the U.S. simply because the numbers are always bigger and tend to have a bigger global influence than what we see out of Canada).

So happy birthday, index fund. You're more popular than your creator, John Bogle, could have possibly imagined.

One of the key advantages of an index product is that they are typically cheap. This is because, among other things, there's no requirement to pay for an expensive infrastructure of investment analysts and portfolio managers who determine what should go in the fund. An index fund simply buys precisely what is in the index. And that's it, which is not an expensive proposition.

Advocates of passive strategies suggest that cheap is always better because the less an investor pays in fees, the more of the return that investor gets to keep. That's pretty intuitive. Index funds have also been somewhat effective in pressuring the providers of active strategies to take a closer look at their own cost structures.

There's also plenty of academic literature out there touting indexing as being a superior way to invest because their cost advantage is just so huge when compared to actively managed products. The view is that with fees that are so much lower, passive strategies have an insurmountable long term edge and should do better over time than their actively-managed brethren.

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This is where we want to get into the weeds a bit. Not so much to defend active managers and to admonish indexing, but to simply lay out some facts that should be considered by anyone who is getting close to the point of dumping their actively managed products and sprinting full bore into passive products.

The conclusion of much of the academic literature we cited earlier often cites stats such like this: over the past three, five or ten years, only xx% of active managers outperformed their benchmark (usually the xx% is well below 50%). Talented portfolio managers can and do outperform their benchmark all the time before they take their cut, but after subtracting 2% or even 2.5% in fees a year, outperforming consistently on a net basis can be challenging. This makes a pretty compelling case for indexing, right?

Well, maybe not. Let's take another look at passive products. Assuming portfolio construction is done correctly, no index fund or passive ETF has EVER outperformed its benchmark. Even if fees were zero, the best possible return you could hope for would be the benchmark return. After fees, there is marginal underperformance.

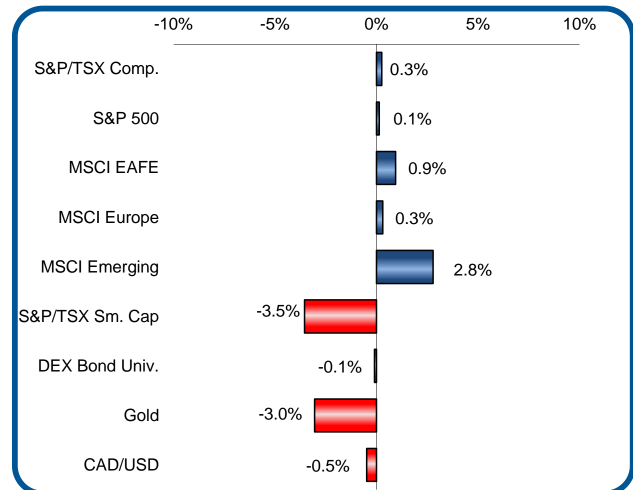
It's also important to make apples to apples comparisons when looking at active funds, index funds/ETFs and benchmarks. A problem we see is that some studies comparing the performance of active funds to their benchmarks use the returns of products that have the compensation built into them as their data set. At the same time, advocates of indexing tout returns that don't have the cost of financial built into them. Looking at things this way overstates the advantages of passive strategies, particularly for anyone who needs advice.

The advice of a quality financial advisor is not free and it does have value. So anyone who invests in an indexed product through a financial advisor will earn a return equal to the benchmark return, minus the fees on the product, minus the fees paid to the advisor.

We believe very strongly in the value of financial advice. We also believe that both active and passive strategies have a place in a portfolio, but if you too think financial advice is of value, then maybe the grim picture of active management painted by the pro-indexing camp is not as bad as it seems.

Active fund managers may have to pull their socks up a bit more from a fee standpoint if they want to stem the tide of dollars flowing out of their products into index funds/ETFs, but investors who need advice should recognize that once both actively managed and indexed products are on a level playing field from an all-in cost perspective, the narrative some have woven about the inherent inferiority of active management seems far less accurate.

# Monthly Overview



*Source: Bloomberg, All Returns are TR and in Local Currency*

Global equities were mixed during August. The S&P/TSX Composite finished the month up 0.3% In the U.S., the S&P 500 traded higher by 0.8% for the month, keeping its year-to-date performance firmly in the green. Gains were also chalked up in Europe, with the Stoxx Europe 600 Index ending the month 1.0% higher. In Asia, the MSCI Asia Pacific Index added 2.0%. (All returns are in $CAD)

The main economic story in Canada during August was GDP for June and the second quarter overall. Economists widely expected that the impact of the wildfires that stormed through Fort McMurray, Alberta earlier in the year would weigh heavily on the quarter, so it was not a surprise that annualized GDP fell at a rate of 1.6% (1.5% exp.) for the three month period ended June 30. This was the worst quarterly print in seven years (Q2 of 2009). The largest anchor on growth came from exports of goods and services which declined 4.5% during the quarter; exports of energy products fell 7.5%. The silver lining in this was that GDP for June alone came in at 0.6% (0.4% exp.) as oilsands operations began to come back online. In addition, with Q2 now in the rear view mirror, the Bank of Canada has predicted that growth will pick up in the third quarter - to the tune of 3.5% - as oilsands operations continue to resume and rebuilding efforts throughout Alberta also add to growth. New fiscal policy efforts including the child benefit and fresh infrastructure spending are other items that the Bank is keeping an eye on as positive tailwinds for the economy. Canadian manufacturing sales for June were another welcomed bright spot, coming in above expectations as they gained 0.8% after shedding 1% in the prior month. This was mainly attributed to an increase in purchases of transport equipment and machinery. Even after stripping out the effects of exchange rates, sales gained 0.5% on a constant dollar basis as well.

With central banks seemingly in the driver seat, investors have been constantly keeping a close eye on the two economic factors that purportedly define the path of Fed policy: the labour market and inflation. The labour market in the U.S. continues to tighten with July nonfarm payrolls drubbing estimates (255K actual vs. 180K exp.). More importantly than the headline number is what is beginning to occur under the hood: wage growth ticked up to 2.6% in July, the highest rate in seven years. After years of stagnant wage growth since 2009, increasing wages are not only an indication of a tightening labour market but also have ramifications for price levels as higher wages should translate into higher spending, resulting in inflationary pressures.

Although headline personal consumer expenditure prices (PCE) fell back to 0.8% in July, core PCE (stripping out food and energy) remained steady at 1.6% where it has been for five months. Cheap energy prices have continued to weigh on broad price measures, however, the case could be made for higher inflation levels if wage growth progresses further, the U.S. dollar exhibits weakness or energy prices undergo a sustained rally. Voting members on the Fed's policy setting panel remain split on a rate hike decision, however, some members with more hawkish views have swayed investor sentiment regarding the future path of interest rates at recent speaking events. Currently, fed funds futures are pricing in a 24% chance of a rate hike at the September meeting and just over 58% for December.

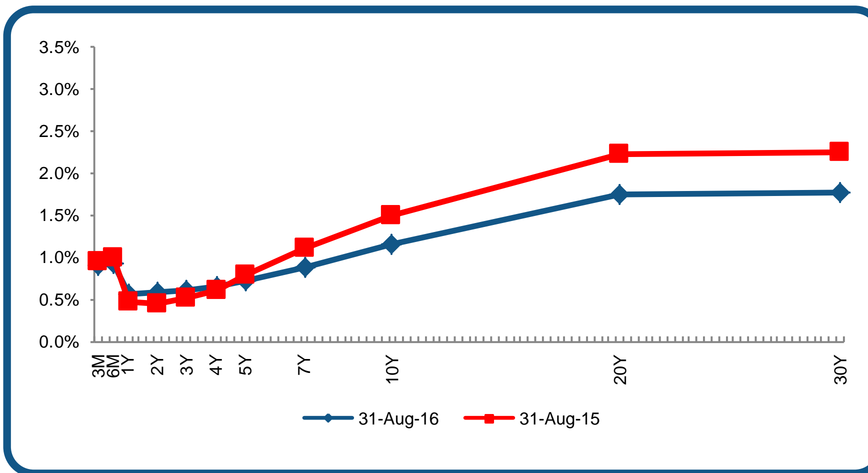
Economic data out of the UK has begun to exhibit the effects in the aftermath of the Brexit referendum vote held in June. The July services PMI figure fell into contraction territory at 47.4, down from 52.3 in June. This was the largest monthly decrease ever and reflected sharp declines in output and new business. The services sector represents 75% of the UK's GDP. Similarly, the PMI gauge for manufacturing also indicated contraction with the reading coming in at 48.2. Moving to the housing market, July home sales underwent their sharpest decline since 2008, however, given the strict supply of houses economists believe tight supply will provide a floor to pricing. The Bank of England held its rate decision meeting at the beginning of August, where it was announced that the benchmark interest rate would be cut by 25 bps to a record low of 0.25% in an attempt to stabilize the economy. In addition, an expansion to the quantitative easing program was announced, to the tune of an additional 60 billion pounds of government bonds, and up to 10 billion pounds of corporate bonds.

# Monthly Market Statistics: August 2016

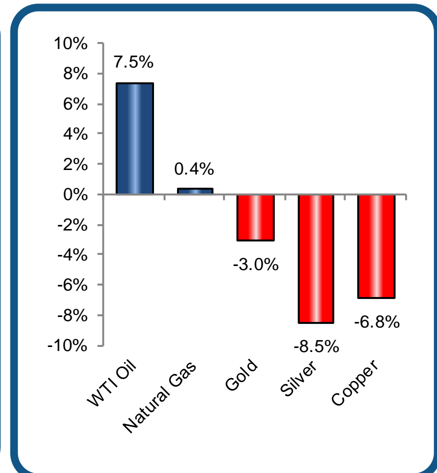
## Total Return Index Returns (Annualized After One Year)

| | Local Currency Returns | | | | | | | Canadian Dollar Returns | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1M | 3M | 6M | YTD | 1YR | 3YR | 5YR | 1M | 3M | 6M | YTD | 1YR | 3YR | 5YR |
| TSX Composite | 0.3% | 4.5% | 15.2% | 14.4% | 8.7% | 8.1% | 5.9% | 0.3% | 4.5% | 15.2% | 14.4% | 8.7% | 8.1% | 5.9% |
| S&P 500 | 0.1% | 4.1% | 13.6% | 7.8% | 12.6% | 12.3% | 14.7% | 0.6% | 4.3% | 10.2% | 2.3% | 11.8% | 20.9% | 21.7% |
| MSCI EAFE | 0.9% | 1.8% | 8.4% | -1.5% | -0.2% | 7.3% | 10.7% | 0.5% | 1.9% | 7.4% | -4.2% | -0.3% | 10.8% | 11.9% |
| MSCI World | 0.5% | 3.3% | 11.9% | 4.3% | 7.0% | 10.0% | 12.6% | 0.6% | 3.5% | 9.5% | 0.1% | 6.6% | 16.2% | 16.8% |
| MSCI Pacific | 0.7% | -0.6% | 7.4% | -7.2% | -5.5% | 6.8% | 11.2% | 0.2% | 5.2% | 11.6% | -1.8% | 5.6% | 12.5% | 12.0% |
| MSCI Emerging | 2.8% | 9.0% | 17.1% | 11.1% | 10.9% | 6.0% | 5.6% | 3.0% | 12.4% | 19.3% | 9.0% | 11.5% | 9.2% | 6.0% |
| TSX Small Cap | -3.5% | 7.1% | 28.9% | 30.2% | 22.7% | 6.2% | 0.9% | -3.5% | 7.1% | 28.9% | 30.2% | 22.7% | 6.2% | 0.9% |
| Global Small Cap | 0.5% | 3.5% | 15.2% | 6.7% | 7.3% | 10.3% | 13.2% | 0.6% | 4.0% | 13.2% | 2.9% | 7.7% | 16.8% | 17.7% |
| CDA Bond Uni. | 0.1% | 1.8% | 4.4% | 5.0% | 5.8% | 6.1% | 4.7% | 0.1% | 1.8% | 4.4% | 5.0% | 5.8% | 6.1% | 4.7% |
| CDA 1-5 Yr Bond | 0.0% | 0.6% | 1.2% | 1.3% | 1.5% | 2.7% | 2.4% | 0.0% | 0.6% | 1.2% | 1.3% | 1.5% | 2.7% | 2.4% |

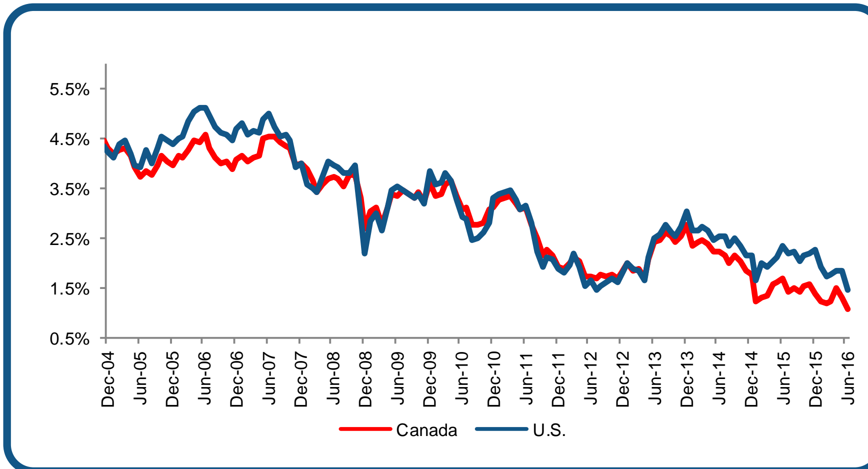
## Canadian Yield Curve



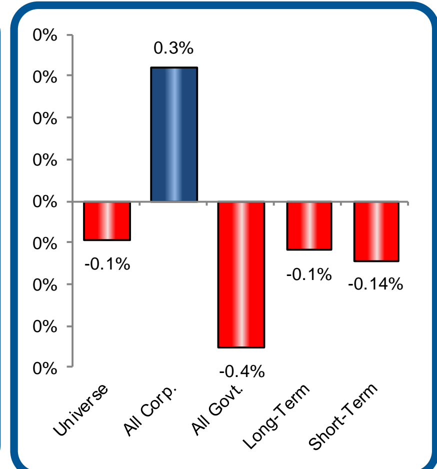

## Commodities Performance (1M)




## 10YR Government Bond Yields



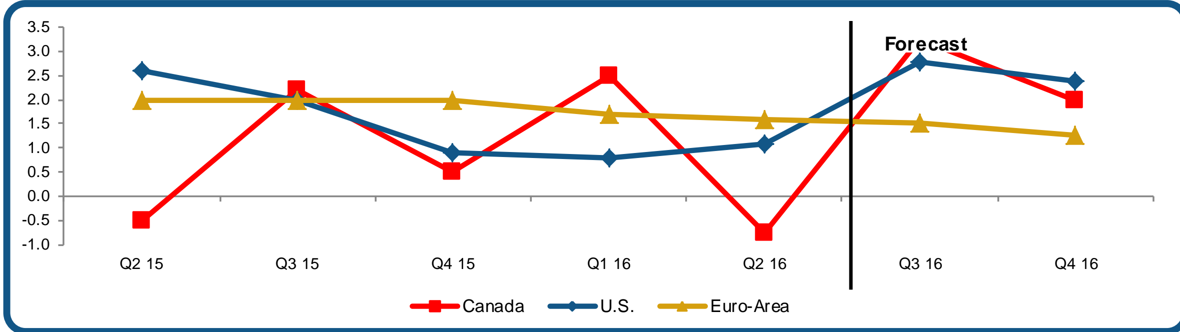

## FTSE/TMX Bond ETFs (1M)



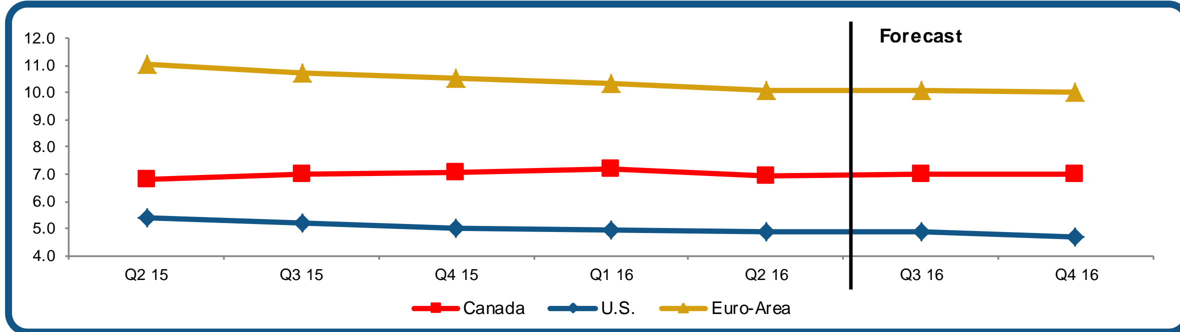

*Source: Bloomberg, iShares.ca*

# Economic Statistics

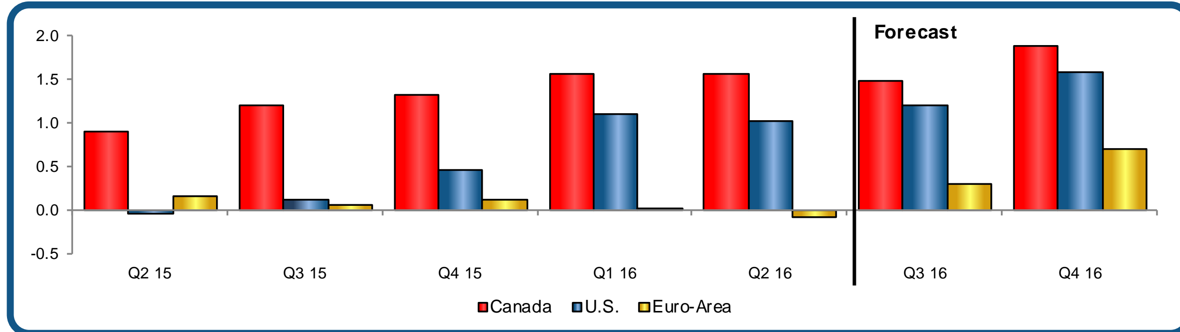
## Real GDP (%)



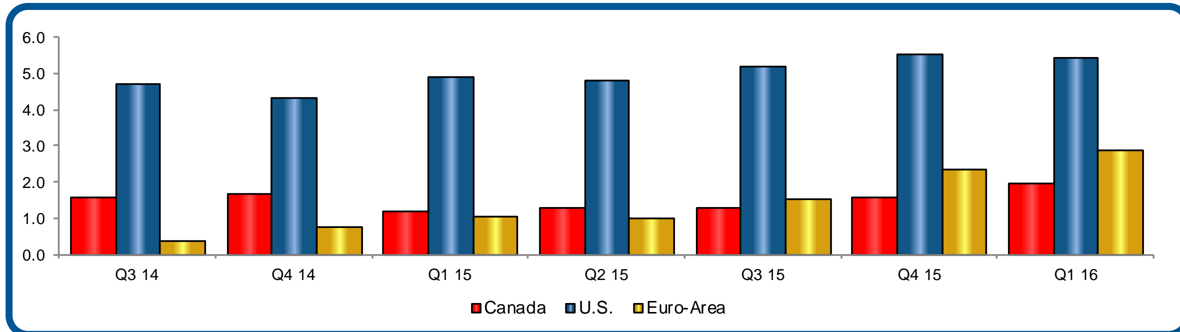

## Unemployment Rate (%)




## Consumer Prices (YoY %)




## Housing Prices (YoY %)




*Source: Bloomberg*

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