Active versus Passive – The Neglected Risks

"Risk comes from not knowing what you're doing.
Price is what you pay. Value is what you get."

~

Warren Buffett

One of the many pleasures of working in this business is the opportunity to converse with many educated people. That was the case last week when I was surrounded by 516 of some of the smartest people in the business during Raymond James's National Business Conference in Toronto. As expected, I didn't get a chance to pick the minds of all attendees, but I did get to exchange insightful dialogue with a few dozen of my closest colleagues and friends. One topic at this year's conference was the ongoing structural changes that the financial business is undergoing. We discussed tightening of regulations, stricter compliance oversight, client relationship management, risk assessment and evolving technological requirements. This "sea of change" has significantly increased the capital, time and infrastructure required to operate in an increasingly competitive (and shrinking) financial services landscape.

From an investment perspective, the majority of the conversations involved deliberations on "proper" asset allocation and the transition to fee based vs. commission based investment management. But nothing garnered more attention than the debate between active versus passive management (passive referring to low cost, low volatility, index based strategies). For someone who studies the market and its current trends, this is certainly of no surprise. One doesn't have to look much further than the watershed of advertising and proliferation of passive products that have soaked the mindset of the investing public over the past number of years. Marketing of these products has been tremendously effective, as they have played off an environment where traditional asset allocation has been challenged for the better part of two years. Fund flows are proof of this. Volumes are further evidence. The passive drum beats "active management is dead" and the music echos loudly in this low return environment. *"Why pay fees when 90% of active managers underperform their benchmark"* has become the slogan de jour. Admittedly, this argument does carry some merit as a large percentage of managers do charge excessive fees without adding much value. We call them closet indexers.

But this argument should be seen in the context of the operating environment. 2016 hasn't been all that easy. Equity markets began the year with a sell-off that reset the record books. Commodity prices collapsed to multi-year lows. A leading G20 nation decided to break free from the grips of a longstanding European economic relationship. The political system south of the border has created more angst, separation and uncertainty than at any time in recent memory. Monetary policy amongst central bankers has been cloudy at best. Further back, 2015 was alike in its challenges, but was mirrored by the performance of a few large cap tech names (remember FANG). Softer earnings, a strong U.S. dollar and a slowdown in China also crowded the headlines. The end result has been a stock market that has essentially traded sideways since the mid/late stages of 2014 as seen in the chart below, represented by the S&P 500 Index.

Indeed, looking back, buying a passively managed index fund over the past two years might have netted a better relative return if one had simply closed their eyes and carried a mental fortitude that allowed them to ignore the aforementioned. But I doubt anyone with capital, and a heartbeat, had the stamina to overcome such adversities. That's why hindsight investing is so easy and why the marketing of low fee, passive strategies has been even easier. But what happens when we break free of this two year consolidation that I have discussed in these commentaries? Well, there are two scenarios: 1) we break down from current levels, or 2) we break out above current resistance. Let's evaluate.

Scenario 1: A breakdown would imply lower stock prices until selling is exhausted and the passive strategy would simply follow suit. The good stocks would attempt to offset the bad stocks (if you own an index fund), but as I learned many years ago, "when stocks are bad, stocks are bad!" Cue in 2008-2009 and 2001-2003. A "close your eyes" type of strategy would undoubtedly deplete capital in a falling market, as "passives" ignore fundamental and technical analysis, at a time when analyzing a business and determining entry and exit points is critical. Moreover, despite how low the management fees are, these strategies always underperform their benchmark or index and ultimately ignore the most important tenet of investment management, the management of risks. That's why passive strategies could be seen as: **P**erpetually **A**llocated **S**tructured **S**olutions **I**nherently **V**alidating **E**rosion (of capital).

Scenario 2: A breakout from the two year consolidation occurs and stocks trade to new all-time highs (which we continue to believe is the current set up). Performance is driven by earnings improvement (see table next page) and a willingness of participants to pay up for that earnings growth. Fundamentals move to the forefront again and uncovering value amongst individual securities rewards active managers. Sectors of the market that have been "bid" up over the past two years as part of the defensive positioning are re-valued. Capitalizing on these winners protects the equity growth achieved, following the second most important tenet of investment management - buy low, sell high. From a "rate" perspective, yields ratchet higher and interest sensitive sectors experience further downside pressure. Passive fixed income strategies are exposed as "floating" NAVs trend lower in response to a lack of a fixed maturity date. In the end, active management will require additional costs, but costs that reflect decision making that hopefully builds wealth. The shifting dynamics of markets inevitably requires active management and tactical decisions to ensure portfolios and asset allocation are kept present. That's why active strategies could best by summed up as: **A**llocation **C**ontributes **T**remendously to **I**ncreasing the **V**alue of **E**quity.

So you have to ask yourself, what strategy is most suitable given the outcomes discussed in the two scenarios? Certainly the first option leaves little in the way of confidence, in particular, if capital preservation is your primary objective. Option two will not directly penalise a passive strategy, but recognizing when specific asset classes become over or undervalued will likely provide better risk-adjusted returns. Factor in the impact of human emotions (Fear, Hope and Greed) and the case for passive management becomes even less convincing. Marketing these products can only last so long. It's just a matter of time. And believe me, when the tide goes out, many passive investors will be actively looking for a tactical swimsuit to cover their unwanted exposure.

That's why here at HugganWhite Wealth Management we have always believed in active management. Throughout the years we have employed an active management approach across the various platforms we offer: commission based accounts, Viridian accounts and the Partners investment program. Each of these offerings provides our team with the tools necessary to manage client portfolios in a manner that reflects the rapidly changing investment business. Twenty years ago, a large percentage of Canadian investment portfolios were focused predominantly on mutual funds. The mutual fund business grew exponentially as financial institutions and independent investment firms expanded their lineup. Today, the mutual fund business now includes an estimated 19,000 various offerings or strategies, of which we use approximately 12. This approach to portfolio construction traditionally involved a commission based structure in which an advisor would be paid a percentage up front to buy the mutual fund and stocks (generally 1-2%). More recently though, the investment business has migrated towards a "fee-based" approach, where commissions are excluded and advisors are compensated based on a percentage of assets under management. Clients invested in our Viridian and Partners program fall into this category. As part of our compensation, advisors, including HugganWhite, provide additional wealth management services such as tax planning, financial planning, investment management, estate and retirement planning and insurance services when needed. The benefit to this strategy is a far more comprehensive offering and it only strengthens the pillars on which a relationship is built - understanding and trust. It is not about the trade, it's about helping clients achieve their goals.

Earlier this month a major shift regarding fee based investing was announced by Bank of America Merrill Lynch (USA). The brokerage firm announced that they will no longer give retirement savers the option of paying a commission for trades, a wholesale exit from the traditional Wall Street sales model in accounts. The brokerage unit told its more than 14,000 brokers that after April 10, 2017, when the new rules take effect, investors who want a retirement account at Merrill will need to pay a fee based on a percentage of their assets, instead of having the option of being charged for each transaction made in their account. While I think that such dramatic changes to the Canadian investment landscape is unlikely in the near term, it does give some insight into how large brokerage firms view the financial advisor relationship model moving forward.

HugganWhite Wealth Management

When I look at the business model here at HugganWhite Wealth Management, the practice is split roughly 80% fee based/20% commission based. Part of the fee based compensation is derived from direct fees in our Viridian and Partners accounts, while some is via trailer fees, which is part of the management expense ratio (MER) applied by mutual fund companies. **Certainly there are pros and cons to each model, but we have always recommended the most suitable option for each client to ensure that fees are kept to a minimum, while you receive the best investment advice possible for dollars spent.** That said, the sands are shifting and there is a major push by regulators in Canada towards a fee only model. While this model does have many advantages, it is not the best for everyone, especially investors with smaller accounts, whom we fear will fall through the cracks if we go down this road in Canada.

As mentioned many times in the past 18 months, you will be receiving new statements in January 2017, which will outline the fees you are paying on your accounts and show your rates of return. Again for Viridian and Partners accounts, this is nothing new. Although we are extremely prudent in ensuring our clients know how we get paid and exactly how much they have earned investing with us in percentage and dollar form, some financial advisors have not been forthcoming with this information which is why the regulation was created in the first place. The pressure on them going forward will be enormous.

We have always believed that our clients want to know a few key important aspects when it comes to our relationship:

- **How much did I start with? What is my original invested capital?**
- **How much risk am I taking to achieve the desired return I am comfortable with?**
- **Are my financial goals being met today, in retirement and for the latter stages of my life?**
- **Is my estate protected to ensure a lasting legacy?**
- **What are the costs to implement my wealth management plan?**
- **How much have my assets grown over time?**

As we move forward, one thing is certain; these questions will likely never change. Regardless of the account model, investors want to know they are working with a team they can trust and ultimately have the confidence that their best interests are put before that of their advisor. For 15 years as a leading investment team here in the Okanagan, we have always ensured that this is one of our main business principles. As a valued client, you have hired us to address the complexities involved with financial management and our unrelenting promise to our clients is to provide the best solutions to help them achieve those goals.

Once again, thank you for the trust and confidence in allowing us to manage your financial affairs. As always if you have any questions or comments please do not hesitate to call or email.

Sincerely,

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