



TOOLBOX



BY

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POWER OF INDEXATION

Market-tracking funds can have advantages, especially during a downturn.

THE battle still rages between those who propose to “be” the market and those who prefer to “beat” it. But thanks to a deluge of new options, passive and active products can now co-exist in portfolios.

And with the recent advent of index mutual funds designed specifically for the MFDA channel, those advisors now have almost as much choice as their IIROC counterparts with respect to indexation products.

There are currently about 100,000 financial advisors in Canada, but only about 23,000 are IIROC-licensed. That means, until recently, only 23% of advisors could even consider index products. Exchange-traded funds (ETFs) are directly available only to IIROC licensees and the index mutual fund lineup, as of a few years ago, didn’t provide much by way of compensation.

Mutual fund assets have been dropping as a percentage of market share, while ETF assets are growing (despite the headwind of dropping market values). It didn’t take long for the industry to put two and two together—there has been a genesis of MFDA-friendly index funds recently—which means all advisors can now access index products and get paid as well. The DSC, Low-Load, Front-End and F-Class index funds are all available.

Core and Explore

One strategy that’s growing in popularity with both the IIROC and MFDA channels is the core and satellite approach (a.k.a. core and explore). It can also be referred to as “buying cheap Beta, and ponying up for

expensive Alpha.” Essentially, it involves replacing actively managed large-cap funds with index funds and then using specialized active managers (small- and mid-cap, sector-specific, alternative asset classes, etc.) or other strategies to round out the portfolio. Typically, the core represents about 60% to 90% of the portfolio and the satellite about 10% to 40%. The specialized managers tend to be more costly, but since their exposure is in the satellite portion of the portfolio, the overall cost of the portfolio is lower, as the bulk is in rock-bottom-cost index funds.

Many of the most popular (in terms of assets) large-cap funds aren’t all that different from their benchmark indices. If you compare the top 25 holdings of the biggest funds in Canada against the top 25 holdings in the S&P/TSX Composite Index, you’ll find a lot of similarity in names and weightings. Let’s suppose Fund XYZ has an 80% similarity to the index but carries an MER of 2.4%. If we strip out 1% for trailers, to separate the issue of advisor compensation from investment management costs, we’re left with a cost of 1.4%. (Or you can simply look up the MER of the F-class version if available.)

Meanwhile, we can track the index for about 0.25% with a plain vanilla index fund from Barclays Global Investors. Let’s do some simple math: At 1.4%, a \$100,000 investment would cost \$1,400 per year for the active fund. So how would a core-and-satellite approach with this \$100,000 differ?

We would pay 0.25% on \$80,000 of our portfolio for a cost of \$200. That leaves \$1,200 in leftover fees for the remaining \$20,000 in **continued on page 10**

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continued from page 9 assets. Dividing \$1,200 by \$20,000 comes to 6%, which means we could try to find specialized managers who cost less than 6% per year for the remaining \$20,000, and on a cost basis that's at par with the stand-alone large-cap fund. So, Fund XYZ is charging 6% per year for the actual active calls the manager is making.

Considering that more specialized funds being used to round out portfolios charge much less than 6%, you can confidently approach clients with a proposal for a reduction in fees—and perhaps the potential of higher risk-adjusted returns to boot.

Advisors can quickly look up the R-squared value of any fund in Canada, which essentially tells you how similar your fund is to the index, on www.fundlibrary.com. Our sample fund XYZ would have an R-squared of 0.80. You can consider replacing the high R-squared funds with index funds, and look for low R-squared funds for your satellite positions.

Downturn Protection

Many advisors object to indexation as a core component in a portfolio and the most-quoted concern is the perception that index funds can't protect like a fund manager can in a down market.

But the data unfortunately doesn't support that conclusion: According to Standard and Poor's, when the tech bubble burst (from August 2000 to December 2002), Canadian Large Cap Equity funds underperformed both the S&P/TSX Capped Composite Total Return Index, and the S&P/TSX 60 Capped Composite Total Return Index on an asset-weighted basis.

Further, consider the performance of Fundamental Index tracking funds (available as either mutual funds or ETFs). These funds re-weight companies in an

Weighing Returns

	FTSE RAFI Canada Index	S&P/TSX Total Return Index	Fundamental Index Excess Return
2000	30.94%	7.41%	23.53%
2001	2.10%	-12.57%	14.67%
2002	-11.92%	-12.45%	0.53%
2003	31.83%	26.74%	5.09%

index based on their fundamental metrics as opposed to market-capitalization. Think of it as weighting companies based on their fundamentals, or profitability, today as opposed to weighting them based on the market's collective guess as to future performance, which is reflected in the current stock price. The theory is that since there's no link to stock price with a fundamental index fund, the participation in pricing bubbles (and anti-bubbles) is eliminated.

Next, compare the FTSE RAFI Canada Index (the fundamental index) versus the S&P/TSX Total Return Index's calendar year returns from 2000 to 2003 (see "Weighing Returns," this page). In this particular bear market, the downside protection was nothing short of spectacular. When back-tested from 1962 to the end of 2007 against the cap-weighted S&P500, the U.S. fundamental index outperformed by 2% on an annualized basis—by 0.7% in bull markets and by a whopping 5.8% during bear markets.

These funds are slightly more expensive than their cap-weighted cousins (approximately 40 bps more), but if they outperform by 2% going forward the math is pretty attractive, especially if they're more client-friendly in turbulent times. Fundamental index strategies are available within mutual funds and as ETFs in Canada.

Additional Applications

There are other roles ETFs can play, depending on the advisor's and client's objectives:

IIROC Only—there has been such an explosion of ETFs that IIROC advisors can basically replicate any investment strategy with relative ease. If there's an index, there is an ETF somewhere out there that tracks it.

To index or not to index is not the question anymore.

For example, strategy ETFs replicate a particular investment strategy—PBP in the U.S. allows you to track the S&P500 index with a buy-write strategy layered on top. It will blindly write at-the-money call options on the index every month, and you don't have to hold an options licence.

However, it's important to note with strategy ETFs and any thinly traded ETF that the premia and discounts to net asset value (NAV) can be quite large. The index you need to track may look cheap, but the ETF may be trading at a 10% premium to NAV on the day you're looking to buy. Conversely, you'll want to avoid selling the ETFs on days with a large **continued on page 12**

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continued from page 10 discount to NAV.

Pair Trading—a popular trade in 2008 was to go short on crude oil futures while simultaneously going long on natural gas futures—working on the assumption that the historical ratio of oil to gas prices would revert to its mean. The same style of trade can be made in a number of different areas. For example, if you think gold has gone up, but silver hasn't gone up as much as it normally should with respect to gold, you could short gold bullion and go long on silver—and even if gold went up you could make money on the trade if silver went up more. Again, all this can be facilitated with ETFs—and no need for a futures licence.

Leverage—Leveraged and Inverse-Leveraged ETFs are very popular as trading vehicles, but some advisors use them as a means for implementing a temporary hedge. If you have a portfolio of individual stocks, you can create an imperfect hedge by purchasing an inverse-leveraged ETF that tracks an index closely resembling your portfolio. If the index (and hence your portfolio of stocks) goes down, your double-

inverse ETF goes up—offsetting some of the losses. It's a double-edged sword though if your index (and your portfolio of stocks) goes up, for then the double-inverse ETF will create a drag on the upside performance.

Probably the best use of this type of hedge is for portfolios with a large unrealized gain inside a non-registered account. The client may have new funds to invest and want to reduce his or her exposure to the market temporarily without triggering capital gains. For most other situations, you can replicate the partial hedge by simply shifting some assets to cash.

Trade the Volatility—with market volatility so extreme, many brokers are using leveraged ETFs as trading positions for quick runs in and out of the market, sometimes for only hours at a stretch. One approach that has worked on painful days—when the market's down close to 10%—is taking a contrarian bet before the close and purchasing a leveraged ETF. The next morning's activity could quickly yield double-digit gains as markets have tended to bounce back the morning after. Horizons

BetaPro offers 200% and 200% inverse exposure to numerous indices both domestically and internationally. Trading on the American exchanges, there are a few providers of 200% leveraged ETFs, and recently Direxion launched the first 300% and 300% inverse exposure ETFs. In just over one month they've gathered almost \$1 billion in assets. These, however, are not ideal products for long-term, buy and hold investors due to the compounding leverage risks but they have much appeal for short-term trading.

To index or not to index is not the question anymore. Index products are here to stay, and now they're available to virtually all financial advisors in Canada with many different types of compensation options. Theory and practice suggest one day advisors will not only spend time trying to figure the correct allocation to equities and fixed income for individual clients, but also the correct allocation to passive and active products. Someday, 100% active or passive allocations may become as rare as 100% equity or fixed income is in a portfolio today. ^{AE} **BANERJEE**