

Canadian HealthcareNetwork

Why the movement to ETFs and passive investing?

By Andrew Neatt and John Naas

When a new investment vehicle challenges and surpasses the asset base of long-established rivals, it's worth inquiring into the causes that contributed to this achievement. The shift of assets from active to passive management . . . surely must count as one of the most important developments in modern financial history. —Craig Lazzara, Managing Director, Global Head of Index Investment Strategy, S&P Dow Jones Indices, Aug 2020.

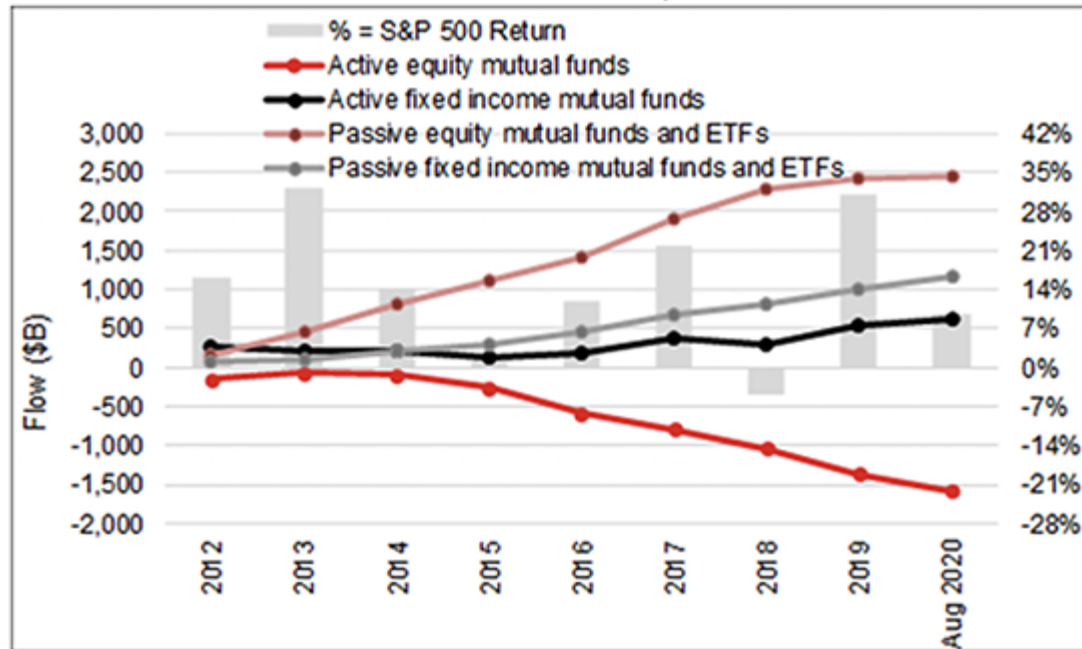


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There is no question globally there is a powerful movement towards passive (index) investing and the use of exchange traded funds (ETFs) as an investment vehicle to access those indices. The question is why is this happening? First, we must review the “what.” In the United States, the popularity in passive investing is nothing new, but as the chart below shows, this popularity has been gaining strength relative to actively managed investments since 2012. Digging deep into the data supporting the graph below reveals some interesting and compelling trends. Let’s take 2012 as an example. In that year, \$159.9 billion US dollars flowed out of actively managed equity mutual funds and ETFs while \$163.4 billion US dollars flowed into passive equity mutual funds and ETFs. However, the numbers for fixed income were quite different. In that same year, \$265.6 billion US dollars flowed into actively managed fixed income mutual funds and ETFs while only \$81.8

billion dollars flowed into passive fixed income mutual funds and ETFs. Fast forward four years to 2016 and the picture looks somewhat different. The trend in equities continued with \$328.2 billion US dollars flowing out of actively managed equity mutual funds and ETFs while \$307.4 billion US dollars flowed into passive equity mutual funds and ETFs. However, in that same year, passive investing for fixed income surpassed the popularity of actively managed fixed income with \$57.4 billion US dollars flowing into actively managed fixed income mutual funds and ETFs while \$157.8 billion US dollars flowed into passive fixed income mutual funds and ETFs. Fast forward almost another 4 years to 2020 and year-to-date to the end of August it shows a continuing trend of popularity with passive investing. \$213.6 billion US dollars have flowed out of actively managed equity mutual funds and ETFs while \$20.5 billion US dollars have flowed into passive equity mutual funds and ETFs. The trend in fixed income also continues with \$105.2 billion US dollars flowing into actively managed fixed income mutual funds and ETFs while \$155.4 billion US dollars have flowed into passive fixed income mutual funds and ETFs.

Funds Cumulative Flows in the U.S. \$



Source: National Bank of Canada, Bloomberg Finance L.P.

Now let's take a look at the flow of funds in Canada for passive and actively managed investments, but also include the trend in ETF investing in this country. The following is a summary of annual net fund flows into mutual funds versus ETFs in Canada since 2016 (in Cdn dollars):

- In 2016, \$16.7 billion net into Actively Managed Mutual Funds. \$200 million net into Passive/Index Mutual Funds. Total Mutual Funds \$16.9 billion.
- In 2016, \$4.7 billion net flowed into Actively Managed ETFs. \$11.7 billion net flowed into Passive/Index ETFs. Total ETFs \$16.4 billion.
- In 2017, \$21.7 billion net into Actively Managed Mutual Funds. \$1.7 billion net into Passive/Index Mutual Funds. Total Mutual Funds \$23.4 billion.
- In 2017, \$7.5 billion net into Actively Managed ETFs. \$18.3 billion net into Passive/Index ETFs. Total ETFs \$25.8 billion.
- In 2018, \$15.9 billion net out of Actively Managed Mutual Funds. \$500 million net into Passive/Index Mutual Funds. Total Mutual Funds -\$15.4 billion.
- In 2018, \$8.9 billion net into Actively Managed ETFs. \$12 billion net into Passive/Index ETFs. Total ETFs \$20.9 billion.
- In 2019, \$4.3 billion net out of Actively Managed Mutual Funds. \$2.4 billion net into Passive/Index Mutual Funds. Total Mutual Funds -\$2 billion (rounded).
- In 2019, \$12.3 billion net into Actively Managed ETFs. \$17.8 billion net into Passive/Index ETFs. Total ETFs \$30 billion (rounded).
- In 2020 to the end of August, \$5.8 billion net out of Actively Managed Mutual Funds. \$1.4 billion net into Passive/Index Mutual Funds. Total Mutual Funds -\$4.4 billion.
- In 2020 to the end of August, \$9.2 billion net into Actively Managed ETFs. \$23 billion net into Passive/Index ETFs. Total ETFs \$32.3 billion.

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This data reveals some interesting changes taking place in Canada. First, the move towards ETFs and away from mutual funds since 2016 is quite obvious. For example, in 2016 slightly more funds were being directed into mutual funds versus ETFs. However, since that time the trend has changed with ETFs attracting approximately \$32 billion more in assets than mutual funds in 2019. Based on what has happened to the end of August of this year the trend to ETFs and away from mutual funds is continuing.

The data also clearly shows a changing trend in Canada when it comes to active versus passive investing. In 2016, actively managed investments took in a net \$21.4 billion while passive strategies only attracted \$11.9 billion. However, in 2019 active only attracted a net amount of \$8 billion while passive experienced a net inflow of \$20.2 billion. This trend towards passive in Canada seems to be continuing as we have seen \$3.4 billion flow into active management year-to-date 2020 to the end of August while \$24.4 billion has flowed into passive/index strategies.

As Craig Lazzara pointed out in his August 2020 report, fifty years ago there were no index funds; all assets were managed actively. The shift from active to passive began as the academic community called attention to the failure of the average active manager to outperform passive benchmarks.

So, this brings us to the why.

Annually S&P Dow Jones Indices publishes a report called SPIVA Scorecard. The report looks at the performance of active money managers versus their relevant passive benchmarks. In the latest 2019 report, 92% of Canadian Equity Funds underperformed their benchmark in 2019 and 86% underperformed over the decade. Extending the time horizon beyond 10 years makes active management look even worse. Managers globally are similarly challenged.

When an active manager beats a benchmark, how can we judge whether the result is of genuine skill or merely of good luck. As Berlinda Liu, Director, Global Research & Design at S&P Dow Jones Indices pointed out in her article titled *Canada Persistence Scorecard: Year-End 2019*, "genuine skill is likely to persist, while luck is random and soon dissipates." The U.S. report showed only 3.84% of domestic (US) equity funds in the top half of the distribution in 2015 maintained that status annually through 2019 significantly below what random chance would predict. Similarly, just 0.18% of the 2015's top-quartile domestic U.S. equity funds maintained that performance over the next 4 years, again below random chance.

What about recent results factoring in the first months of 2020 during the pandemic? According to S&P Dow Jones, 64% of domestic US equity funds underperformed the broad S&P Composite 1500 in the initial four months of 2020 and 67% underperformed in the past 2 quarters. During the one-year period ending March 31, 2020, 72% of domestic U.S. equity funds underperformed.

On the fixed income side, Vanguard released a recent report called *Urban Legends of Fixed Income Investing*. It showed an investor in 2004 had a 12% chance of picking an active U.S. Fixed Income Fund that outperformed its benchmark over the subsequent 15-year period (ending December 31, 2018, using data from Morningstar, Inc.).

So, the movement to indexing is understandable, but why the movement to ETFs?

There are several good reasons, but perhaps most important to us is their improved tax efficiency relative to traditional mutual funds. Tax efficiency is improved for several reasons but primarily related to the flow of money in and out of the investment vehicle. Flows can have a significant impact on the tax efficiency of open-end mutual funds because outflows require managers to sell securities which increases the likelihood that they may realize capital gains that must be distributed. In contrast, ETFs can mitigate the impact of cash outflows by using the in-kind redemption process to meet withdrawals.

Beyond the tax efficiency advantage of ETFs over mutual funds, other advantages such as the timeliness and flexibility of trade execution, and the transparency of investment holdings have undoubtedly contributed to the growing popularity of ETFs.

There are some who continue to argue against index investing and the use of ETFs. Why? Some argue ETF/index investors will be quick to abandon their investment strategy and sell out of their ETF at the first sign of danger. As Tim Buckley, CEO and Vanguard Chairman (one of the largest Index/ETF providers in the world) recently pointed out about Vanguard investors, through the recent volatility less than 0.5% of investors abandoned their portfolios and the majority of investors (83%) held fast from late February to May and didn't transact. Furthermore, 9% of our Vanguard clients rebalanced into the storm and bought equities.

Others have long argued that ETFs will not function properly in a heavily stressed market. Well, let's look at March of this year, arguably one of the most stressed environments for the fixed income market in history. How did fixed income ETFs function? Dave Nadig of ETF Trends wrote in a March 2020 article on Fixed Income ETF investing that investors, whether a buyer or a seller, received the proper price of their Fixed Income ETF during the dramatic sell-off in March. In short, Bond ETFs maintained their liquidity and were actually the primary mechanism for price discovery in the fixed income market.

So, the growth of indexing and ETFs continues and with this growth we have witnessed a significant increase in the number of index strategies available to investors. Today, the attraction of indexing goes beyond investing in the traditional market cap indices like the well-known S&P 500. An area that we find attractive for investors is something called smart beta. This particular brand of indexing has experienced considerable growth in recent years. Smart beta is simply a term referring to factors or characteristics of the market that have provided long term and persistent return premiums historically. There are many different definitions and examples of factors, but we believe there are four distinct factors—Momentum, Value, Volatility and Quality.

The evidence is clear about the advantages associated with investing in indices and the effectiveness of investing in those indices via ETFs. In the end, we believe these advantages helped shake up the investment landscape leading more investors to index investing and ETFs.

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