

Rebundling Passive Performance

A second look at the cost equation

BY NORM ROTHERY

Advisors using actively managed funds have taken a beating from index-fund advisors in the popular press over the issue of fees. But the argument for indexing is usually made by relying on raw index returns and usually targets investors who don't want advice. The case for indexing is substantially weaker when all of the costs associated with advice on passive portfolios are added up.

A classic example of using raw index returns comes regularly from the Standard and Poor's Index Versus Active Funds Scorecard For Canadian Funds. The Q4 2007 report said, "Only 24.3% of active funds outperformed the S&P/TSX Composite Index." But this performance figure does not include the cost of advice. Nor does it even include the cost associated with buying an index or exchange-traded fund (ETF). As a result, the performance figures are not reflective of the practical experience of Canadian investors.

Similarly, it is important to look at total fee levels when comparing the new breed of index-oriented (or passive) advisors to more tra-

ditional commission-based active advisors.

To use a real world example, I decided to explore the fee-structure charged by a well-known passive-investing advocate. He charges an annual fee of 1.4% on assets up to \$250,000 and 0.7% on additional assets up to \$2 million. The cost of index funds, ETFs, and other investment products is not included and there is an additional \$80 commission to buy each ETF or stock.

At 1.4% the annual fee is hefty compared to standard rates of advisor remuneration. Indeed, it represents at least a 40% premium. Because larger portfolios get a discount, the more typical fee level of 1% is hit (not including GST) at just over \$583,000. Problem is, advisors work with client portfolios averaging \$146,200 according to the 2006 Advisor's Edge Dollars & Sense Survey. As a result, the vast majority of potential clients would pay a big premium.

Some portfolio assumptions are required to determine the total effective MER for passive advice. I decided to add up the total fees on

a simple balanced ETF portfolio with 60% in stocks and 40% in bonds. More specifically, the portfolio is composed of 20% iShares TSX Composite (XIC), 20% Vanguard Total Stock Market (VTI), 20% Vanguard All-World ex-US (VEU), and 40% iShares Canadian Bond (XBB). This particular portfolio has a blended annual cost of 0.23%, not including commissions. The all-in cost of passive advice for various portfolio sizes is provided in the accompanying table for two different reinvestment and rebalancing scenarios. The first assumes that trades are made for reinvestment, or top-up rebalancing, every six months. (In this case some distributions are not immediately reinvested, which will lead to tracking error but reduced commission costs.) The second scenario uses quarterly periods and assumes 20 trades are made a year.

I included smaller portfolios in the table but it is important to point out that our passive advisor shuns those with less than \$250,000 to invest. I took this liberty because most active advisors work with less

EFFECTIVE MER OF PASSIVE ADVICE

Portfolio Size	Semi-Annual Reinvestment	Quarterly Reinvestment
\$100,000	2.50%	3.30%
\$150,000	2.24%	2.77%
\$200,000	2.10%	2.50%
\$250,000	2.02%	2.34%
\$300,000	1.85%	2.11%
\$350,000	1.72%	1.95%
\$400,000	1.63%	1.83%
\$450,000	1.56%	1.73%
\$500,000	1.50%	1.66%
\$550,000	1.45%	1.59%
\$600,000	1.41%	1.54%

Source: Norm Rothery

wealthy clients.

As the fee figures demonstrate, the value proposition isn't bad for larger portfolios but it really isn't competitive for smaller portfolios. Even at \$250,000, a 2.34% effective MER is very similar to the total cost charged by active advisors. I should hasten to add that passive advisors don't have a monopoly on frugality. Solid active portfolios can easily be constructed for less than 2%.

There is of course a big difference between the two approaches.

The passive advisor's portfolio is practically guaranteed to trail the index by the fees charged unless some sort of timing strategy is involved.

But the active advisor's portfolio may well outperform the index

before fees and therefore may fare better than the index advisor's portfolio on an after-fee basis.

In both cases, clients get advice but once all of the fees are added up, small active portfolios tend to have the advantage. They cost less, they may outperform, and clients still benefit from advice.

For moderate portfolios the fee difference between advisor-informed active and passive portfolios is marginal.

Those with large portfolios have to ask themselves, how much extra do I want to pay for a chance to outperform the index? I suspect that most clients would be willing to pay more than a few basis points extra to profit from a good portfolio manager.