Structure Trumps (Trading and/or Switching)

THE PROBLEM:

Many investors believe that they need to trade regularly, or hire a professional to trade on their behalf in order to be successful. Be it trading stocks, switching managers, or tactically rearranging portfolio weightings in anticipation of a market event, investors often find themselves using strategies that by and large do not produce the best results.

HOW THIS AFFECTS INVESTORS:

The perception that trading is good for your portfolio and a reliable way to increase returns sets investors off in the wrong direction. Instead of setting up a structured long-term portfolio, investors focus too much energy on trying to make the next right move. In essence, they are in search of the Holy Grail, and are on a dangerous path towards performance chasing and other bad investment habits.

THE SOLUTION:

Investors must become aware that constant trading and switching (in any form) is no replacement for long-term structure. A diversified portfolio that is well-structured and follows a rigourous and disciplined approach will provide a better investment experience than a portfolio that relies heavily on trading.

WHAT INFLUENCES US TO THINK THIS WAY?

Today's financial reality is such that we are constantly bombarded with information about what to do next with our portfolios. Everyone from the financial industry itself to the media outlets that cover it are clamouring to tell you what you should be doing right now. The prevailing message is that we need to do something right away or miss out on the latest opportunity. We are pressured into thinking that trading or switching investments will improve our financial wellbeing, and that the more trading and switching we do, the better. Whether we make these trades on our own, or hire a professional manager to execute them on our behalf, we succumb to a major investment pitfall that can prove to be a costly mistake. This paper will help show that active trading is no substitute for a long-term strategy that relies on diversification and buying and holding asset classes.

In 1966, Professor Eugene Fama of the University of Chicago Booth School of Business developed the theory of the efficient market hypothesis, which states that the pricing of stocks and bonds is efficient, with all reliable information being priced in. Fama's research advocated for investors to focus more on returns in the long run and the asset classes themselves and ignore actively managed trading strategies. His work led to the growth of index investing, and won him the Nobel Prize for economics in 2013.

FOUR COMMON INVESTOR TRADE & SWITCH IDEAS

What exactly do we mean when we refer to active trading and switching? Here are the four most common scenarios reviewed in this report:

1. Hiring money managers to actively trade within an asset class
2. Hiring money managers to actively trade asset classes (tactical asset allocation)
3. Individuals trading asset classes on their own
4. Individuals switching from one manager to another

We begin our review by examining whether or not professional traders are consistently adding value through their trades.

1. Actively trading stock picking money managers leads to shortfalls:

The world of active money management hinges on the premise that a professional money manager can beat the market (benchmark index) using his superior skill. Oftentimes this involves stock picking and market timing. Unfortunately for the managers, (and the investors who hire them) their track records don't live up to their promises. Active money managers have consistently underperformed their broad respective benchmarks (see Table #1). This performance gap was first documented in studies during the 1960s. It has been the case in every decade since.

Table #1 only shows average returns, yet Eugene Fama's 50 years of research help us understand the reason for the shortfalls identified above. To be fair, active managers have high expenses that must be deducted from the returns of their strategies, creating an additional hurdle for them to jump.

TABLE #1: PROFESSIONALLY MANAGED AND ACTIVELY TRADED CANADIAN MUTUAL FUNDS VS. THE INDEX

(For the period ending December 31st, 2012)	1yr	5yr	10yr
SHORT-TERM CANADIAN BONDS			
Median Mutual Fund Manager in Short Term Cdn. Bonds	1.30%	3.00%	2.80%
DEX Short Term Bond Index	2.01%	4.64%	4.38%
Professional Manager Performance (shortfall/gap)	(0.71%)	(1.64%)	(1.58%)
CANADIAN BONDS			
Median Mutual Fund Manager in Cdn. Bonds	3.00%	4.90%	4.20%
DEX Universe Bond Index	3.60%	6.35%	5.97%
Professional Manager Performance (shortfall/gap)	(0.60%)	(1.45%)	(1.77%)
CANADIAN EQUITY			
Median Mutual Fund Manager in Cdn. Equity	6.60%	-1.30%	6.80%
S&P/TSX Capped Composite Index	7.19%	0.81%	9.21%
Professional Manager Performance (shortfall/gap)	(0.59%)	(2.11%)	(2.41%)
U.S. EQUITY			
Median Mutual Fund Manager in U.S. Equity	10.10%	-1.30%	0.60%
S&P 500 Index (total return)	13.04%	1.64%	2.26%
Professional Manager Performance (shortfall/gap)	(2.94%)	(2.94%)	(1.66%)
INTERNATIONAL EQUITY			
Median Mutual Fund Manager in International Equity	15.20%	-5.10%	2.00%
MSCI EAFE (net dividend)	14.32%	-3.71%	3.32%
Professional Manager Performance (shortfall/gap)	-	(1.41%)	(1.32%)
EMERGING MARKET EQUITY			
Median Mutual Fund Manager in Emerging Market Equity	13.60%	-3.00%	9.00%
MSCI Emerging Market Index (net dividend)	15.50%	-0.91%	11.26%
Professional Manager Performance (shortfall/gap)	(1.90%)	(2.09%)	(2.26%)

Source: Globeandmail.com, Standard & Poor's Index Services Group, MSCI data © MSCI 2013, Scotia Capital Inc., Blackrock Inc.

Picking stocks is hard, picking managers to pick stocks is hard, and picking the right managers at the right time to pick the right stocks is even harder.

~ AQR Capital Management white paper entitled Building a Better Core Equity Portfolio, by Ronen Israel and Dan Villalon. May 2013

What about the investors who claim they and their advisors have effective criteria to select the best managers? The numbers are no more encouraging when we start investing with the top quartile managers or traders. The S&P Dow Jones produced a manager persistence report entitled Does Past Performance Matter?: The Persistence Scorecard. The study tested the performance of top traders in the subsequent years after they were named to the top quartile. Table #2 shows that managers and traders with 1st quartile five-year track records had a hard time replicating that performance over the next five years. In fact, only 11.94%, 10.14% and 12.9% of US-based funds in US Large Cap, US Mid Cap and US Small Cap strategies respectively were able to get back up on the podium as 1st quartile managers in the following five years. These persistence studies produce similar outcomes in markets around the world. Picking the best traders and managers is not only impossible, but doing so on the basis of past results is risky. As Table #2 shows, selecting the best-performing active trading manager in no way guarantees they will replicate their results.

> *Only 11.94% of 1st Quartile 5 year managers, repeated as 1st Quartile in the subsequent 5 year period.*

TABLE #2: MANAGER PERFORMANCE DOES NOT OFTEN REPEAT

	Funds	1st Quartile	2nd Quartile	3rd Quartile	4th Quartile	Merged/ Liquidated	Style Changed	Total
US Large Cap Funds 1st Quartile	134	11.94	20.15	18.66	23.88	18.66	6.71	100
US Mid-Cap Funds 1st Quartile	69	10.14	5.8	14.49	11.59	8.7	49.27	100
US Small Cap Funds 1st Quartile	93	12.9	18.28	26.88	25.81	8.6	7.53	100

Source: S&P Dow Jones Indices, McGraw Hill Financial

2. Investors who hire tactical asset allocators to trade between asset classes get skunked too:

In the mid-1990s, a new breed of manager was marketed to investors. They were called tactical asset allocators, and they were touted as knowing how to make the best trades between asset classes. Unlike the traders and managers we studied above, tactical asset allocators sought to add value by trading asset classes. They claimed to know exactly when to switch between asset classes; whether it was transitioning between stocks and bonds or moving between Canadian and US stocks, the tactical asset allocators were convinced they could make a profit by timing the market.

These tactical asset allocators have huge research teams and high-profile market strategists at their disposal. Unfortunately, the results of their trades do little to justify investing with them. Over 1-year, 5-year and 10-year periods, Canadian investors would have been better off buying and holding a balanced fund (as seen in table #3). Incidentally, the average management fee of a tactical asset allocation fund is 0.42 basis points higher than a balanced fund. Over ten years, the fees themselves almost account for the performance shortfall.

Table #3: Canadian tactical asset allocation managers vs. balanced funds

(For the period ending July December 31st, 2012)	1yr	5yr	10yr
Canadian Median Manager Tactical Balanced	5.30%	-0.10%	4.40%
Canadian Median Manager Neutral Balanced	5.70%	1.80%	4.90%
Canadian **Tactical Manager Performance (shortfall/gap)**	(0.40%)	(1.90%)	(0.50%)

Source: Globeandmail.com

In the US, (where the investment universe for tactical asset allocators is much larger) the results are no better. Morningstar completed a series of comprehensive Tactical Asset Allocation studies ending December 31st, 2011. They studied the results over what should have been one of the most opportunistic periods of the last half century – the period going into, through, and coming out of the 2008/2009 financial crisis. If there were ever a time for these superstars to shine, this was it. They compared their tactical asset allocation findings and results with those of Vanguard Balanced Index Fund (VBINX), which invests its assets in a 60%/40% stocks/bonds using indexes and passively managed asset classes in a buy and hold structured approach. Below are the summary findings from the Morningstar report:

"In short, our extended study found scant evidence that these funds delivered on their goal of delivering competitive returns with a smoother ride. **Most gained less** *than the Vanguard fund, were* **more volatile and prone to downside, or both.** *This is consistent with our previous Morningstar Tactical Asset Allocation findings.*

Indeed, **only 14 of the 81 tactical mutual funds** *in existence since October 2007 posted lower downside-capture ratios during the 2008 financial crisis, and the spring/ summer 2010 correction, as well as the recent European debt-related down-*

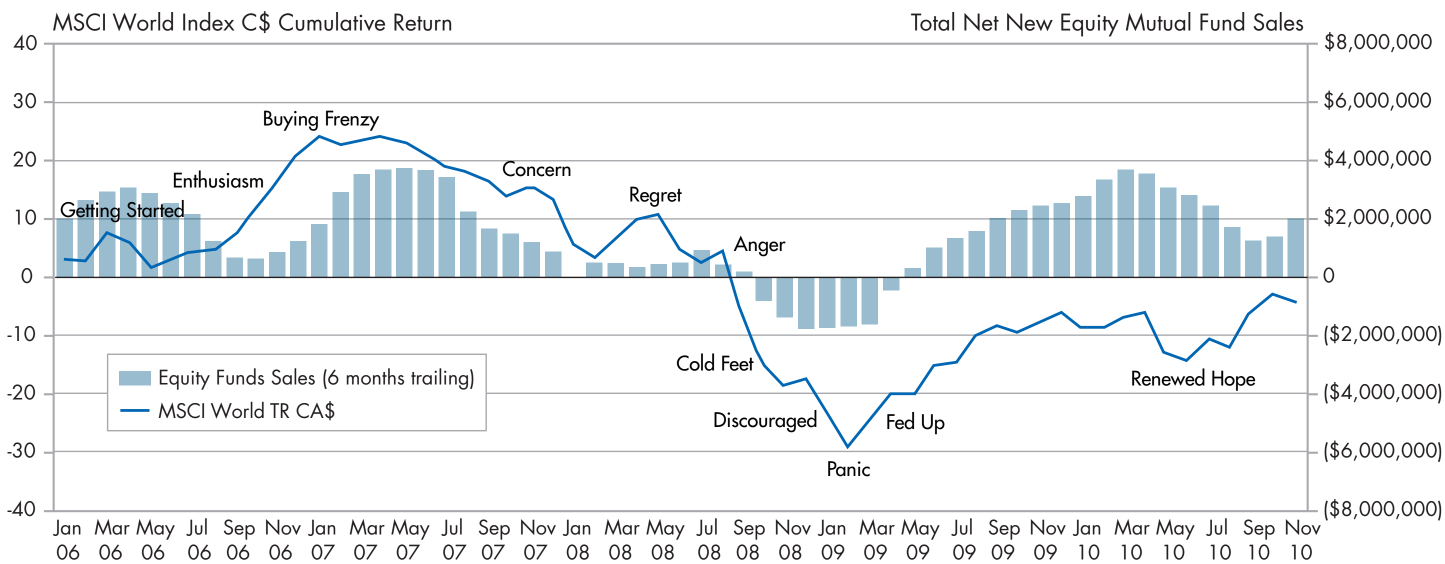
turn. In other words, there was a less than **one-in-five chance that the insurance would consistently pay off versus what one could achieve through a simple balanced fund."**

The evidence is quite clear that these tactical asset allocation trading strategies are a big win for the investment firms and less so for investors. The end result is more fees for the investment firms and smaller returns for you.

3. Individuals produce even worse trading results.

As we have already discussed, professional traders are not particularly effective at consistently identifying money making trading opportunities from the volatility in the markets. Unfortunately, individuals are even worse. The chart below is a dramatic illustration of how investors reacted to market moves in recent years. The blue line represents global stock market returns between 2006 and 2010, while the blue bars represent the amount of money added to equity mutual funds during that period. The correlation is remarkable: investors reliably poured more money into equities after they had gone up in value, and pulled money out of the markets after prices declined. In other words, they bought high and sold low with depressing consistency.

Chart #1: Total net new equity mutual fund sales vs. Morgan Stanley Capital International World Index (MSCI) Canadian dollars. January 2006 – November 2010



Data Sources: The Investment Fund Institute of Canada and Morningstar® EnCorr® (TD Asset Management Inc.)

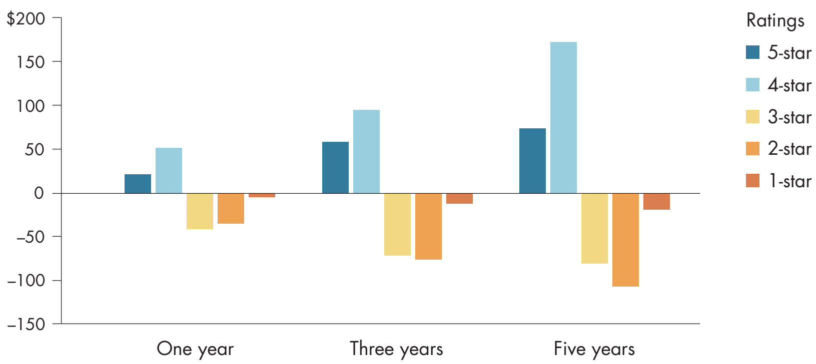
We know that errors like these are often caused by our emotional attachment to money. Family finances and investing stir up our most primal feelings of security and our desire to "make it" in life. Wrestling with these feelings while riding the roller-coaster of stock and bond returns may lead us to trade or switch investments that we later regret.

Investors trading and switching their funds cause serious harm to their long-term returns.

4. Individuals who pour money or switch into the manager strategies with the best ratings often see underperformance thereafter.

Firing and hiring money managers is no easy task. Manager selection decisions usually point investors towards recent performance. Investors tend to switch into or hire managers with the "best recent" performing strategies as shown in chart #2.

CHART #2: HIGHEST INVESTOR CASH FLOWS GO TO THE BEST-RATED MANAGERS OF THE DAY

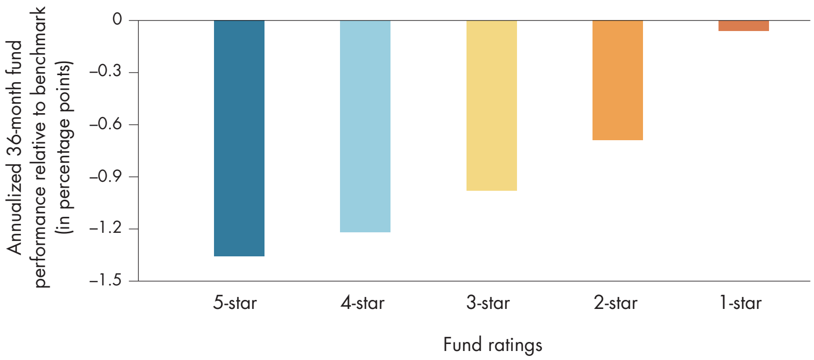


Source: 2013 Vanguard white paper entitles "Vanguard's Principles for Investing Success"

Cash flows for Morningstar-rated funds in peroids after the ratings were posted

As chart #3 shows, these top rated strategies unfortunately underperform immediately following their initial bold performance. Just when individuals thought they were making a money-making trade or switch, they were unwittingly setting themselves up for future disappointing performance.

Chart #3: Star manager performance relative to benchmark



If you think that the manager selection challenge noted above is limited to retail investors and their advisors using mutual funds, think again. Even at the most sophisticated levels of investing—the arena of the institutional pension fund—the manager selection process is unpredictable and inconsistent. High-priced institutional consultants and high-level boards spend a tremendous amount of money and energy trying to make smart decisions around the hiring and firing of active managers. Yet research demonstrates that this practice fails to add value.

In their 2008 paper "The Selection and Termination of Investment Management Firms by Sponsors" published in the Journal of Finance, Amit Goyal and Sunil Wahal shed some light on this complex decision-making process. They examined the actual selection and termination decisions between 1994 and 2003 of 3,400 institutional pension funds in the most cutthroat market—the U.S. institutional marketplace. Goyal and Wahal concluded that institutional plan sponsors typically "hire investment managers after large positive excess returns but that this return chasing behaviour does not deliver positive excess returns thereafter." They determined that plan sponsors would have done just as well by leaving the fired manager in place instead of bringing in the high-performing new manager.

What does this tell us about trying to hire and fire or trade and switch investment managers? If North America's top institutional pension manager selection experts themselves can't successfully predict and identify the next top manager, what hope do individual investors, their advisors, or their advisor firms have?

Structure will provide a better investment experience:

The truth of the matter is that no one can consistently produce moneymaking trades. We have seen in the above trading scenarios just how hard it is for professionals and regular investors alike to trade between stocks, asset classes, and managers. The increased portfolio activity fails to add value because of the randomness of asset returns. As the table below demonstrates, markets and asset classes move in a random and unpredictable fashion. In this diagram, each colour represents a different asset class that is worthy of being included in a Canadian investment portfolio. They are laid out year by year in a stacked format with the best performance within that calendar year on the top and the worst performance on the bottom. It becomes obvious after looking at this mosaic of colours that asset class returns are extremely difficult to predict. Becoming aware of the nature of asset class returns helps savvy investors realize that structure will trump trading and switching.

Table #4: Asset class returns are often random; attempting to switch between asset classes is unproductive and risky.

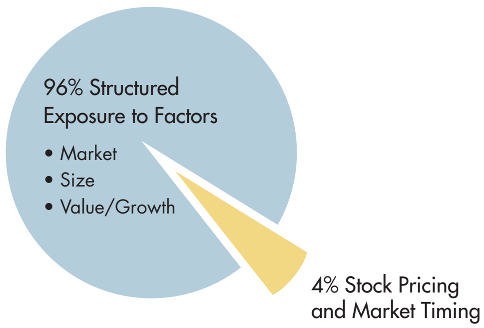
2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
36.18	24.88	2.58	36.10	23.47	24.11	35.72	9.82	2.56	68.35	38.09	11.72	15.08
28.30	21.56	2.39	31.32	22.49	21.44	29.88	4.27	-21.94	46.22	23.38	4.30	14.96
12.24	19.35	-3.63	30.11	17.53	19.56	26.10	3.36	-22.85	35.05	21.50	2.04	14.72
7.41	4.36	-3.79	27.83	15.28	10.97	26.08	2.15	-24.94	27.29	17.61	0.90	14.55
5.17	1.63	-3.86	26.74	14.47	10.95	23.18	-5.25	-25.55	25.12	16.40	-3.52	14.13
1.54	1.05	-12.45	18.85	11.49	10.72	22.11	-7.92	-30.06	13.99	14.53	-5.19	13.82
0.24	-6.40	-16.02	13.57	10.98	10.69	18.15	-10.09	-30.67	13.85	10.26	-8.71	13.04
-5.54	-11.56	-16.75	11.60	8.63	4.16	17.25	-10.14	-32.53	10.98	9.16	-10.00	11.68
-7.77	-12.57	-16.77	7.46	8.42	3.05	16.56	-15.63	-33.00	9.26	2.22	-10.26	7.19
-8.82	-13.41	-20.47	5.46	2.80	2.57	15.58	-17.01	-35.24	3.47	0.43	-12.43	0.91
-10.80	-16.55	-22.85	2.86	2.25	2.29	3.93	-29.73	-45.71	0.36	-2.14	-13.78	0.80

- Canadian Fixed Income
- Canadian Large Cap
- Canadian Value
- Canadian Small Cap
- US Large Cap
- US Value
- US Small Cap
- US Real Estate
- International Large Cap
- International Value
- International Small Cap

Focus on structure and invest to win

Evidence and research show that long-term asset class allocation and market exposure are the dominant drivers of portfolio performance. Asset class investing is the most prudent and successful long-term investment management strategy because it relies on structured exposure to factors and not stock picking and market timing.

Portfolio structure and asset allocation determine performance



source: Dimensional Fund Advisors

Even though trading and switching strategies like stock-picking and market-timing generate headlines in the daily business newspapers and the nightly TV investment shows, research demonstrates that asset class investing is by far the most important factor in determining the variability or movement of your overall portfolio.

Studies have demonstrated that buying, holding and rebalancing asset classes may account for up to 96% of the variation of portfolio returns. The figure above highlights the results of a study that compared returns from a large number of different institutional portfolios and proved that the difference in variation could mainly be explained by three primary asset allocation portfolio weightings: equity markets vs. bonds; small company stocks vs. large company stocks; and value company stocks vs. growth company stocks. Stock picking and market timing accounted for only 4% of the variation.

Win with structure and discipline in the long-term.

Investors can create and maintain successful portfolios by relying on proven methods of structure and stability instead of using trade and switch strategies that will detract from their portfolios.

EIGHT STRATEGIES TO STAY STUCTURED

1. Maintain a long-term, diversified portfolio
2. Maintain the integrity and structure of your asset allocation
3. Resist the urge to trade or to hire traders
4. Do not let your emotions lead you to trade your portfolio
5. Trades should be done ONLY to rebalance the long term diversified portfolio
6. Use index or passive asset classes to capture asset class returns
7. Include Fama French Multi-factor exposure to higher return asset classes
8. Use a financial advisor that subscribes to asset class investing

This paper was co-written by the members of the Final Frontier Group (FFG). Founded in 2006, the FFG is an independent group comprised of six successful portfolio managers and financial advisors affiliated with various firms across Canada. The mandate of the Final Frontier Group is to facilitate the sharing of unbiased "best practice" ideas and portfolio research.

The common thread uniting members of the group is a keen interest in the science of investing and the desire to excel at client service. The advisors in the FFG collectively oversee more than $1 billion worth of private client assets.

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