Beware the Stampede. The Herd is Building.

The Rise of Passive Products.

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Executive Summary:

The growth of exchange-traded funds has been explosive. At the end of June 2016 global assets in ETFs reached a new record high of US$3.177 trillion. Today, approximately one-third of American equities are held by index-tracking funds. In some cases the unintended consequences of the rise of passive products may be a misallocation of investment capital and the potential for higher volatility due to 'herding' behaviour. Active management encourages a healthy investment ecosystem and a higher level of trust by investors by contributing to efficient markets. It also holds the promise of earning returns that are better than simply 'average'.

According to the June 2016 industry report from ETFGI, a research and consultancy firm, global ETF/ETP assets reached a new record high of US$3.177 trillion. Vanguard, a leading company by assets in passive investing, reports assets under management of greater than US$3.5 trillion, over 70% of which are in index tracking products. Through Vanguard funds, investors own approximately 5% of every publicly traded company in America and 1% of every public company abroad. In fact, a full one-third of American equities are held by index-tracking funds. In 2015, investors in America withdrew $145 billion from actively managed funds and put $398 billion into passive ones[1]. ETFs in Canada surpassed $100 billion for the first time in May of 2016. ETFs make up approximately 7.8% of Canadian mutual fund industry assets.[2]

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Global ETF and ETP Growth

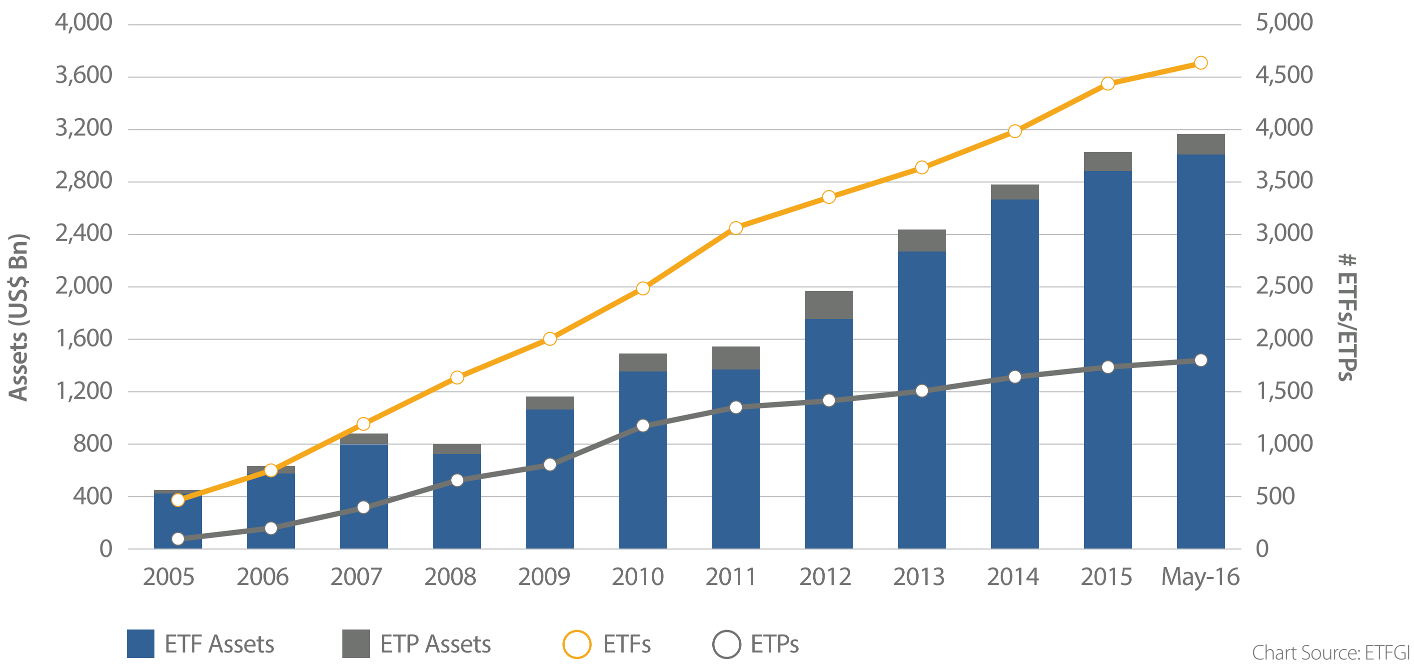

Chart Source: ETFGI

Unintended Consequences

Helping to accelerate the growth of passive products are new industry regulations (e.g. CRM2, fiduciary standards) and new technologies from fintech companies. Striving to reduce management fees as much as possible, the shift to passive indexing has largely ignored the central tenet of investing - seeking attractive returns on invested capital (ROIC). Passive indexing is agnostic to valuation and is therefore relegated to being a "price taker".

Furthermore, market capitalization based indexing can inflame the valuation of certain stocks as incremental flows push the price of the largest stocks higher while starving smaller companies of capital. Extrapolated to the larger economy this may dampen economic growth over time.[3] At the time of writing, Apple Inc., the largest company in the world by market capitalization, is 68% owned by institutional investors. Its top three institutional investors are Vanguard, State Street and BlackRock which together own approximately 16% of the shares outstanding (source: Bloomberg). In a market cap weighted index fund, Apple along with the next largest companies Alphabet, Microsoft and Exxon Mobile will continue to get investors' capital simply on the basis of being the largest companies - irrespective of each stock's valuation and potential ROIC.

Another unintended consequence of the rise of passive indexing can be the large concentrations of ownership in stocks by investors all using the same risk algorithms. The result may be herding behaviour and increased market volatility. Case in point, BlackRock has US$4.6 trillion under management but also has an influence on almost 7% of the entire world's financial assets through its proprietary risk-management platform, Aladdin. A significant portion of the world's investable assets tied to the same way of thinking may exacerbate market volatility in times of stress.[4] Even with instantaneous information, powerful data crunching tools and intelligent, competitive individuals managing assets globally, the sheer volume of data can hamper good investment decisions. Data should not be mistaken for knowledge, and it's certainly not a substitute for wisdom.

For individual investors the relentless pursuit of lower management fees to bolster returns may limit access to high-quality professional advice which, in turn, may lead to poor investment results over the long term. For example, coming into the financial crisis of 2008, how much would an investor have been willing to pay for the sound advice of having proper asset class diversification? An all-equity, Do-It-Yourself investor would have found no safe harbour throughout that tumultuous period simply by paying lower fees in an all-equity ETF portfolio.

As illustrated in exhibit below, the Canadian equity market is concentrated in three sectors: Financials, Energy and Materials. ETFs that replicate this idiosyncratic sector exposures encourage large allocations to the Energy and Materials sectors irrespective of their lower earnings contribution. The largest ETF in Canada, iShares S&P/TSX 60 Index ETF is CA$12.06 billion at June 30, 2016. It represents almost 12% of the total ETF assets in Canada.[5] By its very construction, an index does not take valuation into account. This means that at any given time, an index may include significantly overvalued securities.

The critical message of the preceding paragraphs is that passive investors assume the volatility and risk characteristics of the underlying benchmark and therefore downside protection is impossible. Common sense says that a value portfolio, containing only a subset of undervalued securities, is less risky than an index in its entirety. We believe that "risk" should be understood as the potential for a permanent loss of capital and that investment success depends on mitigating drawdowns that impair the rate at which capital compounds.

Earnings vs. TSX Weight

	Weight			Source of Earnings		
	TSX	BG Canadian Equity	Diff	TSX	BG Canadian Equity	Diff
Energy	20.2%	12.4%	-7.8%	2.3%	-1.5%	-3.8%
Materials	14.4%	4.9%	-9.5%	3.1%	6.0%	2.9%
Industrials	8.6%	9.9%	1.3%	13.0%	10.9%	-2.0%
Cosumer Discretionary	5.9%	12.1%	6.2%	6.4%	15.5%	9.2%
Consumer Staples	4.0%	5.1%	1.1%	2.7%	4.7%	2.1%
Health Care	0.6%	0.0%	-0.6%	-0.1%	0.0%	0.1%
Financials	35.7%	41.3%	5.6%	62.3%	54.1%	-8.2%
Information Technology	2.7%	2.8%	0.1%	3.1%	1.8%	-1.3%
Telecom	5.6%	11.6%	6.0%	6.4%	8.3%	1.9%
Utilities	2.3%	0.0%	-2.3%	0.9%	0.0%	-0.9%
Real Estate	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Total	100%	100%		100%	100%	

- Financials make up 36% of the TSX but contribute 62% of earnings
- Energy accounts for 20% of the TSX but only 2% of earnings at present
- BG captures more than 100% of earnings in Materials with only 34% of the sectors weight in the TSX

Source: Beutel Goodman As at June 30, 2016

Efficient Markets Require Active Management

Classic fundamental analysis is about weaving together a mosaic of disparate information sources in order to identify attractive opportunities. Capital is deployed on the basis of a satisfactory ROIC - not simply based upon the market capitalization of a company or, in the case of some fixed income ETFs, the level of indebtedness.

Pundits have leveled criticism against active management pointing to the fact that the median manager cannot beat the benchmark on a net of fees basis. Active management has been the victim of its own success as many bright, well-educated professionals have entered the arena and used their analytical prowess to bring stock valuations in-line with company fundamentals.

Market efficiency is the degree to which stock prices reflect all available, material information. Without a healthy ecosystem of active managers performing independent analysis on stocks there may not be adequate price discovery. The surge of passive investing may cause stock prices to deviate from their intrinsic value for greater periods of time and therefore provide increased opportunity for active managers. Efficient markets, facilitated in part by the work of active managers, enables investors to participate with confidence knowing that security prices are fair for both buyers and sellers. It allows growing companies to raise substantial amounts of needed capital and encourages a level of trust by millions of investors.[6]

In their role as supporter of a healthy financial ecosystem, active managers can find attractive investment opportunities when the indexes are expensive. At Beutel Goodman, our equity process requires, at least, a one-third discount to business value (a stock's fundamental intrinsic worth) over a three year investment time horizon. Although one may argue that at a macro level stock markets are fully-valued, recently we have uncovered a number of individual high-quality stocks trading at attractive valuations by employing bottom-up, fundamental analysis.

Fixed Income

With reference to equity market cap-weighted ETFs, investors have effectively arrived at a consensus of the individual valuations of the companies they are comprised of. Successful companies that create desirable products and services, that are led by competent managers and can grow their earnings will naturally attract additional investment capital. In most cases, the companies with the largest market capitalization have justifiably achieved their position based upon fundamental characteristics which makes them compelling to investors. In contrast, fixed income capitalization-weighted ETFs, skews investors towards the most indebted issuers. Liquidity is paramount for fixed income ETFs, therefore large issuers of debt may be favoured irrespective of credit risk. In fact, a deteriorating company that issues more debt to address its financing needs may find itself becoming a larger portion of the overall index and therefore, investors' portfolios.

At Beutel Goodman, our high-quality fixed income portfolios are comprised of securities that have passed our strict investment criteria: Liquidity, Transparency, Non-Cyclical, and High Barriers to Entry. Independent due diligence on corporate bonds is critical in order to avoid defaults. We believe that it's important not to rely solely on the ratings of the credit rating agencies. Three bonds illustrate why:

Enron

Credit agency S&P assured investors that Enron credit was investment-grade...right up to Enron's declaration of bankruptcy. The credit agency maintained its rating even though they had greater access to Enron's books than did the public. Days before Enron admitted to overstating profits, a key S&P analyst expressed his strong belief that Enron's off-balance sheet problems were nothing to worry about.

Bell Canada

On April 17, 2007 Bell Canada enjoyed an S&P rating of A(-)...by September 24th 2007 the credit agency had downgraded Bell Canada 4 credit levels to BB(+)…or "junk"…due to LBO risk.

ABCP (Rocket Trust)

Rocket Trust received a DBRS rating of R-1 (high) in Feb 2003. In August 2007, the paper stopped rolling and maturity could not be funded…and DBRS reaffirmed their rating of R-1 (high). DBRS downgrade to a D (default) only when Rocket Trust filed for CCAA protection.

In summary, active professional fixed income managers employing duration, yield curve and independently-vetted credit decisions have ample tools in order to ensure adequate liquidity in a portfolio and protect against a permanent capital loss.

Opportunity, Choice and Identity

Active management, both for equities and fixed income, has spawned a robust global industry creating many high-quality employment opportunities. It has helped integrate the world's stock and bond markets while incorporating the markets for commodities, currencies, real estate and consumer receivables. An increasingly unified global market has produced faster growth, more innovation and democracy, and better prospects for world peace[6].

Active management provides choice and the opportunity to do better than simply average.

Indexing is "socializing" investing, promising all investors the same result: the market return (minus a modest management fee and trading costs). There are many reasons why people invest including to fund their future income needs, have a positive societal or environment impact and support free market capitalism. When it comes to investment vehicles, a breadth of choice allows investors to express their own unique tastes. Similarly, when shopping for an automobile, some consumers express their preference for the basic utility and price-point of a Chevrolet Cruze, while others appreciate the high-performance and vivaciousness of a Corvette. Each consumer is satisfied with their unique choice because it's consistent with their identity, values and goals.

It's the prerogative of an informed investor to make an empowered choice of whether to be satisfied with an 'average' result or be willing to pay more for the prospect of superior future risk-adjusted returns.

SOURCES:

1 "Index We Trust", The Economist, June 11, 2016
2 Canadian ETF Association, Industry Statistics, June 20, 2016 and IFIC, May 31, 2016
3 "Heading Passively To The Poorhouse", Charles Gave, Gavekal Research, May 2016
4 "The Monolith and the Markets", The Economist, December 7, 2013
5 Canadian ETF Association, Monthly Report June 2016
6 "In Defense Of Active Investing", Charles D. Ellis, CFA Financial Analyst Journal, July/August 2015

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