Why U.S. equity funds in Canada are so lousy

Costs, incentives and resources are possible factors behind the category's weakness.

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Active management is usually a tough game to play anywhere, but the S&P 500 has been an almost unbeatable foe for active Canadian managers who run U.S. equity funds.

To be sure, the S&P 500--the most widely-used bellwether of U.S. market performance--has been a difficult opponent for U.S. stock fund managers everywhere. Because the index is home to some of the world's most widely followed and liquid companies, such as Apple (AAPL), ExxonMobil (XOM) and General Electric (GE), stock prices quickly reflect new information, which makes it hard for active managers to gain an edge. The index also can be prone to extended stretches where a small number of constituents, including Amazon.com (AMZN) and Facebook (FB) more recently, dominate returns. When success relies on getting a handful of calls right, active managers will have a harder time differentiating themselves.

Active U.S. equity managers in the Canadian market have stood out, but not in a good way. Through May 2016, just two of the 66 active funds (or 3%) in the U.S. Equity category that have 10-year records outpaced the S&P 500 Index over the period. Only one fund--Beutel Goodman American Equity--delivered better volatility-adjusted results than the index after fees. (Our calculations exclude multiple versions of the same fund, as well as index funds and those that hedge their currency exposures.) Active U.S.-domiciled large-cap managers don't exactly shine either, but with 28% of funds with 10-year records beating the benchmark, they've performed better than their Canadian counterparts.

Why have Canadian active managers fared so poorly investing south of the border? Here are some plausible reasons why.

U.S. equity funds are too expensive

If there's anything we can say with absolute certainty, it's that fund performance improves when fees go down. All else being equal, cheaper funds beat more expensive funds. The average management-expense ratio (MER) in our sample was 1.95%--a cost disadvantage even Warren Buffett, let alone mere investing mortals, might find difficult to overcome. That's about a percentage point more than what large cap domestic stock funds charge in the U.S. The U.S.-sold funds may have fared better not because the managers are smarter but because their costs are lower.

Our calculations were based on the lowest-price share class available at the start of our research period. Lower-cost shares for DIY investors and fee-based advisors were often not available, and a 1.95% price tag is more representative of what you'd pay today investing through a commission-based advisor. Had our sample had much-lower costs, the outcome would look a little more promising. With a 0.9% MER--a levy low enough to land in the cheapest 20% of fee-based share classes--roughly 20% of funds in the category would have outperformed the S&P 500. That's not especially impressive, but the reality may be less dire than it appears at first blush.

That said, most funds in our sample would have been underperformers at any price: Two-thirds lagged the S&P 500 *before* fees over the period.

The S&P 500 is an imperfect yardstick

The S&P 500 may be the benchmark for two-thirds of the funds in our sample, but it's not always the best performance measure. Most U.S. equity funds hold more mid- and small-cap stocks than the index; the S&P 500's average market cap is approximately $90 billion (in Canadian dollar terms), versus $60 billion for the median actively managed fund in the group. In addition, the portfolios may differ in terms of investment style (value and growth). Pitting funds with strong all-cap, value or growth orientations may make for apples-to-oranges-to-bananas comparisons.

Consider Investors U.S. Large Cap Value, for instance, which lagged the S&P 500 by 0.9% annually (before fees) over the 10-year period. The Russell 1000 Value Index better reflects the fund's large-cap-value strategy, and it outperformed that benchmark by 0.4% per year. On the other hand, Mackenzie U.S. All Cap Growth beat the S&P 500 by 1.2% annually (before fees) over the period thanks to growth stocks' recent strength, but fell short of the more appropriate all-cap-growth Russell 3000 Growth Index by 0.2% per year.

While style effects may explain why some funds lagged the S&P 500, they're unlikely the cause of the U.S. Equity category's systemic underperformance. Adjusting for style and market cap factors doesn't paint active managers in a more favourable light: Over the 10-year period, 70% of funds underperformed a custom benchmark that reflected their historical style exposure.

The client is the problem

With track records like these, one might wonder why active U.S. equity funds have attracted assets. After all, poor performance isn't usually a big selling point. Many of the category's biggest offerings haven't needed eye-catching returns to capture investor attention, however. That's because these funds enjoy a continuous flow of new money from large, highly popular fund of funds sponsored by their parent organizations. For example, about 75% of assets in the country's largest U.S. stock fund--$4.1-billion PH&N U.S. Multi-Style All-Cap Equity--are held by the RBC Select funds of funds distributed by its parent company. Meanwhile, in-house funds of funds represent 80% of TD U.S. Blue Chip Equity's $1.6 billion in assets and 68% of $925-million Franklin U.S. Rising Dividend.

This isn't to say these funds are doomed to underperformance. Indeed, TD U.S. Blue Chip Equity has been among the category's best long-term performers, though given that it's subadvised by large U.S. asset manager T. Rowe Price, it's not exactly a Canadian success story. Also, these funds still have a client to satisfy, even if it's their own parent organization. It's not in the parent company's interests to let performance troubles fester if they ultimately impact returns of their funds of funds.

Even so, the impact of less-than-stellar performance by a fund of fund's underlying holdings will usually pale in comparison to bigger return drivers like asset allocation. The decision to hold U.S. stocks is likely a more consequential decision than the choice of vehicle for investing in them. Unless performance is remarkably bad, an unimpressive U.S. equity fund can still play its part in an overall portfolio.

Managers are under-resourced

Canadian managers aren't the only ones vying for an outsized slice of U.S. market returns. They compete on a global stage, often against better-resourced rivals. Giant asset managers like Fidelity and T. Rowe Price enjoy the scale to field an army of analysts specializing in sector, industry and asset class groups, with dozens focused on U.S. stocks alone. The much-smaller Canadian industry can't easily support large teams, especially in an asset class that comprises a relatively small slice of industry assets. (Of the roughly $1.2 trillion in Canadian funds, $76 billion are in the U.S. Equity category.) These teams won't offer the same breadth of coverage as larger ones--or if they do, it may come at the expense of research depth.

Resources alone don't assure success, of course. Canadian active managers have been somewhat more successful investing globally (a universe which includes U.S. stocks), where a larger opportunity set presumably places a greater strain on resources. It's possible a wider investment universe gives Canadian managers a better shot at identifying opportunities than in the closely watched, highly liquid U.S. market. Canada-based global equity managers also favour approaches requiring less research breadth. Managers investing in hundreds of stocks across the globe need an army of analysts, but it's less necessary if the strategy is to hold a smaller collection of best ideas.

Indexing or bust?

In most asset classes, investing passively is likely to deliver above-average results, if only thanks to low costs. The case is especially strong in U.S. equities, a relatively efficient market where Canadian active managers appear to have no discernible competitive advantages. And it's an area where the country's high fund expenses make it very hard to compete against low-cost passive alternatives like Vanguard S&P 500 Index ETF (VFV) and iShares Core S&P 500 Index ETF (XUS), which levy 0.08% and 0.10% MERs, respectively. Judged against the historically long odds of outperformance in U.S. stocks, the near certainty of index-like returns looks like a safer bet.

If active management is such a loser's game, it may appear odd Morningstar gives four actively managed U.S. equity funds in the category--Mawer U.S. Equity, Beutel Goodman American Equity, NEI Ethical American Multi-Strategy and RBC O'Shaughnessy U.S. Value--positive Analyst Ratings. Positive ratings indicate Morningstar analysts believe a fund is likely to outperform over the long haul. The ratings--Gold, Silver or Bronze--signify how confident we are that a fund can outperform its peer group and/or market benchmark. That we've given the four positively rated U.S. strategies Bronze ratings reflects the difficulty even by capable active managers in besting passively managed alternatives over the long haul, but thanks to management skill and process discipline, along with low-to-moderate costs, we think it's likely they will outperform most of their peers. Indexing may be a safer bet, but not all active funds are guaranteed losers.

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