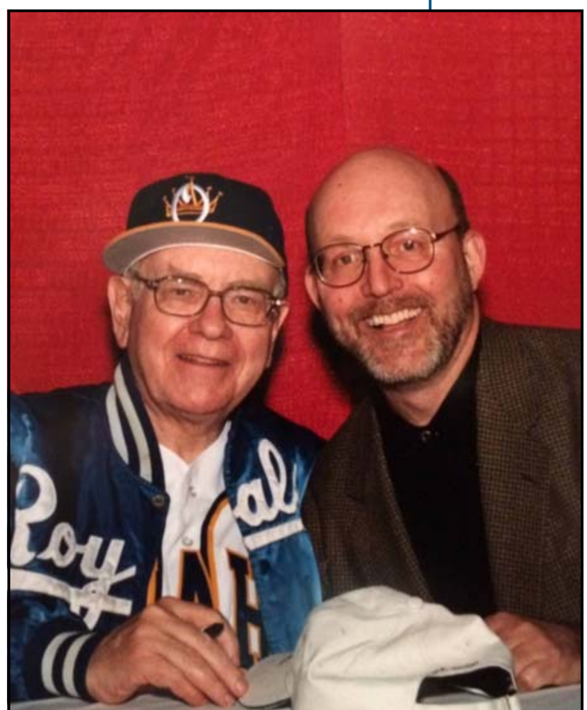
The Cumming Millennium

Special Edition

Another Strong Endorsement for Passive Investing

On the wall in our office meeting room is a very special photograph. It is a picture of Bruce and Warren Buffett from May 4, 2002. That was the year Bruce was fortunate to be invited to Berkshire Hathaway headquarters to meet the *Oracle of Omaha*. Underneath the photograph we placed an engraved plaque that reads: **Warren Buffett asks Bruce Cumming for Advice!!**

A little tongue-in-cheek? Perhaps not.



Investors and advisors alike have long made the annual pilgrimage to Omaha to hear Warren Buffett speak. This year, though, we bet they were surprised with some of Warren's remarks. He straightforwardly endorsed passive investing and suggested a portfolio of inexpensive index funds for his own survivors. Here's the actual quote from his February 28, 2014 annual letter to shareholders of Berkshire Hathaway:

"My money, I should add, is where my mouth is: What I advise here is essentially identical to certain instructions I've laid out in my will. One bequest provides that cash will be delivered to a trustee for my wife's benefit. (I have to use cash for individual bequests, because all of my Berkshire shares will be fully distributed to certain philanthropic organizations over the ten years following the closing of my estate.) My advice to the trustee could not be more simple: Put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund. (I suggest Vanguard's.) I believe the trust's long-term results from this policy will be superior to those attained by most investors – whether pension funds, institutions or individuals – who employ high-fee managers."

This isn't the first time Warren has endorsed index funds. He previously said investors are better off putting their money in low cost index funds. "A very low-cost index is going to beat a majority of the amateur-managed money or professionally-managed money." He went on to say, "The gross performance may be reasonably decent, but the fees will eat up a significant percentage of the returns. You'll pay lots of fees to people who do well, and lots of fees to people who do not do so well."

Warren Buffett certainly seems to be on the same page as Bruce.

For over five years, through our Core & Explore investment program, we have been recommending the application of a passive investing strategy versus the use of active investment management. These are two basic but very different approaches to investing.

The most common and least successful is to invest in products that use active managers. Active managers make ongoing investment decisions by researching and deciding what stocks to buy and sell and the actual timing of those myriad of trades. The second, lesser used approach, is with passive investing which mimics an index and provides broad market exposure.

Mutual fund managers, investment counsellors, and most stockbrokers charge investors fees and commissions to delegate investment decisions to these "experts" but the outcome is frequently unfavourable. The science of investing has been studied and written about for six or seven decades. The academics have consistently shown active management simply does not work over longer time periods. Rating agency Standard & Poor's annually produces a report card comparing active portfolio managers against their benchmark index.

Over a five year period, how many Canadian portfolio managers failed to beat the Canadian TSX Composite index? Would you believe over 70% failed to beat the index? How about in the US? Less than 3% of active funds beat the S&P 500 index in Canadian dollar terms. In the global equity space, less than 9% of active managers beat their benchmark index.

What value is being added if the vast majority of managers fail to beat the index? This is why you own indexes and enjoy lower fees at the same time, and if you don't, you should. We believe better performance with lower fees is the right investment strategy.

Perhaps not so tongue-in-cheek after all?

Do lower fees really make a difference?

Absolutely! Mutual funds employ highly skilled teams which spend a lot of time researching, building complex computer programs and models, and focus a lot of activity into buying and selling. They do this in an attempt to beat the market. But, as we just noted in the previous article, active managers are not successful at this. Rather, all of their active buying and selling results in higher management fees and taxes, which again hurts your overall returns.

Let's look at the numbers by comparing the Management Expense Ratios (MER) of Canadian Equity Funds from some of our larger banks versus the low cost index funds we provide through our *Core & Explore* program. The TD Canadian Equity Fund - A has an MER of 2.19%. The RBC Canadian Equity Fund's MER is 2.06% and the BMO Canadian Equity Class Fund has an MER of 2.46%. We think these are just too high. And to add insult to injury some of these high MER funds also carry additional fees just to purchase the fund. Our *Core & Explore* Canadian Equity Fund has an MER of just 1.1%, just about half of the banks' funds, and there are no sales commissions charged at the time of purchase leaving more of your money working for you. We think that makes a difference. Don't you?

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