Liberty International Investment Management
111 Peter Street, Suite 621 Toronto, ON M5V 2H1
o: 416-304-9510 f: 416-304-9900
toll-free: 1-844-304-9510
www.libertyiim.com

Pros and Cons of Different Investment Options

In 2016, new legislation called CRM2 will come to Canada. Once enacted, all financial institutions in Canada will be required to disclose all investment management fees to clients. To some investors in mutual funds and other bank products, this additional disclosure could be an 'eye-opener' for them when they learn exactly the total fees that are being charged.

At Liberty, we understand that investors have many different services and products through which they can manage their investments. These options include one or a combination of the following:

- Investing in mutual funds;
- Investing in Exchange Traded Funds ("ETFs");
- Investing in stocks and bonds on their own through a self-directed account; and,
- Investing with an investment counselling firm, like Liberty.

Before investors select one or more of the above choices, they should be well aware of the pros and cons associated with each vehicle so their choice can be aligned with their investing style and preferences.

In this article, we provide background and discuss the pros and cons of investing in mutual funds and ETFs. We'll leave commentary on investing individually through a self-directed account or with a large financial institution for another time. The benefits of working with Liberty are explained on the Liberty website in The Liberty Manifesto.

Mutual funds

Mutual funds are professionally managed investment vehicles that pool funds from many individuals to invest in securities. These vehicles became widely available in the 1970s and grew in popularity during the bull markets of the 1980s and 1990s as interest rates fell and investors searched for yield.

Benefits of Mutual Funds

1. **Mutual funds offer a targeted investmen**t.

   Investors looking to participate in a particular style, geography or asset class can use mutual funds to achieve this. Examples of fund mandates include Large Cap, Indian Equities or a focus on infrastructure assets.

2. **Access to popular managers.**

   Mutual funds provide the public access to invest with well-known and often renowned investment managers that would otherwise only work with institutional investors. A famous example would be Peter Lynch and the Fidelity funds during the latter part of the last century.

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Drawbacks of Mutual Funds

1. **Fees are high and opaque**

   Mutual funds are actively managed holdings where the portfolio manager makes decisions and trades within the portfolio as they see fit. On top of the portfolio manager's management fee, the mutual fund must also absorb recurring accounting and marketing costs. Since mutual funds are often sold through an intermediary such as a stockbroker or financial planner, distribution fees are also tacked on to what investors must pay.

2. **Liquidity can be an issue**

   Mutual funds trade only once daily, generally later in the trading day or just prior to the market close. For investors looking for faster execution times or hoping to benefit from news on a particular holding, mutual funds provide a weak execution strategy.

ETFs

ETFs were created in response to the backlash from investors over high mutual fund fees. The first commercial available ETF was issued during the 1980s. These vehicles have grown in popularity as investments, topics for many books and the focus of many websites.

Benefits of ETFs

We believe there are five major benefits of owning ETFs. They are:

1. **Lower Fees**

   ETFs are passively managed. As such nobody is picking individual stocks. Rather, the investor gets the whole basket of the index, sector or country ETF. An example would be the S&P 500 Index ETF (SPYD), which is deigned to mirror the components of the S&P 500 and therefore does not require any stock picking. Because of this, the fees are much lower than actively managed mutual funds. That's because the mutual fund company faces higher costs such as the management fee, accounting and marketing expenses and fees for distribution (known as front-end or back-end loads).

2. **Liquidity**

   ETFs are traded like a stock. Unlike closed-end funds, the ETFs can be traded any time during market hours. If there is a particular event that drives an investor to make a purchase or sale, they can do so within the course of the trading day.

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3. **Diversification**

   An investor can gain instant diversification with the purchase of a single ETF. For example, the MSCI World ETF provides an investor with exposure to over 1,500 global companies.

   Or, if an investor wanted to diversify by assets, they could purchase a global ETF for stocks and one for bonds. All their investment goals could be accomplished in just those two ETFs.

4. **Control over Capital Gains.**

   Unlike mutual funds where the portfolio manager creates capital gains / losses through active trading, ETF investors can control the crystallization of capital gains themselves.

5. **Dividends can automatically be re-invested.**

   In most ETFs, dividends of companies in the basket can be re-invested immediately. The timing for closed-ended ETFs or index funds may vary.

<u>Disadvantages of ETFs</u>

Not everything is as it seems. There are disadvantages to owning ETFs. They include:

1. **ETFs rarely outperform the index**

   Investors will usually make the index return less the fees. They will rarely outperform the index due to the fact that even though the holdings are the same, the managers of the ETFs must be compensated, so fees are levied.

2. **You get the whole basket of holdings, not just the best**

   Within an ETF, there are great companies, mediocre firms and flat out bad stocks.

   We think that investors would have a better chance to perform well if they focus on the great companies and try to avoid the mediocre or bad ones. That’s where customized actively managed portfolios offer value.

3. **Tracking differences**

   In addition to the underperformance of an ETF relative to the index due to management fees, there are also tracking differences. If an ETF charges 1% to track an index, the ETF returns should lag the index return by 1%. However, there are other fees/charges that can cause the Total Expense Ratio to be higher. They include transaction and rebalancing costs, the timing of those transactions and the cash drag (the timing of

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dividend distributions). Over time, these additional charges can materially contribute to a divergence in performance of the ETF from the underlying index.

4. **Country indexes may be skewed to large companies**

   When considering the makeup of a country ETF, one stock could represent a large percentage of that index. Therefore, the performance of that index would be skewed by that one stock. For example, in late 2000, Nortel represented more than 40% of the S&P TSX Composite's value. This was great for holders of an S&P TSX Composite ETF as Nortel's price rose, but ultimately when the stock price fell, so did the value of the ETF.

5. **Equal-weighted versus market-cap weighted**

   Some ETFs contain stocks that are equally weighted – if there are 50 stocks in the ETF, the average holding will be two per cent. This is laudable for keeping performance equalized but it also requires more trading to keep the positions consistent. As a result, the greater the trading, the higher the costs.

   Some ETFs are weighted according to their market capitalization (share price x shares outstanding). This creates a performance skew as the ETF's return will be affected by the stocks with the largest market capitalization. Think of a situation where a stock increases in value faster than other stocks on the index. Under this scenario the stock will be responsible for a large component of the index's value. Unfortunately for investors, they are purchasing more of the stock as it becomes more valuable. This buying at inflated prices goes directly against the age old mantra 'Buy low, sell high'.

6. **Correlation among holdings with an ETF**

   The best way to avoid downside risk is to own a basket of stocks that aren't correlated with each other. Unfortunately, most ETFs have heavy correlation. For example, a Canadian ETF that matches the S&P TSX Composite will have over 30 per cent invested in financial institutions and resource stocks. If one or both sectors plummet, the underlying ETF will suffer.

7. **The Bid-Ask Spread May be Large**

   If the underlying ETF invests in illiquid companies, the costs will increase because of the bid/offer spread. For example, a large-cap company may have a bid/offer spread of five cents, while a more illiquid small-cap stock may have a bid/offer spread of 25 cents. The greater the spread, the greater are the costs.

8. **Holding costs of ETFs are usually higher than individual stocks**

   The commission costs paid to the broker to trade in and out of the position may be the same but investors are also saddled with the management fee levied by the group running the ETF.

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ETF Offspring: The Robo Advisor

Throughout the years investors have been subject to many investment 'crazes'. Be it tulips, high-yield bonds, tech stocks or subprime mortgages, there is always something new on the horizon. The latest 'craze' appears to be Robo Investing.

Robo Advisors bill themselves as a smarter, easier way to invest. For a relatively small service fee (usually 0.15% to 0.25% of the amount you invest), these companies tailor a portfolio of ETF investments for you using their proprietary algorithms. These ETFs have been handpicked by the people behind the Robo Advisor and tend to represent specific asset classes (e.g. equities, bonds, real estate) or investing styles (e.g. value, growth, or some combination). In essence, the Robo Advisor offers an asset allocation service layered on top of ETFs that all investors could access on their own.

The Robo Advisor will also regularly re-balance your portfolio and some have even gone so far as to incorporate basic tax minimization strategies. All you really have to do is answer a few questions, fund your account or link up to your brokerage account, and the investments are taken care of for you. It's the definition of "set and forget".

Robo Investing comes with additional costs and fewer services

Here are some things to remember if deciding to use a Robo Advisor service:

1) The total cost of investing is the ETF fees and the Robo Advisor management fee.
2) Robo Investors will optimize your portfolio based on the capital you give them but won't take into account other investments you may own. Therefore, they don't consider your entire financial picture.
3) Investors may have no input to how the money is invested. Therefore, there's no customization that caters to the individual.
4) Investors get no other financial planning or financial advice. If you want those services with a Robo Advisor, you'll have to pay more.

As always, be prudent and before you invest, consider all the pros and cons and then decide what's best for you.

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