FINANCIAL POST

Saturday, September 3, 2011

Investors finally get a break

Michael Nairne, Serious Money

Ken Cedeno/Bloomberg News

John Bogle, founder of Vanguard Group.

What is the single best predictor of a fund manager's ability to outperform his or her peers? Sorry, it isn't prior returns – we all wish it were that easy. Nor is it risk or the turnover in the fund. The unsurpassed predictor of a manager's relative performance is his or her fund's expense ratio.

In a study spanning 2005 through early 2010, Morningstar found that, as a group, cheaper funds beat their more expensive counterparts in every asset class and in every time period. Morningstar concluded, "Investors should make expense ratios a primary test in fund selection. They are still the most dependable predictor of performance."

Given the corrosive impact of costs on performance, Vanguard Group Inc.'s recently announced filing of a prospectus to offer an array of exchange-traded funds in Canada is a seminal event. Many Canadians are not familiar with the Vanguard story, but this firm's advocacy of low cost, long-term investing has been a game changer in the U.S. investment business.

Founded in 1974 by visionary John Bogle, Vanguard from its conception radically departed from industry practices. First, Vanguard has a unique ownership structure – it is owned by its U.S. domiciled funds, which, in turn, are owned by the fund shareholders. With its investors in the roles of both clients and owners, Vanguard is dedicated solely to their interests and manages all of their funds on an at-cost basis.

Second, Vanguard embraced very early the fact that low-cost index funds, on average, outperform higher-cost actively managed funds. In 1975, it launched the first index fund for retail investors, the Vanguard 500 Index Fund, designed to track the investment performance of the S&P 500. And the fund has delivered in spades. A major study in 2000 found the after-tax returns of the Vanguard 500 Index Fund beat those of 84% of its peers over the prior 20-year period.

Cost is a major reason. U.S. investors with as little as US$3,000 can invest in the Vanguard 500 Index Fund at a management expense ratio of 0.17%, while those with US$10,000 or more enjoy an expense ratio of 0.06%. In a glaring contrast, equity index mutual funds in Canada in 2010 had an average expense ratio of 0.87%, while actively managed equity funds had a management expense ratio of 2.29%. Consider this: The HST component of many Canadian funds' costs is higher than the total management expense of the Vanguard 500 Index Fund.

With Vanguard leading the way, assets in low-cost index mutual funds and exchange-traded funds (ETFs) in the United States have soared to US$2-trillion and now comprise 20% of long-term fund assets. In Canada, I estimate the comparable share is just over 6%; we are 10 years behind the United States in embracing low-cost index funds.

But the pace of change is accelerating. In 2010, Canadian investors poured nearly $10-billion into ETFs. Even the banks are jumping in. BMO Asset Management manages an array of ETFs, while RBC Global Asset Management is now entering the fray to compete with long-standing market leaders BlackRock Asset Management Canada Ltd. and Claymore Investments Inc.

This rivalry is great for investors, but it is Vanguard's entry that promises to ratchet up the heat and drive down costs another notch. In the United States, Vanguard is the standout leader in low expense ratios. According to Lipper, a fund consulting firm, Vanguard's average ETF expense ratio in the United States is

0.17%, less than one-third the industry average of 0.53%. Expect Vanguard to be the low-price leader in Canada as well.

Investors today face daunting hurdles to their financial success. Bond yields are at their lowest level since the Second World War. Stocks are breathtakingly volatile and, although increasingly fairly priced, aren't a bargain yet. Investors need a break somewhere and Vanguard is about to bring them one in the form of lower fees.

VANGUARD'S STARTING SIX

Six ETFs are expected to be rolled out by the end of this year. Fees have not been announced but Vanguard says they will be in line with Vanguard's low-cost philosophy.

- The Vanguard MSCI Canada Index ETF will track the MSCI Canada Index.
- Vanguard Canadian Aggregate Bond Index will track the Barclays Capital Global Aggregate Canadian Float Adjusted Bond Index.
- Vanguard Short-Term Bond Index ETF will track the Barclays Capital Global Aggregate Canadian Government/Credit 1-5 Year Float Adjusted Bond Index.
- Vanguard MSCI U.S. Broad Market ETF will track the MSCI U.S. Broad Market 100% Hedged to CAD Index.
- Vanguard MSCI EAFE Index ETF will track the MSCI EAFE 100% Hedged to Canadian Dollars Index.
- Vanguard MSCI Emerging Markets Index ETF will track the MSCI Emerging Markets Index.

-Michael Nairne, CFP, RFP, CFA, is the president of Tacita Capital Inc., a private family office and investment counselling firm in Toronto.