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# MoneySense

SPECIAL EVENT EDITION

# ROADMAP TO RICHES

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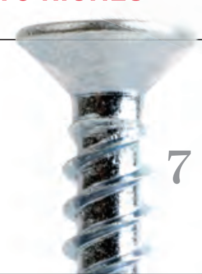
MAY 27, 2017



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Photographs by Nikki Ormerod (couch); Adrian Armstrong (money); iStock (screw); Illustration by Raymond Biesinger

# Find your Road to Riches

**WELCOME TO THE MONEYSENSE EVENT WHERE** we help you get on the right road to building wealth. Maybe you're getting started and don't have much money left after paying your bills. Relax, you have to start somewhere. We can help. Or maybe you have already been successful in building up a little nest egg but want to make sure you have your money in the right investments. We have you covered there, too.

At *MoneySense*, we encourage everyone to save and invest. And we think it's almost equally important to consider *how* you save and invest. In particular, we believe one of the smartest things you can do is keep your fees low. If you do that, while investing with a sound investment strategy, you are going to keep a lot more of your money. And that means you will have a lot more success in planning for a comfortable retirement down the road. That's what the Road to Riches event is all about. Getting on the right path —and staying on it.

I hope you enjoy this special edition of *MoneySense* magazine. In it, we have packaged up some of great stories that have run in recent issues, with a focus on portfolio strategy that has a low-fee bias. That includes our guide to the ETF All-Stars, a three-option approach to build your own Couch Potato portfolio and Norm Rothery's spicy spin on that classic passive index strategy, which we call the Hot Potato.

Visit us online and sign up for ***MoneySense Invest***, our new free weekly newsletter (follow the Subscribe link on our home page). And keep sending us your questions.

**DAVID THOMAS**
**letters@moneysense.ca**

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Note: Below are the answers to the Road to Riches quiz. Test yourself on page 26 then come back here for the answers. (No cheating.)

## HOW SMART ARE YOU?
ANSWERS

### NOVICE

**01 FALSE.**
If you're in a low tax bracket (earning, say, $50,000 or less), you'd be better off with a TFSA and saving your RRSP contribution for when you're in a higher tax bracket.

**02 B) A low credit score.**
If you have a credit score below 500 you will not qualify for a mortgage.

**03 C) Price-to-earnings ratio.**
A P/E ratio is a way to value stock prices.

**04 A) Management Expense Ratio.**
Think of the MER as the cost to own a fund. It covers the operating costs, like the cost to buy and sell stocks, and the management fee, which pays the portfolio manager.

**05 FALSE.**
There is no law or regulation that requires you to use a real estate agent during a purchase or sale of a home (or any other piece of real estate).

**06 C) $2,000 per year.**
For a simple portfolio you can expect to pay fees equal to about 0.8% of your assets in your portfolio.

### INTERMEDIATE

**01 D) Student loans.**
Student loans are better dealt with separately as borrowers are eligible for tax credits on interest.

**02 TRUE.**
They include cash, mutual funds, stocks and GICs. They're all fair game.

**03 NO.**
There is a term for this: Superficial tax loss. In order to make the tax claim you must wait 30 days before repurchasing the shares.

**04 FALSE.**
While you do have to pay a penalty to break any type of mortgage, you will pay less to break a variable rate mortgage, sometimes much, much less.

**05 A) Withdraw 4%.**
Barring some significant medical advancements that improve longevity, your nest egg should last 30 years if you plan to withdraw 4% per year.

**06 B) $50,000 per beneficiary.** You can contribute $50,000 per beneficiary, but that can be significantly increased with government contributions.

### EXPERT

**01 C) $52,000.**
The TFSA debuted in 2009 and even though annual contributions have fluctuated from $5,000 annually to $10,000 annually (depending on the year), as of Jan. 1, total cumulative contribution room for those over 30 is $52,000.

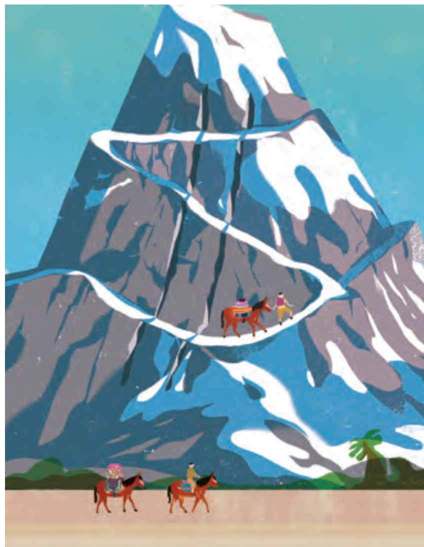
**02 FALSE.**
While it is mostly true that your investments grow tax-free, there is still some tax leakage. If you have any U.S. holdings that pay a dividend those dividends are subject to a 15% withholding tax.

**03 D) All of the above.**
Limit orders will help protect you from seeing your order filled at a price you didn't expect.

**04 A) Trigger a capital gain.**
Capital losses will be denied on 'in kind' contributions to registered accounts. In order to be able to claim the loss, you will need to sell the investment and contribute the cash.

**05 TRUE.**
Stiff interest penalties of 1% per month on money owing accumulate until the debt is paid off. This is very onerous so it makes sense to move a tax bill up in priority. Once it's gone, proceed with the debt snowball like normal.

**06 FALSE.**
While filing your taxes annually is a smart habit, if you know you are getting money back there is no penalty to filing late—although why you would procrastinate if you're owed a refund is beyond us.



ASK MONEYSENSE

# How Active is your Passive?

ETFs used to be about tracking the market, not trying to beat it. Now a new breed of funds is turning that idea on its head. Here's a closer look at smart beta **by Dan Bortolotti**

**ETFs** used to be about tracking the market, not trying to beat it. Now a new breed of funds is turning that idea on its head. Exchange traded funds, or ETFs, have long been the cheap, boring building blocks of *MoneySense*'s passive Couch Potato portfolios. The oldest and best-known ETFs simply hold all the stocks in a popular index, such as the S&P/TSX60, which includes the 60 largest companies in Canada. No, new ETFs that specialize in certain sectors are no longer on the fringes. But are these "smart-beta ETFs" really worth adding to your portfolio?

Keep in mind that in finance, beta is a measure of risk: A stock with a high beta is more sensitive to the stock market's ups and downs than one with a low beta. And because an index fund is designed to mimic the performance of the overall market—no more, no less—people sometimes describe this strategy as "capturing beta"

At the other end of the spectrum are active investors, who try to outperform the indexes by picking stocks or timing the market. They are said to be looking for "alpha," the excess return over and above the performance of the benchmark.

Small beta falls somewhere in the middles of these extremes. And while smart-beta ETFs are more expensive than the Couch Potato products of yore, they are a lot cheaper than traditional active funds, which routinely carry fees of 1% to 3%. Smart-beta ETFs typically have fees in the range of 0.15% to 0.75%, which mean they only need a small edge to outperform.

Here's how they work. Smart-beta ETFs are designed to target what are called "factors," or shared characteristics that can help explain the risk and return of a group of stocks. This term is really just jargon for things like low price, small company size, and patterns in price movements. Decades of academic research have shown that these factors have led to outperformance over the very long term and in almost all countries. So before you start building a portfolio with ETFs that promise exposure to these factors, here's a rundown of the five factors and what to know about them:

**VALUE.** It's well understood that stocks priced cheaply relative to their fundamentals delivered higher returns than the overall market. There are several ways to define a value stock, but the most common measures are low price-to-book and price-to-earnings ratios. Stocks with high dividend yields are sometimes also lumped in with value stocks.

**SIZE.** When it comes to stock returns, bigger is not better. Small companies deliver higher returns than large companies over the very long term. The cut-off is typically a market capitalization of $2 billion or less.

**MOMENTUM.** There's lots of evidence that when stocks rise in price they continue that trend for months before eventually coming back to earth. Likewise, stocks that have recently fallen in price tend to keep dropping in the medium term. The sweet spot for these trends seems to be longer than two or three months, but less than one year.

**LOW VOLATILITY.** It's counterintuitive but low volatility stocks actually tend to outperform—if not earning higher returns, then at least similar returns with less risk.

**QUALITY.** Generally speaking, low-debt, profitable companies tend to outperform. While that might seem obvious, it's not, because these high-quality companies should be expected to have higher stock prices. Yet there's evidence they have delivered out-sized returns even if they're not cheap.

The promise for outperformance by tapping into these factors is tempting. For instance, in the U.S., large value stocks outperformed the S&P 500 by more than two percentage points annually from 1935 to 2015.

## Build a more strategic ETF portfolio—for less

Here's a sample of the smart-beta ETFs offered by Canadian fund providers. Notice that ETFs with same objective (such as targeting value or low-volatility stocks) often use very different strategies. This makes it difficult for investors to decide which ones to choose

| Smart-beta ETF | Ticker | MER | Factor | Strategy |
|---|---|---|---|---|
| iShares Canadian Value Index ETF | XCV | 0.56% | Value | Screens for stocks with low price relative to earnings, book value and dividend yield. |
| First Asset Morningstar Canada Value Index ETF | FXM | 0.68% | Value | Screens for stocks with low price relative to earnings, cash flow, book value and sales, plus upward earnings revisions. |
| Vanguard Global Momentum Factor ETF | VMO | 0.39% * | Momentum | Selects stocks based on price momentum during previous six to 12 months. |
| First Asset MSCI Canada Quality Index Class ETF | FQC | 0.66% * | Quality | Selects profitable Canadian companies with stable earnings and little debt. |
| BMO MSCI USA High Quality Index ETF | ZUQ | 0.34% | Quality | Selects profitable U.S. companies with stable earnings and little debt. |

* Estimated based on management fee.

illustration by Jenn Liv

# START

OUR BEST TIPS

## THE NEW RULES OF MONEY

Some rules about saving, spending and retirement are changing fast. Here are 3 to consider:

■ **Is saving 10% of your gross income enough?** Unfortunately, no—not to guarantee a good retirement. "This was never a good savings rule, because the amount you need to save varies according to your income," says Dan Bortolotti, a certified financial planner with PWL Capital in Toronto. In fact, if you're a high-income earner—making $150,000 or more annually—you should be saving a lot more than 10% (20% or more may be required).

■ **Renting can be the smart choice.** Sometimes it just makes more sense to rent, and invest the savings. For those who live in Toronto or Vancouver, the average rent for a downtown condo is about $1,700, while the average resale value of that same condo hovers just above $375,000. Factor in the monthly maintenance fees and the cost to own can add $200 or more per month, Rent, invest the extra, and in 10 years you could save $31,300 (assuming a 5% annual return and no change in rental rates).

■ **Forget Freedom 65, too?** The new rule should be retire at 70, says John De Goey, portfolio manager with iA Securities. Why? Longevity has increased and CPP, OAS and company pension plans are simply inadequate to sustain a comfortable life style for 30-plus years.

# Savings advice at every age

With all of life's competing financial priorities, it's easy to overlook the benefits of saving and using an RRSP for retirement planning. We have some age-specific advice to help you squeeze more into your savings.

**YOUR 20s: Focus on fees.** It's usually best to go with lower-cost mutual funds and other financial products but if you're getting good service, it may make sense to pay a bit more. But with money tight, GICs and working with a robo-advisor makes sense.

**YOUR 30s. Priority planning.** Consider a mix of Tax-Free Savings Accounts (TFSAs) and Registered Retirement Savings Plans (RRSPs) to save you money at tax time.

**YOUR 40s. Pin-point your asset allocation.** As you get closer to retirement, you may want to take less risk with your investments. But this isn't for everyone. Talk it over with a financial advisor and choose an asset allocation that suits your investment style and takes into consideration company pensions and other stable income you may have coming your way when you leave the workforce.

**YOUR 50s AND 60s. The consolidation conundrum.** You've probably been a great saver and investor all your life, but your 50s is the time to consolidate all the accounts you have throughout several financial insitutions. Try to consolidate to one bank that suits your needs.

*Condensed from a "The Savvy Investor's Guide to RRSPs" by **Bryan Borzykowksi** from the February/March 2016 issue of* MoneySense

# DON'T GET SCREWED

**Too many investors are being poorly served by the advisors managing their life savings. In fact, the financial industry is frequently guilty of doling out bad advice, delivering indifferent service, peddling awful products and charging too much for the privilege. Here's a six-point plan to help you avoid falling victim:**

**Licensed to sell.** Some of the saddest cases of financial abuse involve criminals posing as legitimate advisors. So before becoming a client of any financial advisor, take the time to find out which type of license they hold and which investments they're allowed to sell. Simply go to aretheyregistered.ca. Anyone licensed by the MFDA or IIROC, or who holds the portfolio designation, should appear in this database. (Insurance and financial planners will not, however, unless they are also licensed investment advisors.)

**Risky business.** Make sure the investments registered to you are suited to your risk tolerance. And make sure your advisor is recommending investments appropriate to your goals, experiences, income and risk tolerance.

**The fine print.** Make sure you never sign a blank form when opening new accounts with an advisor. Take it home and review it before signing. And make a copy for your own files.

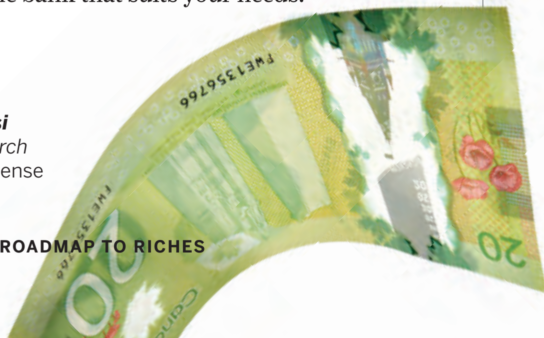
**Borrowing time.** Don't borrow to invest. Be suspicious of an advisor who gets pushes this idea.

**Buyer beware.** Avoid buying mutual funds with deferred sales charges (DFCs), also known as back end loads. They lock you into products for several years and you'll have to pay a penalty to get out. Better to walk away from these.

**In your best interest?** Look out for the Client Relationship Model (CRM2), a series of regulatory changes to be fully implemented by the end of this year. It requires full fee disclosure by advisors in both dollars as well as percentages, and provides you with an annual report that includes your personal rate of return.

*Condensed from Screwed, by **Dan Bortolotti**, first printed in the January 2016 issue of* MoneySense.

Photograph by Adrian Armstrong; iStock



# START

PORTFOLIO FIX

## A portfolio built to minimize taxes

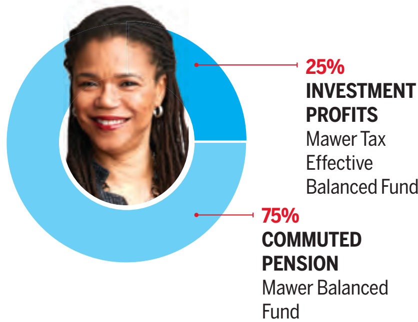
Marie Lewis wants to minimize taxes on savings and grow the pension money in her LIRA

### THE PROBLEM

The 58-year-old business analyst from Toronto plans to retire in a couple of years, but needs to invest two recent windfalls. Last month, she transferred the six-figure commuted value of her company pension to a Locked-in Retirement Account (LIRA). She also sold an investment property and has an extra $60,000 to invest. Lewis plans to use the money to augment CPP and OAS payments at age 65. She wants a low-cost, tax-efficient portfolio that's easy to manage on her own. Lewis has a 60/40 RRSP portfolio of equities and fixed income but is debating taking on more risk with the money. "I'd like an after-tax return of 3% annually so the money lasts."

### THE FIX

Calgary-based certified financial analyst Paul Wheaton says Marie needs a simple, balanced portfolio. In fact, just two low-fee, stellar-performing Mawer mutual funds with 60% equities and 40% fixed-income holdings will allow Lewis to meet her goals with little volatility. Wheaton recommends Lewis invest 100% of her LIRA money in the Mawer Balanced Fund, and 100% of the money in the taxable account in the Mawer Tax Effective Balanced Fund. Both funds give exposure to a broad mix of asset classes at a low MER of just 0.94% annually. "The funds invest in companies trading at a discount to their intrinsic value," says Wheaton. As well, the tax-effective version is more tax-efficient for non-registered accounts. Distributions from the funds are re-invested, and Lewis can set up simple automatic withdrawals, he says. *—Julie Cazzin*



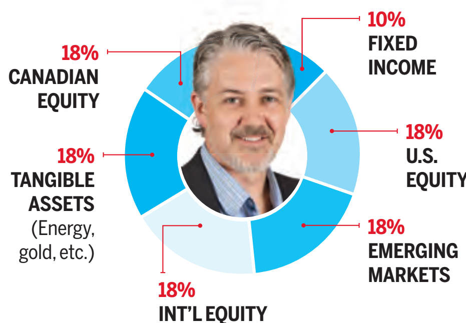

PORTFOLIO FIX

## Seeking a simpler, more diversified portfolio

Jeff Hudson is a DIY investor who wants fewer and easier to monitor holdings

### THE PROBLEM

The 47-year-old business owner from Kelowna, B.C., is a busy man. He's a DIY investor who manages RRSPs and TFSAs for himself and his wife Debbie, 52, but he doesn't always have the time to carefully review their portfolio. "I stick to the couch potato for half our RRSPs, but get impulsive and stock pick the rest of the time for all the accounts," says Jeff. The result? A portfolio that's hard to manage, is seldom rebalanced and whose performance is difficult to assess. With no company pensions, Jeff wants their money to grow tax-efficiently for retirement. He considered hiring an investment advisor, but wasn't comfortable paying a 2% fee. At some point he says he'll likely need help, but for now wants a simple DIY strategy.




### THE FIX

John DeGoey, portfolio manager with Industrial Alliance Securities in Toronto, says the biggest problem with Jeff's portfolio is that it's too exposed to Canada. "Home country bias is a common problem with investors," says DeGoey, who recommends Jeff lower his Canadian equity holdings to 18% from 41%. Jeff is overexposed to energy and pipeline stocks. On the flip side, he has little exposure to emerging markets, which provide diversification with strong growth. DeGoey believes Jeff should double his holding in this area to 18%. With a growing portfolio it makes sense to consider independent financial advice, which may not be as pricey as Jeff believes. *—Julie Cazzin*

Photographs by Darren Hull; Micah Bond

FAMILY PROFILE

## Sharing the wealth

Francine, 50, wants to retire, sell her business and be fair to all her kids in the will. Can she?

**THROUGH HARD WORK,** Francine Rousseau, 50, built a software business worth more than $1 million that pays her an annual salary of $180,000. As a single mom to Freddy, she worked 24-7 to make a success of herself and her business. Now, with second husband Gabriel, 58, and on the brink of retirement, she'd like to write her will and sell her business.

But she's hesitant because Gabriel, a social worker making $55,000 annually, earns much less than she does. Even though they've been married 14 years, Francine says that all of the $1.3 million they have in savings are a result of her hard work. Complicating the decision is the fact that Gabriel has two children from a previous marriage. "I want our wills to be fair but am having trouble convincing myself that leaving three equal shares is really the right thing to do. I want to leave more to my son Freddy but I really don't want to be unfair. What should I do?"

### EXPERT ADVICE

**Sort out insurance and wills.** She needs a will—fast. "If she died tomorrow, everything would go to her spouse and that's it," says wills and estate lawyer Ed Olkvovich.

**Take care of the kids.** Francine can give to Freddy without penalizing her step-children by purchasing a $500,000 term life insurance policy that would cost Francine $5,590 a year. As beneficiary, Freddy will get the money tax-free when she dies. Then they split the rest three equal ways.

**Get an exit strategy** for the business. She needs financial advisors. "If she can transition for two or three years where she works only a few months, she can retire seamlessly," says Toronto career coach Caird Urquhart.

PORTFOLIO STRATEGY

# Top portfolio tips from the pros

We collect some investment advice from investment managers. The stories ran in 2016 and have been edited to focus on general advice, given that specific stock tips may no longer apply. Always do your own homework when investing **by Bryan Borzykowski**

**1** "The demand for dividends isn't going to disappear anytime soon. North America's population is also getting older—the first baby boomers turned 70 in 2016—and aging investors have always loved dividends. They want to protect capital, save money and generate income. So how do you find good dividend stocks? "When buying dividend-payers, watch the payout ratio, which is the percentage of earnings a company pays out in dividends—it depends on the sector, but generally you don't want the number to be too high compared to its peers, between 40% and 80% depending on the sector. As well, look at free cash flow, how much debt a company is carrying—a debt-to-EBITDA ratio of three times is getting high—and how they're spending their money. It's a good sign if a company has money left over after paying for capital expenditures and dividends."

**Jason Gibbs,**
a portfolio manager with 1832 Asset Management

**2** "Stay away from businesses that are spending more than they take in. One of the worst things that can happen to one of these companies is a dividend cut."

**Jason Gibbs,**
a portfolio manager with 1832 Asset Management

**3** "Europe has been a challenge. Low interest rates and quantitative easing has caused high-quality stocks to rise without actually fixing the Eurozone's problems. A lot of attention has been given to Europe's multi-nationals, which has left a number of well-run small- and mid-caps out of the limelight. We're finding better value in this space."

**Matt Peden,**
lead manager of the Trimark Europlus fund, which has a five-star Morningstar rating, and has 20% of its assets in cash

**4** "Many emerging market nations, such as Russia and Brazil, have become incredibly cheap. Compared to their historical averages, some markets are trading at a 30% discount. I like Russia, which has a number of stocks trading at below 10 times earnings and is now benefitting from rising oil prices. "

**Gerardo Zamorano,**
a director at Brandes Investment Partners, which specializes in emerging markets

**5** "There are a number of bright spots here in Canada. I'm keen on Canadian companies that have international exposure, and in particular, exposure to the U.S., which continues to see decent growth."

**Vishal Patel,**
a North America-focused manager with Dynamic Funds

**6** "Canada's banks and telecoms are interesting. They're oligopolies, which is usually positive for stocks, and their services will almost always be needed."

**Vishal Patel,**
a North America-focused manager with Dynamic Funds

**7** "I'd suggest putting 30% of one's North American portfolio in domestic equity and 70% in the U.S. You want the long-term sustainable companies and while you get that with, say, the Canadian banks, you also want the Googles and the Microsofts of the world. If you're just in Canada, you're making a call on commodities."

**Vishal Patel,**
a North American-focused manager with Dynamic Funds

**8** "I like a U.S. business with little or no leverage today, so when rates rise again these companies won't be affected. I'm also interested in operations that are making money now, versus ones that are promising big profits in the future."

**Colin Wong,**
co-manager of Mawer Investment Management's five-star Morningstar rated U.S. Equity Fund

**9** "Credit card companies, such as Mastercard and Visa, they have no balance sheet, they just make money when you order coffee. Auto parts companies meanwhile make replacement parts for many different types of vehicles. These attributes make these sectors attractive."

**Colin Wong,**
co-manager of Mawer Investment Management's five-star Morningstar rated U.S. Equity Fund

**10** "It's only a matter of time until yields rise and bond prices fall."

**Philip Petursson,**
managing director at Manulife Investments

There are thousands of ETFs on the market. Our panel samples them all to identify the best bets for each major category

**BY JONATHAN CHEVREAU**

# THE BEST ETFs FOR 2017

Ordering a pizza online always involves more work then you expect. First you pick the flour or spelt and the thickness of the dough. Then it's the sauce and baking instructions. And that's all before you pick from a list of 75 toppings.

Unfortunately, no matter how much you try to design the perfect pizza, you discover that too many toppings results in a soggy, undercooked pie. We think endless choice is better, but that's just not the case with pizza. And guess what, it's the same with ETFs.

According to the Canadian ETF Association there are more than 450 exchange-traded funds (ETFs) trading on the Toronto Stock Exchange with more being added on a regular basis. As if that not daunting enough, there are thousands more for to choose from on U.S. and foreign exchanges.

But the average investor needs far fewer ingredients to cook up a portfolio that is as magnifico as a Pizza Quattro Stagioni. How many? You could make the case for building a portfolio of just four ETFs, providing you with a healthy mix of Canadian, U.S. and international equities as well as your fixed-income needs.

The 2017 edition of the *MoneySense*

Photograph by Adrian Armstrong

ETF All-Stars does just that, providing three recommendations in each of the three major equity categories, plus five in the fixed-income category. Selecting from this short list, either on your own or with a trusted advisor, should be a straightforward exercise.

Regular readers of *MoneySense* will recognize this as a classic "Couch Potato" approach to investing: Create a simple investible portfolio that can be held for the long term, is broadly diversified, highly tax-efficient and yet carries minimal investment management costs. In effect, this four-fund portfolio is the equivalent of a global balanced fund, but with a much lower cost.

As in prior years, our mandate to the panel was to focus only on ETFs trading on the Toronto Stock Exchange, which simplifies the currency issues that arise if Canadian investors buy ETFs trading on U.S. or foreign stock exchanges. That said, our picks include both ETFs that provide both direct unhedged exposure to foreign equities, as well as some that hedge back into the Canadian dollar (but all still trading on the TSX).

This is the fifth instalment of the All-Stars: the first was published in February 2013. Only three of the 14 ETFs identified in that original report remain on our list. New products and increasing competition have been a win for investors. Nowhere is this more obvious than in the management fees charged by our All-Star funds. A balanced portfolio made up of the original ETFs would have had an MER of around 0.3%. The same portfolio mix comprised of our current ETF All-Star today would have an MER half that amount.

That might not sound like a big deal until you consider how that would affect a portfolio over time. The difference on a $100,000 portfolio earning 3% a year would be more than $7,000 in additional fees over 25 years.

Readers will be happy to discover 12 of last year's 14 picks are back (sporting an even slimmer overall MER). So too is our panel, which was almost unanimous in making the two tweaks to the previous line-up, affecting our top picks in US equities and fixed income.

In both cases, slightly lower cost was the motivating factor. Yves Rebetez, a member of our esteemed panel and editor of ETF Insight, notes these changes "further reduce the overall MER of the All-Stars as a package."

From the get-go our goal was not to feature the ever-changing ETF flavours of the month, but to create a low-cost core portfolio of broadly diversified investments that could serve for years if not decades.

## CANADIAN ETF ALL-STARS

**Our picks of the best, low-cost Canadian-focused ETFs for your portfolio**

Home country bias or no, Canadian equities remain the core asset class for domestic investors, in both registered plans and taxable ones. Our expert panel saw no reason to tinker with its three solid picks from last year.

The Vanguard FTSE Canada All Cap Index ETF (VCN) and iShares' Core S&P/TSX Capped Composite Index ETF (XIC) each provide broad market exposure to 221 and 250 domestic stocks, respectively, and both sport a rock-bottom management fee of 0.05% or five basis points (MERs, which include the management fee and trading costs, are 0.06%). VCN was launched in August of 2013 so now has three-year performance data. XIC was launched in 2001 and has 10-year data.

For taxable plans, the Horizons S&P/TSX 60 ETF (HXT) continues to give non-registered investors favourable tax treatment, by effectively commuting dividends into capital gains that won't be realized until the units are sold some time in the (hopefully) far future.

## U.S. ETF ALL-STARS

**Our picks of the best, low-cost U.S.-focused ETFs for your portfolio**

For Canadians, the United States remains the first international market to consider outside our own borders. Under the new administration of Donald Trump the United States stock market should remain a must-own asset class for diversifying beyond the three main sectors of the domestic market: Energy, materials and financials.

Our panel continues to put its faith in the S&P 500 index, the premier benchmark of money managers everywhere. As in 2016, our two Vanguard picks provide low-cost exposure to this key asset class in both currency-hedged (VSP) and unhedged (VFV) versions: Vanguard S&P 500 Index ETF (CAD-hedged) trading under the ticker VSP; and Vanguard S&P 500 Index ETF, trading as VFV. Both trade on the TSX and provide exposure to 508 large-cap U.S. stocks at a very economical 0.08% management fee.

However, the panel decided to replace the third Vanguard ETF in this category, VUN, with a new offering, iShares Core S&P US Total Market Index ETF (XUU), launched in 2015. XUU officially has four holdings, but that's somewhat misleading.

Each of those four holdings are broadly diversified ETFs: 58% is in the iShares Core S&P500 ETF, 30% in the iShares Core S&P Total US Stock ETF, and 6% in each of the Core S&P Mid-cap and Small-Cap ETFs. When you add up the holdings from all of those funds XUU provides exposure to 3,693 holdings, which is about as diversified as anyone could wish. Generally, we urge readers to scrutinize at least the top holdings in any fund (whether equity or fixed income) to get a feel for the businesses they are tiny part-owners in.

"Now that iShares has put XUU in its core fund category and lowered the MER to 10 basis points it's hard to ignore as a potential candidate," says Alan Fustey, one of our cadre of experts and a portfolio manager with Index Wealth Management.

## FIXED-INCOME ETF ALL-STARS

**The best, low-cost fixed-income ETFs for your portfolio**

Four of our five fixed-income picks are back. The big change, almost unanimous by the panel members, was the removal of

### OUR ETF ALL-STAR PANEL

**Justin Bender** is a portfolio manager with PWL Capital in Toronto, and **Dan Bortolotti** is an investment advisor at the firm. They use ETFs for their full-service clients and also help do-it-yourself investors set up their own ETF portfolios.

**Tyler Mordy** is president and chief investment officer at Vancouver-based Forstrong Global Asset Management. The firm specializes in global ETF portfolios for retail and institutional clients.

**Mark Yamada** is CEO of Toronto's PUR Investing, which builds ETF portfolios for both individuals and institutional clients.

**Yves Rebetez**, CFA, is the editor of ETF Insight. Prior to launching the website, he was vice-president of ETFs/Structured Products with RBC Dominion Securities from 2004 to 2011.

**Alan Fustey** is a portfolio manager at Index Wealth Management in Winnipeg. He's been using ETFs with clients for more than a decade.

# ETFs THE BEST FOR 2017

These are the best broad-market ETFs in each major category, as chosen by our panel of experts.

| | TICKER | MANAGEMENT FEE | NUMBER OF HOLDINGS | DESCRIPTION |
|---|---|---|---|---|
| **CANADIAN ETF ALL-STARS** | | | | |
| Vanguard FTSE Canada All Cap Index ETF | VCN | 0.05% | 221 | Exposure to Canadian small, medium and large caps, ultra low fee |
| iShares Core S&P/TSX Capped Composite Index ETF | XIC | 0.05% | 250 | Tracks Canada's best known index with a very low fee |
| Horizons S&P/TSX 60 ETF | HXT | 0.03% | 60 | Tax-efficient; rock-bottom 0.03% fee to extend at least till September 2017 |
| **U.S. ETF ALL-STARS** | | | | |
| iShares Core S&P US Total Market Index ETF | XUU | 0.07% | 3,693 | **NEW!** Replaces VUN because of slightly lower cost |
| Vanguard S&P 500 Index ETF | VFV | 0.08% | 508 | Provides unhedged exposure to the S&P500 at a very low cost |
| Vanguard S&P 500 Index ETF (CAD-hedged) | VSP | 0.08% | 508 | Provides currency-hedged exposure to the S&P 500 at no extra cost |
| **INTERNATIONAL ETF ALL-STARS** | | | | |
| iShares Core MSCI All Country World ex Canada Index ETF | XAW | 0.21% | 5,833 | Global all-cap fund that's lower cost and tax efficient |
| iShares Core MSCI EAFE IMI Index ETF | XEF | 0.20% | 2,408 | Broad coverage of Europe, Japan & Australia |
| Vanguard FTSE Emerging Markets All Cap Index ETF | VEE | 0.23% | 4,249 | Emerging Markets index that tracks China A shares |
| **FIXED-INCOME ETF ALL-STARS** | | | | |
| BMO Aggregate Bond Index ETF | ZAG | 0.09% | 617 | **NEW!** Lowest-cost bond ETF in Canada, replaces VAB |
| Vanguard Canadian Short-term Bond Index ETF | VSB | 0.10% | 336 | Government and corporate bonds with average term of three years |
| BMO Discount Bond Index ETF | ZDB | 0.09% | 79 | Tax-friendly alternative for non-registered accounts |
| First Asset 1-5 Year Laddered Government Strip Bond Index ETF (BXF) | BXF | 0.20% | 25 | Unique structure beats other short-term bond funds after tax |
| BMO Laddered Preferred Share Index ETF | ZPR | 0.45% | 170 | Five-year ladder of "rate reset" preferred shares |

VAB, Vanguard Canadian Aggregate Bond Index ETF, and its replacement by ZAG, the BMO Aggregate Bond Index ETF. Our panelists from PWL Capital championed this swap, but the whole panel endorsed it. As Tyler Mordy, president and chief investment officer at Vancouver-based Forstrong Global Asset Management, explains that the lower MER (0.09% versus 0.12% for VAB) was a factor, although "both funds have great liquidity and tight spreads."

In a blog comparing the two ETFs, PWL Capital investment advisor Dan Bortolotti said "BMO's aggressive cost-cutting has made ZAG the cheapest bond ETF in the country, with a management fee of just 0.09%" that has been in place since June 2016. One benefit of ZAG is that BMO offers a companion fund designed for taxable accounts: the returning All-star BMO Discount Bond Index ETF (ZDB). So by using ZAG in registered accounts and ZDB in taxable accounts, investors can get similar bond market exposure with maximum tax efficiency.

However, Bortolotti cautions that VAB and ZAG have slightly different risk exposures: ZAG has 30% in corporate bonds versus VAB's 20% corporates, which is why ZAG has slightly fewer government bonds and hence a slightly higher yield to maturity.

BXF, First Asset's 1-5 Year Laddered Government Strip Bond ETF, is back for a second year, based largely on its tax efficiency in non-registered accounts. And the panel retained ZPR, the BMO Preferred Share Index ETF, although Rebetez made a strong case for an actively managed alternative, HPR, the Horizons Active Preferred Share ETF. Ⓜ

Advertisement

# TAKING A CLOSER LOOK AT THE ETF INVESTOR IN CANADA

- BY WARREN COLLIER

## Two types of investors seem to be emerging in Canada: Those who use ETFs now and those who want to use ETFs in the future.

Nearly one-third of Canadians now own exchange traded funds, according to the BlackRock ETF Pulse survey, with 93 per cent of these owners planning on purchasing more ETFs over the next 12 months.

But 38 per cent of non-ETF owners are also interested in purchasing ETFs in the next 12 months and 62 per cent of them expect to begin using ETFs at some time in the next three years.

While that's not total buy in just yet, this growing show of interest for exchange traded funds bodes well for future ETF growth in the country and helps explain the investment vehicle's impressive trajectory over the past decade. Last year included another near record of $16.6 billion in net flows that brought total ETF assets under management in Canada to roughly $114 billion at the end of December.

Conducted in September 2016, the Pulse survey also revealed some detail on the "who" and "why" of ETF investing in Canada.

For starters, investors who own exchange traded funds tend to be younger and more engaged with their investments than those who do not own them. They are more likely to be invested in the market as well. ETF owners have an average of just 19 per cent of their portfolio in cash, while non-owners hold 35 per cent, the survey said.

ETF owners also tend to have lower allocations to mutual funds than non-owners who indicated that they would ideally like to hold less mutual funds than they do now (33 per cent of ideal portfolio versus 40 per cent of current).

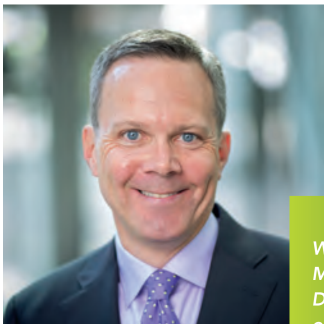
Not surprisingly, low management fees are the top benefit cited by ETF owners, followed by the ability to diversify and reduce risk as opposed to holding individual stocks and bonds.

One area of the Pulse survey that could fall under the "needs improvement" category, however, is the relatively limited awareness of ETFs outside those that offer exposure to broad stock market indexes.

Only 21 per cent of those polled are aware of/or familiar with bond ETFs and that number drops to 7 per cent for both active and smart beta ETFs. Fortunately, most people are curious to learn more about exchange traded funds – whether it's from a financial advisor, financial media or online – suggesting significant growth potential in these areas. In fact, that potential is already being realized.

Fixed income is one of the fastest growing ETF segments in the country with an annualized growth rate of more than 20 per cent over the past five years.

All in all, the BlackRock ETF Pulse survey confirms the growing appeal of ETFs in Canada and the critical role they increasingly play in portfolios. This momentum may build from here.



*Warren Collier, Managing Director, is Head of the Canadian iShares business*

## THREE TIPS FOR TRADING ETFs

The use of exchange traded funds is growing in Canada and around the world in part because they are simple to access on global stock exchanges just like most other publicly-traded equities. Here are a few tips to consider that may help you trade ETFs more effectively.

**1**

9:40am

3:40pm

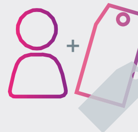
**Timing of the Trade**

Consider placing trades between 9:40am to 3:40pm EST. The 10 minutes after North American markets open at 9:30am and 20 minutes before they close at 4pm EST may be potentially volatile and sometimes result in slightly higher trading costs. Investors should also consider market news and events such as central bank announcements and corporate earnings results that may impact pricing throughout the day.

**2**

**Cost of the Trade**

Many of Canada's discount brokers offer ETFs without commissions, but it pays to do your homework and shop around before placing your trade. Firms often have a set menu of commission-free ETFs, but charge a regular amount for the rest. Some brokerages also may require a minimum purchase amount or let investors buy an ETF for free, but then charge them for selling it.



**Execution of the Trade**

Although there are many different types of trade orders to choose from when buying and selling securities, investors should consider using limit orders to trade ETFs. Limit orders offer investors the chance to set a target price at which they are willing to buy and/or sell shares of a particular ETF. This sets some controls around execution levels and helps ensure that the price of the trade matches objectives.

**3**

**For more information, visit the iShares ETF Education Centre at iShares.ca**

iShares® by BLACKROCK®

The BlackRock Canada 2016 ETF Pulse Survey is a Canadian study into the role of ETFs among Canadian investors, executed by Market Strategies International, an independent research company. Over 400 respondents interviewed were a nationally representative online sample of household financial savings/investment decision makers, age 21–75, with minimum investable assets of $100K and aware of ETFs. All respondents were interviewed using an online survey. This study was sponsored by BlackRock Asset Management Canada Limited and its affiliates. iShares® ETFs are managed by BlackRock Asset Management Canada Limited. Commissions, trailing commissions, management fees and expenses all may be associated with investing in iShares ETFs. Please read the relevant prospectus before investing. The funds are not guaranteed, their values change frequently and past performance may not be repeated. Tax, investment and all other decisions should be made, as appropriate, only with guidance from a qualified professional. This material represents an assessment of the market environment as of the date indicated; is subject to change; and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the funds or any issuer or security in particular. The strategies discussed are strictly for illustrative and educational purposes and are not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. There is no guarantee that any strategies discussed will be effective. © 2017 BlackRock Asset Management Canada Limited. All rights reserved. **iSHARES** and **BLACKROCK** are registered trademarks of BlackRock, Inc., or its subsidiaries in the United States and elsewhere. Used with permission. 141706

# THERE'S MONEY IN YOUR COUCH

# Our ultimate Couch Potato Portfolio guide offers three low-fee, low-fuss ways to get rich. Find the right one for you—then sit back and watch your wealth grow

**BY DAN BORTOLOTTI**

Do you think spending your evenings studying annual reports and researching mutual funds is the recipe for building wealth? If you've spent any time with *MoneySense* you know there's a different way: the Couch Potato strategy. For those new to the idea, it's a simple method of building a diversified, low-maintenance portfolio of index funds designed to deliver the returns of the stock and bond markets with minimal cost. Instead of trying to beat the market, index funds simply try to match it—and by doing so they've consistently outperformed the vast majority of actively managed funds over the long term.

While the premise of the Couch Potato remains the same, a lot has changed since the magazine brought the strategy to Canada 17 years ago. The portfolios have long included the same four components—bonds, Canadian stocks, U.S. stocks and international stocks—but there are many more fund options than there were at the turn of the millennium. As a result, our recommendations have evolved. While investors now have more ways to assemble a Couch Potato portfolio that suits them best, the variety has also caused confusion for those looking to get started with indexing.

The most attractive feature of the Couch Potato strategy has always been its low fees, especially when compared with actively managed mutual funds. But the truth is, fees are only one part of the decision. To appreciate this point, imagine you're trying to decide what to do for dinner. You could take the family to a restaurant and let someone else do the cooking. Or you might grab a prepared meal to serve at home. Finally, you could buy all the ingredients and whip up a dinner from scratch. Of course, the home-cooked meal is the cheapest, but that doesn't mean it's the best option for everyone. If you work long hours, or don't know how to cook, or are afraid of slicing open your hand with a chef's knife, one of the other options makes more sense despite the added costs.

Index investing involves similar trade-offs. You can simply use a balanced fund that holds all the stocks and bonds in a single product. This is the "restaurant" option: it's as easy as it gets, but you pay more for the convenience. You can also build your portfolio from individual index mutual funds, a "heat and serve" option that is a bit more work, but provides more flexibility and lower costs. Finally, you can cook from scratch using ETFs, which offers ultra-low fees and enormous variety that you can tailor to your tastes, but with significantly more complexity and some risk of injury.

In Canada, the choices are surprisingly limited in the first two categories. You might think balanced index funds would be common, but they're not—likley because offering low-cost, simple solutions is not how fund companies make buckets of money. The only products that fit this bill come from Tangerine, the well-known online bank. There are five Tangerine funds, but only three are balanced portfolios (the other two don't have a bond component). They range from the conservative Balanced Income Portfolio, which is 70% bonds, to the aggressive Balanced Growth Portfolio, which holds 25% in each of the four asset classes. The Balanced Portfolio comes down in the middle, with 40% bonds and 20% in each of the three equity indexes—the classic Couch Potato mix. All three funds have the same management expense ratio (MER) of 1.07%.

As for individual index mutual funds, all of the major banks offer them, but only grudgingly. Many bank-sponsored index funds have fees of 1% or more. The

photography By Nikki Ormerod

## Three Ways to Build a Couch Potato Portfolio

Here's how you can build a Couch Potato portfolio using the three options we've compared: Tangerine, the TD e-Series funds, and ETFs. In the examples below we've assumed a traditional balance of 40% bonds and 60% equities, with equal amounts in Canadian, U.S. and international stocks. Many index funds and ETFs have similar names, so we've included the fund codes and ticker symbols to ensure you use the right ones.

**OPTION 1: Tangerine Investment Funds**
It's hard to get any easier than this. This fund has an MER of 1.07%.

**100% – Tangerine Balanced Portfolio (INI220)**

**OPTION 2: TD e-Series Funds**
Make sure you choose the e-Series version of the TD index funds: They are also available in an "I-Series", which is much more expensive because they are sold by TD advisors and discount brokerages other than TD Direct. We also recommend avoiding the "currency neutral" versions of the U.S. and international equity funds, which offer less diversification benefit. This portfolio has an estimated MER of 0.44%.

**40% – TD Canadian Bond Index Fund (TDB909)**

**20% – TD Canadian Index Fund (TDB900)**

**20% – TD U.S. Index Fund (TDB902)**

**20% – TD International Index Fund (TDB911)**

**OPTION 3: ETFs**
There are plenty of excellent ETFs available from the three largest providers in Canada—Vanguard, iShares and BMO. Here's one suggestion for combining some of the cheapest options: This portfolio's estimated MER is just 0.13%.

**40% – BMO Aggregate Bond Index ETF (ZAG)**

**20% – iShares Core S&P/TSX Composite Index ETF (XIC)**

**20% – Vanguard Total U.S.Market (VUN)**

**20% – iShares MSCI EAFE IMI Index Fund (XEF)**

# Which type of Couch Potato are you?

| | TANGERINE INVESTMENT FUNDS | TD E-SERIES FUNDS | ETFS |
|---|---|---|---|
| **Overview** | A single balanced mutual fund that holds bonds, Canadian stocks, U.S. stocks and international stocks | A small family of individual index mutual funds | Funds that trade like stocks on an exchange. Offered by several providers, such as Vanguard, BlackRock iShares and BMO |
| **How much choice is involved?** | You select one of three balanced mutual funds according to your risk tolerance | You use four individual funds to build a portfolio with any asset mix that suits you | You select three to five ETFs from the hundreds available and build a portfolio with any asset mix that suits you |
| **How do you buy these funds?** | Open an account directly with Tangerine | Open an account with TD Direct Investing, the bank's online brokerage | Open an account with any online brokerage |
| **What types of account can be opened?** | RRSP, RRIF, TFSA, non-registered. No RESPs or RDSPs | All account types, including RESPs and RDSPs | All account types offered by bank-owned brokerages. Some independents do not offer RDSPs |
| **Management expense ratio*** | 1.07% | 0.44% | Typically 0.12% to 0.20% |
| **Annual account fees** | None | Up to $100 unless your balance is over $15,000 or you make monthly contributions | Up to $100 but often waived if your balance is above the minimum, typically $25,000 |
| **Commissions to buy or sell** | None | None | $0 to $10 or more depending on brokerage |
| **How easy is the portfolio to maintain?** | Almost completely hands-off: you just add cash in lump sums or through automatic contributions | Moderately easy. You need to learn to place mutual fund trades at TD Direct Investing | Can be challenging. You need to learn how to properly place trades on a stock exchange |
| **How often is the portfolio rebalanced?** | Quarterly | Whenever you make the trades manually | Whenever you make the trades manually |
| **Can you set up a systematic investment plan?** | Yes | Yes, but must be set up for each individual fund | Generally not possible |
| **Are dividends reinvested automatically?** | Yes, all dividends reinvested automatically and fully | Optional: You can take dividends in cash or reinvest them | No, but brokerages can arrange dividend reinvestment plans (DRIPs) for whole shares only |

*Assumes a balanced portfolio of 40% bonds and 60% stocks, divided equally between Canadian, U.S. and international equities

exception is TD's e-Series funds, which stand out for having the lowest fees in Canada: their MERs range from 0.33% to 0.51%. You can select an individual fund for each of the four main asset classes and combine them in any proportion, from cautious to aggressive. The biggest limitation of the e-Series funds is the only effective way to buy them is through a self-directed account with TD Direct Investing.

Finally, we come to ETFs, the darlings of the industry. Their primary appeal is their rock-bottom cost: You can build a portfolio for less than 0.15%. ETFs are also available in enormous variety from several providers—including Vanguard, iShares and BMO—and through any online brokerage. Rather than limiting yourself to the basics, you can find ETFs that zero in on specific categories of bonds or stocks: Short-term or long-term bonds, government or corporate bonds, large companies, small companies, dividend payers and many others. You can also expand your portfolio to include asset classes like emerging markets, real estate or preferred shares, none of which are available with the other options we've discussed.

So, which option is right for you? The answer depends on several factors:

## HOW LARGE IS YOUR PORTFOLIO?

Costs are always important, but if you're just starting out, they aren't the most crucial factor. Consider a young investor with $10,000. She might look at the Tangerine funds with their 1.07% MER and think they're too expensive compared with ETFs at about 0.15%. But in dollar terms that difference is just $92 a year—and that's before you factor in any trading costs you'll incur buying ETFs (but more on that later). For a new investor who may be overwhelmed by the variety of ETFs available or intimidated by the idea of placing trades on an exchange, that's a reasonable price for the user-friendliness of a single balanced fund. On a $200,000 portfolio that fee difference becomes $1,840 a year, which is probably too much to pay for convenience; investors with portfolios that large will be rewarded for learning to use ETFs.

Fees on small accounts are another consideration. The bank-owned brokerages often charge $100 a year on RRSPs that don't meet their minimum account requirements—typically $15,000 or $25,000 depending on the brokerage. Some may charge higher trading commissions if your balance is below a certain threshold. It's almost never worth paying these account fees: If your portfolio is small, choose a no-fee option (Tangerine or one of the independent brokerages), or look for ways to have the fee waived. For example, TD Direct charges $25 per quarter on accounts under $15,000, but will waive this fee if you set up automatic contributions of at least $100 a month—which is a smart habit anyway.

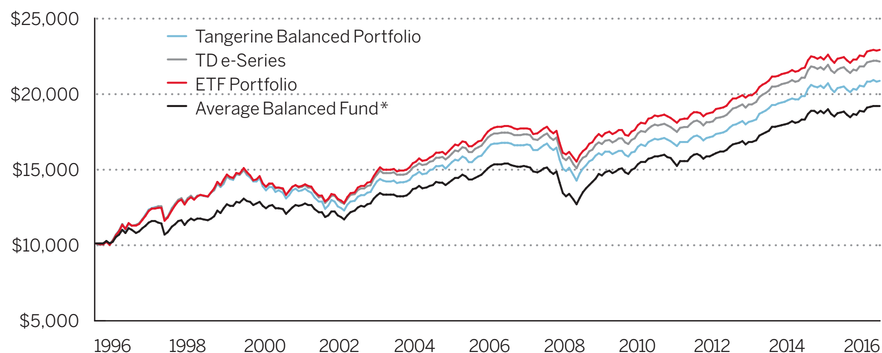
## HOW MUCH OF YOUR PORTFOLIO IS TAXABLE?

The Couch Potato strategy is straightforward if you're investing in tax-sheltered accounts such as RRSPs and TFSAs. But if you have a large non-registered (taxable) account, the simplest solutions don't work as well. Now you need more flexibility to ensure your portfolio is built in a tax-efficient way.

Consider the Tangerine funds: they're a perfectly good choice in your RRSP or TFSA, but they hold a significant percentage in bonds, which are not very tax-efficient. If you use the e-Series funds, you can hold the bond fund in your RRSP while keeping the more tax-efficient Canadian equities in your non-registered account. ETFs give you even more options, including specialty bond funds designed to minimize tax if held in non-registered

## *Why it pays to put your feet up*

If you put $10,000 into the most basic Couch Potato portfolio 20 years ago and sat back, you would have come out ahead versus a typical actively traded balanced mutual fund




**Methodology:** None of the products we use to build our Couch Potato portfolios has been around for 20 years. While we've used actual fund returns beginning in the first full month after each fund's inception, for earlier periods we used the returns of each portfolio's benchmark index and subtracted the current management expense ratio of the fund. This is an imperfect but reasonable proxy for how index funds would have performed. We also compared our portfolios to their peers using data from Morningstar. Fees and subtle variations in the underlying indexes account for the differences in the returns of the three portfolios. The performance of the Tangerine fund does not need to be adjusted for fees since there are no transaction costs to own the fund and it doesn't need to be rebalanced. The returns of the e-Series and ETF portfolios assume perfect behaviour: that is, the investor incurred no transactions costs or account fees and rebalanced at the beginning of every year. Any additional costs would have reduced returns.

* Aggregate performance of all funds in the Morningstar Global Neutral Balanced category

Sources: Morningstar, TD Asset Management, Vanguard, BlackRock, BMO ETFs

accounts. Experienced investors can also use U.S.-listed ETFs, which can also be more tax-efficient.

### HOW WILL YOU BE ADDING NEW MONEY?

All good investment strategies begin with regular savings, and if you're contributing with every paycheque, index mutual funds are ideal. Both Tangerine and TD make it easy (and free) to set up systematic plans that ensure your dollars get invested immediately. While you can arrange for cash to go into your brokerage account every month, you'll have to make the trades manually. And unless you're able to take advantage of a commission-free offering, it's not cost-efficient to make frequent small trades. If you're paying $10 every time you buy or sell an ETF, you should wait until you have at least $2,000 or so before you make a transaction.

### ARE YOU DISCIPLINED ENOUGH TO REBALANCE?

Couch Potato portfolios are very low-maintenance, but you do need to rebalance from time to time. The idea here is to keep your asset mix close to its long-term target, and that can mean selling whatever has recently gone up and using the proceeds to buy what's gone down. That sounds easy in theory, but very few investors do it with discipline. In a year when bonds have fallen sharply and stocks have delivered double-digit returns, which do you think your lizard brain will tell you to buy?

One of the great benefits of balanced funds is that they're rebalanced automatically: The Tangerine funds do it quarterly. A report by Vanguard found that investors who held balanced funds were less likely to make changes to their portfolios during the financial crisis of 2008 and the five years that followed, which means they weathered that event far better than most. The authors pointed out that these one-fund options "may actually help to insulate investors from one of the most insidious risks their investment portfolios face: their own behaviour."

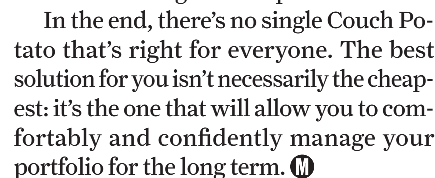
### ARE YOU PRONE TO TINKERING?

There's a well-known idea in psychology called "the paradox of choice." While most of us think we want as many options as possible, the truth is that too much choice is paralyzing, and it can lead to deep dissatisfaction. That's why the limited selection of index funds from Tangerine and the TD e-Series is a blessing in disguise because it's hard to screw up.

ETFs, on the other hand, are available in such variety that investors often find it overwhelming. Too often they build a nicely diversified portfolio and then immediately second-guess themselves. They wonder if they should switch to a different ETF that is a bit cheaper, or add a 5% allocation to some exotic asset class. Inner peace only comes to ETF investors once they realize there is no optimal portfolio, and that constantly making changes is more likely to be a bigger drag on performance than fees.

### HOW MUCH DO YOU ENJOY INVESTING?

Some people consider investing a fun hobby—and then there's everyone else. Indeed, if you're attracted to the Couch Potato strategy it's probably because you don't want to spend a lot of time managing your portfolio: You simply want to enjoy the benefits of diversification and low fees. You can get most of that benefit with simple solutions like Tangerine or the e-Series funds, with a lot less effort than building and maintaining an ETF portfolio.



In the end, there's no single Couch Potato that's right for everyone. The best solution for you isn't necessarily the cheapest: it's the one that will allow you to comfortably and confidently manage your portfolio for the long term. Ⓜ

## *What About Robo-Advisors?*

In the last three years, a new model has appeared in Canada that has attracted a lot of attention from investors interested in ETFs. Dubbed "robo-advisors," these firms design, build and maintain ETF portfolios online, charging a modest fee that often includes trading commissions. That allows you to avoid many of the challenges that come with managing your own ETF portfolio, including investing small amounts, choosing appropriate funds and paying commissions every time you buy or sell.

There are now about a dozen robo-advisors in Canada, including Wealthsimple, Nest Wealth, Wealth Bar, Smart Money and ModernAdvisor. They have a lot to offer investors who are looking to farm out the job of building and maintaining an ETF portfolio. And if you plan to access your accounts on your smartphone and tablet, they're great for that, too. Certainly these services are much less expensive than traditional financial advisors, though they typically offer little or nothing in the way of financial planning.

In terms of cost, most robo-advisors fall somewhere between the Tangerine and TD e-Series options. For portfolios under $100,000 most charge 0.50% to 0.60% on top of the ETF management fees, so the all-in cost is usually in the ballpark of 0.75%.

We haven't included robo-advisors in our comparison because they are significantly different from the DIY options you'd find in the traditional Couch Potato portfolio. The portfolios created by individual firms differ, but they are all more complex than the traditional Couch Potato, usually containing six to 10 ETFs.

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# ARE YOU READY FOR THE HOT POTATO?

MoneySense readers love the steady returns of the classic Couch Potato strategy. This spicier version beat it by 6.7 percentage points annually. It's hot stuff

By **NORM ROTHERY**

Illustration By **KELSEY DAKE**

Some people add chili peppers to almost everything. They gobble down jalapeños and savour habaneros. But even the bravest chili heads balk when it comes to noshing on the hottest peppers in the world. The current king of heat? The Carolina Reaper. You can find videos online of people trying the reaper. They're not pretty.

When it comes to investing, many prefer plain portfolios while others like to spice things up. To the more daring, I offer a fiery take on *MoneySense's* conservative Couch Potato portfolio. Call it the Hot Potato.

Before we start slathering on the sriracha, it's worth remembering what the classic Couch Potato is all about. It dishes out a variety of low-fee diversified portfolios of broad-market index funds (and exchange-traded funds) that can be held for a long time—usually 10 years or more. The only trading they require comes from deposits, withdrawals and the occasional rebalancing, which helps maintain the portfolio's desired asset mix.

The basic Couch Potato method represents a low-cost conventional approach to money management that is suitable for a large number of investors. If you're the passive buy-and-hold type then the Couch Potato might be just the thing for you.

But if you're more adventuresome and want a more active and somewhat unconventional approach, then the unabashedly momentum-based Hot Potato is worth exploring. Like the classic Couch Potato, it comes in several varieties and uses the same low-fee index funds (and exchange-traded funds) as building blocks. But the Hot Potato diverges significantly from the classic version because it employs shorter holding periods and focuses on a single asset class at a time. It adds a lot more zip to money management.

## SIZZLING TUBERS: HEAT OUTPERFORMS OVER TIME

The basic Hot Potato method is inspired by money manager James Montier's 2003 article "Cheap Countries Outperform," which can be found in his book Behavioural Investing. Montier noted that the stock markets of countries that fared the best over the prior 12 months continued to outperform. It is a classic case of momentum in markets and we wanted to test whether a similar approach would work for Canadians.

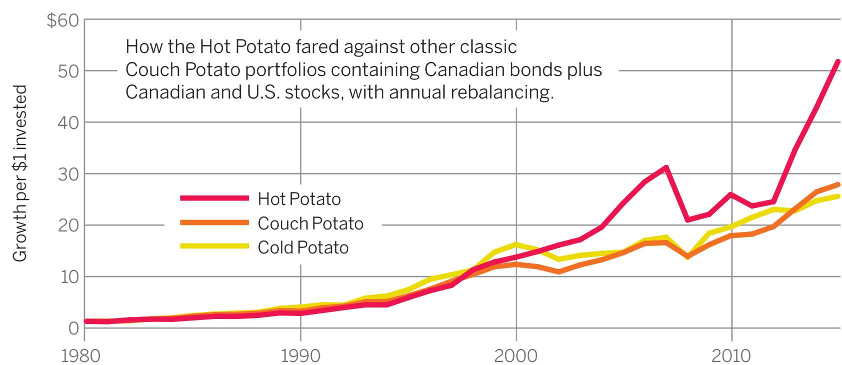
To find out, we start with the original Couch Potato portfolio as a baseline. The original portfolio contains equal dollar amounts of Canadian bonds, Canadian stocks, and U.S. stocks. This no-fuss approach fared well from 1981 through 2015 with average annual returns of 10.0%. That assumes annual rebalancing back to an equal dollar amount of each index. (We used the FTSE TMX Canada Bond Universe index, the S&P/TSX Composite index and the S&P 500 for the performance calculations. All figures include the reinvestment of dividends and interest income, but not fees and taxes, which vary depending on personal circumstances.)

The spicier version of the classic spud strategy is very different: Instead of annually rebalancing back to equal amounts of the three indexes, the Hot Potato looks at the returns of the indexes over the prior 12 months and moves all its assets into the index that fared best. For instance, the top performing index at the end of 2011 was the S&P 500. As a result, the whole Hot Potato portfolio moved into the S&P 500 for 2012, with no money allocated to the other two indexes. U.S. stocks continued to outperform every year since then, thanks in part to the weakening Canadian dollar. As a result, the portfolio stays in U.S. stocks from 2012 on and remains there in 2016.

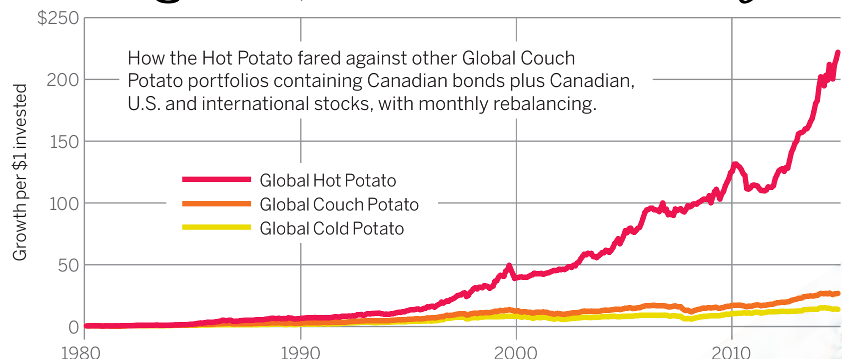
While the Hot Potato requires more attention, the effort is worth it because this portfolio would have gained an average of 12.0% annually from 1981 through 2015. That's a performance advantage of 2.0 percentage points per year for the Hot Potato. Mind you, it also came with a lot more volatility, which has to be expected due to its concentrated approach.

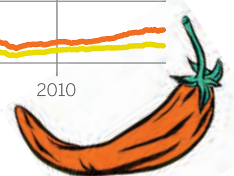
It's worth pointing out that taking the opposite tack and moving into the index that fared the worst over the prior year—call this the Cold Potato approach—yielded returns of only 9.7% annually. It modestly underperformed the original Couch Potato by 0.3 of a percentage point per year. If this pattern repeats, it's not encouraging news for Canadian stocks, which lagged in 2015. See how the Hot, Cold, and Classic versions of the original Canadian Couch Potato fared over time in the chart on the facing page.

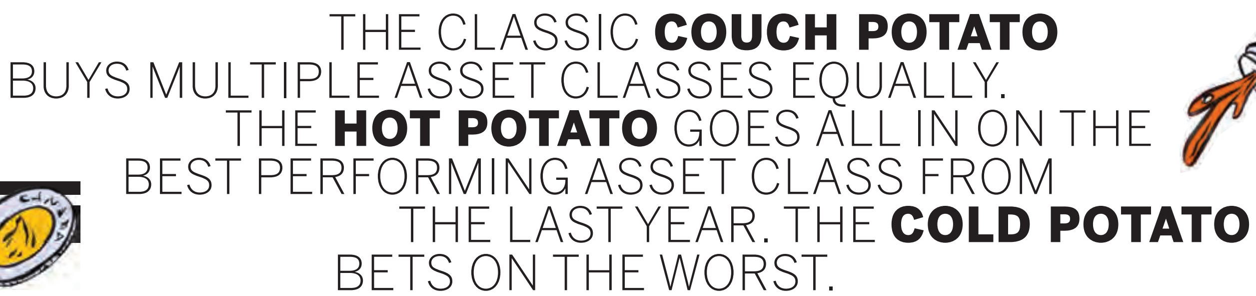
## Hot beats cold and classic




## Go global, Rebalance monthly





## EVEN BETTER: GO GLOBAL AND RESET MONTHLY

While the Hot Potato generated good returns using annual data, it is well known that momentum tends to work better over shorter periods. (For more on this, check out Gary Antonacci's study of monthly momentum strategies for U.S.-based investors in his recent book Dual Momentum Investing.) This time, we'll focus on a global version of the Canadian Couch Potato portfolio to highlight the potential benefits for Canadians of using a similar monthly approach.

The Global Couch Potato places equal amounts of money into Canadian bonds, Canadian stocks, U.S. stocks, and global stocks. It uses the same indexes as the classic Couch Potato with the addition of the EAFE index as the proxy for international stocks.

The classic Global Couch Potato portfolio provided healthy average annual returns of 10.0% from the start of 1981 through 2015, assuming the portfolio's four indexes were rebalanced back to equal dollar amounts each month instead of annually. (Investors who follow the Global Couch Potato are generally less punctual with their rebalancing.)

Just as before, Hot Potato investors would opt for a concentrated approach. At the end of each month, they move all their chips into the single asset class that fared the best over the prior 12 months. If the top performer remains the same, no change is made that month.

The Global Hot Potato portfolio, rebalanced monthly, gained an average of 16.7% per year from the start of 1981 to the end of 2015. It beat the classic Couch Potato by a whopping 6.7 percentage points annually.

While the global version of the Hot Potato was certainly more volatile than the Couch Potato, it came mostly from the sort of upside volatility that few investors complain about. In addition, it nimbly sidestepped several market crashes along the way. In fact, the largest drawdown for the monthly-balanced Global Hot Potato came after the Internet bubble popped in 2000, when it declined 21.4%. But it bounced back almost two years before the Global Couch Potato did, having fallen 29.2% during the same downturn.

The Global Couch Potato drew its biggest loss during the 2008 collapse (31.1%) and didn't recover until 2011. Its spicier sibling fared better because it was invested in bonds for a good part of that period: It fell only 10% from its 2007 high to its 2008 low, and had recovered fully by the summer of 2009.

Once again contrarians fared poorly. The Global Cold Potato Portfolio is moved monthly into the worst performing asset class of the prior year. By doing so, it gained an average of 7.9% annually and trailed the Global Couch Potato by 2.1 percentage points per year. The monthly return history of all three global potato variants is shown in the charts on the opposite page.

## TOO HOT? TAKE IT DOWN A NOTCH

The Hot Potato's propensity for volatility can cause some investors to suffer indigestion. But there are options for people who want to add just a little spice to their portfolios.

For instance, they might opt for something I'll call the Warm Potato approach: Instead of moving all of their money into the hot asset class of the day, investors sell only the worst performing index over the prior 12 months and double up on the best performer. As a result, the Warm Potato is composed of a double weighting in the best performing asset class, none of the worst performer and a single weighting in each of the others.

Applying a somewhat spicier approach to the original three-asset-class Couch Potato portfolio, with annual changes, resulted in average annual returns of 10.6%. That's 0.6 of a percentage point advantage over the regular version. Similarly, applying this method to a global portfolio with four asset classes and rebalancing monthly, would have generated gains of 12.1% per year, beating the classic Couch Potato by 2.1 percentage points per year and with only a little more volatility than the regular version.

## AND NOW, THE DISCLAIMER

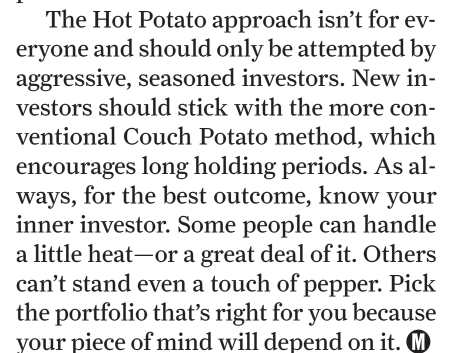
A few words of warning are in order: Past performance does not guarantee future performance. That maxim that applies to all versions of the Couch Potato strategy, and to investing in general. In addition, the Hot Potatoes might underperform their counterparts in the future. Indeed, they are likely do so at least from time to time.

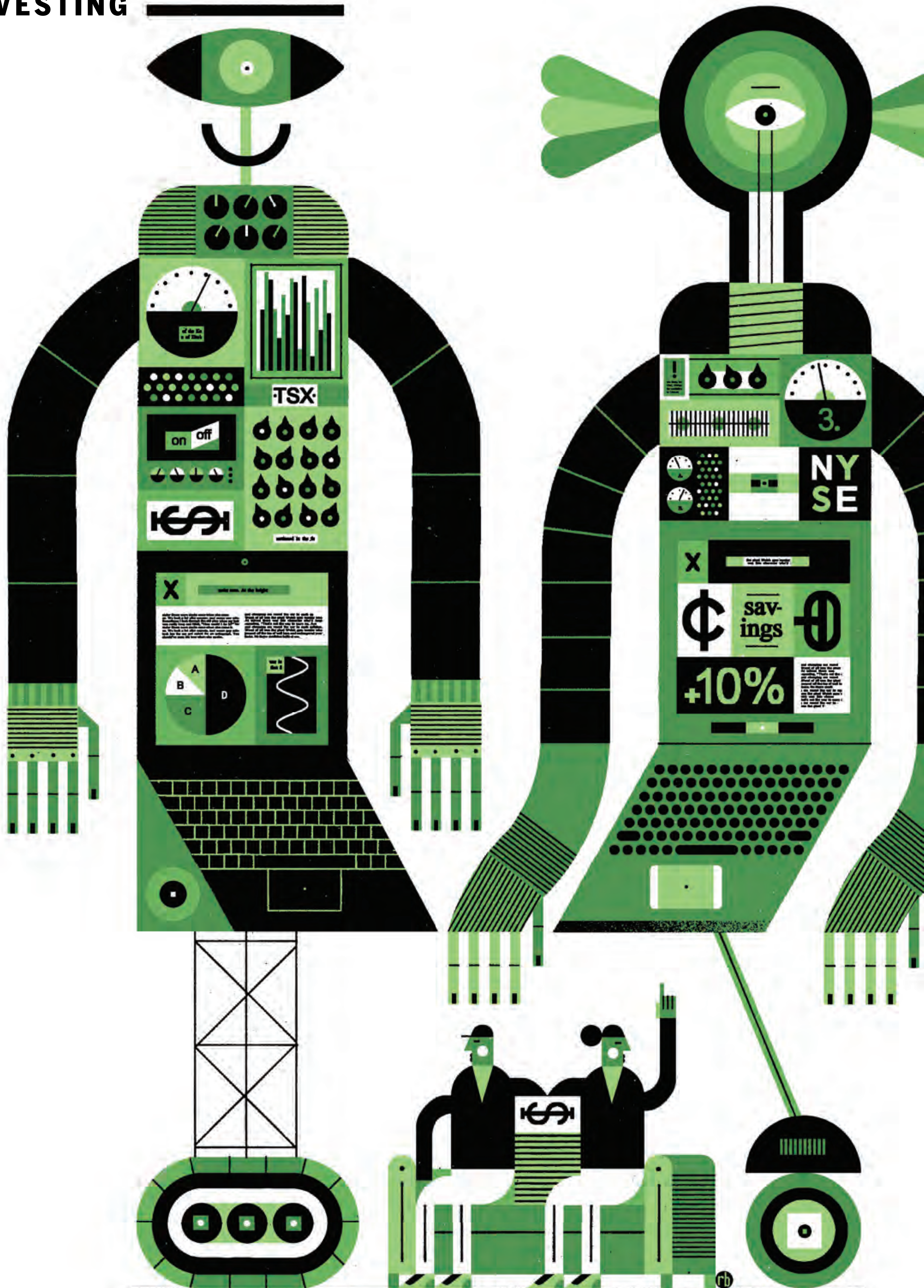
In addition, it's worth considering the fees associated with frequent rebalancing. It's one reason why most Couch Potato portfolios are reset annually or less frequently. The Hot Potato portfolios are more active. For instance, the Global Hot Potato made an average of 1.7 large trades per year from 1981 through 2015. Trading costs (commissions and bid-ask spreads) reduce returns in practice and these have not been factored into the return numbers shown in our charts.

The Hot Potatoes can also trigger capital gains taxes in taxable accounts. As a result, investors should try to minimize such costs by using tax-favoured accounts and opting for liquid low-cost index funds or similar exchange-traded funds.

More subtly, the approach might not work as well as indicated when implemented using index funds or exchange-traded funds because such funds don't exactly track the indexes they follow in practice.

The Hot Potato approach isn't for everyone and should only be attempted by aggressive, seasoned investors. New investors should stick with the more conventional Couch Potato method, which encourages long holding periods. As always, for the best outcome, know your inner investor. Some people can handle a little heat—or a great deal of it. Others can't stand even a touch of pepper. Pick the portfolio that's right for you because your piece of mind will depend on it. Ⓜ

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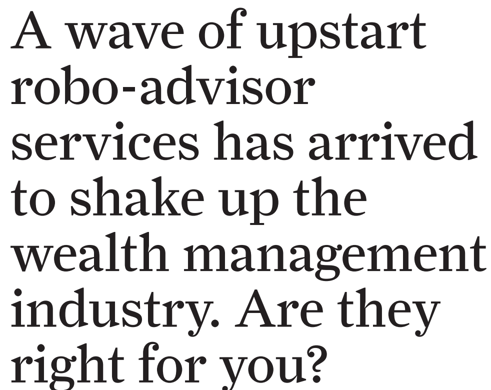
# TIME TO GO ROBO?



A wave of upstart robo-advisor services has arrived to shake up the wealth management industry. Are they right for you?

BY DAVID ASTON
ILLUSTRATION BY RAYMOND BIESINGER

There's a new way of managing your money that's beginning to shake up the investment world. Online portfolio managers—better known as "robo-advisors"—are designed for today's digital world and provide you with a professionally managed portfolio at low cost even if you have only a small amount to invest.

The impact of this wave of robo upstarts on wealth management has been immediate. The big banks and other major players are taking notice, even if only for the automation and ease of paperless account administration and portfolio rebalancing. The bigger and longer-term questions are how much market share the robos will ultimately be able to win and how the disruption could force the traditional advisor community to raise its game.

While at this point robo-advisors in Canada have yet to accumulate a lot in assets, at least 11 firms have launched in the past two years, including Wealthsimple, Nest Wealth and the Bank of Montreal's SmartFolio. It's safe to assume the big banks and discount brokers won't roll over to the new kids in town. At this point, the one thing that is clear is that the investing business is in for some changes. It's time for investors to take a closer look.

"The impact of this is going to be dramatic for sure," says Mark Yamada, president of investment software firm PUR Investing Inc.

## SIMPLE NOT SIMPLISTIC

What robo-advisors do is simple yet profound. They automate parts of the investment process to build and maintain diversified portfolios using exchange-traded funds (ETFs) with low fees. Even better, you can do it without any paperwork, from the comfort of your couch or, more likely, from your smartphone when you're run off your feet with career demands.

However, the adopted name for these new services is misleading because robo-advisors also provide access to qualified human advisors when needed. (Providers hate the term "robo-advisor," but it has nonetheless stuck.) Robo-advisors can save roughly one percentage point in fees for small- and medium-sized investors, compared to the total fees charged for a conventional full service advisor using mutual funds. This is an enormous savings when continuously accumulated and compounded long term.

Generally, robos provide a set number of soundly constructed portfolios composed of ETFs that are automatically matched to each investor's needs, based on an online questionnaire which determines the investor's risk tolerance and objectives. Each portfolio is subsequently rebalanced automatically as needed whenever actual balances diverge significantly from their target allocations.

Usually everything is paperless, right down to you providing an electronic signature in the sign-up process. You can access your account any time you want online and, in many cases, also view your account via smartphone or tablet using an app configured for those devices. Small investors are welcomed—in some cases account minimums are $5,000, in other cases there is no minimum. Meanwhile, qualified human advisors are available by chat, email or phone to answer questions and provide advice on basic investment questions as needed.

While these features can appeal to any age group, the approach obviously fits many younger investors like a glove. "It's going to open people's eyes and it happens at a time when the generations are changing very quickly," says Yamada. "Generation Y is not in all likelihood going to invest the way their parents and grandparents did."

At this point, the robo-advisor customer base in Canada is still tiny. Independent startup Wealthsimple, one of the first firms in Canada to launch and the only one so far to disclose numbers, says it had 10,000 clients and $400 million in assets under management as of December, 2015. But those figures could grow quickly, as has been shown by the U.S. experience, where pioneers Betterment and Wealthfront each have more than US$3 billion in assets. Businesses are keen to get in on the ground floor, with several new players due to come to market to join the 11 services already launched. (In the table on the facing page, we profile five of the most prominent.) Behind the scenes, many are discussing deals and partnerships. Already, Power Financial Corporation has announced an investment of up to $30 million in Wealthsimple.

But perhaps the biggest splash so far has been the heavily marketed introduction of the Bank of Montreal's SmartFolio service in January, the culmination of a seven-month project. "In bank terms, that's warp speed," jokes David LeRiche, director of wealth strategy at BMO Wealth Management. "Getting to this space quickly and getting there first (among the big Canadian banks) was important to us," says LeRiche. "There is an opportunity to establish ourselves as a big brand in this innovative space." Expect other banks and financial institutions to follow. As Yamada says: "Once the banks enter the space, it validates it."

***Some advisors will find they have to learn to 'repurpose and add more value'***

## FILLING A GAP

Robo-advisors serve what Randy Cass, CEO of Nest Wealth, which is rolling out a national robo-advisor service, calls the "forgotten middle." That's the gap in the marketplace between do-it-yourselfers (who can invest very cheaply at a self-directed brokerage but need to contribute time, effort and knowledge to do it well), and conventional full service advisors (who may provide ample advice, but typically charge around 2% in total fees to build portfolios out of mutual funds). Larger investors can tap other options like brokers or investment counsellors who may provide quality advice more cheaply, but you need at least several hundred thousand dollars and probably more to get that kind of advice for much under 2% in total fees.

In contrast, robo-advisors provide an opportunity for investors who don't want to do it all themselves but like the fact they can save surprisingly large amounts in fees. While fee structures vary among robo-advisors, many of their investors pay total fees under 1%, even if they only have a few thousand to invest. (These "total fees" include amounts charged by the robo-advisor as well as the management expenses embedded in the ETFs they use. Note that some robo-advisors charge quite a bit more on small balances.)

Of course, investors who have the time, inclination and knowledge to invest in ETFs effectively on their own can save even more in fees by doing it themselves.

Beyond their simplicity, the key idea behind the robo-advisor model is that it automates parts of the process that enable it to achieve efficiencies, while retaining human involvement where that provides value. If an investment firm has thousands of clients with similar objectives and risk tolerances, there's no particular need for different advisors of varying qualifications to construct and maintain thousands of unique portfolios for individual clients (which of course costs money and produces results of varying quality). Instead a robo-advisor gets the best investment brains in the organization to construct set portfolios, as with different models of cars, that can be matched to different groups of people with similar risk tolerance and objectives. "If it works in the auto industry why can't it work elsewhere?" asks Yamada.

Robo-advisors typically follow sound investment practices to build well-diversified portfolios covering all the main asset categories. Each robo-advisor generally has five to 10 standard portfolios composed of ETFs that vary mainly by the amount of market risk that they carry, covering a spectrum from very conservative to very aggressive. Each set portfolio usually includes core asset categories that include investment-grade bonds, stocks (Canadian, U.S. and global) and sometimes also other asset categories such as real estate investment trusts, emerging markets equities and high-yield bonds. These portfolios can be held in non-registered accounts, TFSAs, RRSPs, RRIFs and often in more specialized accounts like Registered Education Savings Plans (RESPs). Of course, once you agree that the robo-advisor has matched your profile with a suitable portfolio, you need to turn over the day-to-day management of the portfolio to it. Robo-advisors are usually registered as portfolio managers and are responsible for managing your money to a "fiduciary" standard (which

means they're obligated to do so in your best interests). That's higher than the "suitability" standard (which means they can't sell you unsuitable investments) that governs most advisors.

## PASSIVE VS. ACTIVE

Robo-advisors mainly follow in the "passive" investing tradition, which means that you're generally using ETFs to track the market at low cost. Some follow the classic passive approach which uses ETFs that track broad-based market indices based on market capitalization. The classic passive approach also avoids trying to "time the market" by adjusting the asset mix according to market conditions. Others follow more of a hybrid approach that mixes active features with passive ones to varying degrees. This includes using "smart beta" ETFs that may, for example, be designed to have low volatility, instead of following a broad market index weighted by market capitalization. Some may also adjust the asset mix according to market conditions, doing things like boosting the equity component when they think stock prices are relatively attractive.

Passive investing experts have long constructed model portfolios to guide do-it-yourself investors in constructing portfolios. (These include the "Couch Potato" portfolio by financial advisor and *MoneySense* contributing editor Dan Bortolotti, and the "Easy Chair" portfolio by finance professor Eric Kirzner.) Robo-advisors take this one step further by doing everything for you. "It's a logical development of everything I ever talked about," says Kirzner, professor of finance at University of Toronto's Rotman School of Management and an advisor to Wealthsimple. "You're buying a sophisticated version of the Easy Chair."

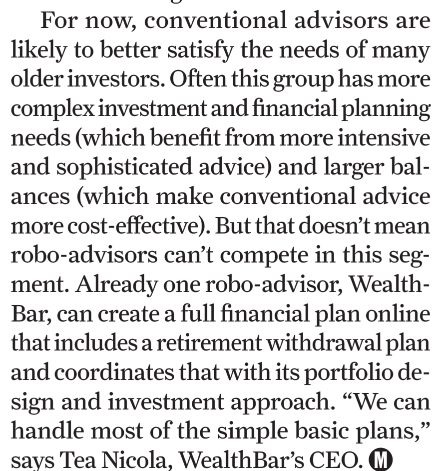
## FITS A DIGITAL WORLD

While robo-advisors are going after clients in all age groups, it has obvious appeal to younger investors who thrive on digital media. These investors have no ingrained history with conventional advisors who are mostly from their parents' generation, and, at this point, have relatively small balances that conventional advisors may neglect.

"We're pretty explicitly focused on young professional investors," says Wealthsimple CEO Mike Katchen, who is 28. "The sweet spot for us is 25 to 45 years old." The typical characteristics of the target client, he explains, is they have income to invest, are aware they should be putting their money to work in a smart way and don't have the time or interest to figure out how to do that themselves. "These folks are often very career-driven and time is often what they are most constrained by. So they'd much rather just outsource it to someone they trust to do a really smart job at a low cost. That to us is the core client."

Robo-advisors won't make conventional advisors obsolete. But it will be much harder for conventional advisors to justify their relatively higher fees if all they do is build and rebalance portfolios. "For a bunch of advisors out there who have been living a very nice life collecting very high fees, doing exactly the same thing a robo-advisor is now doing at a lower fee, they're going to have to repurpose and add more value," says Yamada. Advisors can potentially do this by focusing more on activities like financial planning, tax planning and behavioural investment counselling. And you'll still need a conventional advisor if you want to be heavily involved in the day-to-day decisions of running your portfolio but want expert advice.

While robo-advisors may provide a threat to conventional advisors, they also offer an opportunity. Plenty of discussions are going on about how conventional advisors might incorporate the robo-advisor platform in their own practices so that they can focus more on activities that add value. Nest Wealth's Cass has a message for conventional advisors: "We come in peace." Robo-advisor platforms may also find use in employer group RRSPs and defined contribution pension plans. Employees in those plans often make poor investment choices, but employers have traditionally been loath to pay for costly advice from conventional advisors. Nest Wealth and Wealthsimple both have plans to tackle this segment.



For now, conventional advisors are likely to better satisfy the needs of many older investors. Often this group has more complex investment and financial planning needs (which benefit from more intensive and sophisticated advice) and larger balances (which make conventional advice more cost-effective). But that doesn't mean robo-advisors can't compete in this segment. Already one robo-advisor, WealthBar, can create a full financial plan online that includes a retirement withdrawal plan and coordinates that with its portfolio design and investment approach. "We can handle most of the simple basic plans," says Tea Nicola, WealthBar's CEO. Ⓜ

# A MILLENNIAL ROBO TEST

***We asked Madeleine Aston, 19, a student at Wilfrid Laurier University, to take a few robo-advisors for a run. Here's what she found***

I looked into robo-advisors as a way to invest for someone young like myself who might only have $5,000. I went to the websites of five robo-advisors and tried each of their sign-up processes. I stopped short of opening an account.

What did I think? These services have lots to offer people who want the process of investing to be fast and easy. I liked how simple it was to get a diversified portfolio composed of ETFs that matches the level of risk I'm comfortable with. While some might prefer to be more involved in day-to-day investment decisions, I like the idea of turning it over to someone else.

Robo-advisors let you do pretty much everything online through your computer or through an app on your smartphone. You can communicate with human advisors via chat, email or phone. While an older person may see this use of technology as innovative, it's just the way someone my age does things. Face-to-face meetings filling out paper forms seems out of date to me.

If you're interested in investing with a robo-advisor, it pays to check them out. Most have you complete a questionnaire about your risk preferences and show you a potential portfolio before you open an account, so you can see what you'd be getting. Also, the investment philosophies range from purely "passive" to fairly "active," so you need to make sure you're comfortable with the approach.

Fees tend to be complex, so look carefully, especially with small balances. Counting both robo-advisor fees and the fees built into ETFs, I found that total annual charge on a $5,000 account ranged from $12 to $347!

Overall I think robo-advisors are a great way to invest a small amount of money, and I'd seriously consider turning my $5,000 over to one.

# HOW SMART ARE YOU?

How much do you really know about A) planning and B) retirement? What about C) saving and D) investments? Or buying a house? Find out if you're actually as smart as you think you are. Start our test at the Novice level and work your way up to Expert.

by
Mark Brown
Julie Cazzin
Prajakta Dhopade
Romana King
David Thomas

## NOVICE

**01** Everyone should have an RRSP, regardless of income level.
True or false

**02** Which of the following could prevent you from buying a home?
a) A bad rep with a previous landlord
b) A low credit score below 500
c) Having a line of credit
d) Being self-employed

**03** What is a P/E ratio?
a) Price-to-equity
B) Price-to-expense
C) Price-to-earnings
d) Price-to-expropriate

**04** What does MER stand for:
a) Management Expense Ratio
b) Major Earnings Results
c) Makes Errors Regularly
d) Market Expense Report

**05** You are required to use a real estate agent when buying or selling a home.
True or false

**06** You have a $200,000 portfolio. What will it cost to have a financial advisor build and maintain your portfolio?
a) Wait, I have to pay for that?
b) About $25 an hour
c) About $2,000/year
d) Roughly 3% of your portfolio

## INTERMEDIATE

**01** Debt consolidation is a way of rolling several debts into one monthly bill. But not all debts are worth consolidating. Which of the debts below would you be better off NOT consolidating?
a) Credit cards
b) Personal loans
c) Mortgage debt
d) Student loans

**02** The investments allowed in a TFSA are generally the same as those allowed in an RRSP.
True or false

**03** It's the end of the year and you notice that you've taken a big hit on one of your favourite stocks. You decide to sell it to record the capital loss on your taxes and then you promptly buy it back because you still like the investment. Is this a good strategy?
Yes or No

**04** It doesn't matter if you get a fixed-rate or a variable-rate mortgage, as you have to pay the same penalty to break either type.
True or false

**05** There is a standard rule in personal finance called the 4% rule. What does it refer to?
a) If you withdraw no more than 4% of your nest egg each year in retirement, you can count on not running out of money for at least 30 years
b) 4% of people have most of the money and will never have to worry about running out of it in retirement
c) If you invest 4% of your income each year in stocks, you will be a millionaire by the time you retire
d) If your portfolio returns at least 4% per year your retirement will be secure

**06** The maximum lifetime contribution to an RESP is:
a) $50,000 total per family
b) $50,000 total per beneficiary
c) $5,500 per beneficiary
d) none of the above

## EXPERT

**01** If you're age 30, and on January 1, 2017 you open a TFSA and deposit the cumulative total of all contributions allowable from inception, how much money would you be depositing?
a) $5,500
b) $10,000
c) $52,000
d) $46,500

**02** A TFSA absolves you from paying any tax on investments in that account.
True or false

**03** What is a limit order?
a) An order that will only be filled at the price specified by the investor, or better
b) An order that allows you to set the maximum price you're willing to pay for a stock
c) A method to ensure you don't pay more than you expect for a company's shares
d) All of the above

**04** If you want to put money into an RRSP but don't have the cash, you can make an "in kind" contribution of a pre-existing position from your taxable account. If you do this, remember that:
a) If the investment has gone up, contributing will trigger a capital gain
b) If the investment has gone down, contributing will trigger a capital loss
c) Neither A nor B
d) Both A and B

**05** The only time you may not want to pay your high interest rate debt first is if you have debt owing to the Canada Revenue Agency.
True or false

**06** You must file your taxes annually.
True or false

Answers on page 4

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