Episode 94:
Happy Birthday! The Mutual Fund Structure Turns 100

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[Keith] Welcome to the Empowered Investor. My name is Keith Matthews, and I'm joined by my co-host Marcelo Taboada. Marcelo, how are you today?

[Marcelo] Keith, I'm very good. I'm very happy to be back. It was a long break, but we've been busy with tax season. And podcasting, you know, it's an amazing experience, but it also takes a lot of time. But again, we always said internally that it's a marathon, not a sprint.

[Keith] Yeah, you're absolutely right. We've taken about a six-week break to make sure that the tax season runs smoothly. We did one show last week with Nicholas Berube, and we got great feedback. He's a very, very intelligent, great writer and really promoting.

[Marcelo] Yeah. I listened to the episode and read the book, and I find his way of delivering the message fascinating because, you know, it's a subject that a lot of people are talking about. It's out there in the media, but the way he packages the messages and delivers them is really good.

[Keith] Absolutely. Well, listen, today's show is on the mutual fund’s birthday—100 years. But before we get into that, I want to congratulate you on your anniversary, Marcelo. You have been with the firm for eight years, which is fantastic. It's been an amazing eight years, but also this is our fourth-year anniversary. We started doing the podcast in March or April of 2020. Do you remember that time?

[Marcelo] I still remember the day I was sitting on my couch, working, in the middle of the pandemic, and you gave me a call and said, now's the time to do the podcast. We need to get our message out. Clients need to hear from us. There's no perfect time to do it. And everybody was a bit down, you know, with the fact that it was the first summer of the lockdown. I still remember that day when you called me.

[Keith] You're so accurate. We were in lockdown, March, April. We had no way of having our client meetings. We had no way of meeting clients on a regular basis. And so, we said, let's start doing a podcast every two weeks and be able to engage and speak to clients and contacts and people we wanted to just connect with. So here we are four years later. It's been fantastic. I think the team has done an unbelievable job in terms of researching. It's improved our advice level in terms of making sure we're on top of subjects doing our research. I think clients have really appreciated and listeners have appreciated. So, thank you to everybody for listening. Please give us feedback, give us feedback. We want to continue for another four years easily. But we need to hear from people.

[Marcelo] Yeah, absolutely.

[Keith] So today, Marcelo, it's the 100th anniversary of the mutual fund structure. Yeah, should we celebrate? Well, it's a great show and a great topic. Mutual funds have liberated investors in so many ways. But let's go back in time here. Talk to us about how the mutual fund was created, how, why, and when.

[Marcelo] Yeah, so it was founded in 1924 by a pioneering financier called Edward Leffler. He's essentially the one who created the mutual fund, and he decided to give investors access to a diversified pool of investing. So, think of it like a container, he created basically a container where people could invest in the stock market because before you had to buy single securities, it was only accessible to the elite—only people with a lot of money had access to stock investing and having a portfolio. It was also a time when there was a lot of fraud and private investments, and everything was very murky. So, he came in, and the remarkable thing is that he was a door-to-door salesman. He was used to selling pots and pans, and he just revolutionized the industry with this invention.

[Keith] It was quite an invention. Prior to that, as you mentioned, it was really only individuals who had a lot of capital, who could have a relationship with a stock brokerage firm, and who had enough money to get an advisor. And so most Americans—again, this was developed in the United States—just didn't have that kind of wealth.

[Marcelo] Nope. There are a few factors that gave rise to a little push to the mutual fund. You know, there was the rise of the middle class and the need to have wealth-building tools that people needed access to. Also, the big shift we saw in the eighties from the defined benefit pensions to the defined contribution, because a lot of it was done through work plans and where you put money in, your employer matches. There are a few ingredients that had to converge for the mutual fund just to skyrocket the way it did. You look at it now; it's 16 trillion managed globally in mutual funds or in this container.

[Keith] Let's go back to 1924, the mutual fund structure. I like the way you've used the container word because it's going to hold a whole slew of individual securities, whether stocks or bonds. But let's continue that language with the container throughout the show.

[Marcelo] The one analogy that I thought about is before Henry Ford. In the Model T, only rich people had access to a car, and that democratized access to mobilization and having a car. So, it's sort of very similar in that way.

[Keith] Yeah, a hundred percent. So, what are the pros of a mutual fund?

[Marcelo] I think the biggest one, Keith, is that you can now have a container, which gives you access to a pool of stocks, a pool of diversified investments, and access to foreign markets. So, for example, if you're a Canadian right now and you want to buy single stocks, you have access to Canadian stocks. You have access to US stocks easily. But let's say you wanted to buy some European stocks like Nestle or a big company in Europe that you want to access in your portfolio or even Asian stocks; you couldn't—I mean, you could through different vehicles, but it gets complex. The mutual fund eliminates this problem. It gives you a container that you buy in Canada and access to a diversified portfolio and different markets that before was impossible. Then you have the fact that if you want to buy more of the same container, they can issue shares. And when you want to sell it also, you get a fair price, and it's just easy.

[Keith] So the fair price is an interesting one too, which is this idea that a mutual fund has a net asset value that gets priced at the end of every single day. And so, if you're an investor, and you want your money back, you've got a fair mechanism to get your money back. If you're a purchaser and you want to buy, you end up buying a mutual fund, and you get the day's close, and you get a fair price on those securities.

[Marcelo] The biggest pro for me is it just democratized the process. It gave access to middle-class people and hardworking people, a tool to build wealth that was reserved for the poor or the people who had more privilege at that time. And even now, we take it for granted, but we literally stand on the shoulders of giants, and the fact that we have access to this and anybody, you know, a student out of university can buy a mutual fund and get access to the stock market and have that is a remarkable thing.

[Keith] Yeah. And then, if you put it in context, you're talking about having a monthly contribution for as little as $25, which allows you to buy a position in a mutual fund and add to that on a weekly, a monthly basis. And this is the kind of thing back in the 1920s that was just impossible to do. Now, is it the best vehicle?

[Marcelo] I think we'll determine that in a bit, but I mean, for all intents and purposes, those are the pros of investing in a mutual fund.

[Keith] All right. Thank you, Marcelo. So, what are some of the negative aspects or cons of a mutual fund? Now, let's consider them from a Canadian perspective.

[Marcelo] Yeah, number one, I think everybody would agree is high fees. A lot of very high fees are attached to mutual funds, specifically in Canada. There are a lot of reports that point to this fact. Also, there is a lack of transparency around fees. I mean, how many times have you met a prospect or a client that comes in and you ask them, "How much are you paying in your investments?" And they're like, "I don't know. I just simply don't know." It's not easy to understand how these products charge fees. And then there are some tax implications as well. If you hold mutual funds in a non-registered account or in a corporate account, the capital gains that are generated within the structure are passed down to the end consumer or the person who holds the mutual fund. So that could be another thing to think about in terms of being a con. So, I think those are the three that I can identify.

[Keith] So your first point would be high fees, and we'll get into this a little bit later because not all mutual funds are created equally. No, again, it's a container and it's important to understand that structure. When I look back in time, I remember when my father bought his very first mutual fund. And I think to me, the negative connotation around the mutual fund structure really started coming into play in the seventies, eighties, and full speed in the nineties. And it had to do with because it was such an interesting container, and individuals weren't using these containers, the structures, there was a selling opportunity. So, to me, the negative side of the classic mutual fund industry comes from a sales culture, which is there to try to sell more of them. So, my father, when he first bought his mutual fund, was so proud. He bought an RSP, and he had a defined contribution as an engineer. He bought his first RSP in the 1970s, bought a dynamic mutual fund. The front-end load was 9%. So, Marcelo, this predates you for sure, but 9 percent means you have a hundred dollars. The sales commission is 9. So, your starting portfolio is 91. You put a hundred dollars in for the privilege of having access to these containers. You started with 91 and it was expected to grow. You definitely had to wait a year or two to get back to your initial amount of money. And then thereafter, hopefully over 20 or 30 years, it grew. But the real selling culture came in the 90s, and I remember that time very vividly when there was this massive push across the country from selling organizations to try to get people out of GICs, which at that point were paying 7 or 8%, and into the stock market, which was a brand new concept for middle-class Canadians because nobody had done it before. We grew up in a world where everybody invested in GICs. And so, in that time, the mutual fund industry was dominated by independent mutual fund manufacturers, Fidelities, Templeton, and TriMark’s, and they had to have a sales force to sell them, which were independent financial planners. And that sales force had to be compensated. So, they had all these compensation structures. Unfortunately, it encouraged some behavior and some movement and some tactics that I don't think are in investors' best interest. To me, the con of the classic mutual fund structure is this attachment to a sales culture.

[Marcelo] Yeah, I could see that for sure. And you know, I worked in that world for a year after I graduated from university, at the bank, and at a big mutual fund company. So, I definitely know what you're talking about. It's just this idea of you're buying business, essentially, and you're trying to push product. And it has a sales culture attached to it even now.

[Keith] Well, I think there'll be a balancing act between trying to identify the better mutual funds versus the mutual funds that perhaps exist more in a sales culture. But again, that's less the container issue and more the sales issue. Selling philosophy behind it, but let's switch gears now and talk a little bit about how Canadians invest in mutual funds and sort of the evolution of this process and what that looks like. And then we'll compare Canadians to how our counterparts in the United States invest. And then at the very end, we're going to have some suggestions and recommendations and some good news for Canadians.

[Marcelo] Investing is a solved puzzle. We can get a broad market exposure portfolio in a boring, diversified, and lowest possible cost vehicle. But Canadians still continue to choose the high fee mutual fund to invest their money. So, most Canadians pay high fees and don't even know it. Canadians aren't as sold on the idea of choosing better products, products that have fewer fees. So right now, two trillion dollars are residing in Canadian mutual funds. Compared to 400 billion in ETFs. We'll get into what ETFs are in a second. So, the remarkable thing, Keith, is that a few years ago, the mutual funds dealer association had a study in one out of five Canadians knew exactly how much they were paying into their mutual funds for the products that they had. So, it's mind-blowing to me that we have a lot of advances in the industry. Better products, but Canadians continue to choose high-fee mutual funds.

[Keith] Yeah, so that's an overall theme, and I think the opportunity here is again for improvement. Let's look at the 10 largest mutual funds in the country. So, when we pulled up this list of the 10 largest mutual funds, even when I actually first did it, I was surprised, actually maybe not so much, but 8 are bank-owned mutual funds. And Marcelo, I'll tell you, back in the ‘90s and even the ‘00s, when you look at the top and the largest mutual fund in Canada, they weren't banks. Banks weren't even in the industry. They were all independent mutual funds, so it would have been a Fidelity, it would have been a Templeton, it would have been a Trimark. Yeah, someone specialized in it. It might have actually been Altamira at one point, although I can't remember. All these are names that are not even close to scratching the largest ranking. So, the number one mutual fund in Canada, the largest, is the RBC Select Balanced Fund at 50-something billion dollars with an MER of 1.9 something. So, when we look at that relative to an exchange-traded fund, it's 10 times as expensive as an exchange-traded fund or a low-cost mutual fund that's following an index strategy. So that's just the largest one. So, there are eight more of these in the largest 10. What's happening is that banks are dominating the mutual fund industry in Canada. We have an oligopoly. This is where Canadians are investing in the mutual fund structure. So how big is the mutual fund industry?

[Marcelo] I'll tell you. I have the data right here. In Canada right now, there are 1.8 trillion in mutual funds. No, assets under management. In total, you have 1.8 trillion in Canada. 83 percent is invested in mutual funds, and 17 percent is invested in ETFs.

[Keith] The vast majority of mutual funds are all over the map. There are some high-fee funds and some low-fee funds, but by and large, the largest mutual funds are all bank-owned.

[Marcelo] Yeah. And the average fee is like 1.5 percent of mutual funds in Canada.

[Keith] Yeah. And the high fees, some of them include advice. Some of them don't. The worst scenario is a person. Being in a high-fee mutual fund and not getting advice. You could argue that if you were in a moderate to high fee fund, but you're getting good advice, there was better value there. There are a few boxes being ticked, probably not ultimate, but to me, fundamentally, when you think about business strategy, the issue that Canadians face is that. The mutual fund industry is dominated. The manufacturers are the distributors. And you don't want that in any business. Manufacturer being the bank, being a manufacturer of product. They are also the distributors of products. So, when the manufacturer and the distributor work together as an organization, they have a tendency of being able to squeeze out additional profits and charge more than perhaps they should. Add to that that we have an oligopoly of five or six large financial institutions. You end up with a very, very high fee environment, which is why Canadians are kind of stuck here until individuals see how they could move forward in a different fashion.

[Marcelo] And you look at the numbers. The mutual fund launches per year are also still dominated by mutual funds. So, we know it's a worse product than a lower-cost product. And they're still like, most of the launches are towards this high-fee product.

[Keith] I circle back to this whole idea of the manufacturer and the distributor. When the United States with the registered investment advisor model is the person giving the organization, giving advice, they end up with the same sort of registration as our firm; the organization giving advice is not attached to manufacturing. They are independent and they go towards the best product for the best fee, and they provide that, and they build advice to clients. When you're dealing with the manufacturer and the distributor building those containers together, they are trying to build the most profitable container they possibly can for them. And that, I think, is a fundamental issue that Canadians are kind of stuck with and that we must figure out how to navigate around. The good news is that there are more options. So, let's continue, Marcelo, that's how Canadians invest. So how do Americans invest? Like what's comparable when we think of our cousins to the south?

[Marcelo] Investors in the US are choosing the right thing right now. You see it in the numbers: More than 50 percent of the market is dominated by passive investments in the United States. That was the latest number we got. It's a testament that Americans are really moving towards the right approach.

[Keith] Well, it's interesting that observation, because we looked it up offline before because a number was like 45% in 20-22, two or three years ago, and now it's 50%. So, what you're alluding to, and the US market is a large market, 50% of assets under administration in the United States by individual investors is in index products. And now it might be in an exchange. Low fee. It might be in an exchange-traded fund. Or it could be in a very low fee mutual fund like a Vanguard, which is an enormous, extremely successful, very pro and could be a dimensional fund advisor strategy. These are all low-fee mutual funds, but they're index or passive. So, 50 percent of Americans are choosing. The passive approach tends to be more aligned with independent advice as well. Independent advisory firms, like us, tend to use those strategies more.

[Marcelo] And you see the outflow too. The money that's gone out from actively managed products in the U.S. to passively managed products is huge. So, this growth has been happening for a lot of years now.

[Keith] Well, that's a global trend. And in Canada, we're still quite a bit behind in that. I've been speaking about this for 25 years, Marcelo. As a firm, we've been doing this for a long time. But Canadians just aren't there yet because we're back to that. Who's the manufacturer? Who's the distributor? The distributor is the advice provider whom you get your strategy from.

[Marcelo] So the number of passive investments in Canada, it's only 15. 5%. The U. S. in 2013 was at about 24%. So, it doesn't make sense to me, but we know why.

[Keith] Yes, we know why, and it's an advice issue. But the irony here, Marcelo, is that when I look at the U. S., an actively managed strategy and a mutual fund structure is often around 50 to 70 basis points. So, Americans are choosing, they have access. to low-fee mutual funds, whether they're active or not, they have access to low fee. In Canada, we don't have access to a lot of low fees. A lot of the low fees that used to be around by the Phillips Hager North organization were bought out by the banks. So, Americans who have access to low fees are choosing even lower fees. And they're going into passive investment vehicles, whether it's an ETF or Vanguard solution or dimensional, all-growing strategies. Canadians, who you would think would gravitate, they have way more to save in dollars and cents. The opportunity is way bigger for them to move in this direction. Yet we're still kind of stuck in that old-fashioned way across the country. The data shows that people haven't gravitated as fast as they could. So, to me, I look at that and go, that is an incredible opportunity for Canadians to start improving the way they invest.

[Marcelo] Yeah. I mean, we keep seeing reports over and over about how Fees make a huge difference in your returns, and they can have a big impact on your retirement. So, if you are stuck constantly in like high fee mutual funds, that's eating your returns. And I think just because this is what I don't understand. It's the way also the product is built, people think there are no fees attached. How many times have I spoken to people who feel or think that their mutual fund that charges no fees is a free product? It's crazy.

[Keith] So we've alluded to the ETF, the exchange-traded fund. It's an anniversary for the exchange-traded fund as well, not a precise, because the first exchange-traded fund was developed in Canada and it was called the TIP, the Toronto Stock Exchange Index Participation 35, and then there was the HIP, the 100, and then there was the SPDR in the United States done by the Amex in 93. So, we're about that 30-year, 33-year anniversary. So, it's had incredible growth as well. So, you have a mutual fund structure container that's got a hundred-year anniversary. You have an exchange-traded fund container that's now got a 30-year anniversary. And it's fascinating to see these investment vehicles right in front of us. Investors have great choices now, way more than ever before.

[Marcelo] In Canada, there's a Vanguard portfolio of ETFs. You know, you can buy one portfolio of ETFs, one product. And it'll cost you like 26 basis points, 0. 26%. And you'll have access to a broadly diversified portfolio with a very good investment philosophy. So, it's remarkable, the fact that we can do this now, it's helped a lot of Canadians. But as you can see, I just wish more people would. Gravity towards that, like we've seen in the U. S. I think Canadians will eventually.

[Keith] It will come. I think there are a couple of tipping points. I think the tipping point away from working with a manufactured distributor model, which is the bank model, is coming. I think Canadians are realizing that this is not in their best interest. Their best interest is to not have that because there's a conflict and there's a high-fee environment. So, I think you're going to see a tipping point towards independent advice much faster than ever before. You're going to see Canadians, I think, move way quicker in terms of adopting and embracing index and passive investment solutions, whether they use the ETF container or the mutual fund container. That trend, I think, is really going to push forward in the next 10 years.

[Marcelo] Yes, I agree. And we're seeing it now, you know, there's more thirst for independent advice and evidence-based investing. And you know, what's remarkable, there's a lot of good guys now entering the industry. I'm on LinkedIn, I'm very active on LinkedIn and social media. And I see all these young kids entering the industry now and being super active and following this approach, passive investing, you know, evidence-based and fee-for-service, independent advice. It's very encouraging to see.

[Keith] Yeah. So, let's wrap up, Marcelo. Today's show was not supposed to be a necessarily long show. We were going to celebrate the mutual fund's 100th year birthday. So quick comments to end and then let's wrap it up.

[Marcelo] I think my comment would be, it's remarkable how easy it is to fall into negativity and feel like everything is broken in the world. But. The fact to me that it reminds me that we are in a good period of human history. Not only medically and economically and a lot of things that are working, but the fact that we can buy a portfolio for a very low fee and have diversification and have this wealth-building tool. Accessible to anybody is a remarkable thing and we take it too often for granted.

[Keith] Yeah, I agree. So, I'll end with simply saying great innovation. A hundred years ago, in the mutual fund, the exchange-traded fund, although we're not celebrating it today at the 30-year anniversary of the fantastic four-year anniversary of our podcast, Marcelo, which is wonderful. Thank you to the listeners. Please continue with your comments. And Marcelo, congratulations on your eight years at our firm. Thank you for listening. Thank you so much, everybody, and have a wonderful week.

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