Managed Money Report

PRIVATE CLIENT SOLUTIONS

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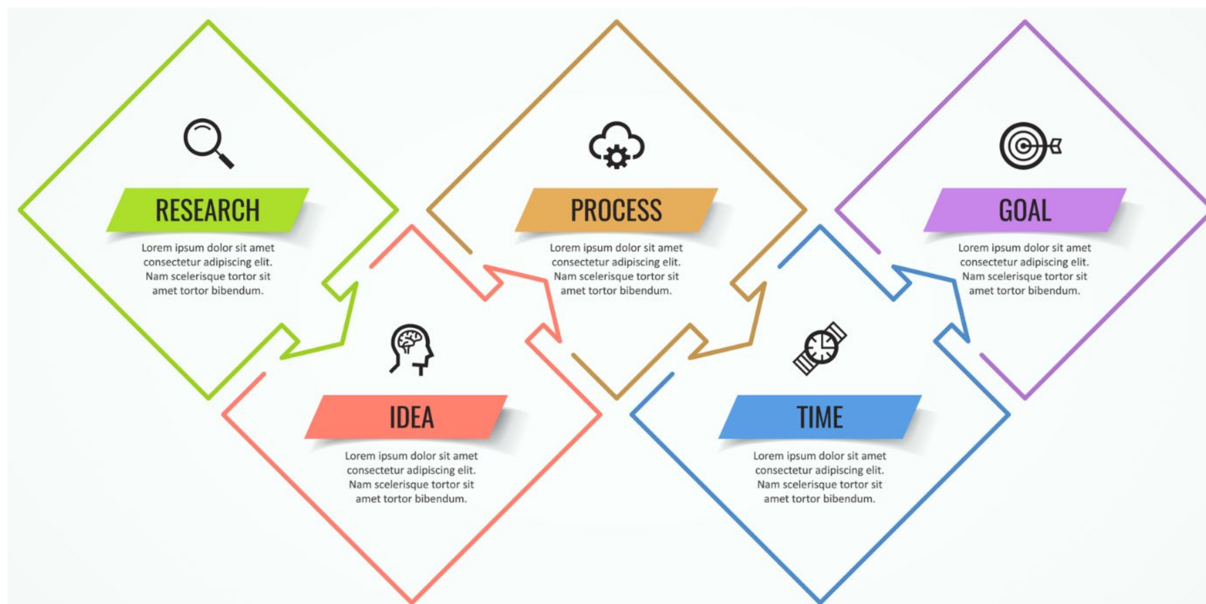
Understanding Underperformance

Understanding the performance drivers of our investments is critical to making the right investment decisions at the right time. These choices can include when to complement your existing portfolio with a new portfolio manager (PM), or perhaps move on from a current one. Understanding performance is also key because all PMs tend to go through periods of out-performance and underperformance relative to the market and their peers. Understanding why a PM is underperforming is critical to ensuring we do not make hasty decisions during short-term underperformance and, in contrast, identify those who are facing long-term structural challenges where we may need to walk away. Effective identification requires a repeatable process for evaluating PMs compared to an appropriate peer base. In this article, we outline some best practices for comparing PM performance to an appropriate peer group, understanding components of PM performance, and what investor biases to be mindful of throughout the process. We conclude by looking at three PMs who have recently struggled with performance that could make attractive investments today.



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Accurate Peer Comparison: Why it is important

The first consideration when evaluating PM performance is comparing your PM to an appropriate peer group. Comparing a deep value manager to a growth manager might tell us which style has performed well recently, but it does not provide us with meaningful or actionable information on the PMs themselves. Relative performance analysis, as described below, allows us to make educated decisions on our manager's performance while linking that performance back to our own long-term goals and investment objectives. This is key because regardless of what we own, there will likely be a manager or index that will outperform us. We should not be asking whether we owned the best performing investment last quarter or last year, but rather, relative to our goals and objectives, did our PM deliver as expected.

Relative performance analysis starts with a good benchmark. A benchmark should be measurable (priced frequently), transparent (you know what is in it), and most importantly, investable. The last point is something that exchange-traded funds (ETFs) changed the game on in Canada. Benchmarks have historically been abstract and overstated performance. We could see the names in them, but we could not invest in them and their performance did not include taxes or transaction fees. Fixed income provides an excellent example; the FTSE Canada Bond Universe index has approximately 1600 separate issues. Given minimum purchase requirements for bonds, it would be almost impossible for an individual to replicate this benchmark. Even ETFs with scale find it challenging to replicate. One of the largest index ETFs tracking the Canadian Aggregate Bond index, **BMO Aggregate Bond Index (ZAG-T)**, has over $6 billion in the strategy and can only efficiently replicate 90% of the index. This is not a failing of the ETF, but a reflection of how illiquid components of the index can be. Individual investors no longer need to worry about this, as we can simply buy the ETF at increments of net asset value (NAV). This is important because ETFs have democratized access to parts of the market that were previously inaccessible, leading to fair comparisons and attractive alternatives.

Manager Performance Analysis: The Basics

It is always important to focus our energy on the things we have control over, and this is true of manager analysis as well. While timing the perfect investment or picking the next star manager would be ideal, it is impractical. We have far more control in understanding a manager's process, their philosophy and approach to determine if that meets our own investment needs. Sounds great, but how can you implement this? While a bit oversimplified, managers tend to follow a few broad sets of rules in their philosophy and approach to investing, including systematic vs discretionary decision making and top-down vs bottom-up analysis. Systematic investors look for rewarded risk factors and develop a systematic plan to exploit them. Discretionary managers utilize skill and expertise as well as knowledge of the individual companies to build a customized portfolio. Top-down managers look for broad based macro themes to drive investment performance, and try to select the securities that best meet a given theme. On the other hand, bottom-up managers focus their attention on fundamental analysis at the company level, selecting the best securities to create a diversified portfolio. Combining our understanding of the manager philosophy with attribution analysis, we can determine if a PM is delivering performance based on skill rather than luck.

Timeframe matters: All things equal, it is better to evaluate a manager over a longer time horizon, preferably a full market cycle. This is because some managers can look "wrong" as they build positions in high conviction names that are currently underperforming. As the age-old saying goes, you need to be where the puck is going to, not where it has been. While longer-term performance is usually best, it is equally important to have stability in management during that time. For example, a fund might have a 10-year track record, but two separate PMs. If this fund relied heavily on the expertise of the manager, i.e., a star PM, then we should only look at performance under the current PM. However, if the fund follows a team-based approach and limits the discretion of any one individual, we can comfortably evaluate performance over its longer time horizon.

Managing our Behavioural Biases

It is logical to want to avoid loss, both in life and investing. However, loss aversion can be a powerful bias that leads to inefficient portfolio construction. Loss aversion is our tendency to prefer avoiding losses more than we prefer gains. There are two typical outcomes with loss aversion; we hold onto losing positions longer than is warranted and, counterintuitively, we sell winning investments sooner than fundamental analysis suggests. Imagine you bought Apple stock on Jan 1, 2000 and sold it on Oct 1, 2007. You would have realized a whopping 500% return on your position. Great pick. However, if you had held it until Oct 1, 2021, that same position would now have an 18,000% return. While cherry picked and assuming a straightforward buy and hold strategy, it illustrates the point well. Owning a fund makes confronting loss aversion easier in some ways but perhaps trickier in others. It means we can ignore the performance of the underlying securities, and instead focus on the portfolio overall and work to understand the manager and their process as discussed previously.

Reverting to the mean

Having a good handle on the drivers of underperformance provides an indication of whether mean reversion might apply. Mean reversion is a belief that over long periods, performance tends to revert to its long-term mean (or average). In PM selection, we can leverage mean reversion to identify managers who have been consistent with their investment style, philosophy and approach, but who have underperformed and could mean revert. Consistency is key, however. If a manager constantly changes their investment approach we cannot rely on mean reversion, as there is no common mean. Based on the factors discussed in this report, we highlight three focus list managers who have consistently followed their process, philosophy and approach, and who look attractive right now.

Three Managers to Look at Now

The following series of charts is an analysis of focus list funds. The charts display two-year rolling information ratios, with standard deviation bands overlaid. Information ratio is a risk-adjusted performance measure. To calculate the information ratio, you take investment returns, subtract benchmark returns, and divide the result by the tracking error between the two as measured by standard deviation. A ratio greater than zero indicates a manager that has outperformed their benchmark with less volatility than the overall market. Standard deviation bands allow us to identify significant deviations from normal. In a normal distribution, we would expect our information ratio to be within 1 std. dev (+ -) 68%, and within 2 std. dev 95% of the time. In the information ratio chart, the first term of the information ratio is displayed visually, i.e., the excess return. This image provides a powerful visual of manager contribution to returns over time.

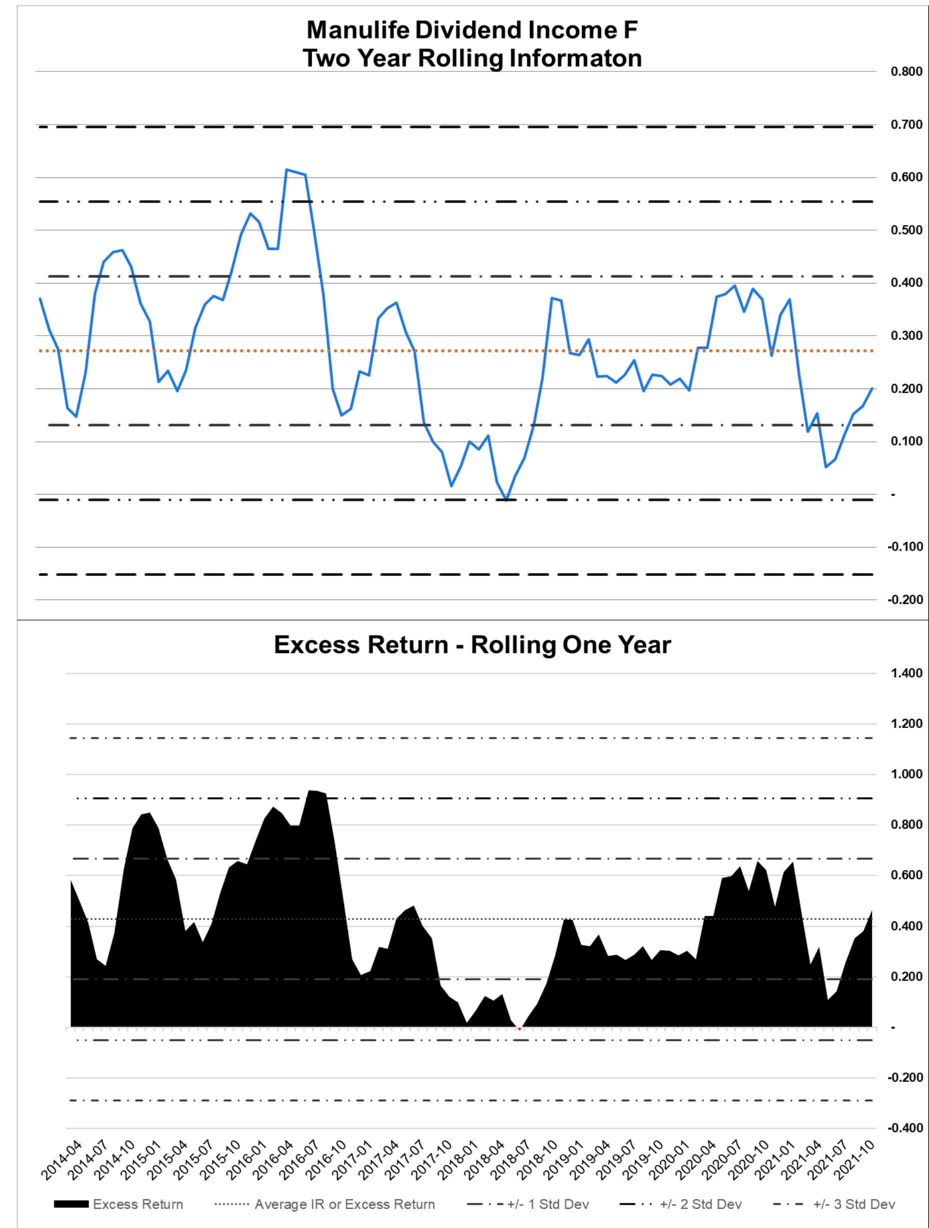
Analysis continues on next page...

Manulife Dividend Income

Manulife Dividend Income fund has a history of delivering consistent excess returns over the benchmark as noted in the chart to the right. The fund recently dipped one standard below its historical average information ratio given a strong run up in Canadian equites. Of our three managers, Manulife has experienced the smallest relative underperformance based on their information ratio, but this appears to be a meaningful deviation from their long-term alpha generating abilities. For long-term investors, this fund complements a broad Canadian allocation, with some geographic diversification.

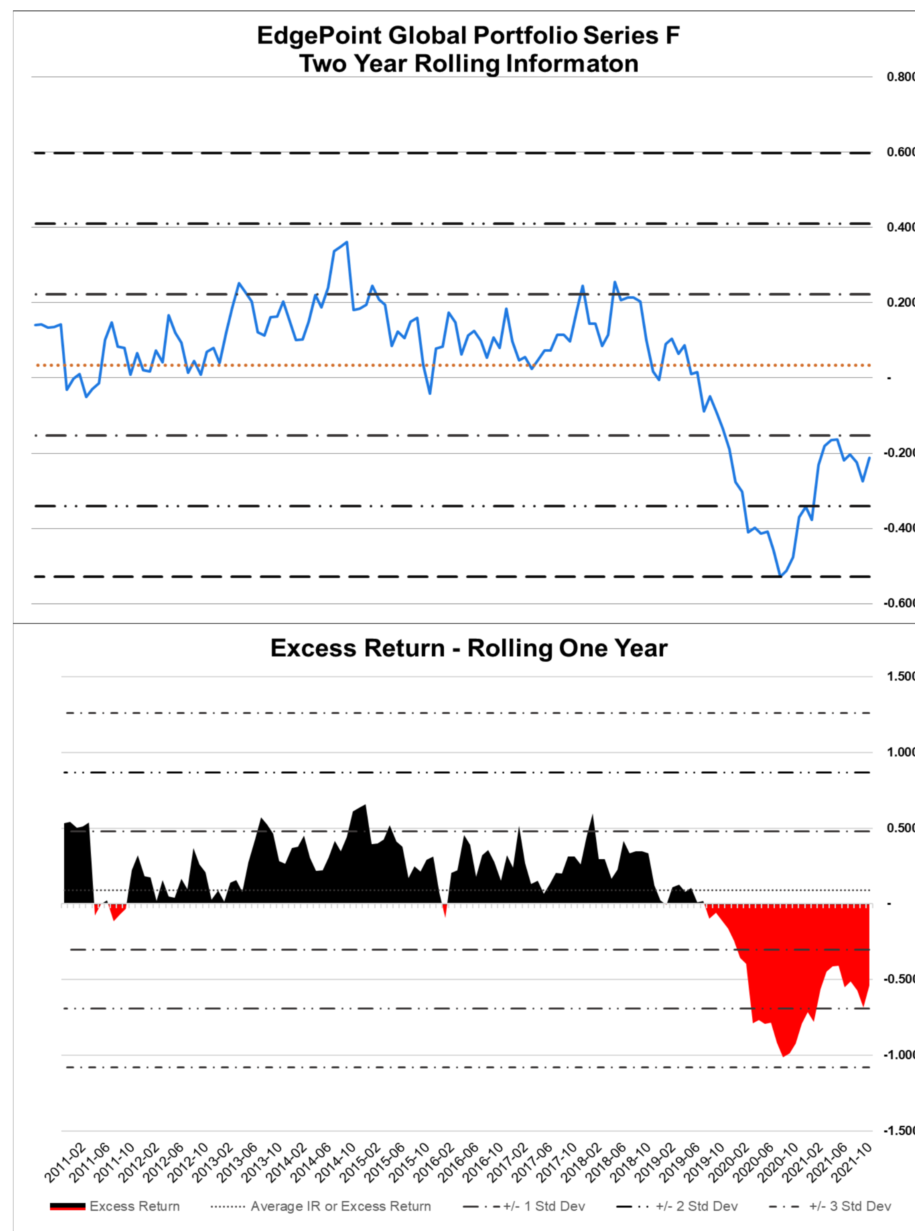
About the fund:

Allen Wicks leads the Manulife essential equity team who is responsible for this fund. The fund employs a bottom-up investment process that focuses on security selection. One important aspect of this fund is their standardized methodology for evaluating companies not only within, but also across industry sectors, market cap, and geographies. The fund's investment process focuses on creating a portfolio that exhibits high profitability with a visible return profile, an attractive valuation, minimal financial leverage and well-diversified earnings sources. A proprietary methodology is employed for security weighting, limiting securities based on the downside potential and the risk-reward of an investment opportunity. The process is repeatable, scalable, and applied with discipline by the team. Overall, the fund favours companies with a high quality management team, as evidenced by a strong track record of capital allocation. The fund falls into the Canadian Focused Equity fund category, allowing them to invest just shy of 50% of securities outside of the Canadian market. This allows them to follow their methodology closely while not having to sacrifice based on availability of companies just in Canada.



EdgePoint Global Portfolio

EdgePoint had consistently delivered excess return to their portfolio up until recently when the fund began to lag peers on a rolling basis as seen in the chart to the right. Style analysis and consistency is key during difficult performance periods such as these. So long as the manager does not deviate from their long-term investment philosophy, we believe there is ample runway for recovery. At the peak of the drawdown in 2020, EdgePoint hit three standard deviations below their average information ratio. While they have made up some significant ground since then we believe there is more room to go.



About the fund:

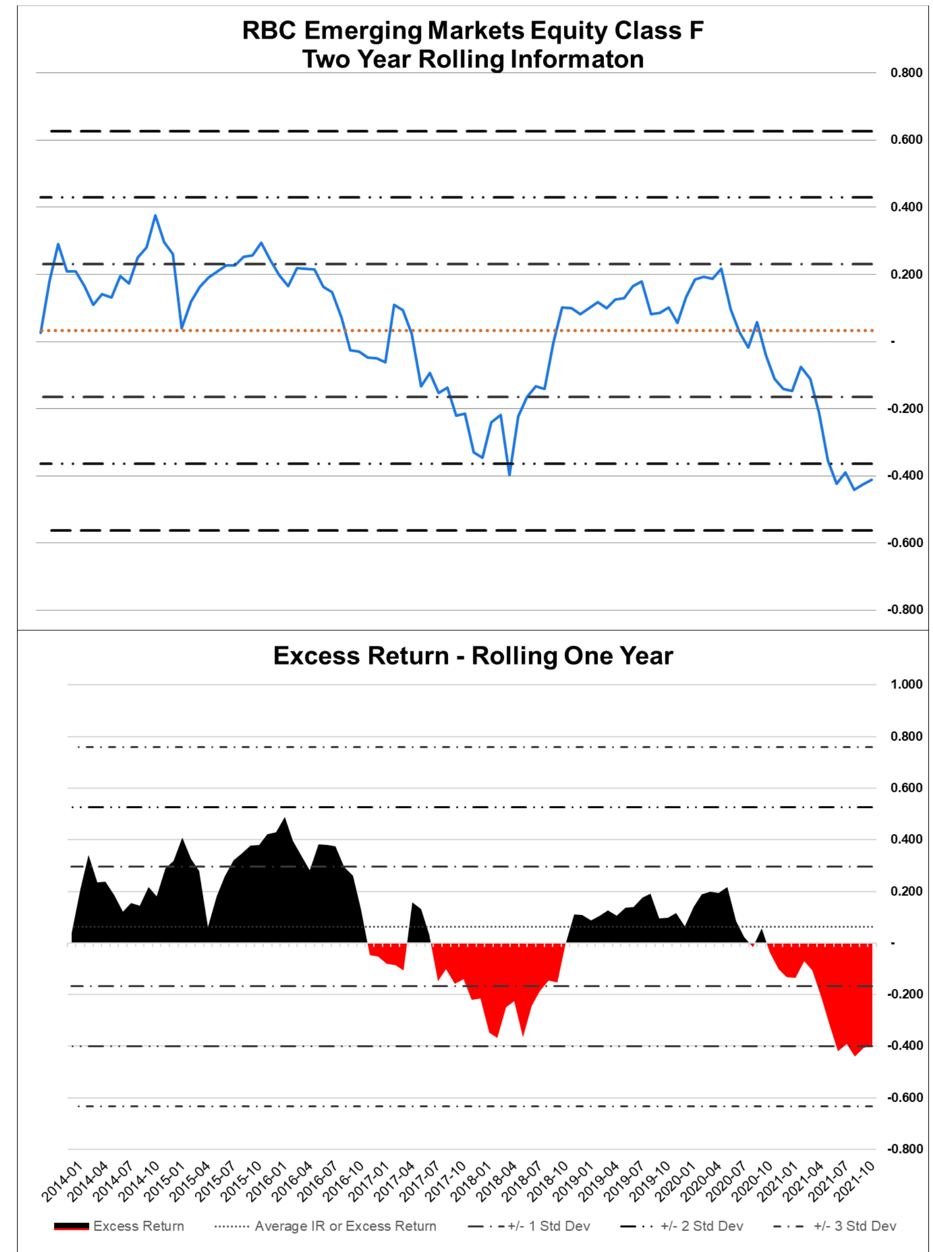
EdgePoint leverages a team approach in their portfolio management process. The investment team is focused on the long term, with an investment horizon greater than 10 years. They will regularly follow and research an individual name for more than a year before adding it to the portfolio, with a focus on quality rather than quantity. The team describes their methodology as having "proprietary insight", i.e., they try to generate ideas that are not widely shared by others. As part of this process, they can and often look "wrong" compared to the market. While there is a lot that goes into their approach, it is also simple. They want to buy good, undervalued businesses and hold them until the market fully recognizes their potential. Following this approach requires an ability to think independently and a commitment to embrace the thorough research required to uncover opportunities the market does not fully appreciate. EdgePoint's value comes from their independent thought and depth of research. Their conviction-based approach also can result in concentrated holdings and overall portfolio composition that looks very different from their competitors and benchmark index.

RBC Emerging Markets Equity

The RBC Emerging Markets (EM) Equity Fund appears to be a great candidate based on our rolling information ratio metric as well as aligning with capital market expectations going into 2022. The pandemic has been challenging for all markets, but it was particularly difficult for emerging market economies to come through. We believe that as supply chain issues begin to subside and the world returns to a new normal, EM economies are poised to rebound with them. The RBC EM fund is just below two std dev from their historical average and could make a great addition to portfolios looking for more geographical diversification heading into 2022.

About the fund:

The RBC EM fund puts an interesting twist on the traditional bottom-up stock portfolio. The team emphasizes investments in high-quality businesses trading at reasonable valuations. Uniquely, the PM team also looks for favourable long-term macro-economic trends within the EM economy that can act as tailwinds for these businesses. This means identifying secular long-term trends present in EM economies, such as infrastructure development and water resources, then identifying companies best positioned to capitalize on these trends. As one might expect, this approach positions the portfolio in sectors and industries with strong growth drivers and opportunities for consistent outperformance. The fund puts an emphasis on understanding how demographics, consumer demand and socioeconomic development will affect the businesses in these markets. From a bottom-up fundamental perspective, the team believes that emerging markets are inefficient for diligent, informed and long-term investors. As a result, they believe that careful stock picking can and should add value over time. We agree that emerging markets lack informational efficiencies and an active touch makes sense.



Bottom Line

- Understanding underperformance is critical to making informed investment decisions that are beneficial to long-term investment success.
- Manager styles and strategies come in and out of favour, but as long as a PM is sticking to their process, short-term weakness can give way to potential buying opportunities.
- Focus List funds, Manulife Dividend Income, EdgePoint Global Portfolio and RBC EM Equity have all experienced difficulties in the short term. However, all of these managers have delivered superior long-term returns and have disciplined investment processes. We view current weakness as an attractive entry point for long-term oriented investors.

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A Brief Refresher on Corporate Class Funds

Investors can use mutual funds to gain exposure to the alphabet soup of investment strategies, such as Canadian large-cap equities, emerging market debt, or commodities exposure. Just like individuals, mutual funds incur taxes based on the income and expenses generated throughout the year. Keeping this in mind, often overlooked is how individual mutual funds are structured from a tax perspective. Investors can purchase a mutual fund established as (i) a mutual fund trust or (ii) a corporate class mutual fund. The distinction between the two types of structure lies in the potential tax implications of distributions paid by the fund to investors.

Most mutual fund products are available in the mutual fund trust structure, whereby investors are unitholders in a given fund with a single investment mandate. A ***mutual fund trust*** is a single legal entity. Interest income, Canadian dividends, foreign dividends, or capital gains generated by the fund's underlying investments are paid directly to unitholders. Taxes are payable on those distributions in the hands of investors. Is there a way to minimize the amount of taxes that mutual fund investors must pay at year-end?

A given ***corporate class mutual fund*** also provides exposure to a single investment mandate, much like the trust structure. From a performance perspective, we would expect similar results from a fund structured as a mutual fund trust compared to an identical fund structured as a corporate class mutual fund. However, the difference lies in the tax implications for the investor. A corporate class mutual fund managed by a fund company is part of a broader corporation that, for tax purposes, shares all of the expenses and income generated by its underlying funds. This structure allows for the sharing of tax liabilities among the funds, meaning that each fund's taxable events net off against each other before making distributions to the investor.

This can benefit the investor by potentially reducing the size of the distribution paid or providing a more tax-efficient distribution.

The corporate class mutual fund structure's primary purpose is to offer tax-efficiency. As such, they should be considered for non-registered accounts instead of registered accounts that are sheltered from tax-related consequences.

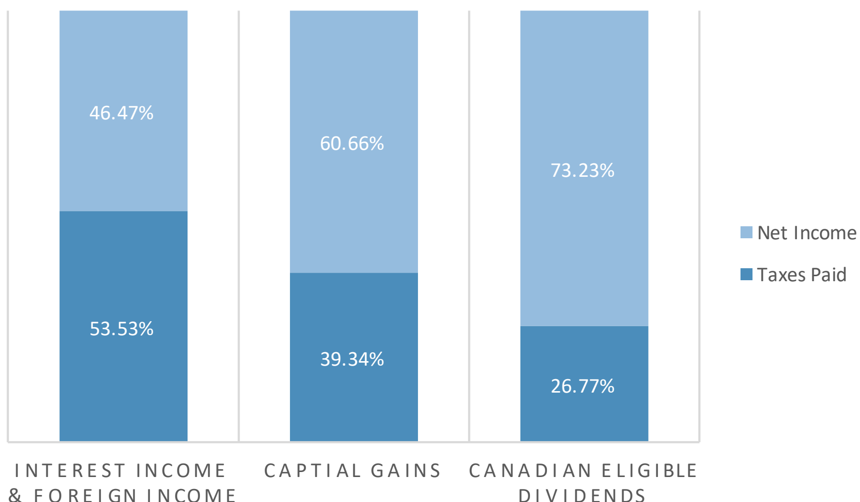
Distinctions of Corporate Class Funds versus Mutual Fund Trusts

	CORPORATE CLASS MF	MF TRUST
ISSUED TO INVESTORS	Shares	Units
ALLOW DISTRIBUTIONS	Cdn Div., Capital Gains, Return of Capital	Cdn Div., Foreign Div., Capital Gains, Interest, Return of Capital
SUITABILITY	Taxable Accounts	Taxable and Non-Taxable Accounts

Tax-Efficient Distributions

Corporate class funds strive to skew the composition of distributions paid to investors to be more tax efficient. From a tax perspective, there are four ways mutual funds generally earn returns: interest income, capital gains, Canadian dividends, and foreign dividends. These are important distinctions because they are all taxed at different rates, some more favourably than others. The distinction is also important because capital losses within the corporation can be used to offset capital gains. As discussed above, a mutual fund trust passes all types of income through to the unitholder. Meanwhile, a corporate class mutual fund is legally only allowed to distribute Canadian dividends and capital gains dividends. This means that interest income and foreign income are taxed within the fund. The fact that a corporate class fund can only distribute Canadian dividends and capital gains may be advantageous to shareholders. For example, holders of a corporate class mutual fund that generates significant interest income and foreign income instead receive the more tax-friendly Canadian dividends and capital gains.

Tax Treatment of Various Types of Income



Source: Raymond James Ltd.; Assumes 2021 highest marginal tax in Ontario

Potential Structural Tax Efficiency within the Fund

Corporate class mutual funds also try to reduce the overall size of any distributions paid to investors. Being able to share income and expenses with other funds enables corporate class mutual funds to reduce the size of any taxable distributions made. With this in mind, an important consideration when investing in a corporate class mutual fund is ensuring that, collectively, all the funds within a mutual fund corporation generate enough expenses to offset the interest income and foreign income generated. This is crucial for ensuring that these types of income, which are taxed at higher rates, are not taxed within the Corporation before distributions are paid, thus creating a double-taxation situation. Therefore, having a broad suite of products in the mutual fund corporation is critical to ensure tax efficiency.

Tax Allocation

How Have Corporate Class Funds Evolved?

In the past, investors could switch between corporate class mutual funds and defer capital gains until they sold out of the broader mutual fund corporation. For example, investors holding *Fund Company A's US Equity Corporate Class Mutual Fund* could switch into units of *Fund Company A's Canadian Fixed Income Corporate Class Mutual Fund* without immediately paying any capital gains. Capital gains would only need to be paid when an investor sold *Company A Corporate Class Mutual Fund* to switch into cash or a fund from a different fund company. This tax-deferral feature was widely popular among investors, but the federal government stopped allowing this as of January 1, 2017. At this point, we do not expect the federal government to mandate any further changes to the structure of corporate class mutual funds.

Mutual Fund Trusts vs. Corporate class structure

Source: AGF

Key Considerations

Further to the consideration of taxes and investment mandate, investors should also be mindful of the fees associated with a given corporate class fund as well as the breadth of offerings a fund company has in a corporate class structure. As mentioned, a corporate class family may not be as tax

efficient if it incurs meaningful interest income from its fixed income offerings but only has a small portion of equity offerings to offset taxes on the received interest payments.

Putting it All Together

Potential Benefits

- Potential to minimize size of taxable distributions
- Potential for more tax efficient composition of distributions
- Potential to generate non-taxable income streams in retirement (T-Class funds)

Potential Drawbacks

- Typically more expensive via higher MERs. Higher MER will lower the return correspondingly.
- Potential for government regulation to impact structure
- Limited availability and capacity from fund companies as tax efficacy can deteriorate over time. At a certain point, fund companies may be required to convert the corporate class to traditional mutual fund trusts.

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Important Investor Disclosures

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