Evidence-Based Investing vs. Indexing

Making a Good Thing Even Better

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INTRODUCTION

As the public grows increasingly familiar with "passive" or "index" investing, it's becoming easier for individual investors to gain cost-effective exposure to globally diversified market returns. That's good news! Even better news is that there is a similar approach we employ for our clients that incorporates the many strengths of passive/index investing while eliminating some of its inherent weaknesses. Beyond passive, we call it **evidence-based investing.**

More than any other approach, we feel that evidence-based investing rigorously incorporates available evidence on how markets have delivered long-term wealth to patient investors. Our aim is to combine sound strategy with objective advice on how to best apply it, so you can tune out harmful distractions and confidently pursue your own highest financial goals.

A Brief History of Indexing

To understand how evidence-based investing works today, it's helpful to review where it came from. Before there was any form of passive investing, there was **active investing.** Active investors try to profit by predicting where and when they're going to experience future gains and losses, and proactively trade in and out of securities, sectors or markets to stay one step ahead. While the idea may seem appealing, there are reams and decades of academic evidence demonstrating that the tactic simply doesn't reliably work, especially after factoring in costs.

In the early 1970s, the first index funds were formed to offer investors a better choice. As the name implies, an index fund buys and holds the securities tracked by a particular index, which is seeking to reflect the performance of a particular asset class. For example, the earliest index funds tracked the popular S&P 500 Index – which in turn tracks the asset class of U.S. large-company stocks. Over time, additional index funds (and similar Exchange Traded Funds, or ETFs) have emerged to track a host of other indices, representing a wide range of asset classes.

Many index funds are well-suited alternatives to actively managed funds, offering tighter control over the actions that academic evidence indicates are critical to expected outcomes:

Asset allocation – How you allocate your portfolio across various market asset classes plays a far greater role in varying your long-term portfolio performance than does the individual securities you hold.

Global diversification – Through broad and deep diversification, the sum of your whole risk can actually be lower than its individual parts.

Cost control – The less you spend implementing a strategy, the more you get to keep.

Inherent Weaknesses in Index Investing

So far, so good. But there are at least a couple inherent weaknesses to index funds.

Index Dependency – Most index funds are generally cost-effective compared to active strategies. But, by definition, they track an index. Whenever that index "reconstitutes" by changing the underlying stocks it is following, the funds tracking it must do so as well – and quickly. In a classic display of supply-and-demand pricing, this generates a buy high, sell low environment as index fund managers must queue up to simultaneously sell stocks that have been removed from the index and buy stocks that have been added.

Compromised Composition – Asset class investing is based on the premise that particular market asset classes exhibit particular return characteristics over time. For example, academic evidence has demonstrated that the stocks of distressed, small-companies are perceived as riskier than stocks of thriving, large-companies. So investors demand – and have by and large received – a premium return for investing in these riskier factors.

An index seeks to accurately proxy the asset class it is targeting. But it's still just a proxy. The S&P 500, for example, tracks 500 U.S. large company stocks out of the roughly 5,000 stocks available for trading on a U.S. exchange. Tracking an index enables pretty good exposure to a targeted asset class, but there's room for improvement by a fund manager who can capture a larger, more accurate representation of the asset class being targeted.

The Advance of Evidence-Based Investing

It didn't take long before academically minded innovators from around the globe sought to improve on the best traits of index funds and eliminate their weaknesses. In fact, many of these thought leaders were the same early adapters who introduced index fund investing to begin with. The results are evidence-based investment funds, which offer us several advantages:

Index-independence – Evidence-based fund managers have freed themselves from tracking popular indexes. Instead, they have established their own parameters for cost-effectively investing in the lion's share of the securities within the asset class being targeted. This reduces the need to place undesirable trades at inopportune times simply to track an index; it allows them to employ more patient trading strategies and scales of economy to achieve better pricing.

Improved Concentration – Untethering themselves from popular indexes also enables evidence-based fund managers to more aggressively pursue targeted risk factors; for example, an evidence-based small-cap value fund has more flexibility to hold smaller and more value-tilted holdings than a comparable index fund. This provides us with more refined control as we construct clients' portfolios according to their individual risk/return goals.

Focusing on Innovative Evidence – We firmly believe that investors are best served when we make it a top priority to heed the evidence on how markets have delivered long-term wealth. Evidence-based investing shifts the emphasis from tracking an index, to continually improving our understanding of the market factors that contribute to the returns we are seeking. By building portfolios using fund managers who apply this same evidence to their fund constructions, we feel we can make best use of the academic insights we already know, while efficiently incorporating credible new ones as they emerge.

A Final Word: Investor Behavior

In many respects, the most important factor driving your investments has nothing to do with market factors. It has to do with your state of mind. To build or preserve sustainable wealth in ever-volatile markets calls for a disciplined outlook based on: (1) adhering to a long-term plan, (2) managing market risks and (3) minimizing the costs involved.

To help you achieve and sustain this challenging level of investment discipline, we take it as our honor and our duty to advise your investing according to reason, based on the best available evidence on how markets work, applied by fund managers who do the same. That's evidence-based investing.

SECOND OPINION SERVICE

When the markets and economies turn volatile and confusing as they have over the past year, even the most patient investors may question the wisdom of the financial path that they've been following. Over the past 20 years, we've reviewed hundreds of investment portfolios and financial plans. We've seen a number of difficult markets come and go. And we can certainly empathize with the people who find that current environment troublesome and disturbing. We'd like to help, if we can, and to that end, here's what we offer.

A no obligation second opinion

Just as it's wise to get a second opinion on your medical health, it's only prudent to get a second opinion on your financial health. Things change. Life moves on. And the financial plan that was right for you five or ten years ago may not suit your needs today. Are your current investments still right for you? Find out with our complimentary, confidential Second Opinion Service.

Our Second Opinion Service will help you clearly see the BIG picture:

- Understand how your money is really invested
- Know your portfolio's risk
- Identify hidden fees
- Learn how to safely maximize your retirement cash flow
- Learn how to reduce taxes (in concert with your tax professional)
- Review your insurance, long term care, and risk management strategy
- Address your estate planning concerns (in concert with your lawyer)

How It Works: From the comfort of your home (via webinar or call) we'll seek to understand your financial goals – and what your investment portfolio and financial plan (if you have one) is intended to do for you. Then we'll review the portfolio for and with you.

If we think your strategies and investments continue to be well-suited to your goals – in spite of the current market turmoil – we'll gladly tell you so, and send you on your way. If, on the other hand, we think some of your investments no longer fit, we'll explain why, in plain English. And, if you like, we'll recommend some alternatives.

Next Step: Simply complete a request for info at www.fwb-inc.com or call us at 1-866-735-5581 and ask for Paul Philip or Ennio Longo.

Note- Due to our low fee nature our service is best suited to investors with portfolios of $250,000 or greater.

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Paul Philip

Paul Philip, CFP, CLU, Investment Advisor

Today's traditional financial planning is sorely lacking. Financial institutions and the media are in business for themselves and it's up to the consumer to recognize this and take responsibility for their own future. For most, finance and economics is too complex and fast changing to manage effectively by themselves. I believe what most people really want is expert professional guidance that they can trust, someone who has their back….and at a fair price. I believe in openness, transparency and value for your hard earned money.

Paul lives in Toronto with his wife Susana and their 2 daughters, Julia and Jacqueline. He is active in his community and is a volunteer coach for underprivileged youth. He is an avid squash player, and loves to have a good time skiing and travelling with his family.

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Ennio Longo, BBA, CFP has been in the financial services industry since 2007. Since that time, Ennio has sought to continually find new and better ways to help his clients in their financial lives. Ennio holds the Certified Financial Planner (CFP) designation and has successfully completed the Canadian Securities course. Ennio specializes in providing holistic financial planning for his clients, raising the bar above the traditional approach employed in the majority of financial institutions. His greatest achievement is seeing the peace of mind his clients receive as he helps them build , protect and enjoy their wealth.

Ennio resides in Toronto with his wife Daniela and their three children Julian, Victoria and Samantha and his favourite past time is being a soccer coach to all three.

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