

Practice Essentials[®] Canada

Three Reasons Why Indexing Works

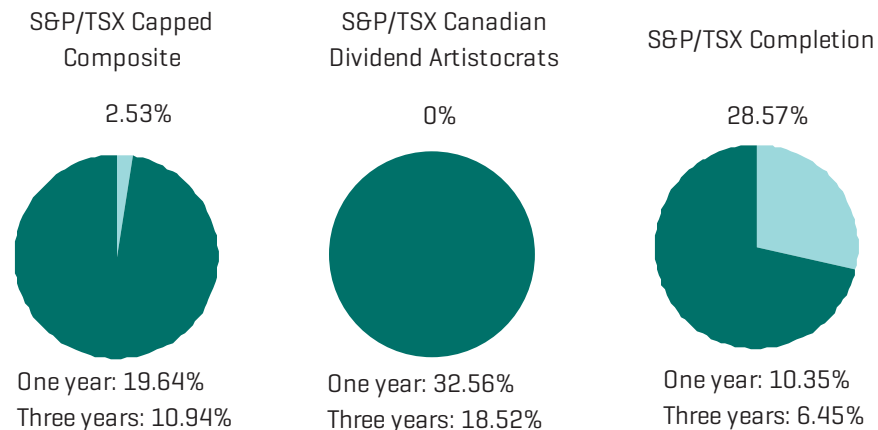
Indexing is a way to invest that is based on choosing investment products that track or mirror an index. The goal of investing with an index-linked product is to achieve the same return as the index. For several reasons, index-based investing may offer investors an alternative to actively managed investments.

1. Most Indices Outperform Actively Managed Investments

Every year, S&P Indices releases the Standard & Poor's Indices Versus Active (SPIVA) Scorecard, which tracks the number of actively managed mutual funds that beat their comparable benchmarks over one-, three- and five-year timeframes. The 2010 SPIVA Canada Scorecard showed that most indices outperformed their comparable Canadian active managers (see Exhibit 1 below).

In the Canadian market, most indices outperformed their comparable active managers.

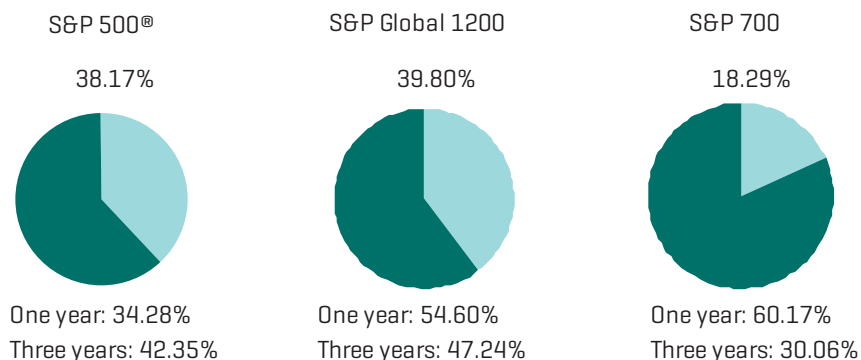
Exhibit 1: Canadian Active Managers Who Outperformed The Index – Five Years Ended 12/31/10



Source: S&P Indices, SPIVA Canada Scorecard Year-End 2010. Data as of December 31, 2010. Charts and tables are provided for illustrative purposes. Past performance is not a guarantee of future results.

This is not a phenomenon that's unique to the Canadian market. Indices in both the U.S. and global markets generally outperform their respective asset managers during similar time frames (see Exhibit 2 on the following page).

Exhibit 2: U.S. and Global Active Managers Who Outperformed The Index – Five Years Ended 12/31/10



Source: S&P Indices, SPIVA U.S. Scorecard Year-End 2010. Data as of December 31, 2010. Charts and tables are provided for illustrative purposes. Past performance is not a guarantee of future results.

Over a five-year period actively managed mutual funds have difficulty consistently remaining in the top quartile.

2. Winning Streaks Don't Often Last

Research suggests that actively managed winning streaks are often short-lived. S&P Indices' Persistence Scorecard tracks the performance consistency of U.S. actively managed mutual funds over consecutive years. Over a five-year period actively managed mutual funds have difficulty consistently remaining in the top quartile (see Exhibit 3 below). In fact, according to the Persistence Scorecard published in November 2011, less than one percent of funds that began as a top-quartile performer in September 2007 ended up in the top quartile almost four years later.

Exhibit 3: Performance Persistence over Five Consecutive 12-Month Periods

Mutual Fund Category	Fund Count at Start	Percentage Remaining in Top Quartile			
		Sep-2007	Sep-2008	Sept-2009	Mar-2010
All Domestic Funds	530	15.09	3.96	1.51	0.19
Large-Cap Funds	160	18.13	6.25	3.13	0.63
Mid-Cap Funds	91	13.19	2.20	1.1	0
Small-Cap Funds	123	13.82	2.44	0.81	0
Multi-Cap Funds	156	14.10	3.85	0.64	0

Source: S&P Indices, S&P Persistence Scorecard: November 2011. Data as of September 30, 2011. Charts and tables are provided for illustrative purposes. Past performance is not a guarantee of future results.

3. Indexing Generally Offers Lower Costs and Greater Transparency and Portfolio Diversification

Reduced investment costs

- Lower fees: Lower management, administration and commission fees and no loads all make the cost of investing in an ETF less expensive than the cost of investing in actively managed mutual funds. Equity mutual fund management expense ratios in Canada average 2.4%. Most ETF management expense ratios are less than 0.5%, according to the Investor Education Fund¹. Over time, this approximately 1.9% in cost savings could add up to extra money in a portfolio.

¹ Investor Education Fund, "What does it cost to invest in an ETF?" (<http://www.getsmarteraboutmoney.ca/managing-your-money/investing/mutual-funds-and-etfs/Pages/what-does-it-cost-to-invest-in-an-etf.aspx>)

- **Less Turnover:** Turnover in exchange traded funds is also lower than in most actively managed mutual funds. ETF holdings only change when the matching index changes. This doesn't happen very often, which means fewer trading costs are passed along to investors. The average turnover in the average U.S. actively managed equity fund in 2004 was 112%, a number that has been steadily increasing from an estimated low of 24% in 1945.² Conversely, the average turnover for the S&P 500 between 1992 and 2010 was 4.68%.³
- **Fewer Trades:** Less trading also means fewer taxable events such as capital gain distributions. Fewer taxes mean more of a portfolio's returns stay in the investor's pocket. For taxable accounts, this could mean substantial savings over time.

Greater Transparency

Most index providers update ETF performance, price changes and constituent lists every trading day on their websites. (Constituent data for S&P Indices is also available at www.standardandpoors.com/indices.) Investments such as mutual funds only publish their top 25 holdings on a quarterly basis. When investors know what's in their portfolio at all times, they can see how closely their money is tracking the objectives and the style of a fund, where security overlaps exist and exactly what exposures are driving performance. If their situation or the markets change suddenly, they have the updated information to change their investments along with it.

More Diversification

ETFs also reduce a portfolio's dependence on single investments. Buying an ETF puts money in the same group of investments that an index follows. Each index can track hundreds—even thousands—of securities, which means results don't depend on one investment.

Geographic, sector and asset class exposure, also provides variety when selecting investments for a portfolio. Indices can even grant access to asset classes that, in the past, were only available to institutional investors such as commodities or difficult-to-research spaces such as emerging markets.

Additional Resources

To access additional Thought Leadership publications from S&P Indices, visit www.spindices.com.

²John C. Bogle, "The Mutual Fund Industry 60 Years Later: For Better or Worse?" Financial Analyst Journal *Reflections*, 2005 (<http://johncbogle.com/wordpress/wp-content/uploads/2010/04/FAJ-Better-or-Worse-60th-anniv.pdf>)

³S&P Indices, "Capitalization Weighted Turnover", 1992-2010 (<http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usdof--p-us-l-->)

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