



LONG LIVE YOUR MONEY

The Passive vs. Active Fund Monitor

Year-End 2016

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ABSTRACT

This report describes the competitive landscape for passively and actively managed funds over the last eleven years in Canada and the United States.

In 2016, Canadian passive funds increased their market share from 10.5% to 11.3% on the back of a positive flow of nearly \$11 billion. Meanwhile, Canadian active funds attracted \$10 billion. Passive flows outpaced active flows for the first time since 2012. Over the same period, passive funds increased their share of the U.S. market from 30% to 34%. U.S. passive funds have attracted \$490 billion, in stark contrast with outflows of \$326 billion for active funds.

Since 2007–2008, Canadian passive funds have doubled their market share from 5.6% to 11.3% and have attracted \$62 billion in net new money, compared to \$47 billion for active funds. Since 2006–2007, U.S. passive funds have more than doubled their market share from 16% to 34% and have attracted a \$2.8 trillion net money flow, compared to a modest \$735 billion for active funds.

Overall, passive funds are gaining ground both in Canada and the U.S. with the help of steady inflows of money. However, the Canadian passive fund industry remains modest relative to the U.S., where passive funds have grown at such a high pace that they are posing a threat to the active fund industry. Finally, we believe the rise of passive funds in general and the corresponding decline of active funds represents a significant transfer of wealth from the financial services industry to the retail investors, as actively-managed funds charge average fees that are much higher than passively-managed ones and yet appear to underperform.

This report was written by Raymond Kerzérho, PWL Capital Inc. The ideas, opinions, and recommendations contained in this document are those of the authors and do not necessarily represent the views of PWL Capital Inc.

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Introduction

This report describes the competitive landscape for passively and actively managed funds over the last eleven years in Canada and the United States. We document the assets under management, market shares and flow of funds for mutual funds and ETFs in aggregate.

1. Methodology

All the data in this report is provided by Morningstar Direct, and accounts for **all mutual funds and exchange-traded funds combined**, in Canada (dating back to 2007) and the United States (dating back to 2006). The data excludes all money-market funds because they are not at the core of the competition between active and passive funds. Funds of funds are also excluded to maintain a consistent methodology between the U.S. and Canadian market data. In order to mitigate the survivorship bias of our study, the data includes funds that disappeared during the period being considered.

Our study focuses on funds categorized by Morningstar as “passively managed, long-term.” This definition of a “passive” fund includes index funds but excludes sector, leveraged and inverse mutual funds and ETFs, which are considered closer in characterization to active funds due to their investment approach. Consequently, we include the latter three sub-categories among active funds.

In contrast, Morningstar categorizes funds from Dimensional Fund Advisors as “passively managed, long-term.” These funds are more similar to the passive philosophy of investment, despite not being index funds. Therefore, this fund sub-group was included in the passive category. Lastly, the Canadian mutual fund data excludes segregated funds sold by life insurance companies.

Since our Mid-year 2016 report, Morningstar has made a significant change in how it compiles data on Canadian mutual funds. The so-called “I” and “O” class funds, for which management fees are negotiated for every individual client, have been added to the pool of mutual funds. We have maintained the same methodology as Morningstar and as a result, this edition of the PAR Report has a more comprehensive data set.

2. Canadian Market 2007–2016

2.1 Market Share

Table 1: Assets under Management in Canada (CAD Billions)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2007-2016 Total Growth Rate
Passive	28	26	41	49	54	68	79	90	99	117	315 %
Active	477	358	445	484	533	576	610	718	842	917	92 %

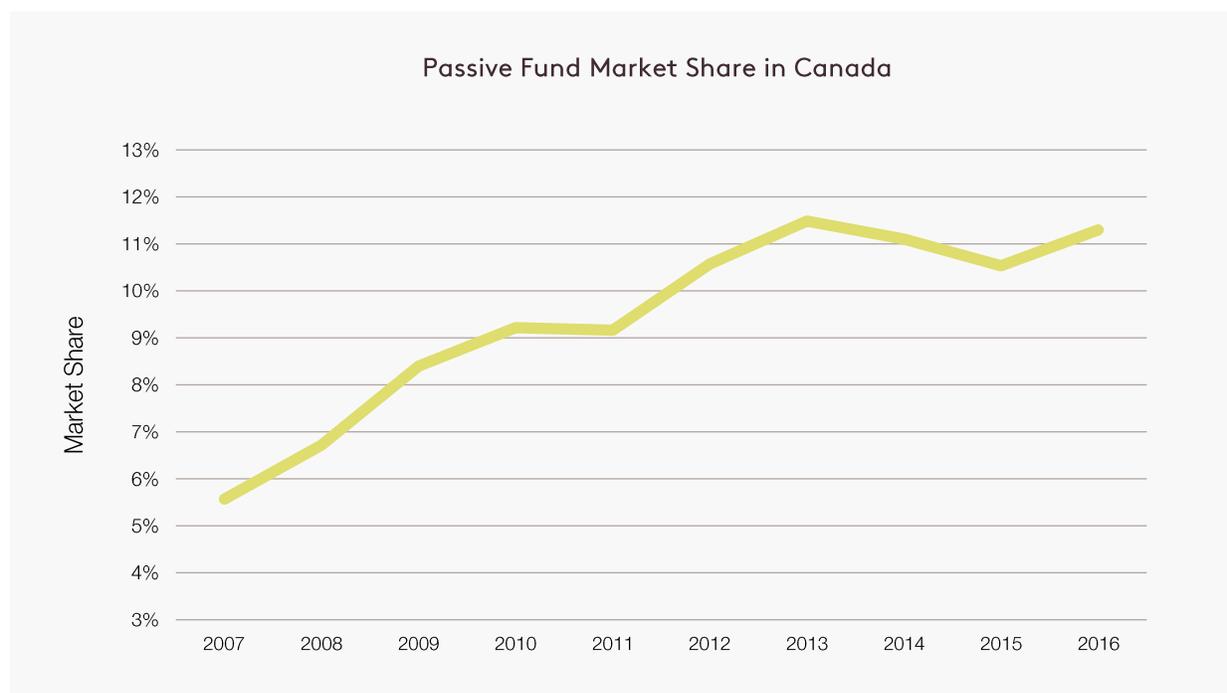
Source: Morningstar Direct

Table 2: Market Share—Canada

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Passive	5.6%	6.7%	8.4%	9.2%	9.2%	10.6%	11.5%	11.1%	10.5%	11.3%
Active	94.4%	93.3%	91.6%	90.8%	90.8%	89.4%	88.5%	88.9%	89.5%	88.7%

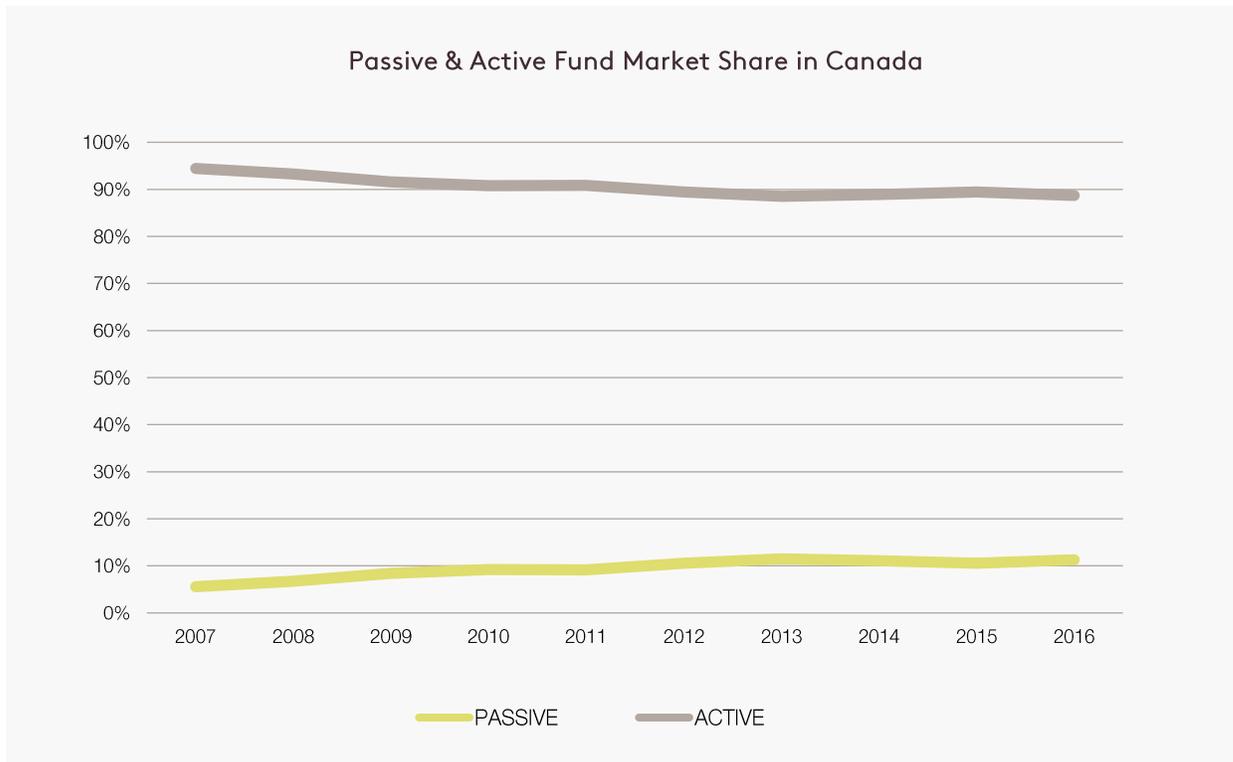
Source: Morningstar Direct

Chart 1



Source: Morningstar Direct

Chart 2



Source: Morningstar Direct

In 2016, the market share of passive funds increased by a 0.8%, from 10.5% to 11.3%. The market share data for Canada displays a positive trend in terms of passively managed funds taking an increasing percentage of the market, from a meager 5.6% in 2007 to 11.3% currently. Correspondingly, the market share of actively managed funds has fallen from 94.4% of the market to 88.7%.

The Canadian data shows not only a clear upward trend in passive fund market share, but also a strong growth rate of these funds between the years of 2007 and 2016. Passive funds experienced an impressive 315% growth rate during this period, compared to 92% for active funds. In other words, passive funds grew three times faster than active funds during the 2007–2016 period. However, in dollar terms, actively managed funds grew by \$440 billion, compared to a gain of \$89 billion for passively managed funds. These impressive gains in active assets under management are mostly due to having the investment returns on a larger asset base, as passive funds attracted more new money in the last 10 years than did active funds (details in Section 2.2).

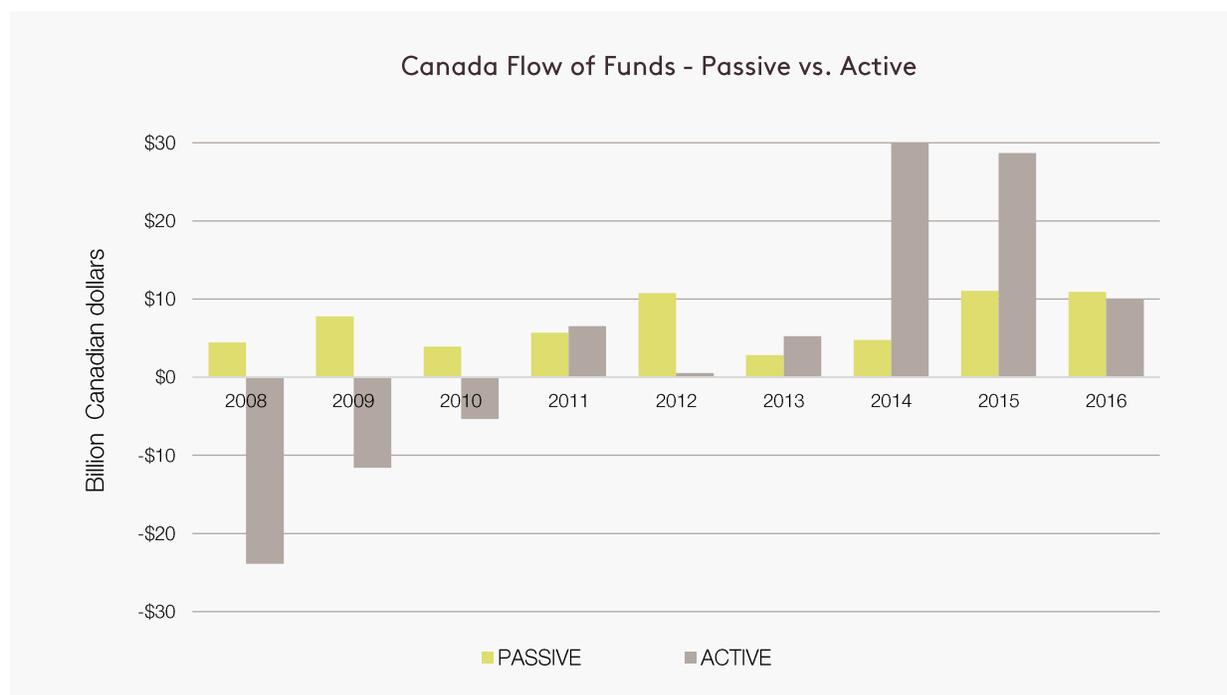
2.2 Flow of Funds

Table 3: Canadian Flow of Funds into Active and Passive Funds (CAD Billions)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Passive	4.4	7.8	3.9	5.7	10.8	2.8	4.7	11.1	10.9
Active	-23.9	-11.6	-5.3	6.5	0.5	5.2	36.6	28.7	10.0

Source: Morningstar Direct

Chart 3



Source: Morningstar Direct

Chart 3 shows the flow of money into passive and active Canadian funds between 2008 and 2016. In 2016, passive funds have collected \$10.9 billion, compared to \$10 billion for active funds. With regards to the multi-year trends, the net flow into passive funds has been stable and positive every year since 2008. During the same time period, the flow of money into active funds has been highly volatile, and the total amount invested fell short of the net investments into passive funds: \$47 billion for active funds compared to \$62 billion for passive funds.

Another noteworthy point is the major contribution of ETFs to the total flows towards actively-managed Canadian funds in 2016. Five of the ten billion dollars in new active money came from ETFs (Ref. Appendix A), beating the previous record for active ETF inflows by \$1 billion. This contribution to active ETFs came mostly from low volatility, high dividend and sector ETFs.

3. U.S. Market 2006–2016

3.1 Market Share

Table 4: Assets under Management in the U.S. (USD Trillions)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2006-2016 Total Growth Rate
Passive	1.2	1.5	1.1	1.6	2.0	2.1	2.6	3.4	4.0	4.3	5.1	324%
Active	6.5	7.2	4.6	6.2	7.2	7.1	8.1	9.6	10.1	9.7	10.0	54%

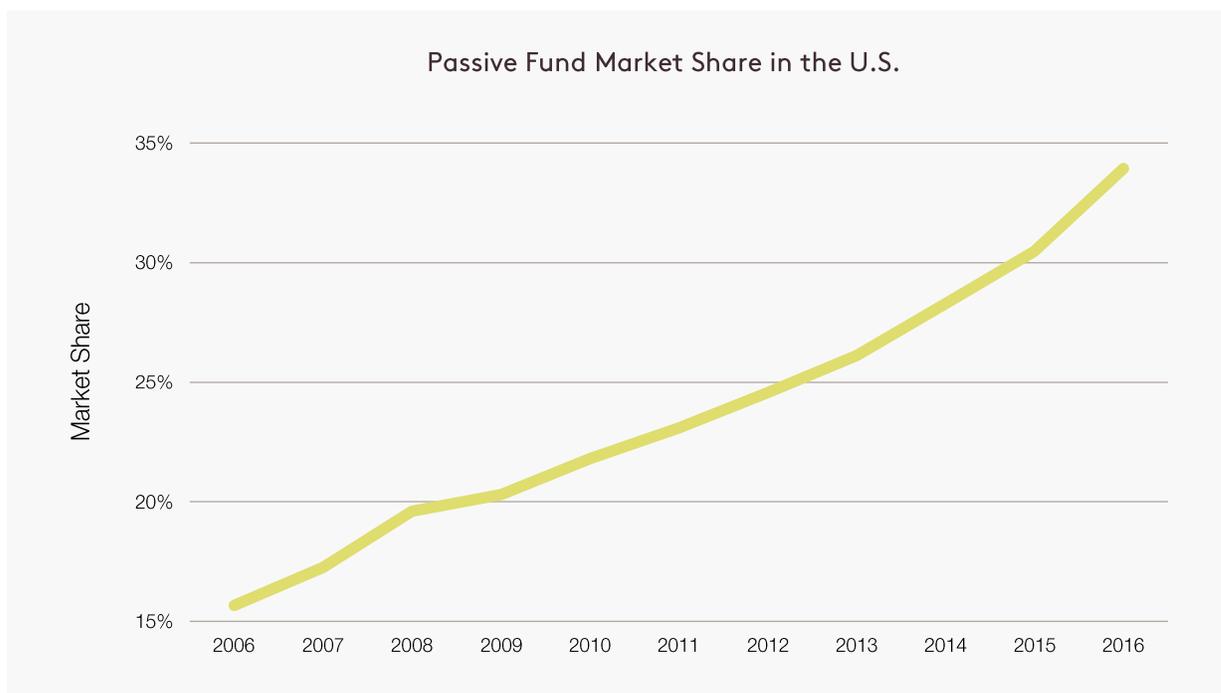
Source: Morningstar Direct

Table 5: Market Share—U.S.

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Passive	16%	17%	20%	20%	22%	23%	25%	26%	28%	30%	34%
Active	84%	83%	80%	80%	78%	77%	75%	74%	72%	70%	66%

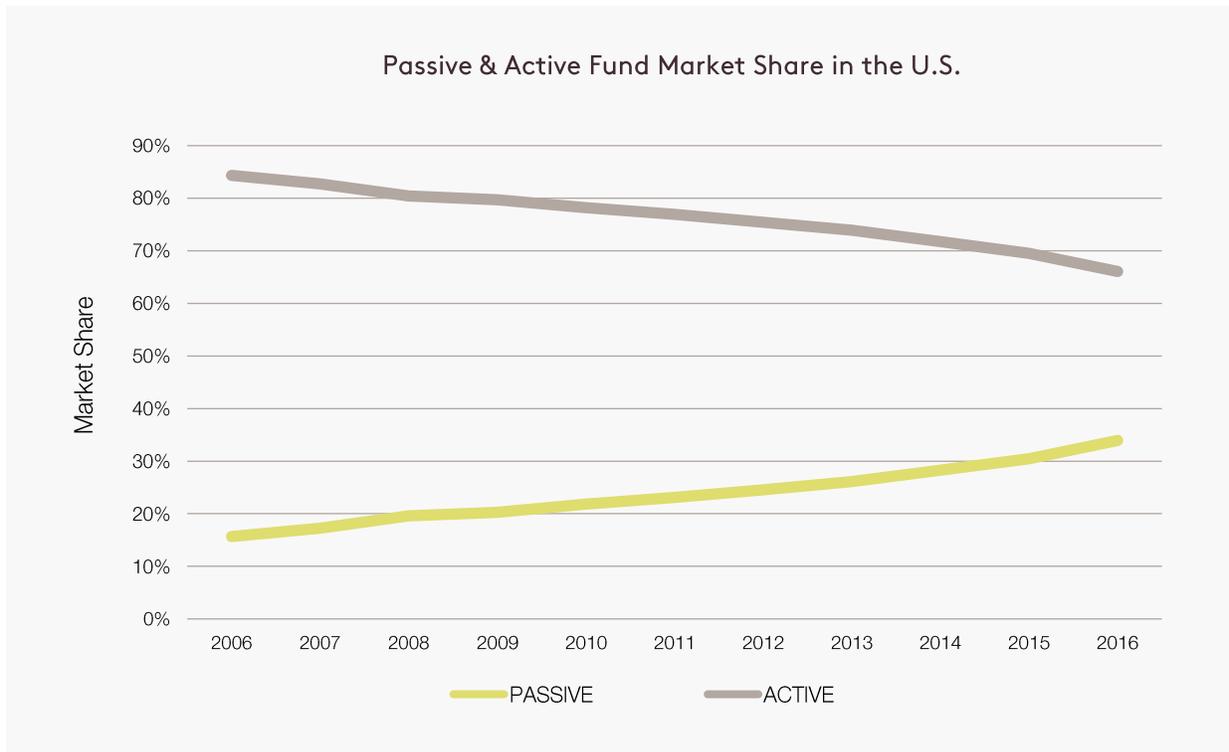
Source: Morningstar Direct

Chart 4



Source: Morningstar Direct

Chart 5



Source: Morningstar Direct

In 2016, the market share of passive funds increased by four percentage points, from 30% to 34%. Data shows a significant increase in market share for passively invested funds, from 16% to 34% of the market between 2006 and 2016. The market share of active funds, on the other hand, fell from 84% to 66% in the same time period. Passive funds also experienced an astonishing growth rate of approximately 324% in 2006–2016, compared to 54% for active funds. The growth rate of passively managed funds outpaced that of their active counterpart by a ratio of 6:1. However, in dollar terms, passive and active funds increased their assets under management (AUM) by similar amounts of \$3.9 and \$3.5 trillion respectively. Similarly to the Canadian market, active funds increased their AUM mostly on the back of having the market gains on a larger asset base, as passive funds attracted more new money in the last 11 years than did active funds (details in Section 3.2).

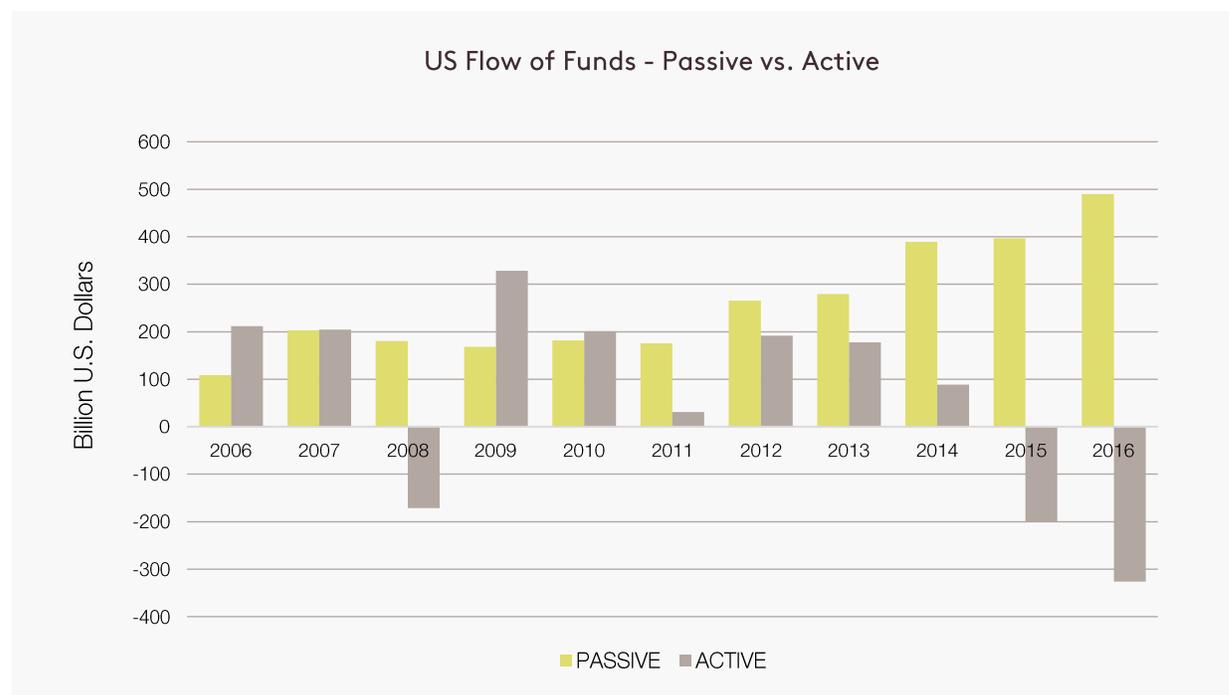
3.2 Flow of Funds

Table 6: U.S. Flow of Funds into Active and Passive Funds (USD Billions)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Passive	109	203	180	168	182	175	266	280	389	397	490
Active	212	205	-172	328	201	31	191	178	89	-201	-326

Source: Morningstar Direct

Chart 6



Source: Morningstar Direct

Chart 6 illustrates the flow of U.S. money into passive and active funds between 2006 and 2016. In 2016, passive funds have attracted \$490 billion in new money, whereas active funds have experienced \$326 billion in outflows. The data shows that, unlike the volatility of active fund input, passive fund additions have been consistently positive since 2006. Active funds show negative cash flows in three different years: 2008, 2015 and 2016. The decreasing flow of funds into active funds stands in stark contrast to the growing figures for passive fund investments, which have registered a new high in 2016 for annual inflows, beating their old record by a landslide. In each of the last 6 years, passive funds attracted more investment than did active funds. From 2006 to 2016, passive funds have attracted \$2.8 trillion in net new money, compared to only \$735 billion for active funds.

4. Conclusion

The competitive landscape is better understood in light of the similarities and differences between the Canadian and U.S. retail fund markets.

Since 2006/2008, both Canadian and U.S. passive funds attracted positive net new money steadily, whereas the flow of funds towards active management has been extremely volatile. Since 2006-2008, passive funds have attracted more money than active funds both in the U.S. and Canada. Lastly, passive funds have doubled their market share on both sides of the border.

However, the passive investment industry is huge in the U.S. compared to Canada. With over \$5 trillion (USD) in assets under management, the U.S. completely dwarfs Canada's tiny \$117 billion (CAD). Even after adjusting for the exchange rate and the size difference between the U.S. and Canadian economies (we divided the U.S. assets by a factor of 10), U.S. passive funds manage over five times more money than their Canadian counterparts.

While Canadian passive funds are gaining ground slowly but surely, U.S. passive funds are growing so fast that they pose a threat to the active investment industry south of the border. Back in 2006, U.S.-domiciled active funds managed \$5 for every dollar managed by passive funds. Nowadays, this ratio has fallen to \$2 for \$1. Meanwhile, in Canada, the data suggests that the traditional active managers remain well in control of the retail fund industry. In fact, the Canadian market share of passive funds has not increased since 2013. Furthermore, our 11.3% estimate for the Canadian market share of passive funds may be overstated, because a large portion of the Canadian mutual fund marketplace is occupied by funds-of-funds, which were excluded from our analysis. In Canada, the presence of passive funds is narrower, being concentrated mostly in ETFs, while in the U.S., the passive investment approach has a strong presence in both the ETF and mutual fund markets.

Lastly, we believe the rise of passive funds in general and the relative decline of active funds represents a significant transfer of wealth from the financial services industry to the investors, as actively-managed funds charge average fees that are much higher than passively-managed ones and appear to underperform on average.

Appendix A: Canadian ETF Data

(Source: Morningstar Direct)

Table 7: Assets under Management (CAD Billions)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2007-2016 Total Growth Rate
Passive	14.6	14.1	23.9	29.5	32.9	43.9	50.0	59.3	68.6	84.0	577%
Active	3.8	5.2	7.4	8.5	9.7	11.4	11.5	15.6	18.4	26.7	610%

Source: Morningstar Direct

Table 8: Market Shares

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Passive	79.5%	73.1%	76.3%	77.7%	77.2%	79.4%	81.3%	79.2%	78.9%	75.9%
Active	20.5%	26.9%	23.7%	22.3%	22.8%	20.6%	18.7%	20.8%	21.1%	24.1%

Source: Morningstar Direct

Table 9: Flow of Funds (CAD Billions)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Passive	3.7	6.0	2.8	4.6	9.0	3.8	6.2	11.7	10.7
Active	2.1	1.5	0.8	1.6	1.6	0.6	3.9	2.5	4.9

Source: Morningstar Direct

Appendix B: Canadian Mutual Fund Data

(Source: Morningstar Direct)

Table 10: Assets under Management (CAD Billions)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2007-2016 Total Growth Rate
Passive	13.6	11.6	16.8	19.6	20.9	24.3	29.2	30.3	30.5	32.8	242%
Active	473.3	352.4	437.1	475.3	523.7	564.8	598.7	702.2	823.8	890.4	88%

Source: Morningstar Direct

Table 11: Market Shares

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Passive	2.8%	3.2%	3.7%	4.0%	3.8%	4.1%	4.6%	4.1%	3.6%	3.6%
Active	97.2%	96.8%	96.3%	96.0%	96.2%	95.9%	95.4%	95.9%	96.4%	96.4%

Source: Morningstar Direct

Table 12: Flow of Funds (CAD Billions)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Passive	0.7	1.8	1.1	1.1	1.8	-0.9	-1.4	-0.7	0.2
Active	-26.0	-13.1	-6.2	4.9	-1.1	4.6	32.7	26.2	5.2

Source: Morningstar Direct

Appendix C: U.S. ETF Data

(Source: Morningstar Direct)

Table 13: Assets under Management (USD Billions)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2006-2016 Total Growth Rate
Passive	383	548	466	687	887	936	1,203	1,476	1,736	1,858	2,244	485%
Active	49	75	76	106	127	126	145	225	269	277	311	536%

Source: Morningstar Direct

Table 14: Market Shares

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Passive	89%	88%	86%	87%	88%	88%	89%	87%	87%	87%	88%
Active	11%	12%	14%	13%	12%	12%	11%	13%	13%	13%	12%

Source: Morningstar Direct

Table 15: Flow of Funds (USD Billions)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Passive	57	123	125	97	107	100	179	142	210	219	265
Active	8	22	39	22	13	17	11	44	32	26	22

Source: Morningstar Direct

Appendix D: U.S. Mutual Fund Data

(Source: Morningstar Direct)

Table 16: Assets under Management (USD Trillions)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2006-2016 Total Growth Rate
Passive	0.8	1.0	0.7	0.9	1.1	1.2	1.4	1.9	2.3	2.4	2.9	485%
Active	6.4	7.1	4.6	6.1	7.1	6.9	8.0	9.4	9.8	9.4	9.6	536%

Source: Morningstar Direct

Table 17: Market Shares

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Passive	11%	12%	13%	13%	14%	15%	15%	17%	19%	20%	23%
Active	89%	88%	87%	87%	86%	85%	85%	83%	81%	80%	77%

Source: Morningstar Direct

Table 18: Flow of Funds (USD Billions)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Passive	53	80	56	71	75	77	88	141	184	192	221
Active	204	183	-209	306	188	14	180	133	57	-228	-349

Source: Morningstar Direct



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