

PWL

LONG LIVE YOUR MONEY

A photograph of a swimmer in a pool, viewed from above. The swimmer is wearing a red cap and dark swim trunks, and is in the middle of a stroke. The water is a clear, light blue. A yellow lane line is visible in the background.

The Passive vs. Active Fund Monitor

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Year-end 2017

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→ Summary

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

In 2017, Canadian passive funds increased their market share from 10.2% to 11.2% on the back of a positive flow of nearly \$13 billion. Meanwhile, Canadian active funds attracted \$18 billion. Over the same period, passive funds increased their share of the U.S. market from 32% to 35%. U.S. passive funds attracted \$663 billion, a sixth consecutive record. Active funds attracted an inflow of \$23 billion.

Since 2007–2008, Canadian passive funds have doubled their market share, from 5.2% to 11.2%, and attracted \$70 billion in net new money, compared to \$75 billion for active funds. Since 2006–2007, U.S. passive funds have more than doubled their market share, from 16% to 35%, and attracted a net money flow of \$3.4 trillion, compared to a modest \$887 billion for active funds.

Overall, passive funds are gaining ground in both Canada and the U.S. with the help of steady inflows of money. However, the Canadian passive fund industry remains small relative to the one in the U.S., where passive funds have grown at a frenzied pace. 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 end investors. Assuming that passive funds charge, on average, a management expense ratio that is 1% lower, this means that \$1.3 billion CAD and \$63 billion USD are saved annually by Canadian and U.S. investors. These savings naturally represent an equal amount in loss of revenue for the investment fund industry.

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 twelve 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 similar in characterization to active funds due to their investment approach. Consequently, we include the latter three subcategories among active funds.

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

2 Canadian Market 2007–2017

2.1 Market Share

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

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2007–2017 Total Growth Rate |
|---------|------|------|------|------|------|------|------|------|------|------|------|-----------------------------------|
| PASSIVE | 26 | 24 | 38 | 46 | 50 | 64 | 74 | 83 | 91 | 107 | 130 | 400% |
| ACTIVE | 480 | 360 | 447 | 488 | 536 | 579 | 635 | 746 | 871 | 947 | 1038 | 116% |

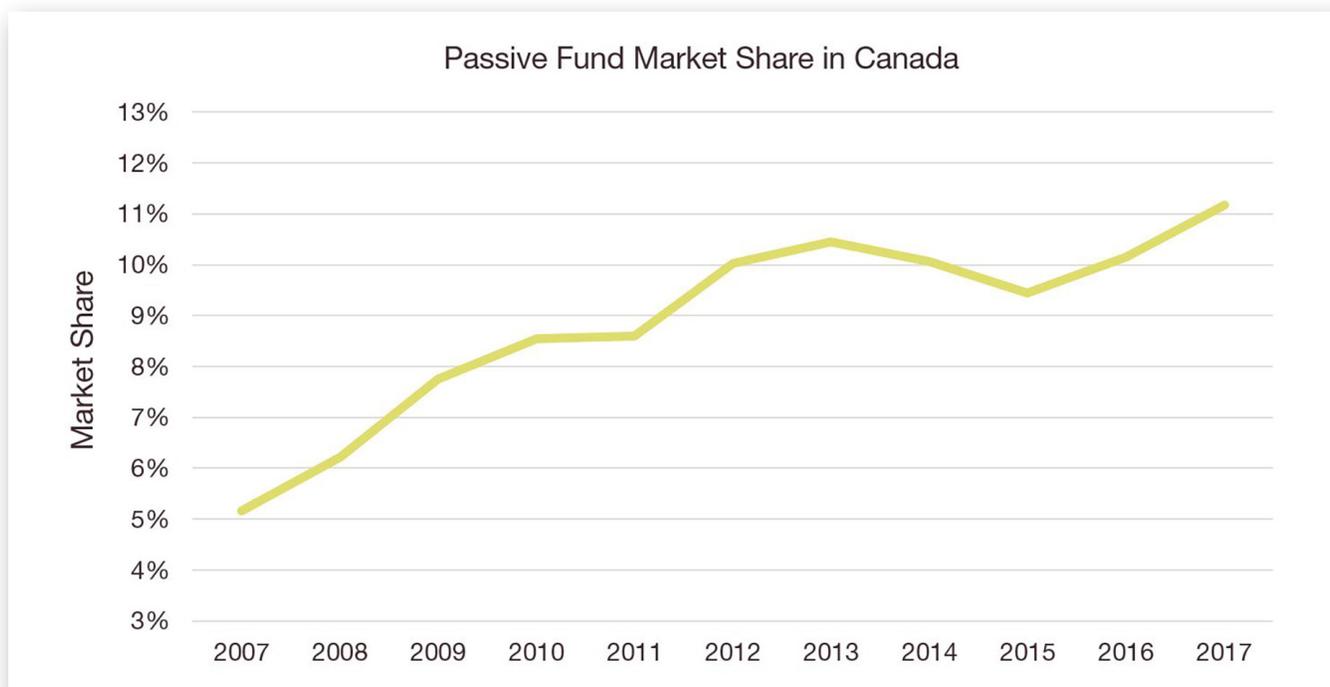
Source: Morningstar Direct

Table 2: Market Share—Canada

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| PASSIVE | 5.2% | 6.2% | 7.8% | 8.5% | 8.6% | 10.0% | 10.5% | 10.1% | 9.5% | 10.2% | 11.2% |
| ACTIVE | 94.8% | 93.8% | 92.2% | 91.5% | 91.4% | 90.0% | 89.5% | 89.9% | 90.5% | 89.8% | 88.8% |

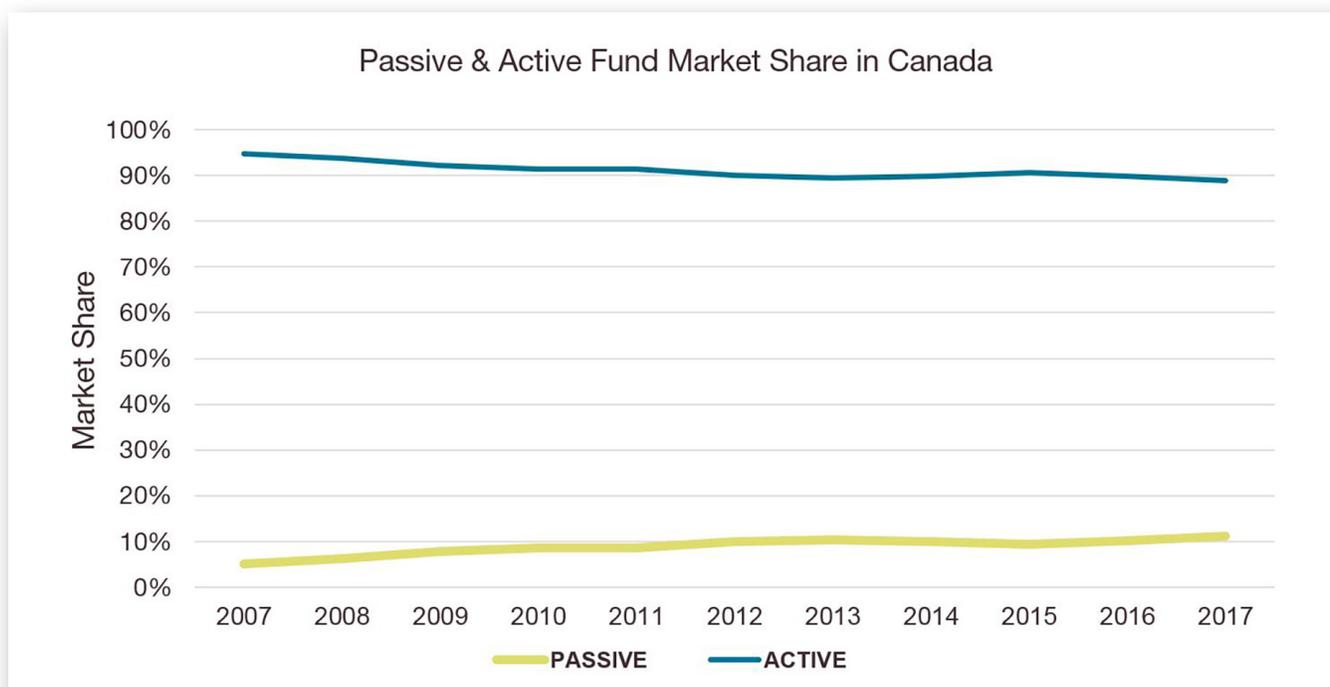
Source: Morningstar Direct

Chart 1



Source: Morningstar Direct

Chart 2



Source: Morningstar Direct

In 2017, the market share of passive funds increased 1%, from 10.2% to 11.2%. 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 5.2% in 2007 to 11.2% currently. Correspondingly, the market share of actively managed funds has fallen from 94.8% of the market to 88.8%.

The Canadian data shows not only a clear upward trend in the market share of passive funds, but also a strong growth rate for these funds between the years 2007 and 2017. Passive funds experienced an impressive 400% growth rate during this period, compared to 116% for active funds. In other words, passive funds grew four times faster than active funds during the 2007–2017 period. However, passive fund gains in market share have slowed considerably since 2014, as active funds resumed substantial inflows.

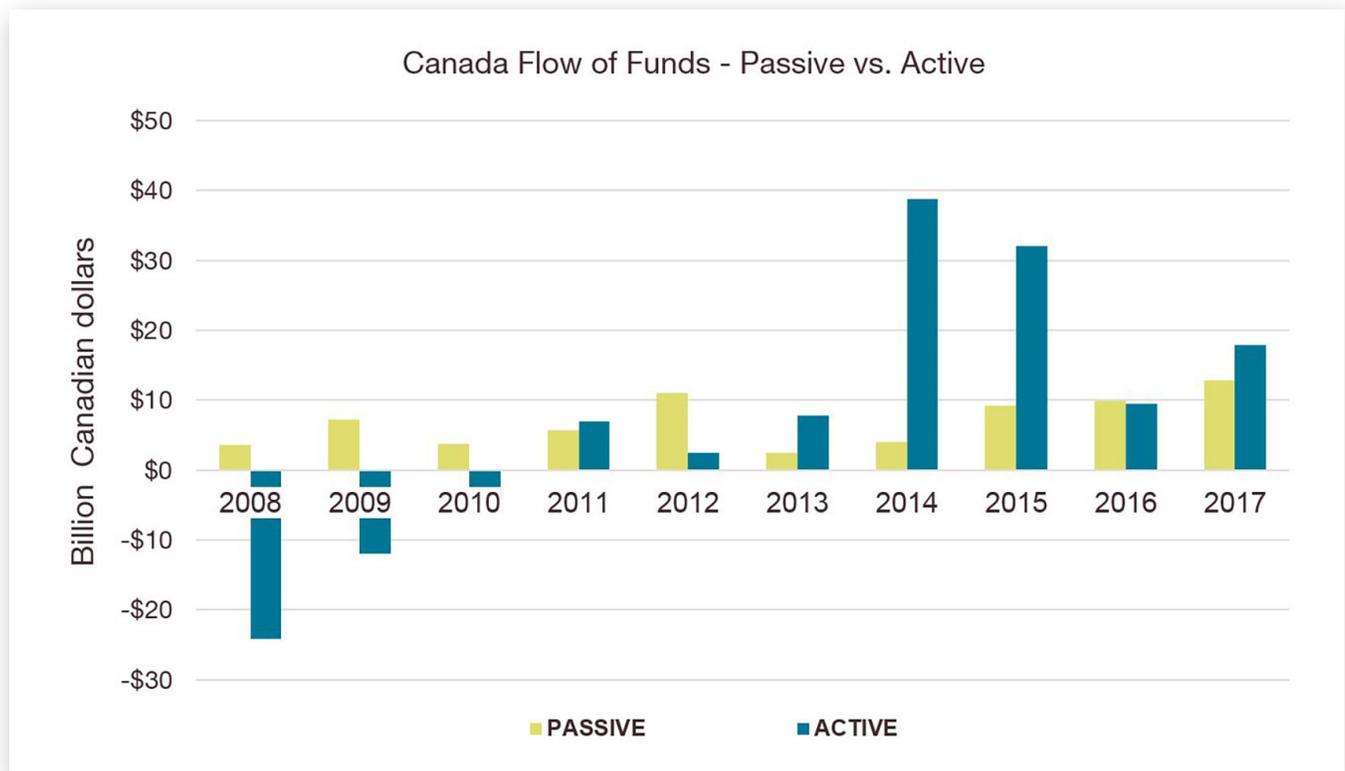
2.2 Flow of Funds

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

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---------|-------|-------|------|------|------|------|------|------|------|------|
| PASSIVE | 3.6 | 7.2 | 3.8 | 5.7 | 11.0 | 2.4 | 4.0 | 9.2 | 9.9 | 12.8 |
| ACTIVE | -24.1 | -12.0 | -4.7 | 6.9 | 2.5 | 7.9 | 38.8 | 32.1 | 9.5 | 17.9 |

Source: Morningstar Direct

Chart 3



Source: Morningstar Direct

Chart 3 shows the flow of money into passive and active Canadian funds between 2008 and 2017. In 2017, passive funds collected a record \$12.8 billion, compared to \$17.9 billion for active funds. As regards multi-year trends, the net flow into passive funds has been stable and positive every year since 2008. Over that same period, the flow of money in and out of active funds has been highly volatile. In fact, Canadian active funds faced significant net withdrawals from 2008 to 2010, during and shortly after the great financial crisis. However, active funds have strongly recovered since 2014, with solid positive inflows.

Overall, since 2008, Canadian passive funds have attracted a \$70 billion net inflow, compared to \$75 billion for active funds.

3 U.S. Market 2006–2017

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 | 2017 | 2006–2017 Total Growth Rate |
|---------|------|------|------|------|------|------|------|------|------|------|------|------|-----------------------------------|
| PASSIVE | 1.2 | 1.5 | 1.1 | 1.5 | 1.9 | 2.0 | 2.5 | 3.2 | 3.7 | 4.0 | 4.8 | 6.3 | 423% |
| ACTIVE | 6.5 | 7.2 | 4.7 | 6.3 | 7.3 | 7.2 | 8.3 | 9.8 | 10.4 | 10.0 | 10.3 | 11.8 | 83% |

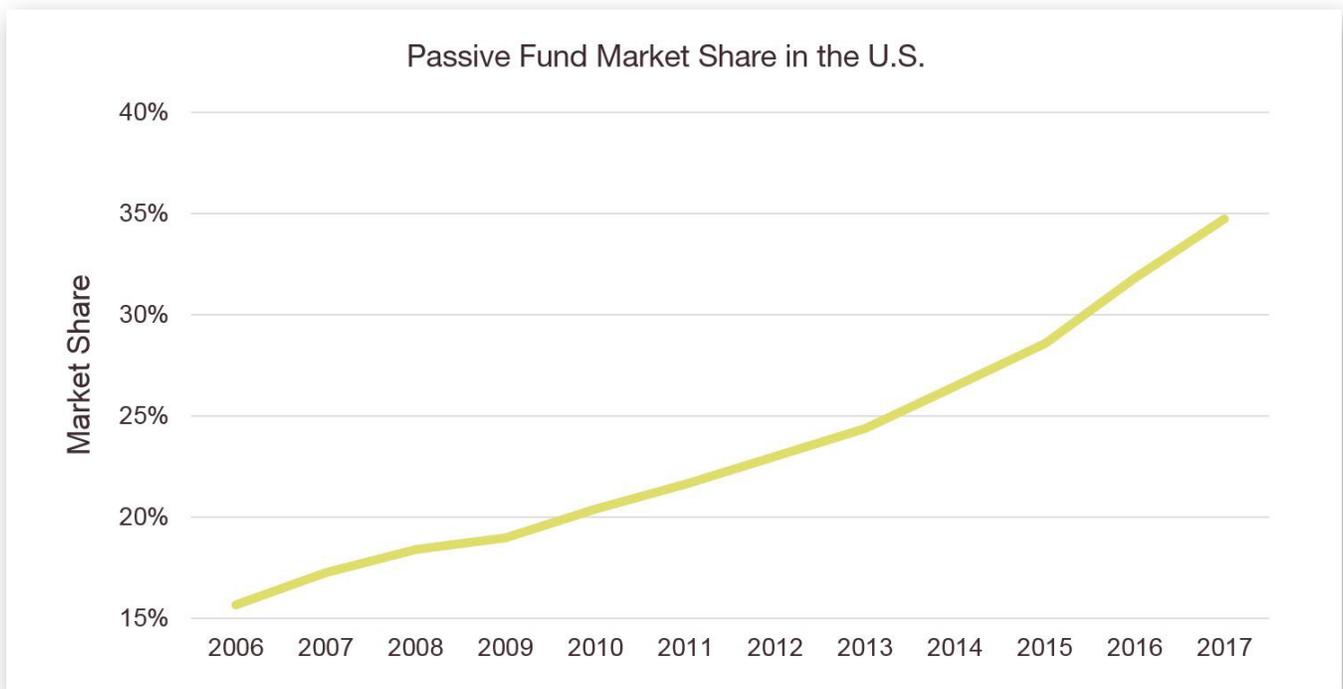
Source: Morningstar Direct

Table 5: Market Share—U.S.

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---------|------|------|------|------|------|------|------|------|------|------|------|------|
| PASSIVE | 16% | 17% | 18% | 19% | 20% | 22% | 23% | 24% | 26% | 29% | 32% | 35% |
| ACTIVE | 84% | 83% | 82% | 81% | 80% | 78% | 77% | 76% | 74% | 71% | 68% | 65% |

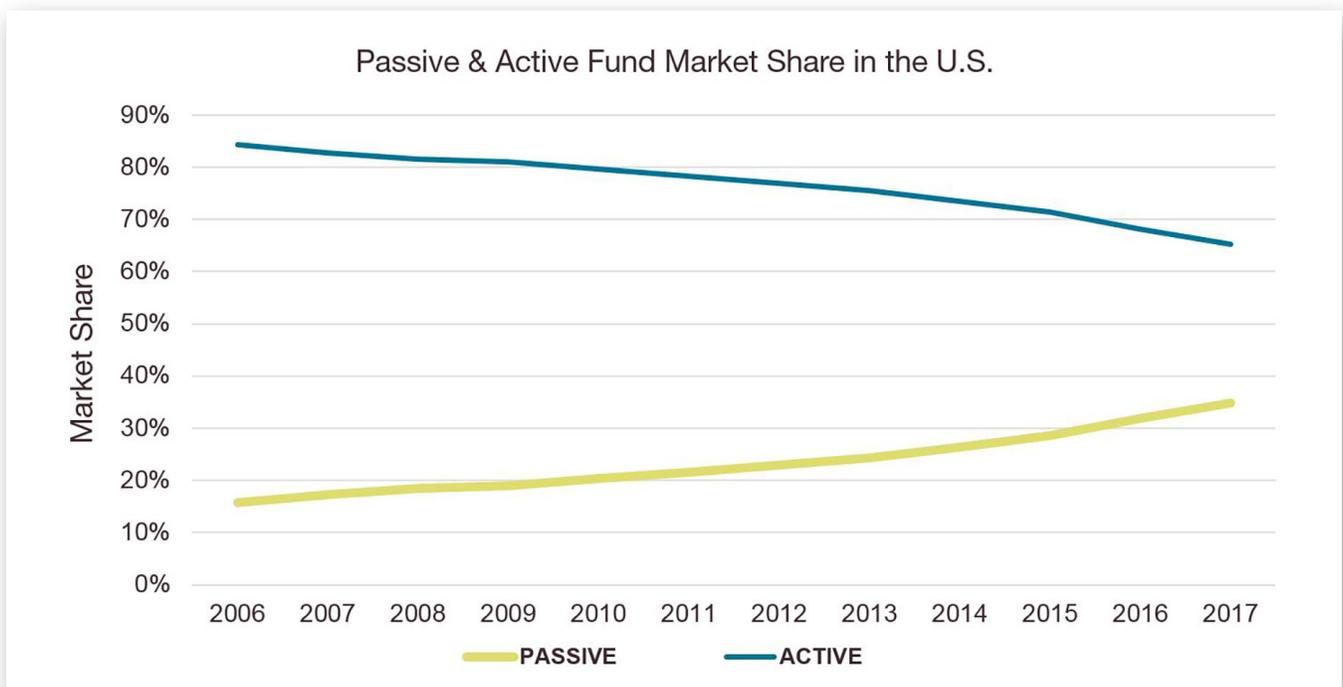
Source: Morningstar Direct

Chart 4



Source: Morningstar Direct

Chart 5



Source: Morningstar Direct

In 2017, the market share of passive funds increased by three percentage points, from 32% to 35%. Over twelve years, the data shows a significant increase in market share for passively invested funds, from 16% to 35% between 2006 and 2017. The market share of active funds, on the other hand, fell from 84% to 65% over the same period. Passive funds also experienced an astonishing growth rate of approximately 423% in 2006–2017, compared to 83% for active funds. The growth rate of passively managed funds outpaced that of active ones by a ratio of 5:1. However, in dollar terms, passive and active funds increased their assets under management (AUM) by similar amounts: \$5.1 and \$5.4 trillion, respectively. Active funds increased their AUM mostly on the back of the market gains having a larger asset base. By contrast, passive funds have attracted a lot more new money in the last 12 years than have active funds (details in Section 3.2).

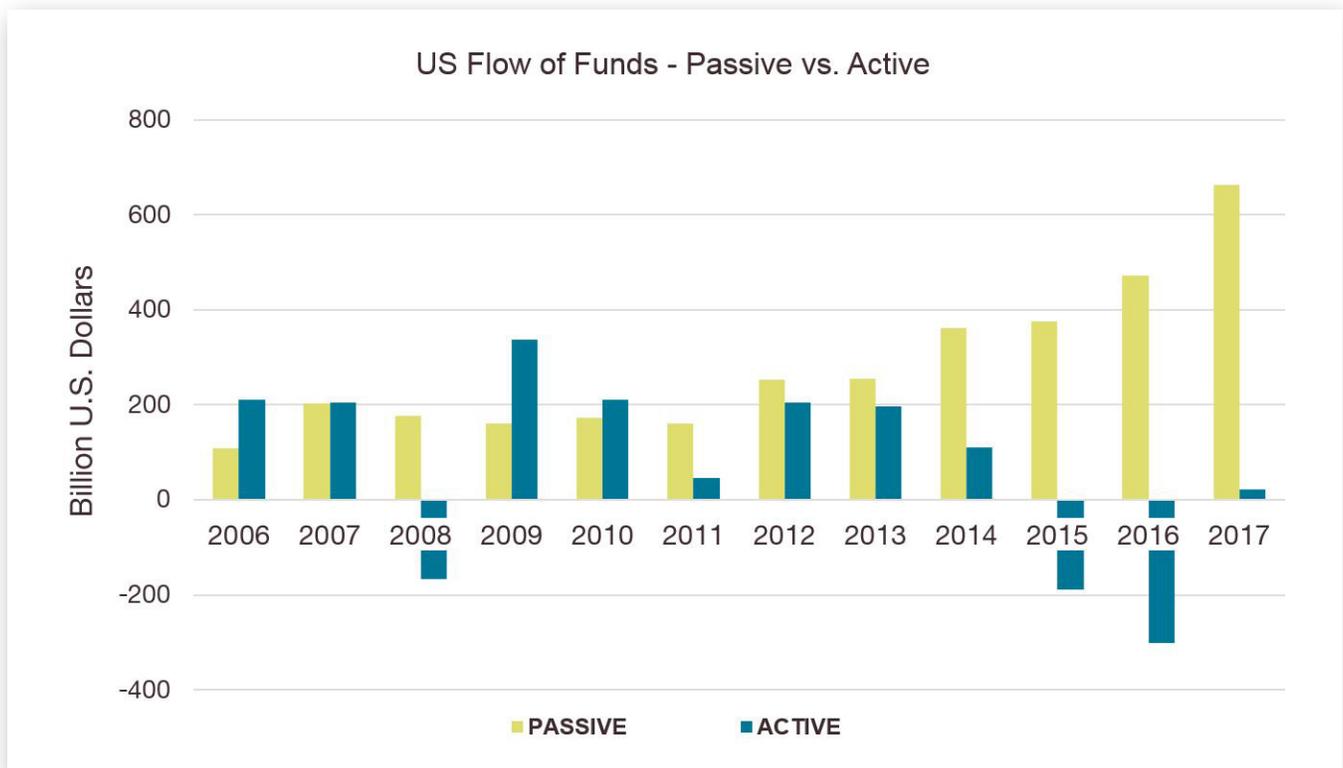
3.2 Flow of Funds

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

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---------|------|------|------|------|------|------|------|------|------|------|------|------|
| PASSIVE | 109 | 203 | 176 | 160 | 173 | 160 | 252 | 256 | 360 | 375 | 471 | 663 |
| ACTIVE | 212 | 205 | -167 | 338 | 211 | 47 | 205 | 196 | 110 | -190 | -302 | 23 |

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 2017. In 2017, passive funds attracted \$663 billion in new money, whereas active funds gathered inflows of only \$23 billion. The data shows that the flows in and out of active funds have been very volatile. Active funds were hit by 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 new highs for six consecutive years. From 2006 to 2017, passive funds attracted \$3.4 trillion in net new money, compared to only \$887 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 2007–2008, both Canadian and U.S. passive funds attracted positive net new money steadily, whereas the flow of funds toward active management has been extremely volatile. It is also true that passive funds have doubled their market share on both sides of the border. But the similarities end there.

The passive investment industry is huge in the U.S. compared to Canada. With \$6.3 trillion (USD) in assets under management, the U.S. completely dwarfs Canada's tiny \$130 billion (CAD). Even after adjusting for the exchange rate and the size difference between the U.S. and Canadian economies (by dividing the U.S. assets by a factor of 8.3), U.S. passive funds manage six times more money than their Canadian counterparts.

While Canadian passive funds are gaining ground very slowly, U.S. passive funds are growing extremely fast. Back in 2006, U.S.-domiciled active funds managed \$5 for every dollar managed by passive funds. Nowadays, this ratio has fallen to less than \$2 for \$1. Meanwhile, in Canada, the data suggests that traditional active managers retain the lion's share of the fund industry. In fact, the Canadian market share of passive funds just surpassed its 2013 record with great difficulty. Furthermore, our 11.2% 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.

We believe the overall rise of passive funds, and the corresponding decline of active funds, represents a significant transfer of wealth from the financial services industry to the investors, as passively managed funds charge, on average, much lower fees than actively managed ones, and they tend to deliver returns that are mainly equal or higher, before fees. In Canada, assuming that passive funds charge an average management expense ratio that is 1% lower, this means \$1.3 billion being saved annually by investors. In the U.S., the savings add up to \$63 billion. These savings represent an equal amount of loss in revenues for the investment fund industry.

Appendix A: Canadian ETF Data

Table 7: Assets Under Management (CAD Billions)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2007-2017 Total Growth Rate |
|---------|------|------|------|------|------|------|------|------|------|------|------|-----------------------------------|
| PASSIVE | 12.6 | 12.3 | 21.3 | 26.4 | 29.9 | 40.7 | 45.6 | 53.8 | 61.1 | 75.2 | 95.2 | 753% |
| ACTIVE | 4.2 | 5.4 | 7.6 | 8.6 | 9.8 | 11.4 | 11.6 | 15.7 | 18.5 | 26.9 | 36.7 | 780% |

Source: Morningstar Direct

Table 8: Market Share

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| PASSIVE | 75.2% | 69.4% | 73.6% | 75.4% | 75.3% | 78.0% | 79.7% | 77.4% | 76.8% | 73.7% | 72.2% |
| ACTIVE | 24.8% | 30.6% | 26.4% | 24.6% | 24.7% | 22.0% | 20.3% | 22.6% | 23.2% | 26.3% | 27.8% |

Source: Morningstar Direct

Table 9: Flow of Funds (CAD Billions)

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---------|------|------|------|------|------|------|------|------|------|------|
| PASSIVE | 3.1 | 5.6 | 2.6 | 4.5 | 9.2 | 3.4 | 5.4 | 9.8 | 9.8 | 12.6 |
| ACTIVE | 2.1 | 1.4 | 0.7 | 1.6 | 1.6 | 0.6 | 3.8 | 2.5 | 4.9 | 6.3 |

Source: Morningstar Direct

Appendix B: Canadian Mutual Fund Data

Table 10: Assets Under Management (CAD Billions)

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2007–2017 Total Growth Rate |
|---------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|--------|-----------------------------------|
| PASSIVE | 13.4 | 11.5 | 16.3 | 19.1 | 20.5 | 23.8 | 28.5 | 29.6 | 29.9 | 31.9 | 35.3 | 262% |
| ACTIVE | 475.6 | 354.1 | 439.8 | 479.3 | 526.0 | 567.4 | 623.1 | 729.9 | 852.9 | 920.1 | 1001.0 | 110% |

Source: Morningstar Direct

Table 11: Market Share

| | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| PASSIVE | 2.7% | 3.1% | 3.6% | 3.8% | 3.8% | 4.0% | 4.4% | 3.9% | 3.4% | 3.3% | 3.4% |
| ACTIVE | 97.3% | 96.9% | 96.4% | 96.2% | 96.2% | 96.0% | 95.6% | 96.1% | 96.6% | 96.7% | 96.6% |

Source: Morningstar Direct

Table 12: Flow of Funds (CAD Billions)

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---------|-------|-------|------|------|------|------|------|------|------|------|
| PASSIVE | 0.5 | 1.7 | 1.2 | 1.2 | 1.8 | -0.9 | -1.4 | -0.6 | 0.0 | 0.2 |
| ACTIVE | -26.2 | -13.4 | -5.4 | 5.3 | 0.9 | 7.2 | 35.0 | 29.5 | 4.6 | 11.6 |

Source: Morningstar Direct

Appendix C: U.S. ETF Data

Table 13: Assets Under Management (USD Billions)

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2006–2017 Total Growth Rate |
|---------|------|------|------|------|------|------|-------|-------|-------|-------|-------|-------|-----------------------------------|
| PASSIVE | 383 | 548 | 466 | 687 | 887 | 936 | 1 203 | 1 476 | 1 736 | 1 859 | 2 245 | 3 036 | 692% |
| ACTIVE | 49 | 75 | 76 | 106 | 127 | 126 | 145 | 225 | 269 | 277 | 311 | 404 | 729% |

Source: Morningstar Direct

Table 14: Market Share

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---------|------|------|------|------|------|------|------|------|------|------|------|------|
| PASSIVE | 89% | 88% | 86% | 87% | 87% | 88% | 89% | 87% | 87% | 87% | 88% | 88% |
| ACTIVE | 11% | 12% | 14% | 13% | 13% | 12% | 11% | 13% | 13% | 13% | 12% | 12% |

Source: Morningstar Direct

Table 15: Flow of Funds (USD Billions)

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---------|------|------|------|------|------|------|------|------|------|------|------|------|
| PASSIVE | 57 | 123 | 126 | 98 | 107 | 100 | 179 | 142 | 210 | 219 | 265 | 420 |
| ACTIVE | 8 | 22 | 39 | 22 | 13 | 17 | 11 | 44 | 32 | 25 | 22 | 45 |

Source: Morningstar Direct

Appendix D: U.S. Mutual Fund Data

Table 16: Assets Under Management (USD Trillions)

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2006–2017 Total Growth Rate |
|---------|------|------|------|------|------|------|------|------|------|------|------|------|-----------------------------------|
| PASSIVE | 0.8 | 1.0 | 0.6 | 0.8 | 1.0 | 1.1 | 1.3 | 1.7 | 2.0 | 2.2 | 2.6 | 3.3 | 300% |
| ACTIVE | 6.4 | 7.1 | 4.6 | 6.2 | 7.2 | 7.1 | 8.1 | 9.6 | 10.1 | 9.7 | 10.0 | 11.4 | 77% |

Source: Morningstar Direct

Table 17: Market Share

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---------|------|------|------|------|------|------|------|------|------|------|------|------|
| PASSIVE | 11% | 12% | 11% | 11% | 12% | 13% | 14% | 15% | 17% | 18% | 20% | 22% |
| ACTIVE | 89% | 88% | 89% | 89% | 88% | 87% | 86% | 85% | 83% | 82% | 80% | 78% |

Source: Morningstar Direct

Table 18: Flow of Funds (USD Billions)

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |
|---------|------|------|------|------|------|------|------|------|------|------|------|------|
| PASSIVE | 53 | 80 | 51 | 63 | 67 | 61 | 74 | 118 | 155 | 170 | 202 | 244 |
| ACTIVE | 204 | 183 | -204 | 315 | 198 | 29 | 194 | 154 | 78 | -214 | -325 | -22 |

Source: Morningstar Direct

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