

**EPISODE 62:
The Rational Round Up: Tax Loss Selling, Gold, Michael Burry and More!**

[INTRODUCTION]

[0:00:05.3] Benjamin Felix: This is the Rational Reminder Podcast, a weekly reality check on sensible investing and financial decision making for Canadians. We are hosted by me, Benjamin Felix and Cameron Passmore.

[0:00:14.9] Cameron Passmore: This week we covered off a lot of material. Some good current topics we covered quickly and then a couple of really good in depth discussions. One around gold which is actually pretty fascinating and the other one around tax loss selling which maybe technical and we ran perhaps along but there are some great takeaways in that.

[0:00:32.2] BF: Yeah, I find tax loss selling to be an interesting topic. We didn't talk about this during the episode but that one came from recently who emailed me saying they've been following Canadian Couch Potato and Justin's Canadian Portfolio Manager Blog and they're doing their own ETF thing but they've been getting to the point where they've got some losses and they're thinking about loss selling but as I was doing the research on superficial losses and stuff like that.

They're starting to wonder like is it worthwhile, is there actually some risk here? And I thought that question was great because I started and never finished a paper on that exact question. So I went and dug that data up and we talked about it on the show today.

[0:01:02.0] CP: It was actually a much more interesting conversation than I thought it was going to be when we prepared for this.

[0:01:06.0] BF: You always think my topics are going to be boring.

[0:01:07.9] CP: I never think they're boring. Sometimes I wonder if we go too long but this one, it was long but it's important and while some people, it may not matter to them, for those that do I think we get a lot out of the discussion. And then we got of course the bad advice that week which I'm sure a lot

of our listeners may already know. But the story to kind of know where we're going with it, the Toronto Star article.

[0:01:24.1] BF: Yup, anyway, we always appreciate people going to therationalreminder.ca website and leaving a comment and we hope you enjoy the episode.

[INTERVIEW]

[0:01:37.4] BFF: Welcome to Episode 62 of The Rational Reminder Podcast. We chose to do three current topics today just because the two of them were interesting but there's actually not a whole lot to say about them.

[0:01:46.0] CP: We can burn through them pretty quick because the other topics are pretty meaty.

[0:01:48.5] BF: Yup, the first one we wanted to chat about was that Horizons which we talked about where we had Jamie Purvis from Horizons on the podcast to talk about the swap based ETF structure and we've talked about this structure in the past and we know that in the most recent budget, the redeemer's methodology which the swap based ETF's had been using to re-characterized income so that holders wouldn't have any distributions, they would just have unrealized capital gains over the long term, which is obviously very tax efficient. The government's targeted the methodology they were using to do that.

[0:02:17.4] CP: That change is inevitable, right? Or it's thought to be inevitable?

[0:02:20.4] BF: Sound like they deferred part of it so as I understand, there were two pieces, there was the income allocation and the capital allocation and I think that the capital they are giving another year to defer because that's the one that was going to affect administration for ETF's mutual funds, they're going to continue considering that but the income portion which is the re-characterization piece that the government was losing a bunch of money on, that's the piece that sounds like is going through.

[0:02:42.5] CP: Horizons is looking to protect their business of course.

[0:02:45.3] BF: I talked to Jamie about it and he said that they had been thinking about doing this change anyway. They're restructuring all of the ETF's that use a swap based structure and they're rolling them into a corporate class structure.

[0:02:57.0] CP: Which I think a lot of people will be familiar with, made popular by CI and other firms.

[0:03:01.4] BF: That's right, yeah. All the different fund types or different share classes within a single corporation. All the units are within one corporation. Now, that used to be interesting because you could switch between classes of the corporation without triggering a disposition.

[0:03:15.2] CP: That was always the pitch.

[0:03:16.2] BF: But that's dead now.

[0:03:17.3] CP: Yup.

[0:03:17.8] BF: There were other issues with that in terms of who capital gains will ultimately be allocated to like it could end up being tax inefficient for some people but anyway, that's gone now.

[0:03:25.7] CP: What's the benefit to Horizons making this switch?

[0:03:28.0] BF: The benefit is, instead of having to rely on the redeemer's methodology which is under this hot fire at the moment, they can just net out gains with losses inside of the overall corporate structure and they can also net out fees from the total income of the fund. Now, the downside with the corporate class structure is if you do have net income in the corporation, unlike with a trust, you can't just allocate it out to be tax in the hands of the unit holders.

With the corporation, if there is a net income position, the corporation has to pay tax at the corporate tax rate. That can hurt if there is net income. But because they have all of this different products under one corporate roof. We wouldn't necessarily expect a net positive return across all their products in most years especially because they have so many specialty products.

[0:04:09.4] CP: But you cannot switch between ETF's like the old corporate class structure and not big capital gains because these are ETF's, right? You have your own cost base.

[0:04:16.2] BF: Even with corporations you can do that.

[0:04:18.9] CP: That's right, that's what I mean. There's no going back to the way it used to be with obviously with an ETF, you have your own cost base, you sell your trigger, you gain a loss. You get your own cause space on the buy side.

[0:04:27.6] BF: The big benefit is that potentially by pulling all of the gains losses and fees, you may not have any distributions from the fund just like it is now. So Horizons believe that the funds are going to be just as tax efficient with the new structure as they were with the old structure.

The other piece is interesting is that they're able to roll all of the trust assets that are currently existing ETF's into the new corporation using a section 85 roll over. Which is a none taxable disposition where you move assets from personally or held in the trust I guess into a corporation.

[0:04:56.8] CP: Cool, you got to give it to Horizons, they're always in the weeds on this kind of stuff.

[0:04:59.6] BF: Are they ever.

[0:05:01.3] CP: Jamie is very articulate on this. On to topic number two, some article we saw in Bloomberg, I guess it was this week. You know, Michael Burry who is made famous in the movie *The Big Short* who made the call on what the CDO's collateralized debt obligations, back in '08.

[0:05:15.6] BF: His fund is not that big.

[0:05:16.8] CP: 340 million or so?

[0:05:18.0] BF: 343 million.

[0:05:19.4] CP: You wonder what conflict of interest but he is basically saying that index funds are creating a bubble in the large stocks.

[0:05:25.1] BF: We've heard this before, the reason that I grabbed this one, I thought it was interesting. The idea that index funds are creating a bubble, I don't know how much credibility that has to it but in this article, Burry was basically saying that he blames this phenomenon for the under performance of small capital value stocks.

[0:05:40.2] CP: Was he arguing or not as much price discovery going on there or is it just the demand side for large cap grow stocks, it's pulling everything up.

[0:05:47.0] BF: I think that the understanding here would be that because of blind money going into index funds, the larger stocks are getting bit up irrationally.

[0:05:55.4] CP: Yeah, but they're still price discovery going on. Still trading line with the small cap value shares. Does that –

[0:06:00.9] BF: I agree with you that's why I said I wouldn't usually grab a headline like this but just the way that they went into this potentially being the reason for small cap in value under performance, maybe it's me just grasping at explanations.

[0:06:12.4] CP: You saw the movie, *The Big Short*?

[0:06:13.6] BF: Yeah.

[0:06:13.7] CP: Christian Bale is great. If you haven't seen the movie, you have to watch it. It's a phenomenal movie. Michael Lewis is such a great story teller.

[0:06:21.3] BF: But it is crazy when you look at the IPO's that are coming out and then have come out and you look at the mega cap tech companies that are doing so well and their PE's are so high, it is unnerving. We believe markets are efficient, we believe in rational pricing but I mean –

[0:06:34.9] CP: Well look at what Ted said last week in the podcast, you know? All this competition and rise of index funds is basically flushing out all the weakest active managers which is arguably making it tougher because you're left with the best fighting over this price discovery.

[0:06:48.8] BF: That's Fama and French's whole thing on when does the market become inefficient due to indexing and they say well, depends who leaves active management. If the only ones left are the good active managers and the bad active managers get booted out, that might actually make markets more efficient. It's a tricky argument to make.

[0:07:02.6] CP: Because if you're the good one, you'll command the premium which Ted also talked about last week and your premium theoretically should equal alpha you deliver. It should just theoretically go away.

[0:07:11.5] BF: But then we also just had people listening to the podcast won't have heard this yet but an Episode 69 coming up, we have Wes Gray from Alpha Architect, his firm and him personally take the stance that a lot of the factor premiums are behavioral. From that view, maybe that is what's going on, maybe the large cap stocks are getting overpriced and they're going to come down in evaluation eventually and maybe the value starts being underpriced and then the argument would be that eventually people are going to realize the value stocks aren't as crappy as we thought they were and the prices are going to come back. Anyway, who knows is the ultimate answer.

[0:07:43.7] CP: is that your little tease looking out whatever it is. Seven weeks and hour something.

[0:07:49.1] BF: That was a fantastic conversation but anyway.

[0:07:51.5] CP: Number three topic, this one quickly. Another article came out from Morningstar that resurrected an old paper and this is pretty cool, it's called Canadian Financial Advice, Good Intentions but Bad Results. Can you believe they have access from two large gain financial institutions which they've sworn to secrecy, of course. Looking at the performance from 3,276 advisors in over 500,000 clients.

[0:08:17.2] BF: I don't know if we've talked about this in the podcast before. I did a video on this specific paper a while ago but the interesting part was Rekenhaller from Morningstar, I guess he just discovered the paper. He wrote about it and it basically shows that advisors are making really bad investment recommendations, not because they're jerks but because they have no idea what they're doing.

The way they prove that or tried to prove that was that, all of the bad investment recommendations that the advisors are making to their clients, they were also doing in their own trading accounts.

[0:08:44.2] CP: And actually paying more themselves than their average client.

[0:08:46.1] BF: In fees, that's right.

[0:08:47.0] CP: In fees, the average MER probably with client is 2.36% and the advisor's fee is 2.43%. But what I found surprising is the performance was much better than it would have expected. Basically, the underperformance is almost completely explained by the fees. I would expect a much larger behavior gap to happen. The quote is they work really hard by the investment errors, what really hurt them were their expenses.

[0:09:10.3] BF: Rekenhaller's is reason for writing this is that the US, like Canada, the US has had all these talks about a fiduciary standard or best interest standard and this is the same thing that we concluded when we read this paper a couple of years ago where Rekenhaller is basically saying he no longer believes that the fiduciary standard is the answer because even if advisors think they're acting in the best interest of the client, if they have no idea what they're doing, then nobody's going to be any better off.

[0:09:33.8] CP: How do they draw that inference from it though? Because it says that the only underperformed based on fees, how do you, where does it leap that they were –

[0:09:40.4] BF: Misinformed?

[0:09:40.9] CP: Yeah, misinformed.

[0:09:42.2] BF: Well, the basis of them being misinformed is that they're investing their own money in high fee actively managed mutual funds. And they're over trading and their performance chasing like all these bad behaviors. I agree, it's interesting that doesn't show up in the performance gap but the point is, it's not like the advisors are investing in Vanguard ETF's while churning active mutual funds for their clients.

They're investing in the same garbage. But Rekenhaller in the last line of his paper I thought was really good, he said, "What I now understand is that most of those gains to benefit investors will come from within the market place by advisors continuing to learn from history and one hopes by stronger educational programs from both their employers and the fund companies that's listed their business. Regulation can and should do its part but advises personal beliefs will lead to change."

That's actually, you know, *Freakonomics* did a whole thing a while ago on the medical field and I don't think they drew inferences to investments, I think I did that in a blog post, I think. But *Freakonomics* talked about the whole shift from medicine being opinion based, to being evidence based and they talk about how it took a whole generation of opinion based doctors who operated that way to literally die off so that evidence based generation could take over.

You got to think it's going to be something similar in financial services where there are so many people with such strong opinions and such strong client bases and sales forces that base everything on opinion and anecdote and it's such a small subset of us that are trying to be evidence based. Yeah, that will be tough to change everybody's mind without a whole generational shift I think. What do you think?

[0:11:08.1] CP: I totally agree, I mean, that's the whole point behind the Rational Reminder.

[0:11:11.0] BF: Yeah, that's right. It is awesome that we know a ton of advisors listening got this podcast so hopefully that's helping turn those tieless have changed.

[0:11:17.7] CP: Okay, portfolio topic this week, it's a pretty meaty one that I know you've had some fun preparing for. It's all about gold.

[0:11:23.4] BF: Yeah. But gold always comes up when we've joked about the recession in the past and by the way, I don't think recessions are funny, I just think that it's funny that people think they can predict them.

[0:11:31.2] CP: And when it comes up in every single meeting, you know it's going to be priced in somewhere.

[0:11:34.7] BF: It's everywhere though, if you go on Reddit, I know you don't go on Reddit as much as I do but it's like every third post is what should be doing to prepare for the recession? What changes should I make in preparation for the recession? It's like, man.

[0:11:45.7] CP: Build a portfolio so you don't have to worry about it.

[0:11:48.2] BF: Right, have sufficient.

[0:11:48.9] CP: Market can go down even if there isn't a recession.

[0:11:51.2] BF: Have enough emergency savings that you don't need to worry about your portfolio even if they're –

[0:11:54.1] CP: Stuff happens and raise for ability. Anyways, gold.

[0:11:56.5] BF: It's like anti-fragility almost.

[0:11:57.8] CP: Totally.

[0:11:58.4] BF: I told you last time, I've been listening to this book, *Coddling the American Mind*. They talk about a lot of what anti-fragility.

[0:12:03.9] CP: If you had people actually ask you about gold lately because I have not.

[0:12:07.0] BF: Not this time around. People are talking about it online and the headlines are talking about it and the price, the gold price shows us that people are interested in it because the price has had a bit of a bull run but yeah, not this time around. I think in past, little market dips and things like that have had more questions about gold for whatever reason it's not coming up as much this time. But I figured it was still worth discussing because just based on the price there's clearly some interest priced into the asset.

[0:12:28.3] CP: And Buffett have the classic explanation of gold and then we use it on a radio show a long time ago when he came out with this so go ahead, tell the story.

[0:12:35.7] BF: Well, Buffett says that gold is not a productive asset so he did this example and we'll talk more about that data in a sec but this is just a good story from Buffet. He gave the example that at the time that he wrote this thing in 2012, the world's gold stock was worth about 9.6 trillion US dollars and he explains it for that amount of money at that time, you could have bought all of the crop land in America in the US, 400 million acres with roughly 200 billion dollars of annual output and you could have bought 16 Exxon Mobils.

Each one earning 40 billion annually and then he says, after that, you'd still have a trillion US dollars in cash left over. I can't remember what he said in the story but something along the lines of you may as well keep some spending cash after a spending spree like this.

[0:13:16.2] CP: I think you said you put all the gold in one pile it would be the size of the major league baseball field

[0:13:20.5] BF: That's right.

[0:13:22.2] CP: Your height with that cube?

[0:13:24.4] BF: Yeah.

[0:13:24.5] CP: Basically just a dead asset that you now have to pay to take care of and custody and guard.

[0:13:28.8] BF: Yeah, then Buffett goes on to say that a century from now, the 400 million acres of farm land will have produced a massive amount of output regardless of the currency regime at the time, which I find to be pretty interesting component of what he's talking about because that's kind of like rebutting against gold as a currency hedge if you buy productive assets.

And then he also says that Exxon will have produced obviously trillions of dollars in profits, maybe not, depending on what happens with the climate change and stuff but anyway, trillions of dollars in profits for shareholders and they will have also grown their assets to be worth many more trillions. And then Buffett says, the gold will have just continued to be a chunk of gold, which like you said, Cameron, you would have pay to care for and store and ensure and all that stuff.

[0:14:02.1] CP: These are great stories but of course as everyone knows.

[0:14:05.7] BF: I got to say this line from this story was too funny. He says, "You can fondle the gold but it will not respond." Anyway.

[0:14:11.5] CP: Anyway, you're going to take the data trip now?

[0:14:13.6] BF: Yeah. If people think about gold is a currency hedge, think about it as the safe haven from stocks. I agree with Buffet's analogy. I think it makes sense but let's see what the data say. There's academic paper by Claude Erb and Campbell Harvey. This is also in 2012 actually and they used gold returns going back to 1975 for a lot of the analysis that went back further for some. But that was when the US came of the gold standard.

[0:14:36.7] CP: Exactly.

[0:14:38.4] BF: The price of gold was heavily affected by I guess the US government policy up until that point. They found that gold has not been a good inflation hedge over the short or long term. Long term, they were saying is 10 years. The volatility of gold's real price and we'll come back to that because that's one of the most interesting components of this discussion.

They did find that going back to the era of emperor Augustus who reigned from 27 BC to 14 AD. Gold has been a pretty good hedge for inflations measured but military pay. 2,000 year in the future liability. Maybe gold is a good inflation hedge. But over shorter periods of time, it's too volatile. They finished that section of their paper saying, "Gold may very well be a long run inflation hedge," and I love this.

"However, the long run may be longer than an investor's investment time, horizon or lifespan." Sure, gold's a good inflation hedge over the very long term but you're probably not going to live long enough for it to be a good inflation hedge for you.

[0:15:28.9] CP: I find gold as such a great story for a lot of people. Quasi-conspiracy theory type people. There's always a story around it.

[0:15:36.1] BF: Yeah, there has to be.

[0:15:37.5] CP: Has to be.

[0:15:38.0] BF: That's by definition, why people will buy gold. Because they believe the story around it enough to believe that someone else will buy it from them for more later. That is how gold is a store of value.

[0:15:48.0] CP: I mention someone I know in the past and said you know, we're all going to you know where, I just want to get there last. That was his reason for wanting to own some gold and I'm like okay, if we do go over to that awful place, how are we going to watch over your gold? How are you going to slice of your gold to buy your groceries at the store? I don't quite get if we do end up in that catastrophic situation.

[0:16:09.6] BF: Yup. Erb and Harvey also looked at hyperinflation and I found this, of the whole paper for me, this was the most interesting piece. They looked at Brazil from 1980 to 2000 where Brazil had massive hyperinflation, their currency inflated at about 250% per year, while the real price of gold in Brazilian terms fell by about 70%. The interesting part about it is that the real price of gold in US dollar terms fell roughly the same over the same time period.

They looked at this throughout the paper and they found that the real price of gold in any country around the world tends to be roughly the same at a given point in time. Real price changes in gold are going to be roughly the same, whatever country you're in. They found that to be true throughout history.

The interesting thing about being in a hyperinflation hedge and using Brazil as the example is that yes, over that time period, holding gold was better than holding whatever the Brazilian currency was and it's not that I don't know what it was, it's just they changed a bunch of times with that time period. Not that I could name any of them to be fair.

Yes, gold would have been better because it only lost 70% of its value as supposed to almost 100%, holding Brazilian currency but the point is that the real price of gold can have a dramatic drop at the time that whatever country you're in is experiencing hyperinflation. It's not like you can hold gold and expect it to maintain its purchasing power just because your country is going through hyperinflation. It could very well happen that your currency is hyper inflating, while the real price of gold is also dropping dramatically. That makes it not a good hedge.

[0:17:35.7] CP: Interesting.

[0:17:36.1] BF: It is fascinating, right? It's like sure, you can hold gold and maybe you won't lose its real value but maybe it will, there's no reason to believe that it won't. Gold doesn't care that Canada is going through hyperinflation, gold's not going to say, "Time to go to the rescue and increases my real value or maintain my real value," it could happen for some other reason.

Gold's real value is plummeting while Canada's dollar is also hyper inflating. I found that to be pretty interesting.

[0:17:57.2] CP: Now, what about when you gold in a portfolio? I know you got some numbers on that.

[0:18:00.8] BF: Yeah, a lot of people say look, I just hold five or 10%, that's reasonable hedge, may have some benefit.

[0:18:06.9] CP: So Erb and Harvey looked at this in the paper too and they did find that 83% of the time, that stock returns were negative in their data set, gold returns were positive. That's interesting. I looked at the gold spot price, I had MSCI, All Country World Index going back to 1988 through to July 2019 so I use that as a sample and the gold spot price on the All Country World Index, had a correlation of 0.085 which is very low. It's basically an uncorrelated asset. Not negatively correlated though, we don't necessarily expect gold to go up when stocks go down, we just expect them to be uncorrelated.

[0:18:36.3] BF: What are the return differences between the two? Yeah, I've got those data points too. I found it interesting though, within the calendar year 2008 when all country world index dropped over 40% in US dollar terms. Gold increased by 5.53% so that seems pretty interesting but over the same time period, US government bonds increased in value by 14%.

[0:18:54.5] CP: Wow.

[0:18:55.4] BF: It's like yeah, gold was maybe a good diversifying asset but bonds were better. The real issue that I have using gold as a diversifying asset even though it's got the low correlation is that it doesn't have an expected return.

[0:19:07.4] CP: That's Buffett's point.

[0:19:09.1] BF: That's at its point, that's — Dimensional's written about this as well. It's like yes, sure, it's uncorrelated but based on modern portfolio theory, you want to have assets that have positive expected returns in your portfolio.

[0:19:18.8] CP: The only reason to own gold there for us because there's a story, you're predicating what might happen and you believe how gold prices may react if and when that happens.

[0:19:27.9] BF: Now, this data point here, it's arguably unfair because it's a period of time where gold happen to not do well and there have been periods of time where it has done well and it is still interesting. So for the same data sample from 1988 through July 2019, the standard deviation of gold spot price was 15.43% compared to 14.85% for the global index.

[0:19:46.3] CP: Just a bit more volatile over those 30 years. 30 plus years?

[0:19:50.0] BF: But its returns for gold are 3.43% before inflation where global stocks would turn 7.85%. You've got more volatility in gold for a much lower return. Now, again, that's time period specific. There have been periods where it's been different and so then I thought, "Okay what does it look like if I add gold to the equity index because it is uncorrelated?"

[0:20:08.4] CP: Yeah because the first example is owning only gold or only the embassy at world index. Now you are just looking about adding a bit into a portfolio.

[0:20:15.3] BF: That's right. So I took global stocks, 90%, 10% gold, spot price and it actually did give and you would expect this based on the low correlation that the portfolio had a lower total return but had a slightly higher risk adjusted return. Okay that's interesting but then I said, "Well, what if we add an asset that actually has a positive expected return and a low or negative correlation with stocks?"

[0:20:35.5] CP: Such as?

[0:20:36.1] BF: So I did one to five year global government bonds hedge to Canadian dollars and added 10% of that to my 90% equity portfolio and that portfolio had a higher total return and a higher risk adjusted return than the 10% allocation to gold.

Now again, time period specific but we would expect that to be true long term because gold does not have a positive expected return and then Erb and Harvey in their paper, you already mentioned this Cameron but you can make the argument gold to safe haven based in this low correlation even if its real value might plummet, which we talked about.

But you can't really take your gold with you in a real catastrophe. So it is like, what does a safe haven mean? Is it a low correlation with stocks? Okay, sure but bonds are probably better for that purpose.

And if gold is designed to be like the ultimate safe haven in real catastrophe then are you going to take it with you? Erb and Harvey gave an example, I can't remember what it was. I should have written it down but it was an ancient city that was sacked and the people that sacked the city took the gold.

[0:21:27.9] CP: Anyways, queue the trolls on our comment section. I am sure gold bars is looking out.

[0:21:32.7] BF: Maybe, I think that we probably take more heat for talking about bitcoin today but who knows?

[0:21:37.5] CP: Okay, on our planning topic. So this one comes up a lot in our world, which is tax loss selling. It is something that is often promoted by robo-advisors as a great value add. So as where if you have a loss in one of your securities in your portfolio, you can trigger the loss and use it against gains that year or pull it forward indefinitely or what we have done in many case, you can take that loss and go back three tax years to prior years.

[0:21:59.8] BF: I think that is the most compelling case if you have a gain in the last three years and you can basically undo the tax that you had to pay by triggering a loss in the current year.

[0:22:07.5] CP: We've done a lot of that, people have triggered gains and you back and it's money in your pocket, right? Just been doing a switch. You have to be careful what you switch in and out of but it is a great strategy to be aware of and it just shows you the value of knowing enough about your tax returns and the source of your income if you do have prior capital gains.

[0:22:23.2] BF: Yeah, you talked about robo-advisors using this as part of their pitch. I am pretty sure Betterment in the States has been saying this for years and I think Wealthsimple now for their higher tier offerings is also saying you can choose to turn tax loss harvesting on or off. Now the challenge that I have with that is that if I am Wealthsimple and I've got automatic tax loss harvesting going on inside the account, they are not as far as I know like you just talked about Cameron, looking at the tax return.

And figuring out is this an optimal thing to do in this year and the reason that it is not necessarily a guaranteed benefit is that there is this rule called superficial losses. So if you sell a security at a loss, you can't own that security for 30 days after selling it if you want to use the loss to offset gains. If you own the same security within 30 days, the loss will be deemed superficial, which means it will be denied by CRA for tax purposes.

[0:23:09.7] CP: And you have to be careful of that.

[0:23:10.8] BF: Well, it is tremendously important obviously and for index investors it means buying an index fund tracking a different index.

[0:23:19.6] CP: So a different supplier is not necessarily good enough.

[0:23:22.2] BF: It is absolutely not good enough it is a lot of people –

[0:23:23.9] CP: You'd think it is because why are different ticker symbol but know that it should be a different property.

[0:23:28.3] BF: Right.

[0:23:28.7] CP: The same goes for making contributions. If you're making any kind of contribution to your registered account that capital loss is denied. So make sure you –

[0:23:35.9] BF: So that can't be identical properties and like you said, if you are fun tracking the same index but from a different company that is a superficial loss. So you have to find a tax loss selling pair, which is an asset that is going to give you a similar exposure in the portfolio because obviously, you don't want to sell the asset and sit on cash. Because then you are potentially losing out on any benefit of the loss sale. So you want to replace say it is a Canadian equity ETF that you sold. You want to replace it with another Canadian equity ETF that is tracking a different index.

[0:24:01.2] CP: There is so many available. It is really not an issue there.

[0:24:03.8] BF: There is not an issue in doing the replacement. The issue comes in the tracking error. By definition, you are not going to get the same returns from two different indexes because we talked about in the podcast a while ago, index is going to have pretty different methodologies in terms of how their waiting securities, how they're selecting securities for the index.

[0:24:22.5] CP: Like you are talking a month, you can go back to the original.

[0:24:24.8] BF: People always say that but we have done this. We have done this in practice, Cameron, where we do a tax loss sale, hope to get back into the security that we wanted to be in and then three days later you are in a big gain position.

[0:24:35.0] CP: Well that happened. We did this in December last year when you try to switch back in January the market popped up so much, we didn't want to trigger the gains again. So you can get land lock for sure.

[0:24:42.9] BF: That's right and then it's like crap, we just did this great loss sale and we saved some tax but now we have this new gain and we can't get back to the security that we don't want to have exposure too. So I looked at this for a couple of different securities just to get a feel for what are the numbers look like. I looked at VCN, so that is Vanguard [inaudible] All Cap and XIC, which is the SMPTX cap composite from iShares and I had data going back to 2013.

Which is when VCN started and I looked through March 2019. I looked at this a while ago and the difference, the performance difference, annualized was 55 basis point. So that's material, 55 basis points is not the material amount. I also looked at XUJ. So that is tracking S&P total market index from iShares versus VUN, which is tracking the Crisp US total market index from Vanguard and September 2013 through March 2019 they had 17 basis point tracking error. So again, not huge but not zero especially when we are talking about index fund world.

[0:25:36.4] CP: And just a reminder, you can only use capital losses to offset capital gains.

[0:25:40.3] BF: Great point.

[0:25:40.9] CP: You can't use it to offset regular income.

[0:25:42.7] BF: Very important reminder.

[0:25:43.6] CP: So there is no point in banking loss just for the sake of banking losses.

[0:25:47.6] BF: Correct. I also look at index returns going back further. So I looked at again, Crisp US total market and the S&P total market index but this went back 2005 because those index data is supposed to live fund data and again, 18 basis point tracking error. Now the big risk is that tracking error is an unpriced risk. You wouldn't expect a positive return for buying a crisp index versus an S&P index.

So you are taking on this random risk for doing the tax loss sale and that gets even more extreme. Like for us using Dimensional, the tracking error is going to be way higher because you can't buy an ETF to replace the exposure but even if you are using small cap per value ETF's the definition of value and even small can be vastly different between different ETF providers.

[0:26:26.9] CP: Exactly and often ETF's they don't have the small cap growth exclusion, so it will not be the same index.

[0:26:32.6] BF: So the thing I wanted to look at is how much value would you be adding if you made the perfect tax loss sale? So I looked at a \$100,000 investment position and I assumed an average annual return of 5% all unrealized capital gains and I assume is an investment drops 50% in the first year.

[0:26:49.1] CP: So it is a single investment.

[0:26:50.3] BF: Just one piece of the portfolio. So a \$100,000 investment now drops to \$50,000. So now we've got a \$100,000 cost based and a \$50,000 market value. If we do a loss sale and assume that we have a gain in a previous year to offset, we'll get a tax savings or a tax refund of \$13,383.

[0:27:06.4] CP: So you are pulling that \$50,000 loss back to a prior year's capital gain refiling that tax return and tricking your refund.

[0:27:13.3] BF: Correct and then just to model the example, I assume that that \$13,383 in tax savings is reinvested in the position. So now in our loss sale case, we have \$63,382 invested and the cost base because we have sold and re-bought a different security –

[0:27:29.1] CP: So you took the tax refund of 13 grand, added it back to \$50,000 portfolio. Now you have \$63,000.

[0:27:35.2] BF: Invested in a non-identical property, tracking a similar market.

[0:27:38.4] CP: So I think our listeners can tell when I am trying to make sure we are keeping this straight because it is hard to do numbers over a podcast.

[0:27:43.8] BF: I think you have been doing a good job. It is not like this is the first time we have talked technical podcast.

[0:27:47.4] CP: I think they are onto our recipe.

[0:27:48.5] BF: Yeah, I think you're right. So that's case one. Case two, what is we didn't trigger the loss? Now we got \$50,000 invested with a higher adjusted cost base of a \$100,000. So I think that's one of the most important things to understand about loss sale is that it is tax deferral. You are not making tax disappear, you are deferring taxes into the future and that shows up as a lower adjusted cost base.

[0:28:07.7] CP: So \$63,000 cost base portfolio versus a \$50,000 portfolio with a cost base of a 100 grand.

[0:28:13.2] BF: That is correct. So then I went forward 30 years into adjusted the future value of each portfolio at 5% and sold the assets and paid the tax, paid the capital gains tax to find what is the difference in annualized growth after tax between these two cases.

[0:28:29.2] CP: So basically that \$50,000 portfolio, the next 50 it makes is tax free because its cost base is so much higher. In fact that is what is going on versus 63,000 everything you grow from here is taxable. That is the big difference.

[0:28:42.4] BF: Correct and then the whole point of me doing this number crunching is to figure out the value add and basis point terms. Now this is time period specific, so we are looking at a 30 year time period. If we change the time period, if we go longer the annualized difference decreases because the value of the deferral relative to the overall portfolio becomes smaller.

[0:29:00.1] CP: The proportion of \$50,000 tax free becomes a smaller proportion of the total gain.

[0:29:04.9] BF: Correct and then the other big piece of this what is your tax rate when you eventually trigger the gain. You do the loss sale of a 20% tax rate and then ultimately sell at a 55% tax rate, you might actually be worse off.

[0:29:14.2] CP: Okay, suspense is killing us.

[0:29:15.9] BF: Okay, so 53.53% tax rate at the time of deferral and then future tax to 20%. So this is the perfect loss selling case. I found a tax alpha. I named it like the additional risk adjusted return from a higher after tax return. It added 74 basis points of value on that position not on the whole portfolio on that one position, which is meaningful. It is meaningful even relative to that tracking area of 55 basis points for those two Canadian ETF's that we looked at.

[0:29:41.9] CP: So that is because you have an extra \$13,000 kicked into the portfolio that is compounding over those years. That is what is going on here, it is that value of that extra tax money you are getting back that is compounding all that amount of time. That is what is driving this, as opposed to value that is next \$50,000 being tax free.

[0:29:58.4] BF: It is also spread in tax rates, right?

[0:30:00.8] CP: But that is the same of all scenarios though.

[0:30:02.8] BF: You're right.

[0:30:04.6] CP: So it is the value getting your money back to the government that's adding the value.

[0:30:08.4] BF: But the spread also changes. I think it change the future tax rate. The advantage changes if you lower the future tax rate.

[0:30:14.4] CP: So the future tax rate is higher. The advantage is –

[0:30:17.4] BF: Less and if future is actually lower like we use in our example, the 20% in the future, the advantages are greater.

[0:30:23.9] CP: Yeah, for sure that makes sense. Wow that is really interesting.

[0:30:27.2] BF: Yeah, well I guess because of that chunk of tax savings that we got to invest, the \$13,383, the lower your tax rate was at that time, the smaller that number is going to be.

[0:30:35.6] CP: But behaviorally, the big takeaway here is if you did do this, make sure you kick that refund back in the kitty.

[0:30:41.8] BF: Well from an economic perspective, if you have that cash it's the same deal. In terms of the actual like tracking this example you're right.

[0:30:48.4] CP: I know but behaviorally, you might be better off leaving that unrealized gain in there if someone is just going to blow it on something.

[0:30:53.1] BF: Oh wow, interesting.

[0:30:54.4] CP: Right? Say yes you came out mathematically ahead in this perfect sanitized world that you have described. But if someone is not inclined to kick it back in, that unrealized free gain that is coming up going forward is like a for savings plan.

[0:31:08.8] BF: Yeah, that is interesting. So then I looked at what if the future tax rate with 53.53% if it stayed the same and the value added from the deferral drops to 57 basis points.

[0:31:17.3] CP: That is still big.

[0:31:18.1] BF: Still big.

[0:31:18.9] CP: That is amazing.

[0:31:19.8] BF: Now, I also thought about what if the capital gains rate inclusion rate increases in the future and the value then drops even further because you hear the government sometimes talking about increasing capital gains inclusion to 75%. The only cases where you would expect it to detract value is if you are doing a loss on a low tax bracket. So that comes back to that idea of Wealthsimple or whatever doing loss selling for people blindly just because the person checks the box. Yes I want loss selling.

If that person has the taxable account but they've got a low tax rate like maybe they are running 75k but they just have some taxable investments. If they are deferring tax at a low rate and they end up for whatever reason being in a higher tax rate in the future maybe they are making large RSP withdrawals or whatever, it could make you more soft potentially, which is why understanding each individual situation if you are going to be doing loss sales is so important.

And then the other crazy piece about this and this is the last thing I thought off as I was thinking about this problem is that if your horizon is too long I pushed out to a 100 years just what I was doing the analysis to see what it looked like and at a 100 years, the difference is 25 basis points. So that seems to be where it converges. That is the maximum value of the deferral over a very long period of time. So you can't be doing this for too long over a period of time.

But you also have to do it at a period of time where your current tax rate is higher than your future tax rate but you can be doing it for a sale too far in the future. Well I mean you can but the benefit is not going to be as great. So it is like the ideal case is the year before you retire. You do a big loss sale and then you are at a lower tax rate the next year but the reality is that someone who is about to retire probably doesn't have unrealized losses in their portfolio.

So it is like you have to have this perfect storm of situation to make the loss sale obviously beneficial enough to offset the tracking error of an ETF that you didn't originally want to own. The tracking error could be positive too though I guess but that is a random risk.

[0:33:03.6] CP: Right, fascinating. I would venture the guess and most people who have prior gains would love to bank the loss to get their refund.

[0:33:09.8] BF: Probably and we have done that too and even though I am not generally as you can tell from this conversation, I don't think tax loss selling is an obvious tax alpha. I think it can work in some cases but we are super selective with when we do it. Someone has to be in a high tax bracket, they have to have current or past year capital gain or an obvious maybe future capital gain but yeah, we're very careful. Now it is again, a little different with us because we are using the dimensional stuff, which is a little bit harder to find tax less selling pairs for.

Maybe it is interesting to talk about briefly because we use the all in one portfolios, which we can sell and then rebuy underlying components to get very similar exposure. It is just more of a hassle and less efficient to manage but somebody using VGrow or whatever could do a similar thing.

[0:33:50.8] CP: So onto our bad advice of the week. This is a hot one and man, all over this woman on Twitter so –

[0:33:57.7] BF: Have you heard of her before?

[0:33:59.4] CP: I had not hear of her but man, I knew as soon as I saw the title of the article I said, "Oh man she is going to get killed in the group on Twitter." Just the people we all follow in this community. So title in Toronto Star was, "Why Low Fee Investment Products are Bad for You." and all you need to do is read that title and say, oh boy here we go like, cue the screams.

[0:34:18.5] BF: I feel a bit guilty about calling people out by name on the podcast but the woman who wrote the article was Lesley-Anne Scorgie. I mean her name is on the article so anybody could Google her anyway but on her website personally, I found her positioning of herself to be a little bit of a turnoff just because of the way that she refers to herself as a personal finance guru. I joked with somebody on Twitter that I wonder when guru is going to be a regulated title.

[0:34:39.8] CP: I mean it seems her breakthrough is when she was on the Oprah Winfrey Show I think when she was 17 or 18 years old so the video is on YouTube.

[0:34:46.8] BF: Well she has written a few books. I like to be fair, she is strung together and what looks like an impressive career but anyway.

[0:34:52.3] CP: And runs a coaching program where she charges a monthly fee to give advice to people.

[0:34:56.5] BF: I have to say is terrifying, based on what she wrote in the article that people are – I mean again, it is not meant to be a personal attack. But charging people for investment advice or financial advice I guess because I don't think she is licensed but based on the information that she wrote on the article it doesn't seem like she has a handle on the type of evidence that we talked about on this podcast.

[0:35:14.2] CP: Well yeah and I think the line that really got me and perhaps both of us is that this quote from the article that she doubles over with laughter when she watches ads for low fee investment products.

[0:35:25.4] BF: That's right, maybe this is why I didn't feel as bad calling her by name because it was a pretty obnoxious article.

[0:35:30.0] CP: "But when the flash and sizzle of these snappy ads fades, these aren't the only thing you need to care about. The rate of return is actually the more important factor. It needs to be appropriately paired to your risk tolerance." Absolutely. "In plain speak, your invested dollars need to be exposed to a healthy level or market risk in order to grow and you will pay some fees for this."

[0:35:46.9] BF: I took some pretty serious issue with that comment because yes, you do want to be exposed to market risk but no, you don't need to pay high mutual fund fees to get exposure to the market. Let's carry on with the bed of lies.

[0:35:56.8] CP: Yeah. "So bottom line though is that if your investments don't generate a healthy rate of return in the long run somewhere north of 7% after fees they won't keep up with the market and then saving money on your fees won't matter either way. Far too often – "

[0:36:09.9] BF: Can we pause there, did that make any sense? If you are not earning 7% after fees you won't keep up with the market.

[0:36:17.3] CP: "It shows the data that paying more in fees will help you keep up with the market."

[0:36:21.9] BF: 7% is an arbitrary number. If you own only a market cap ETF, you will by definition keep up with the market even if you are not getting 7%.

[0:36:29.3] CP: So let us finish off here. "Far too often, returns get overlooked by investors as they get sucked into the low fee story narrative. Don't let this be you."

[0:36:39.1] BF: So now this one I always find to be a bit tricky because we use Dimensional funds at 40 basis points versus iShares at 10 basis points but Lesley-Anne and the article is not talking about higher expected returns in small cap in value exposure. She's talking about higher past returns.

[0:36:54.1] CP: Like the first of the third story we had on this podcast tying it with the average MER well north of 2%, which is where the industry is.

[0:37:00.2] BF: So you got to go find funds with good 10 year performance and I think in the article she says that she prefers to use Morningstar to do this analysis. So if you go find the good funds, so she says, "But with research and some investment guidance you can steer clear of poorly performing investments and focus instead on buying the ones that are generating a strong rate of return."

Not expected to generate the ones that have been generating. Lesley-Anne goes on to explain in the article that benchmarks to look for above average rate of return for the majority of the past 10 years, independent research from – yeah, I already talked about the Morningstar thing now –

[0:37:32.4] CP: Morning Star said that fees are the one thing that is a predictor of higher returns.

[0:37:36.3] BF: Morningstar always said this, they have formally done two papers on it. Once in 2010, once in 2016 where they look at their whole database of funds and in both cases found that the single best predictor of future fund performance was fees where lower cost funds almost always had higher returns than higher cost funds. They broke it up in the quintiles, the cheapest quintile always beat the most expensive quintile of funds.

[0:38:00.0] CP: There is a ton of data to back this up and we go through all kinds of data points but I mean I think everyone knows her main message.

[0:38:05.5] BF: Yeah. So Lesley-Anne had some dialogue in Twitter about this and this morning actually, we are recording this on Friday, the 30th. So this morning she or maybe last night, she posted on Twitter that she apologizes. That the title of the article was misleading but she's asked the Toronto Star to change it. So actually the title we said "Why Low Fee Investment Products are Bad for You", it's changed now to something slightly different.

[0:38:26.6] CP: It changed to, "Low Fees are Important but Don't Overlook Rate of Return."

[0:38:29.8] BF: So my response on Twitter is that changing the title wasn't enough.

[0:38:33.1] CP: She changed over what was said.

[0:38:34.2] BF: So finished the story with, "Fees should be a side note not the main storyline." and again, that is at complete odds with the arithmetic of active management from sharp. It said at odds with Morningstar's data is –

[0:38:45.8] CP: It's at odds with what was actually said in the article.

[0:38:48.4] BF: What do you mean?

[0:38:49.1] CP: I mean she doubles over in laughter when she watches ads for low fee investment products. Anyways, fees matter.

[0:38:55.2] BF: Fees are arguably the most important predictor of future fund returns now. Mark Carhart in his 1997 paper on persistence and mutual fund performance did find that funds that were persistently out performing mutual funds or persistently outperforming were doing so based on exposure to the known factors. So I think that is as important as fees are, acknowledging my own vices here is as important as fees are, exposure to the known risk factors are also pretty important.

[0:39:17.8] CP: Got it. Anything else?

[0:39:19.2] BF: No, I think that's it.

[0:39:20.3] CP: Great, thanks for listening.

[END]

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