What Bay Street Doesn't Want You to Know

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This report was written by Raymond Kerzérho. 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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Canadians are in a love-hate relationship with Bay Street's big financial institutions. Here, the market for financial services is primarily controlled by an oligopoly of ten large financial institutions.[1]

On the one hand, Canadians take pride in their financial system, which has proven to be rock-solid. Since the turn of the millennium, major institutions from the US, the UK, and even Switzerland have either failed or required rescue. Meanwhile, large Canadian institutions have remained mainly unscathed through the first quarter of the century. The way they are regulated and the moderate level of competition they face may explain why they are so resilient. We particularly like our banks because they are familiar, with branches across the country and a heavy presence in the media.

On the other hand, these large institutions owe their resilience, in part, to their high profitability. In 2024, the oligopoly netted earnings of over $59 billion. While these institutions have significant operations in foreign countries, we Canadians are paying for the lion's share of these profits. Most of us are happy to benefit from a stable financial system, but overpaying for financial services is not a recipe for individual financial success. To reap more benefits from your portfolio, you need to face a few hard truths that Bay Street would prefer you ignore.

[1] Royal Bank of Canada, TD Bank, Bank of Montreal, Scotiabank, CIBC, National Bank of Canada, Desjardins, Manulife Financial Corporation, Canada Life, and Sun Life Financial Inc.

1. The Investment Industry Is in a Conflict of Interest

Investment Industry vs. Politics

The investment industry and politics share a common point: they are in the business of managing other people's money, which entails potential conflicts of interest.

In the Canadian Parliament, the Office of the Conflict of Interest and Ethics Commissioner's mission is "to help elected and appointed public officials avoid and manage conflicts of interest." Canadian securities regulators addressed conflicts of interest through the launch of the Client Focused Reforms in 2019.

What Are the Client-Focused Reforms?

These reforms include the following elements:

Know Your Client (KYC): Registrants are required to collect comprehensive information about clients, including their personal and financial circumstances, investment knowledge, risk profile, and investment time horizon. This information must be updated regularly.

Know Your Product (KYP): Registrants must thoroughly understand the securities they offer, assessing aspects such as structure, features, risks, and costs. They are also obligated to monitor these securities for significant changes to ensure ongoing suitability for clients.

Conflicts of Interest: Firms must identify and address material conflicts of interest in the best interest of the client. Disclosure of such conflicts is required, but disclosure alone is insufficient; firms must take appropriate steps to mitigate or avoid these conflicts.

Misleading Communications: Registrants are prohibited from using titles or designations that could mislead clients regarding their qualifications or the nature of their relationship.

Relationship Disclosure Information (RDI): Enhanced disclosure requirements mandate that firms provide clients with clear information about the products and services offered, any limitations (such as offering primarily proprietary products), and the potential impact of fees on investment returns.

The fact that regulatory action is addressing these issues is positive, but the fact that the issues exist to the point that regulatory intervention is required should be understood by consumers.

What About a Fiduciary Duty for Financial Advisors?

These regulatory reforms come short of imposing a fiduciary duty on financial advisors and their employers. A fiduciary duty would hold financial advisors accountable to act in the best interest of their clients. Under the current regulation, most financial advisors must recommend products that are "suitable" for a client, but not necessarily the best product available for that client.

Regulators considered adopting a fiduciary standard, but the investment industry resisted the change. A legal analysis commissioned by the Canadian securities industry lobby groups affirmed that the country's regulatory system for financial advice is at least as stringent as regimes in other countries that are adopting their own forms of fiduciary duty for retail advisors.[2] Industry representatives also claimed that imposing a fiduciary standard would increase compliance costs, reduce access to advice, and limit the variety of products they could offer.

Some registration categories, however, are held to a higher standard. Portfolio Managers with discretionary trading authority over their clients' accounts are not held to a statutory fiduciary standard, but they are held to a common law fiduciary standard.[3]

Evidence from the Field

In 2024, the CBC investigated the sales practices at branches of the five major Canadian banks. Here is what they found about the financial advisors they met:

- Their employer pressured them to maximize product sales and act as salespeople rather than advisors.
- They sometimes had very limited knowledge of the products they recommended.
- They provided misleading information about product fees.
- They were limited in the array of products they could offer.
- They sometimes provided advice that was detrimental to their client's best interest, such as recommending not paying off high-interest debt.

Note that the Ontario Securities Commission has done its own follow-up analysis and confirmed CBC's findings in more detail.[4]

Finding a Good Financial Advisor

The quality of the financial advice available on the Canadian market varies widely. When searching for the right financial advisor, the following guideposts may be helpful.

[2] Langton, James. « Canadian regulation of advisors exceeds global models: report ». Investment Executive, November 11, 2013, https://www.investmentexecutive.com/news/industry-news/canadian-regulation-of-advisors-exceeds-global-models-report/?utm_source=chatgpt.com.

[3] *CSA Consultation Paper 33-403 – The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice Is Provided to Retail Clients.* Oct. 25, 2012, https://www.osc.ca/sites/default/files/pdfs/irps/csa_20121025_33-403_fiduciary-duty.pdf.

[4] « Sales Culture Concerns at Five of Canada's Bank-Affiliated Dealers ». Ontario Securities Commission, 2024, https://www.osc.ca/en/news-events/reports-and-publications/sales-culture-concerns-five-canadas-bank-affiliated-dealers.

Type of Firm

Ideally, the advisory firm's interest does not conflict with yours. Typical problems arise when the firm holds an inventory of products, receives commissions from fund companies, or sells its own "house" funds.

Compensation Structure

Ideally, the advisor and the advisor's employer are paid directly by you. If their compensation depends on product providers, they may have an interest in selling you the products that are the most lucrative for them, at your expense. Commission-based compensation can also be problematic, as it incentivizes the advisor to trade actively to generate revenue.

Registration Category

The title of the person you're dealing with is important, as this reflects registration categories established by regulators. The most common categories are:

- Registered Representative (RR)

  RRs may offer a wide range of investment products, including stocks, bonds, mutual funds, and options.

- Investment Representative (IR)

  IRs are allowed to execute orders and provide some basic information.

- Dealing Representative – Mutual Funds

  Dealing Representatives – Mutual Funds are allowed to sell mutual funds and similar products (e.g., segregated funds, GICs in some cases).

- Portfolio Manager (PM)

  In contrast with other registration categories, PMs are authorized to manage discretionary accounts. To receive this title, professionals must meet high proficiency requirements, such as earning a CFA or CIM designation (which will be discussed in the next section). Portfolio managers in Canada are held to a fiduciary standard under common law, though no statutory fiduciary duty exists.

Credentials

In Canada, holders of the **Certified Financial Planner (CFP)** and **Financial Planner (F.Pl.)** designations are subject to professional standards that include fiduciary-like duties. However, whether a legal fiduciary duty applies in a strict legal sense depends on the context of the relationship, the services provided, and the jurisdiction where the advisor operates. The CFP designation is granted by FP Canada, while the F.Pl. designation (*Planificateur financier*) is regulated by the *Autorité des marchés financiers* (AMF) and governed by the *Chambre de la sécurité financière* (CSF) in Quebec. Their body of knowledge includes financial management, investment, tax planning, retirement planning, insurance, and estate planning.

Certified Investment Managers (CIMs) are bound by a fiduciary duty when registered as a portfolio manager for the assets they manage for you on a discretionary basis. Their training equips them with expertise in portfolio construction, asset management, and client-focused advice.

Holders of the **CFA (Chartered Financial Analyst)** designation are not automatically subject to a fiduciary standard in all circumstances. Still, they are required to adhere to high ethical standards as part of the CFA Institute Code of Ethics and Standards of Professional Conduct. Obtaining the CFA designation requires extensive training covering seven areas of knowledge: investment analysis, financial reporting and analysis, portfolio management, economics and quantitative methods, ethics and professional standards, research and communication, and industry knowledge.

2. Fees Matter, Big Time

Mutual fund advertising sometimes claims that "fees are not all that matters." While this statement is technically correct, it is a mistake to understate the importance of fund fees.

In a 2019 study of the US market[5], fund research firm Morningstar asserts that "fees are the best variable for predicting future (open-end mutual funds and exchange-traded funds) relative performance." The author notes that the asset-weighted expense ratio has declined every year since 2000, primarily due to "large outflows from expensive funds, inflows into cheaper funds, and an increase in the number of active funds reducing fees." The paper also reports that "although fees are mostly lower across the board, active-fund investors paid about four-and-a-half times more than passive-fund investors."

In a recent study of the Canadian market,[6] Morningstar writes, "Seeking low-cost funds has paid off for investors over the past five years. Cheaper exchange-traded funds (ETFs) have outperformed more expensive ones. They tend to survive longer than their more expensive counterparts as well." The author has classified ETFs by fee quintiles. The lowest-fee quintile outperformed the most expensive by 3.06% (10.74% vs. 7.68%).

In a 2008 paper titled "Presidential Address: The Cost of Active Investing,"[7] Professor Ken French from Dartmouth College states, referring to the US retail fund market, "Under reasonable assumptions, the typical investor would increase his average annual return by 67 basis points over the 1980–2006 period if he switched to a (less expensive) passive market portfolio." Yet another research article published in the International Review of Economics[8] reports: "We find that mutual fund families which charge loads, high expenses to their most favoured investors and have high turnover tend to perform badly, even gross of these fees."

[5] Johnson, Ben. "Investors Pay Less For Funds Than Ever Before." *Morningstar Magazine*, 2019, p. 49-52.

[6] Tran, Lan Anh. "How ETFs Are Winning Over Investors with Cheap Fees." Morningstar.ca, 2025, https://www.morningstar.ca/ca/news/265393/how-etfs-are-winning-over-investors-with-cheap-fees.aspx?utm_source=chatgpt.com.

[7] French, Kenneth R. "Presidential Address: The Cost of Active Investing." *The Journal of Finance*, vol. 63, nº 4, August 2008, p. 1537-73. DOI.org (Crossref), https://doi.org/10.1111/j.1540-6261.2008.01368.x.

[8] Tower, Edward, and Wei Zheng. "Ranking Mutual Fund Families: Minimum Expenses and Maximum Loads as Markers for Moral Turpitude." *International Review of Economics*, vol. 55, nº 4, December 2008, p. 315-50. Springer Link, https://doi.org/10.1007/s12232-008-0052-7.

When considering fees, there is also the issue of how much return investors can expect to harvest. A 2024 PWL study[9] examines the long-term equity return projections of several prominent organizations, including BlackRock, AQR Capital Management, and the Vanguard Group. The median net-of-inflation expected return for global equities was 4.5%. Let's consider that equity mutual fund fees in Canada often equal or surpass 2%. This means that investors paying high fees will likely leave 44% of returns to fund managers and retain only 56% for themselves. High fee mutual funds often include a trailing commission to compensate the advisor. If this is the case, the investor must consider whether the advice she benefits from is worth such a return sacrifice.

You may wonder whether a small percentage of extra return makes any difference for investors. A study published by consulting firm Mercer[10] proposes an answer. The analysis of various investment management fees in the market found that a representative individual paying the median level of fees available to the individual investor (1.9%) would be ready for retirement by age 70. Comparatively, an individual paying 0.6% in fees – the median fee available to investors in a workplace defined-contribution (DC) and savings plan – would be financially ready to retire by age 66. Higher fees can set back retirement by several years.

Make no mistake. We, as investors, can't control how markets perform. But we can control the one variable with the most significant impact on returns by investing in low-fee products. Such a simple investment strategy can be a life-changing decision for the better.

[9] Kerzérho, Raymond. What Should We Expect from Expected Returns?, PWL Capital, 2024, https://pwlcapital.com/what-should-we-expect-from-expected-returns/

[10] "Higher Fees Can Set Back Retirement by Four Years." *www.mercer.com*, Mercer, 2022, https://www.mercer.com/en-ca/about/newsroom/mercer-retirement-readiness-barometer-2022/.

3. Experts Can't Forecast Markets Reliably

What stocks should I buy? Is now the right time to invest? Where will interest rates head in the coming year? Are we heading into a recession? These are all legitimate questions, but they will not provide valuable guidance, because, with few exceptions (that I will discuss later), humans cannot forecast markets.

Individual Stock Selection

The first study of expert stock selection skills was published in 1932 by economist Alfred Cowles.[11] He looked at 7,500 recommendations issued by sixteen financial institutions and found that they underperformed the average stock return by 1.4%. He also examined the performance of twenty fire insurance companies and found that their portfolios underperformed by 1.2%. Finally, reviewing the stock forecasts of twenty-four financial publications between 1928 and 1932, he reported that they collectively failed to add value.

A more recent study[12] examined the stock recommendations from 153 investment newsletters. Overall, the data revealed no significant evidence of superior stock-picking ability.

Lastly, a study reviewed the stock recommendations made by prominent money managers at Barron's Annual Roundtable from 1968 to 1991.[13] The recommended stocks outperformed the market on average by 1.9% over the fourteen days following the publication. However, this outperformance vanished after three years, demonstrating that the recommendations were meritless for long-term investors.

Forecasting the Market's Direction

Other studies address experts' ability to forecast the general direction of the stock market. In a paper titled "Do Financial Gurus Produce Reliable Forecasts?"[14] researchers reviewed the predictions of sixty-eight professional forecasters. Only four of them made accurate predictions 70% of the time or more. Additionally, five of them were incorrect 70% of the time or more.

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[11] Cowles, Alfred. « Can Stock Market Forecasters Forecast? » Econometrica, vol. 1, nº 33, 1933, p. 309-24, https://www.jstor.org/stable/1907042.

[12] Metrick, Andrew. "Performance Evaluation with Transactions Data: The Stock Selection of Investment Newsletters." *The Journal of Finance*, vol. 54, nº 5, October 1999, p. 1743-75. DOI.org (Crossref), https://doi.org/10.1111/0022-1082.00165.

[13] Desai, Hemang, et Prem C. Jain. « An Analysis of the Recommendations of the "Superstar" Money Managers at Barron's Annual Roundtable ». The Journal of Finance, vol. 50, nº 4, September 1995, p. 1257. DOI.org (Crossref), https://doi.org/10.2307/2329351.

[14] Bailey, David H., et al. « Do Financial Gurus Produce Reliable Forecasts? » From Analysis to Visualization, édited by David H. Bailey et al., Springer International Publishing, 2020, p. 255-74. Springer Link, https://doi.org/10.1007/978-3-030-36568-4_17.

Another study[15] reviewed fifty scientific research papers on sophisticated methods, such as Artificial Neural Networks, used to predict the market's trend. The authors conclude: "Even though a lot of research efforts have been made, the current stock market prediction techniques still have many limits. From this survey, it can be concluded that the stock market prediction is a very complex task, and different factors should be considered for predicting the future of the market more accurately and efficiently."

Insiders' Predictive Skills

Evidence suggests that corporate insiders can accurately predict the direction of their firm's stock. In the paper titled "Insider Trading and Stock Prices,"[16] researchers report that insider actions have positive predictive power for future returns. However, the authors warn that only directors and executives (not large shareholders) have predictive power. They also warn that executive actions have predictive power only for small firms. This may suggest that investors can outperform based on insiders' reports. However, in Canada, regulations require insiders to declare their transactions only within five days following the trade. Thus, insiders' stock selection can be replicated, but not their timing.

Investing Based on Portfolio Structure

It is common for people to believe that they should invest based on forecasts. This is understandable, as Bay Street firms and the media repeat this message relentlessly. However, this method of investing is likely to produce a messy investment experience and subpar returns. Trying to forecast the market also makes the investment process more emotional than it should be, because you're trying to act on something you can't control. A better way to invest is to focus on the things you can control. Diversifying globally and maintaining a mix of stocks and bonds that is appropriate for you will likely deliver more predictable results than relying on market pundits.

[15] Gandhmal, Dattatray P., and K. Kumar. "Systematic Analysis and Review of Stock Market Prediction Techniques." *Computer Science* Review, vol. 34, November 2019, p. 100190. DOI.org (Crossref), https://doi.org/10.1016/j.cosrev.2019.08.001.

[16] Tavakoli, Manouchehr, et al. « Insider trading and stock prices ». International Review of Economics & Finance, vol. 22, nº 1, April 2012, p. 254-66. ScienceDirect, https://doi.org/10.1016/j.iref.2011.11.004.

4. Thematic Funds Make No Sense

Thematic funds promise high returns by concentrating on technological, economic, or demographic megatrends such as artificial intelligence, aging populations and renewable energy.

This type of product is not new. According to Morningstar, the first thematic fund was the US-based Television Fund, launched in 1948, which sought to profit from the surging television industry. At the time, there were only one million television sets in the US, and colour televisions were about to make their debut.

Investing in thematic funds involves overweighting portfolios in the stocks of promising high-growth industries without taking risky concentrated bets on one or a few stocks. While this strategy may seem wise, its weakness resides in its implied assumption that high-growth industries will outperform the market. This is far from a sure thing. A 2024 study by Morningstar[17] reveals that thematic funds tend to underperform global equity markets. Over fifteen years, ninety percent of US thematic funds have been closed or underperformed.

So, thematic funds underperform. Why is that? Ben Johnson, Head of Client Solutions, Asset Management at Morningstar, explains: “Investors in thematic funds are making a trifecta bet (a term from the racetrack). Specifically, they are implicitly betting that they are: 1- Picking a winning theme--one that is real and durable, 2- Selecting a fund that is well-placed to harness that theme--that owns stocks that are positioned to capitalize on it in a meaningful way. 3- Making their wager when valuations show that the market hasn't already priced in the theme's potential. The odds of winning these bets are low, but the payouts can be meaningful. Still, the long-term performance figures for thematic funds are not flattering.”[18]

Other research[19] analyzed the performance of US “specialized” sector and thematic exchange-traded funds (ETFs) between 1993 and 2019 and found they underperform the market, on average, by 3%. The authors observed that thematic ETFs are often launched after the underlying stocks have delivered high returns due to high investor sentiment, and that these returns subsequently falter. In other words, product manufacturers launch thematic ETFs with no other investment strategy than selecting stocks that have performed well recently and correspond to a popular theme at the time. The authors observe: “Our results suggest that specialized ETFs fail to create value for investors. These ETFs tend to hold attention-grabbing and overvalued stocks and therefore underperform significantly. This underperformance persists for at least five years following launch.” They add that evidence suggests that specialized ETFs are launched just after the very peak of excitement around an investment theme, on average. To add insult to injury, the authors observe that specialized ETFs charge high management fees and offer poor diversification.

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[17] Lamont, K., Calay, M., Motori, D., Black, M., “Morningstar Global Thematic Funds Landscape 2024,” Morningstar, 2024.

[18] Johnson, Ben. « Morningstar ». Are Thematic Funds Worthy of the Hype or a Risky Distraction?, 2021, https://www.morningstar.com/funds/are-thematic-funds-worthy-hype-or-risky-distraction.

[19] Ben-David, Itzhak, et al. “Competition for Attention in the ETF Space.” 28369, National Bureau of Economic Research, January 2021, https://doi.org/10.3386/w28369.

To summarize, thematic funds embody a common marketing strategy from the financial services industry. These products cater to an appetite from some retail investors for high-profile stocks with a "story" that appears to justify extreme return expectations and high fees. These products generate high revenues for manufacturers and poor returns for investors.

5. Dividends Are Not Magic

Many investors love their dividends. I understand. It can be enjoyable to receive payments from the companies in which we invest, and dividends provide a sense that the stocks we hold are sound, profitable businesses. But concentrating portfolios on high and/or growing dividends has serious downsides that are worth considering.

Dividends Are Not Free Money

When a company distributes a dividend payment, its stock value declines by the same amount. This works in theory and practice. A paper published by two economists from the Federal Reserve of Minneapolis[20] reported that "in a variety of tests, marginal price drop is not significantly different from the dividend amount. Thus, over the last several decades, one-for-one marginal price drop has been an excellent (average) rule of thumb."
The corollary to this relationship is that if there were two identical companies, one distributing dividends and the other not, both companies would deliver the same return to investors, but in different forms. The stock of the non-dividend-paying company would appreciate more than the stock of the dividend-paying company, to equalize returns.

Please understand me: I'm not saying that dividends are not important. They represent a significant portion of stock returns. But dividend-paying stocks are not intrinsically superior to their non-dividend-paying counterparts.

Dividend-Paying Stocks Outperform? Really?

Yes, dividend-paying stocks outperform the market, but… known factors explain this excess return.[21,22] They do outperform due to their significant overexposure to the value and profitability factors. The Fama-French five-factor model explains 99% of the return variations of funds targeting high and growing dividends. Once these factors are accounted for, dividend-paying stocks display a significantly negative alpha of nine basis points per month, equivalent to roughly -1% per annum[23]. Dividend payers are also less volatile than non-payers, which can be primarily attributed to their limited exposure to small-cap stocks.

[20] Boyd, John, and Ravi Jagannathan. "Ex-Dividend Price Behaviour of Common Stocks." *The Review of Financial Studies*, vol. 7, nº 4, 1994, p. 711-41.

[21] Swedroe, Larry. "There Is Nothing Special About Dividends." Morningstar, 2024, https://global.morningstar.com/en-gb/stocks/there-is-nothing-special-about-dividends.

[22] Swedroe, Larry. "Should Investors Be Indifferent to Dividend Impact on Stock Returns?" *Alpha Architect*, 2023, https://global.morningstar.com/en-gb/stocks/there-is-nothing-special-about-dividends.

[23] Ibid.

Deficient Diversification

Excluding non-dividend-paying stocks from portfolios shrinks the field of opportunity for investors, as 60% of US stocks and 40% of international stocks do not pay dividends.[24] In practice, dividend-oriented funds are even more restrictive, focusing on the highest-paying stocks. Comparing the dividend-focused ETFs to their broad market index counterparts among the three largest providers in Canada, we found that dividend ETFs held on average seven times fewer securities.[25] Furthermore, dividend-oriented funds are generally underexposed to specific market sectors, such as information technology. In addition, dividend-paying companies tend to operate in mature industries, so they return money to shareholders because of limited growth opportunities.

A Higher Tax Bill for Individual Investors

As discussed earlier, high-dividend funds substitute capital gains with dividends. In Canada, the tax treatment of Canadian-sourced dividends varies by provincial jurisdiction. However, for middle to high-income earners, these dividends are generally less tax-efficient than capital gains. For residents of Ontario, the 2024 marginal tax rate on income of $112,000 is 3.7% higher for eligible dividends than for capital gains. This tax disadvantage increases with taxable income, reaching 12.6% for an investor with a taxable income of $247,000 or more.[26] This tax disadvantage is much larger for foreign dividends, since they do not benefit from the Canadian dividend tax credit. Additionally, individual investors who hold US and international dividend funds in RRSPs, RRIFs and TFSAs do not escape taxation, as foreign countries collect foreign withholding taxes on these funds. A notable exception, though, is dividends from US-listed ETFs holding US stocks, which are not subject to foreign withholding taxes when held in an RRSP or a RRIF.

Dividend Funds Are Expensive

A common point of dividend and thematic funds is that they originate from a product differentiation marketing strategy. This type of strategy aims to increase profit margins for product providers. Canadians tend to believe that dividend funds are “special”. Evidence shows that, despite their poor performance, actively managed dividend funds enjoy the highest loyalty of any equity fund category in the Canadian market.[27] Furthermore, dividend funds are often more expensive than more diversified comparable products. For example, the dividend ETFs from the three largest ETF providers in Canada charge higher fees than their broad-based equivalent by a 0.23% margin.

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[24] Swedroe, Larry. “There Is Nothing Special About Dividends.” Morningstar, 2024, https://global.morningstar.com/en-gb/stocks/there-is-nothing-special-about-dividends.

[25] Source: iShares, BMO, and Vanguard.

[26] Source: RCGT.

[27] Nelesen, Joseph, et al. SPIVA® Canada Scorecard. S&P Dow Jones Indices, 2024, https://www.spglobal.com/spdji/en/documents/spiva/spiva-canada-year-end-2024.pdf.

Behavioural Benefits and Risks of Dividends

Many commentators argue that dividend-based strategies bring behavioural benefits, and they may be right.[28] Investors who have low trust towards stocks in general may be reassured that dividend-paying companies are truly profitable. This confidence may foster investor discipline. Receiving dividends is a pleasant experience for some investors, serving as a form of positive reinforcement. Being "paid to wait" may be particularly helpful during times of market turmoil, encouraging investors to stick to their long-term oriented strategy. Evidence suggests that dividend-paying stocks are sold less frequently, and the propensity to sell is less dependent on price changes than for non-dividend-paying stocks.[29]

However, dividend strategies also carry behavioural pitfalls. Investors often fail to account for the impact of dividends on share prices and tend to be overly optimistic about future share appreciation. More importantly, investors rarely reinvest dividends in the stocks from which they came. Also noteworthy is that demand for dividend-paying stocks increases in times of low interest rates, suggesting that investors mistakenly view them as a substitute for fixed-income investments.[30]

Overall, dividend-oriented strategies underperform when accounting for value and profitability factors. They produce under-diversified, high-cost portfolios that are deeply tax-inefficient. In return, some investors may draw behavioural benefits in the form of better discipline. However, once we realize that dividends are not a magic solution, investment discipline can be achieved with a higher risk-adjusted after-tax expected return using low-cost, broad-market passive funds. Unfortunately, the financial services industry is likely to continue encouraging investors to allocate funds to dividend funds due to their higher profit margins and greater customer loyalty.

[28] Heinzl, John. "The Powerful Dividend Benefit Nobody Talks About." *The Globe and Mail*, 2025, https://www.theglobeandmail.com/investing/education/article-the-powerful-dividend-benefit-nobody-talks-about/.

[29] Hartzmark, Samuel M. "The Dividend Disconnect." *SSRN Electronic Journal*, 2016. DOI.org (Crossref), https://doi.org/10.2139/ssrn.2876373.

[30] Ibid.

6. Active Trading Is a Weapon of Mass Wealth Destruction

The financial services industry will do everything possible to encourage you to trade more, including zero-commission policies that provide the illusion that trading is costless. Don't worry, they won't go broke. From bid-ask margins on high volume to other forms of invisible compensation, intense trading activity is highly lucrative for financial intermediaries. But is it profitable for investors? Certainly not. Here is why you shouldn't succumb to the lure of active trading.

Active Traders Underperform by a Wide Margin

In a famous study, Barber and Odean[31] surveyed the accounts of more than 66,000 US households from 1991 to 1996 and compared the returns of frequent and infrequent traders. While infrequent traders underperformed the broad market by 1.1%, the frequent traders underperformed by 5.5%. When adjusting for the tendency of investors to hold small value stocks, the frequent traders underperformed by 10.3%. The authors highlighted high trading costs as a primary cause of underperformance.

Fatal Attraction for Lottery Stocks

While higher costs partly explain the underperformance of active retail investors, another culprit is behavioural biases. A paper titled "Who Gambles in the Stock Market?"[32] concludes that individual investors are attracted primarily by lottery-type stocks. Another study found that stocks whose trading is dominated by speculative retail investors underperform stocks with the least retail participation by 0.6% per month.[33] Retail investors are attracted to small, volatile stocks that have recently performed exceptionally well. Another study[34] found that stocks that have experienced extremely high daily returns in the last month tend to exhibit poor future returns.

[31] Barber, Brad M., and Terrance Odean. "Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors." *The Journal of Finance*, vol. 55, nº 2, April 2000, p. 773-806. DOI.org (Crossref), https://doi.org/10.1111/0022-1082.00226.

[32] Kumar, Alok. "Who Gambles in the Stock Market?" *The Journal of Finance*, vol. 64, nº 4, August 2009, p. 1889-933. DOI.org (Crossref), https://doi.org/10.1111/j.1540-6261.2009.01483.x.

[33] Han, Bing, and Alok Kumar. "Speculative Retail Trading and Asset Prices." *The Journal of Financial and Quantitative Analysis*, vol. 48, nº 2, 2013, p. 377-404. JSTOR, https://www.jstor.org/stable/43303805.

[34] Bali, Turan G., et al. « Maxing out: Stocks as Lotteries and the Cross-Section of Expected Returns ». Journal of Financial Economics, vol. 99, nº 2, February 2011, p. 427-46. DOI.org (Crossref), https://doi.org/10.1016/j.jfineco.2010.08.014.

Unfavourable Odds Against Stock Picking

Beyond trading costs and retail investors' appetite for low-expected-return lottery-type stocks, stock picking by individual investors often results in concentrated portfolios. In an examination of more than 40,000 client accounts from a large discount brokerage firm, Goetzmann and Kumar[35] found that the average investor held a total of four stocks. The stock market is unfavourably tilted against holders of concentrated portfolios. In a 2019 paper,[36] Hendrik Bessembinder and his co-authors analyzed the long-term returns of global stocks from 1990 to 2018. They found that over the whole sample period, only 40% of stocks outperformed one-month US Treasury bills. The distribution of long-term stock returns is positively skewed: most stocks tend to underperform, while a few extremely high-performing stocks explain the market's overall positive returns. If you hold one or a few of these stocks, you may enjoy outsized returns. But most holders of concentrated stock portfolios are mathematically bound to underperform.

Men Do Worse than Women

Evidence suggests that men and women trade excessively, and that this is detrimental to returns. Individual investors often take too much credit for their investment success, leading to overconfidence and excessive trading. Barber and Odean[37] studied the stock investments of 35,000 households from 1991 to 1997. Women's portfolio turnover was 53%, while men's was 77%. These turnover numbers translate into an average holding period of less than two years, which is probably too short for long-term investors without an information advantage. Both men's and women's "buy" transactions tend to underperform their "sell" transactions. In other words, they trade for the worse rather than for the better. The difference is that women exhibit less overconfidence and trade less than men, and as a result, their underperformance is less pronounced.

To summarize, individual investors who actively trade individual stocks face innumerable hurdles. High trading costs, a preference for lottery stocks, recency and overconfidence biases, and the fact that most stocks perform poorly ensure that there will be very few winners in the stock trading game.

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[35] Goetzmann, William N., and Alok Kumar. "Equity Portfolio Diversification." *Review of Finance*, vol. 12, nº 3, January 2008, p. 433-63. DOI.org (Crossref), https://doi.org/10.1093/rof/rfn005.

[36] Bessembinder, Hendrik (Hank), et al. "Do Global Stocks Outperform US Treasury Bills?" *SSRN Electronic Journal*, 2019. DOI.org (Crossref), https://doi.org/10.2139/ssrn.3415739.

[37] Barber, Brad M., and Terrance Odean. "Boys Will Be Boys: Gender, Overconfidence, and Common Stock Investment." *SSRN Electronic Journal*, 1998. DOI.org (Crossref), https://doi.org/10.2139/ssrn.139415.

7. Broad-Market Passive Funds Are Marvellous

A substantial body of evidence supports the superiority of low-cost, broad-market passive funds over actively managed portfolios. Most observers believe passive funds outperform because of their low fees. Fees matter, but they are not the whole story. Research has shown that passive beats active, even before fees. Broad market passive funds are the best solution for most investors, but don't count on Bay Street to tell you that.

Institutional Active Managers Underperform

In 1992, Lakonishok, Shleifer, and Vishny[38] studied the performance of US pension funds from 1983 to 1989. They found that pre-fees, the active US equity portfolios held by pension funds collectively underperformed the S&P 500 every year. On average, 54% of pension managers failed to beat the index, pre-fees. The authors conclude: "As far as performance is concerned, pension fund equity managers seem to subtract rather than add value relative to the performance of the S&P 500 Index... Much of the organization of the industry seems to be driven by its need to provide sponsors with good excuses for poor performance."

A 2024 report from Standard & Poor's analyzed the performance of US-based institutional managers. The SPIVA® Institutional Scorecard[39] documents that most fixed-income managers failed to outperform in 11 of 18 sub-asset classes on a pre-fee basis, and in 17 of 18 on a net-of-fee basis. Active equity managers performed even worse, underperforming in all 22 sub-asset classes, both on a pre-fee and post-fee basis.

The Failure of Active Retail Funds

Most actively managed institutional funds underperform. Since fees are higher for retail than for institutional funds, we should not expect good results from retail active mutual funds.

Morningstar provides evidence on the retail market.[40] In a 2025 study of active US retail funds covering a wide array of asset classes, the authors conclude: "Actively managed funds' long-term record against their passive peers remained stable. Less than 22% of active strategies survived and beat their passive counterparts over the ten years through 2024."

[38] Lakonishok, Josef, et al. "The Structure and Performance of the Money Management Industry." Brookings, https://www.brookings.edu/articles/the-structure-and-performance-of-the-money-management-industry/.

[39] Ganti, Anu, et al. SPIVA® Institutional Scorecard. S&P Dow Jones Indices, 2024, https://www.spglobal.com/spdji/en/spiva/article/institutional-spiva-scorecard/.

[40] Armour, Brian, et al. "Morningstar's US Active/Passive Barometer Year-End 2024." Morningstar, 2025, https://www.morningstar.com/business/insights/research/active-passive-barometer.

On the Canadian side, a PWL Capital study[41] found that low-cost, broad-market passive ETFs outperformed a majority of active funds over ten years across all asset classes reviewed: Canadian fixed income, Canadian equity, US equity, International developed equity, and emerging markets. Many of these passive funds were ranked in the first quartile, net of fees. Another study by Morningstar found that only 18% of active Canadian equity funds outperformed their passive equivalent.[42]

Why Do Passive Funds Outperform?

Lower Fees

A recent PWL study[43] shows that, on average, passive funds in Canada cost 1.06 percentage points less than their active counterparts. Simple arithmetic dictates that actively managed funds must first overcome their cost differential to match the return of their passive equivalents.

Lower Turnover, Transaction Costs, and Cash Drag

Actively managed funds tend to trade more actively than passive funds. They also hold more cash on average than their passive counterparts. An empirical study[44] found that transaction costs and fees collectively subtract 1.6% from the returns of US actively managed equity funds. Another 0.7% is deducted by "non-equity holdings," which is most likely cash.

Individual Stock Returns are Positively Skewed

Broad-based passive equity funds tend to be highly diversified, often holding hundreds if not thousands of securities.[45] By comparison, the median US-based actively managed mutual fund typically has only a few dozen stocks.[46] In addition to eliminating security-specific risk, the extreme diversification of passive funds enhances expected returns. Research demonstrates that the total market performance is disproportionately influenced by a small number of stocks with extremely high returns, especially over long horizons. Holding all small, mid, and large-cap stocks ensures capturing these high performers. John Bogle (the legendary founder of the Vanguard Group) once compared active investing to searching for a needle in a haystack. He suggested buying the haystack (the market portfolio) rather than searching for the needle was a better solution.

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[41] Kerzérho, Raymond. « Do Passively Managed ETFs Perform Well? » PWL Capital, 2023, https://pwlcapital.com/do-passively-managed-etfs-perform-well/.

[42] Davis, Christopher, and Michael Keaveney. "Have Active Canadian Equity Fund Managers Earned Their Keep?" Morningstar, 2015.

[43] Kerzérho, Raymond. The Passive vs. Active Fund Monitor. PWL Capital, 2025, https://pwlcapital.com/wp-content/uploads/2025/03/20250318-The-Passive-vs-Active-Fund-Monitor.pdf.

[44] Wermers, Russ. "Mutual Fund Herding and the Impact on Stock Prices." *The Journal of Finance*, vol. 54, nº 2, April 1999, p. 581-622. DOI.org (Crossref), https://doi.org/10.1111/0022-1082.00118.

[45] One of the world's largest equity funds is the Vanguard Total Stock Market Index Fund, holding over 3,500 securities.

[46] Kacperczyk, Marcin, et al. "On the Industry Concentration of Actively Managed Equity Mutual Funds." The Journal of Finance, vol. 60, nº 4, August 2005, p. 1983-2011. DOI.org (Crossref), https://doi.org/10.1111/j.1540-6261.2005.00785.x.

8. Principal-Protected Notes: You Can't Have Your Cake and Eat It Too

"Principal-Protected Notes" or "PPNs" promise to benefit from the price appreciation of the stock market while the issuing entity guarantees your principal at maturity. These products are akin to a bond, except that instead of paying interest, the PPN will pay a return at maturity based on the appreciation of a stock index or a group of stocks (if this return is positive) in addition to returning the principal.

The issuer generally hedges their position by using the proceeds of the issuance to purchase a zero-coupon bond and a call option on the index underlying the PPN. The difference between the proceeds and the cost of the hedging position will be the profit of the operation that the issuer and the dealer (which can be the same firm) will share. On the surface, PPNs appear to offer the best of both worlds with a principal guarantee and participation in the stock market appreciation. But there is a wrinkle to this story: the literature on PPNs and other complex investment products finds that they are sold at prices ranging between 4.5% and 8% above their fair value.[47]

However, investors can create their own PPN at a fraction of the cost charged by the financial services industry.

For example, a hypothetical eight-year provincial government zero-coupon bond yielding 3% would cost $7,837 per $10,000 of face value. If you have a few thousand dollars to invest, buying a zero-coupon bond with 78.37% of your capital will earn you 100% of the principal in eight years because of compound interest. You can then invest the remaining 21.63% of your capital in a low-cost broad-market equity ETF, et voilà! You now have a guarantee to recover your principal in eight years, plus participation in a stock market index! And as a bonus, you will receive dividend payments (if the underlying stocks pay dividends) from your ETF, something you'll never get from a PPN. In contrast to PPNs, you can exit this investment before its maturity at a reasonable cost.

The lesson from the PPN market is that they are complex products aiming to exploit the myopic loss aversion bias to extract outsized profits from investors. PPNs are not much different from a portfolio of stocks and bonds. Lastly, complexity is not your friend. Financial firms create complex and opaque products primarily because they are lucrative for them, rather than for investors.[48]

[47] Bernard, Carole, et al. "Locally Capped Investment Products and the Retail Investor." *The Journal of Derivatives*, vol. 18, nº 4, May 2011, p. 72-88. DOI.org (Crossref), https://doi.org/10.3905/jod.2011.18.4.072.

[48] Carlin, Bruce I. « Strategic Price Complexity in Retail Financial Markets ». Journal of Financial Economics, vol. 91, nº 3, March 2009, p. 278-87. DOI.org (Crossref), https://doi.org/10.1016/j.jfineco.2008.05.002.

Final Thoughts

Successful investing requires introspection. Are you an investor or a speculator? What do you want to achieve? Do you want to be well-off or extremely wealthy? The first option requires diversification and a systematic, unemotional method of saving and investing, with a high probability of success. The second option requires a lottery-like, high-volatility, high-stress investment approach, which entails a low likelihood of success.

Another success factor is to adopt sensible assumptions. Smart investing requires being modest enough to admit no one can forecast markets. Of course, we all know stocks outperform bonds and GICs most of the time, but no one can predict what the market will do, or which stocks will outperform in the coming years. Investing based on portfolio structure (with an appropriate asset mix) is superior to a prediction-based approach.

Finally, success depends on understanding the financial advice business. The financial services industry is a profit maximization compact. It uses its marketing arsenal to persuade investors that they need costly or complex investment solutions. This industry also benefits if you trade actively. The evidence discussed here suggests that active trading, high costs and complexity are not in investors' favour.

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