Should You Buy ETFs Or Stocks?

Keith Richards

A couple of readers of the *MoneySaver* have asked a few question that might be of interest to other readers. One reader enquired about options – and how one might utilize them within a sensible investment strategy. Another reader asked for some guidance regarding picking individual stocks versus using ETFs. The editors of the *MoneySaver* have asked me to address these subjects over two separate articles. This column will address the question regarding stock picking versus ETFs. In my next column I'll cover the basics on utilizing options within an investment portfolio.

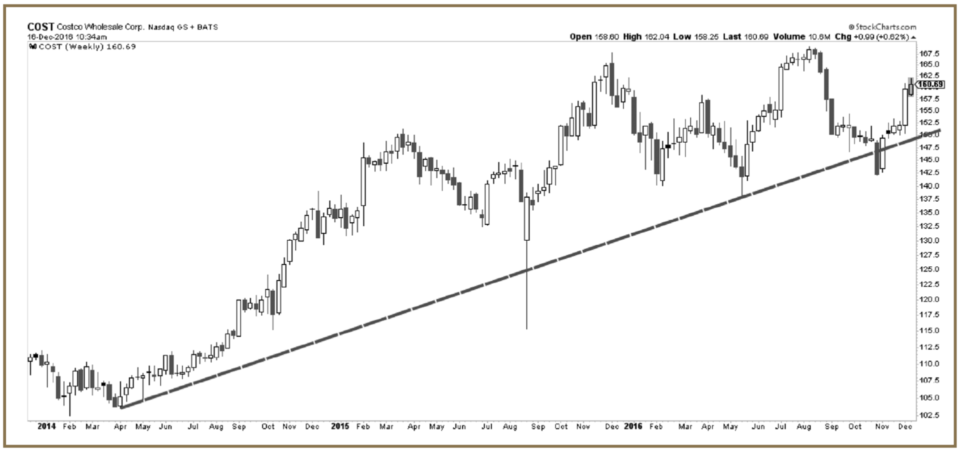
When we try and decide if we should buy a sector ETF versus a good stock, we want to examine the variability of stocks within that sector. Some stocks within a sector might massively outperform their peers. Others might underperform the group. This is called dispersion of returns within a sector. Sectors with stocks that don't vary too much from the mean (average return) do not offer stock pickers an advantage. The performance of all companies in these sectors tends to be similar. A great example of this type of sector is the Canadian banks. Beyond a couple of outliers or regional plays like Laurentian Bank (LB-T) and Canadian Western Bank (CWB-T), the Canadian banks tend to move together – largely led by the big six. That's because there really isn't a lot of room for the banks to offer unique or entrepreneurial advantages over each other. Same thing with utilities on both sides of the border. They are highly regulated, have fixed assets and product lines, and can't offer much in the way of growth or entrepreneurial advantages over their competitors. Since the dispersion of returns amongst utilities and banks tends to be narrow, picking a stock from each sector doesn't offer meaningfully higher returns for the added risk.

Contrast the Canadian banking sector and utilities sector to the technology sector. Here, we have some pretty big dispersion of returns. Take a look at the two search engine giants Google (GOOGL) and Yahoo (YHOO). Google, which we at ValueTrend own, is up about 50% since the end of 2014, while Yahoo is down about 20% in the same period! The same observation applies to the retail sector. The behemoth of low price merchandise, Walmart (WMT-US) is down almost 20% since the end of 2014. Meanwhile, discount merchandise and wholesale club Costco (COST-US) is up about 20% over the same period. We hold a position in Costco.

Stock-picking offers an advantage over ETFs when there is a wide dispersion of returns from the mean – as is the case in the retail and technology sectors. You have an advantage by using a rigorous analysis process to separate the stock with the best potential from the stocks with the worst potential in those sectors. Disciplined analysis could be used to spot mispricing, offering stock-pickers an opportunity to exceed the sector index based ETFs returns. That's because the sector index will hold both the winners and the losers. The "zigging" of one stock offsets the "zagging" of another stock in a sector with a wide variance of returns. This often results in a flat to low return when there is high dispersion of returns between the component stocks that make up the index.

At ValueTrend we employ a Chartered Market Technician (CMT) to review stocks for trend and price behavior via my analytics, and a Chartered Financial Analyst (CFA) through my associate Craig Aucoin. Craig reviews companies positively identified by my technical analysis by looking at their financial statements and business prospects. Between our two disciplines, we have had success in identifying the induvial stocks in sectors that perform at the higher end of their group's performance range.

What about broad market index ETFs versus stock



picking? For example, you can own the broad S&P 500 index by purchasing S&P 500 SPDR's (SPY-UN) or the broad TSX 60 index via the iShares ETF (XIU-T). It's true that less experienced investors are particularly suited for indexing. That's because passively holding index ETFs eliminates emotion. Investing emotionally – buying into greed, and selling into fear, is the biggest reason individual investors lose money. Indexing offers diversified stock portfolios, simplicity, decreases odds for emotional errors, and reduces costs and tax obligations surrounding trading.

Despite these advantages, there is a catch to passive index ETF investing. At the current time we are faced with high valuations and macro-economic risks. A stock picker focused on buying high-quality companies at the right time, then selling them when they become fairly priced might have an advantage in this environment. Remember 2008-early 2009? An index tracking the market lost over 52% from the market's June 2008 peak to its March 2009 trough. During market selloffs a passive index strategy will definitely suffer.

Unlike the passive index approach that can be crippled by market volatility, an approach that is rooted in technical analysis can take advantage of market shifts. Like weather forecasting, technical analysis does not result in absolute predictions about the future. Instead, technical analysis can help investors identify the current levels of risk, versus the current levels of potential returns on the market. A strategy that can identify changes in trends and market risks can and will outperform a blanket "buy and hold" at-all-costs mentality in a volatile environment. To learn more about technical analysis, I humbly recommend my book Sideways, and my blog at www.valuetrend.ca – both of which are geared towards teaching retail investors how to incorporate technical analysis.

Passive investing can actually be a riskier and costlier investment strategy than a carefully planned system of buying and selling assets. Case in point, while the broad markets were cut in half from the market peak, our equity platform was down only 26% from June of 27th in 2008 to December 31st of that year. More importantly, the active approach we employed got our equity platform back to break-even by the end of 2009. The S&P 500 did not reach breakeven until 2013, and the TSX did not break even until 2014. This means that the passive ETF strategy was substantially more volatile, and took much longer to break even than our active approach. Interestingly, the TSX is still more or less flat since its 2008 highs. So a passive investor buying a TSX index ETF in June 2008 has realized little beyond a relatively small dividend return to date, and has suffered through tremendous volatility in that period.

I am a fan of utilizing both ETFs and individual stocks in an investor's portfolio. The managed platforms that we run at ValueTrend are currently allocated to hold about 20% ETFs, and 80% individual stocks. While we do attempt to achieve market outperformance through individual stock analysis, sometimes we choose to take a position in low-variance sectors to exploit the trend of the index without the added individual security risk. Like most things in life, there is a time and place for everything.

Keith On BNN

I'll be on BNN televisions call-in show, *MarketCall* on Monday Feb. 6th, 2017 at 6:00pm. Tune in to BNN to catch me live on BNN's premier call-in show, where viewers like yourself can ask my technical opinion on the stocks you hold.

Call in with questions during the show's live taping between 6:00pm and 2:00 pm. The toll free number for questions is 1 855 326 6266. You can also email questions ahead of time to marketcall@bnn.ca – it's important that you specify they are for me.

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