Why an American market guru is calling Canada the 'North Korea' of investing

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Wes Gray sees Canada as the "North Korea" of investing.

Citing a lack of transparency in the mutual fund business and an investing public seemingly content to pay excessive fees, the Canadian market is still a long way from a client-friendly regime, says Mr. Gray, chief executive of asset manager Alpha Architect and a rising star in U.S. quantitative investing.

Despite heightened awareness around fees and their power to destroy long-term returns, Canadians saving for retirement are still parking their money in traditional mutual funds, the vast majority of which carry management expense ratios of 2 per cent or more. "Down in the States, if you had a fund that charged 2 per cent plus, you'd get murdered," Mr. Gray said.

Having studied under Nobel Prize winner Eugene Fama, Mr. Gray employs an approach to both value and momentum investing informed by behavioural economics and financial research.

And he's now eyeing the Canadian market. Alpha Architect has teamed up with Calgary-based wealth manager SmartBe Wealth Inc. to bring the U.S. firm's approach north, starting with an ETF set to launch this fall.

Mr. Gray spoke with The Globe and Mail about what it takes for investors on either side of the border to succeed.

What are your impressions of the Canadian market?

In the U.S., everything's getting more transparent. Canadians are pretty bright folks and yet their financial system is like North Korea. We know the reason – the banks control everything. Canada just seems so prime to move into the future but for some reason it's slow on the uptake. A lot of it comes down to distribution channels where you never get to see the real fees. We would love to help people be more cognizant of fees and not just believing whatever the bankers are telling you.

How do you plan on doing that?

We got approached by SmartBe because we have a reputation as an education-first type of firm. They know the Canadian market, they know the culture. We know research, data, transparency, education. And we're the index provider.

Canadian stocks are generally cheaper and have underperformed the U.S. for several years. Is there good value in Canada right now?

Two questions there. First, does Canadian equity risk make sense now relative to other equity risk because it's gotten beat up? Instead of owning U.S. equities at some of the highest prices of all time, maybe you want to shift a bit into the cheaper market of Canada. That's probably reasonable. Over the long haul, cheaper equals higher expected returns. Second, if you want to own Canadian stock market risk, how do we own it? And you generally want the cheapest securities and you want to own the highest momentum securities.

This is a market that has made it tough for stock pickers to beat their benchmarks. Is value investing dead?

I don't think there's anything fundamentally broken about value investing. It's just been on a bad run and it just happens to be the case that a lot of the "shiny rock" stocks have kept being really shiny for a long time. Factor investing is simple but not easy. In order to earn [excess] returns, you've got to take on risk and do something different. You've got to own the pain to get the gain. If you can't handle the heat, maybe you should own a Vanguard fund.

Do all types of value investing get unfairly lumped together?

A lot of quant strategies use book-to-market as a sign of cheapness, which has had a horrific run over the last 10 years. But there are other ways to measure value. You could use P/E ratios. We use enterprise multiples – basically, what would a private-equity buyer have to pay to buy this entire company? That metric over the last 10 years has been basically in line with market performance, but with a lot more volatility.

To quote Eugene Fama, "the premier anomaly is momentum." Is that the one you primarily try to exploit?

Gun to my head, over the next 20-30 years, what strategy do I think will have the highest expected return? I'd probably say momentum. What strategy will also have the highest volatility? I'd also say momentum.

Why can momentum investing work so well over the long term?

The reason these things work is because they're riskier. You can't eliminate risk. Even God has to take risk to get excess performance.

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