Investors: Buy This Stock Instead of an Index Fund

Description

More and more investor money is flooding into index funds.

For the most part, this is a good thing. Index funds have far lower fees than the average mutual fund. Canadian mutual funds charge, on average, more than 2% annually. Index funds charge as little as 0.05% — although most specialty index funds are closer to 0.5%.

A difference of 1.5% or 2% can really make a difference over time. Let’s look at a very simple example. Say you invest $10,000 per year for 30 years. The stock market returns 9% per year, so we can expect an index fund to match that. A mutual fund does the same, but does so before fees are deducted. The net return to an investor is 7.5%.

The first investor ends up with $1.62 million, which is easily enough for a middle-class retirement. The other still does pretty well, but only ends up with $1.2 million.

Who couldn’t use an extra $400,000?

But there are issues with index funds too. The TSX Composite Index is a great example of this. Canada’s largest stock index is dominated by just three sectors — financials, metals and mining, and energy. These three sectors alone make up 68% of the index.

Thus, buying a TSX Composite ETF is essentially making a bet on three sectors. This is easily remedied by buying other ETFs that offer more diversification, but that adds a layer of complexity to something that’s supposed to be easy.

Fortunately for index investors, there’s a much easier way to get exposure to a plethora of assets. And it doesn’t come with any management fee.

Enter Brookfield

Brookfield Asset Management Inc. (TSX:BAM.A)(NYSE:BAM) has a simple business plan. It invests in the best assets it can and holds them for a very long time.

It does this in three different ways. The largest is through a series of publicly traded partnerships. Brookfield accumulates assets on its balance sheet and then spins them out. These partnerships own everything from real estate to renewable energy. Brookfield's stake in these subsidiaries is worth $49 billion.

The company also runs a number of private funds, which invest in everything from U.S. multifamily real estate to private equity. These funds collectively manage $47 billion.

The company also has $12 billion invested in publicly traded securities on behalf of banks, pension funds, and other institutional clients.

And these are just the main categories. Altogether, Brookfield Asset Management has some $250 billion in assets under management. It has grown these assets by 11% per year since 2011.

The kicker

Brookfield has a lot of similarities with index funds. It holds a vast array of assets that are managed at a very low fee. But there's one important difference.

Leverage.

Normally when people think debt, they think of a massive mortgage or credit card interest keeping somebody down. But debt is also used responsibly by thousands of companies and individual investors.

This debt is the big difference between Brookfield and an index fund. And it's a good thing too.

Brookfield has an enterprise value of $117 billion. It's market value is $44.5 billion and it has $72.5 worth of debt and preferred shares. Only $8 billion of that debt is tied to Brookfield itself; the rest is from its ownership stakes in its many subsidiaries.

What's the point? Investing in Brookfield is like investing in an index fund on steroids. The debt gives it a little extra boost when markets are good. This means Brookfield Asset Management should do better than the market over time, although that will come with a little more risk when the market does poorly. Still, it's a fine trade-off to make, especially since markets do tend to go up over time.

The bottom line

Index investors should take a closer look at Brookfield Asset Management. It has everything a passive investor looks for, including a diverse array of assets, a very reasonable management fee, and a history of long-term performance. Oh, and it has crushed the TSX Composite over the last five and 10 years.

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