feature

Exchange Traded Fund*amentals*

Fully transparent investing, with lower fees and solid returns

One of the most intriguing investment classes to have emerged over the past decade is Exchange Traded Funds (ETFs). Growth and interest in ETFs has been stellar, especially when compared to mutual funds.

ETFs are similar to mutual funds, but they offer numerous advantages that every investor must know. When properly selected, ETFs can form a solid foundation for your portfolio.

WHAT'S AN ETF?

Sometimes referred to as "index" funds, ETFs are diversified baskets of stocks or bonds that replicate the performance of a market index.

The first ETF was constructed in 1993 as a low-cost way for investors to obtain exposure to the performance of the S&P 500 (a basket of 500 largest American companies). Because ETFs are not actively managed like mutual funds, ETFs are referred to as "passive" investments.

The ETF market has since grown to over $1 trillion worldwide. The Toronto Stock Exchange (TSX) is home to 100 ETFs that track everything from fixed income to equities to sector-specific activities – such as utilities, energy, financials – and country-specific sectors – such as emerging markets – and even specialty sectors, like commodities and gold bullion.

ETFs are fully transparent, in that the investor can view all of the holdings within that ETF at any time. Mutual funds do not offer this privilege.

IShares, Canadian Large Cap TSX60, is Canada's largest ETF. This ETF tracks Canada's largest 60 companies as measured by their market weight. The largest company on the TSX is presently the Royal Bank and, as such, forms the largest weighting at eight per cent.

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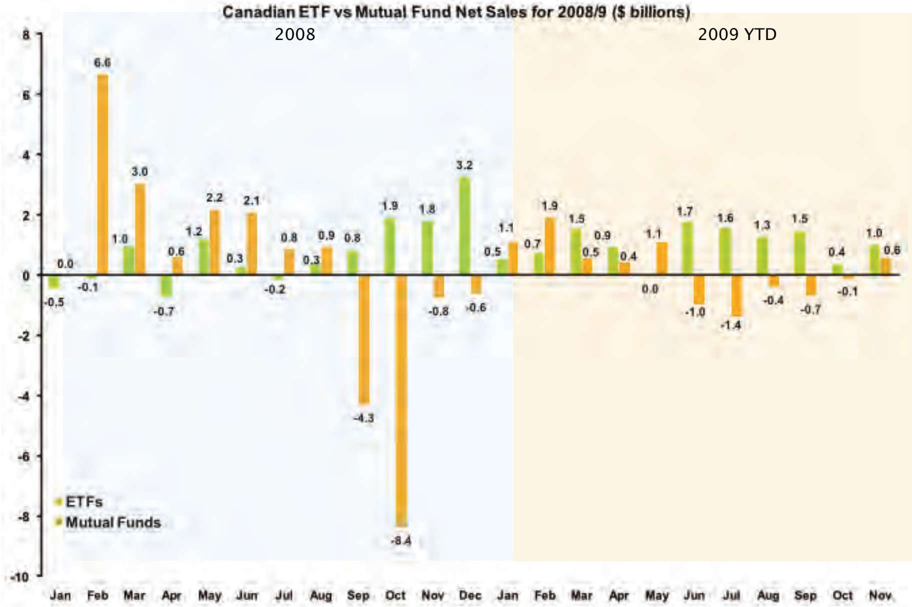
Chart 1

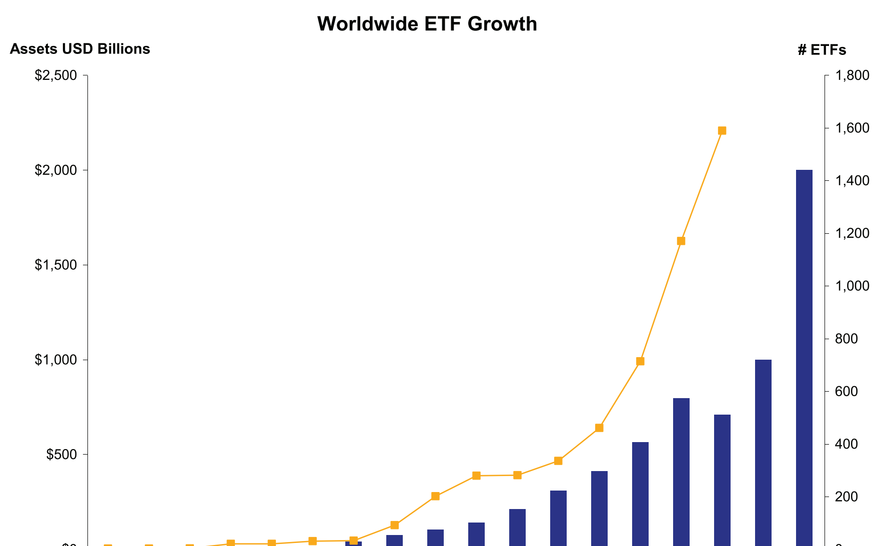
Mutual Fund vs ETF Sales



Source: IFIC, Bloomberg

Chart 2

Worldwide ETF Growth



	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009-F	2011-F
Assets USD Billions	$0.8	$1.1	$2.3	$5.3	$8.2	$17.6	$39.6	$74.3	$104.8	$141.6	$212.0	$309.8	$412.1	$565.6	$796.7	$711.0	$1,000	$2,000
# ETFs	3	3	4	21	21	31	33	92	202	280	282	336	461	714	1,171	1,590		

Source: Blackrock, Bloomberg

Again, with the advantage of full transparency, an investor can always view the complete list of companies and weightings within the corresponding index.

ETF FUNDAMENTALS

One of Canada's fastest growing ETF providers constructs its indexes using a fundamentally different approach. The "fundamental index" methodology eliminates a company's market weight from being the sole determinant in its ranking within the index. Instead, companies are ranked based on their dividend growth, cash flow, and other key business fundamentals. Known as RAFI Indexing, the resulting ETF is quite different than market-weighted ETFs. RAFI performance has been superb.

Over the past decade, the RAFI Canada Index has returned an average of 10.77 per cent per year versus 5.56 per cent per year for the iShares TSX60. Now compare these returns to the median Canadian equity mutual fund of 4.9 per cent per year.

ETFs VERSUS MUTUAL FUNDS

Some mutual funds have performed remarkably well compared to the index, and can therefore justify their fees. But as a whole, ETFs offer a number of distinct advantages.

Mutual funds offer broad diversification, but with various embedded fees (known as Management Expense Ratios or MERs), as mutual fund companies employ a team of portfolio managers and analysts with the goal of actively picking investments in an effort to outperform a benchmark index each year.

Since ETFs are passively managed, and do not employ these portfolio management teams, their costs are a fraction of those charged by mutual funds. The median Canadian mutual fund MER is 2.4 per cent, while the median Canadian ETF MER is 0.6 per cent. Simply put, on a $100,000 portfolio, this is a savings of $1,800 each year.

During the height of the financial stress in the autumn of 2008, $8 billion was *added* to ETFs, while mutual funds experienced massive outflows to the tune of $14 billion (see Chart 1). This could be the result of any combination of reasons. Perhaps one reason was transparency. Investors knew what they owned at all times. Equipped with this knowledge, investors were better prepared to make an educated decision. Looking back, holding onto your investments, and actually adding to them, was the prudent thing to do, as 2009 boasted one of the largest bull markets in history.

Not all ETFs are created equal. Some ETFs use advanced market correlation strategies, while some offer currency hedging to mitigate the impact of currency movements. As such, selecting the appropriate ETF can be difficult.

Advisors must be securities-licensed to recommend, or even discuss, ETFs with their clients. Only 20 per cent of advisors meet this criteria. If your advisor is not having the conversation with you, or educating you as to the importance and benefits of ETFs in your portfolio, your advisor may be part of the other 80 per cent who are only licensed to recommend mutual funds.

Better-informed investors, making pro-active and educated decisions based on full transparency, have a far superior chance at financial success. •