Exchange-traded funds

Exchange-traded funds: find out how they work and what the catch is. We compared them to index funds and to traditionally managed funds to better prepare you for questions from your clients.

Exchange traded funds (ETFs) have rapidly become big business in the United States. They have also experienced exponential growth, and therefore they have attracted a lot of media attention on both sides of the border. The reason for the huge growth rate is not as apparent – for one thing, ETFs have attracted big institutional investors – particularly the pension funds. The fact this is a brand new investment option has a great deal to do with it. Nevertheless ETFs remain a small portion of financial markets as a whole.

History

Did you know that the first exchange traded fund in the world was launched in Canada in 1989 by the Toronto Stock Exchange (TSE)? Known as TIPs 35, the Toronto 35 Index Participation Units was linked to the 35 largest and most liquid stocks on the exchange. HIPs (Toronto 100 Index Participation Units) followed soon after, linked to the largest 100 companies on the TSE. The biggest holders of these investment vehicles were the institutional investors, especially big pension funds. The TIPs/HIPs advantage was its tiny management expense ration (MER) of only four basis points.

In October 1999, Barclays Global Investors (BGI) launched the iUnits S&P/TSE 60 Index Participation Fund (i60s). By March 2000, TIPs and HIPs were merged with it. The i60s MER is 17 basis points, more than four times that of the old TIPs fund, but still only a fraction of comparable mutual (index) funds tracking the same TSE indices.

Our American counterparts leaped onto the ETF bandwagon and launched many variations of their own – SPDRS “spiders”, HOLDRs “holders”, Qube and DIA “diamonds” track the S&P Depository Receipts, Holding Company Depository Receipts, NASDAQ and Dow Jones, or segments thereof, respectively.

So, what exactly are ETFs?

ETFs invest directly into the basket of stocks that comprise the target index. Units are created, which are usually about 1/10 of the index. The units are traded directly in stock exchanges; they are bought and sold through stockbrokers. Each transaction incurs brokerage fees, from as low as $7 for discount brokers to $50+ through personal brokers. Like equity-focused segregated and mutual funds, ETFs create dividend and capital gains income, which enjoy preferential tax treatment. They can be included in either registered or non-registered portfolios.

However, their minimal MERs cannot be taken for granted. In the U.S., many ETFs have MERs that inexplicably exceed those of comparable index mutual funds. In Canada, as index popularity increases, the same situation could arise.

Index returns

Experts differ on the merits of investing in indexes versus actively managed funds. Some say fund managers rarely “beat the index” and therefore index investing is the way to go. Others say that actively managed funds benefit due to experts shrewdly reacting to market events. Many fund managers were able to outperform the TSE300 last year.

ETFs claim to have minimal tracking errors due to virtually no cash content. The actual indices have no cash content, so a cash component to an index fund automatically creates a gap in potential returns. This may explain the widely differing performances of the Canadian index funds that tracked the TSE300 this year. At one point, the index had a YTD return of 10.4%, but over two dozen tracking index funds at the time returned anywhere between 5.9% and

17.1% for the same period. Other factors contributing to the performance gap include the fact that until recently, funds could not contain more than a maximum of 10 per cent weighting in any single security, so each fund would have handled the Nortel[1] component differently. There is also a time lag between reallocating index content and reallocating index fund content, and the index fund's actions to match the index may occur at different prices.

The TSE300 consists of a couple of large stocks, a few healthy stocks and a number of smaller stocks. The Dow Jones Industrial Average consists of fewer than 100 stocks. A large change in any of the key stocks can greatly affect the performance of the index. Investors need to understand how the underlying stocks fit with their investment goals, diversification plans and risk tolerance.

Risks

ETF units would be totally inappropriate for the typical wealth-accumulation-phase client because these clients typically take advantage of dollar-cost-averaging and make regular investments, and brokerage fees for each investment would quickly make ETF units very expensive. The composition of the index can be a disadvantage too, as evidenced on Oct. 25, 2000 when nervous investors dumped Nortel, having suddenly decided it was overvalued, and caused the TSE300 to drop over eight per cent in a day. This event may have rocked the index investors; however, we can take pride in the fact that **none** of our professionally managed funds experienced a decline of the same magnitude.

Exchange traded funds may look attractive on the surface, but make clients aware of the risks they carry: the high transaction costs, the Nortel experience in October 2000, the lack of professional fund level investment management, and the unavailability of financial security advisor support in times of market volatility. Buying into an index means being exposed to all grades of stocks: the good, the bad, and the ugly. Professionally managed funds can avoid the worst of the lot.

ETF units carry a number of pitfalls for the unwary investor. The following chart highlights some of these risks in comparison to passive index funds and managed funds.

[1] At its peak, Nortel comprised over 30 per cent of the TSE 300 index

	ETF	Index Fund	Equity Fund
Type of investment	Passive	Passive	Managed
MER %	.08 – .25	.80 – 2.25	2.0 – 3.5
Tax efficiency	Very efficient due to low turnover, minimal cash component – lower taxable income.	Very efficient due to low turnover, minimal cash component – lower taxable income.	Inefficient due to high turnover, higher cash balances – higher taxable income.
Where to get them	Through stock brokerages, investment dealers.	From fund providers, financial security advisors.	From fund providers & financial security advisors.
Fees	Brokerage fees on every buy/sell transaction: $7 - $50 plus. Ideal for large investments to hold (minimizing trading fees). Poor choice for dollar-cost-averaging strategy.	No fees (except loads, which diminish to nil over time). Ideal for dollar-cost-averaging strategy.	No fees (except loads, which diminish to nil over time). Ideal for dollar-cost-averaging strategy.
Timing	Buy/sell orders processed all day, at that moment's price.	Buy/sell orders taken all day, but processed/ priced at that night's closing unit value.	Buy/sell orders taken all day, but processed/ priced at that night's closing unit value.
Availability	Currently only one in Canada – no diversification – new versions (5) coming out soon, i.e. capped, sector, value, growth, income – potential inability to sell a small lot to mainly institutional investors or no buy orders that day.	Many fund families offer index funds, in Canadian and a wide variety of foreign indices. Small lots easily traded.	All fund families offer equity funds in Canadian and foreign investment opportunities. Small lots easily traded.
Taxation	Fewer capital gains(losses) triggered due to low turnover of securities holdings; dividend income. No option for automatic reinvestment of income In an RRSP, foreign content must be monitored – ETFs can quickly exceed the limit.	Fewer capital gains(losses) triggered due to low turnover of securities holdings; dividend income. Automatic dividend/capital gains reinvestment RRSP eligible. Foreign content semi-contained.	Higher capital gains(losses) due to higher turnover of securities holdings; dividend income Automatic dividend/capital gains reinvestment RRSP eligible. Foreign content semi-contained.
Other	• No track record – unclear how closely they will mimic their target indices. • No minimum. • 800 lb. gorilla – high-fliers like Nortel expose investors to single-stock volatility – index composition is important. • Ideal for bull markets, not bear markets. • Lack of professional advice; undisciplined approach.	• Some funds have minimum investments. • 800 lb. gorilla – high-fliers like Nortel expose investors to single-stock volatility – index composition is important. • Ideal for bull markets, not bear markets. • Rarely sold through advisors, resulting in an undisciplined approach due to lack of planning.	• Some funds have minimum investments. • No over-weighting in any one stock – limited to 10% of fund assets – reduced exposure. • Fund manager can employ more sophisticated strategies i.e. value, growth, defensive, etc.. • A more disciplined, planning-focused approach, beginning with invaluable advice from your Financial Security Advisor.