

To ETF or not to ETF?



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There's been a lot of media coverage and commentary from the investment community on the benefits of Exchange Traded Funds (ETFs). Much has been said about their superior outperformance and their relatively more attractive cost structures.

We take a look at the main arguments in support of ETFs, as proffered by the media and some investment pundits, and set out the facts as we see it. These arguments typically cover price, performance, transparency, tax efficiency and diversification.

	Claim	Fact
Price	ETFs are cheaper than mutual funds.	The reported fees for ETFs do not include transaction fees and other costs that are included in mutual fund fees. As such, comparing the reported fees of an ETF to a mutual fund does not provide you with true apples to apples comparison of costs.
Performance	ETFs perform better than the average mutual fund.	Once all fees and transactions costs are included to the cost of an ETF, the true performance of an ETF is reduced by those costs, potentially making them a weaker performing investment relative to the average mutual fund.
Transparency	All security holdings are disclosed at all times.	Knowing what securities are held within an ETF alone is not in itself valuable knowledge for making prudent investment decisions. The security positions that are held within an index-based ETF are not as actively managed as those held within a strategic or tactical mutual fund. As such, risk or volatility management is lower for an index-based ETF compared to a mutual fund. This is so because no active decisions are made to alter the holdings within the ETF to account for changing market conditions. In contrast, a mutual fund manager is able to actively manage investments and change the securities held within the Fund based on their evaluation of current and future market, security or other relevant investment risks.
Tax Efficiency	Less internal activity means better tax efficiency.	Over the past 10 years, the largest Canadian ETF distributed more income in a less tax efficient manner to investors when compared to the average distribution by the 10 biggest Canadian equity mutual funds.
Diversification	ETFs allow for better diversification as they are made up of the major securities on an index. ETF holdings are also diversified across a variety of industries and market sectors.	ETFs can be concentrated. As an example, in 2000, most index-based ETFs were heavily concentrated in the Technology sector— e.g. in 2000, Nortel and Worldcom were index heavyweights. In turn, both securities were large holdings in an index-based ETF. ETF providers were unable to underweight the technology sector to protect investors on the downside because the make-up of the ETF itself is designed to mirror the make-up of the index.
Volatility	ETFs are less volatile than mutual funds.	ETFs have displayed much more volatility than mutual funds. They don't have the ability to increase or decrease their cash positions because they are not mandated to hold cash. As ETFs mirror an index, cash is not considered an asset class for an ETF.

1. CLAIM: ETFs Are Cheaper Than Mutual Funds

ETF proponents suggest that the lower management expense ratio (MER) on an ETF, relative to a mutual fund, contributes to better performance returns by the ETF. This is like saying a lower priced car offers greater value and performance compared to a more expensive and better engineered car. The assumption here is that price is the key determinant for performance.

Unfortunately the manner in which MERs are derived for an ETF is not directly comparable to how it is derived for a mutual fund. Each has different components that contribute to their respective MER calculations.

For example:

Total Costs	ETFs	Mutual Funds
Transaction costs	Not included	Not applicable
GST charge*	Not included	Included
Professional management fee	Not applicable	Included
Cost of advice	Not applicable	Included

*An ETF investor incurs a GST charge on transaction costs. A transactions cost is incurred each time an investor buys, or sells, an ETF.

Example 1

A hypothetical example of how transaction costs impact the cost of an ETF

Assume John has an ETF portfolio that has a 50% exposure to an equity ETF and a 50% exposure to a fixed income ETF. If the equity ETF has an MER of 0.50% and the fixed income ETF has an MER of 0.20%, then the published MER for John's portfolio is calculated as follows:

MER is $(0.5 \times 0.5\%) + (0.5 \times 0.2\%) = 0.35\%$

However, this is not the total cost for John's ETF investments. He must still account for his transaction costs and the applicable GST charge.

Assume he contributes \$500 every quarter through a Pre-Authorized Chequing Plan (PAC) to each ETF held within an RRSP account. Assume also that the transaction costs for each trade is \$24 plus applicable GST charges (currently 5%).

John's total cost as a percentage:

$$\begin{aligned}
 \text{Transaction cost} &= \frac{[(4 \text{ trades per year}) (2 \text{ ETFs } ((\$24 + \text{GST}^*)))]}{[(4 \text{ trades per year}) (2 \times \$500)]} \times 100 \\
 &= \frac{4 \times \$50.40}{\$4,000} = 5.04\% \\
 \text{Total cost} &= 0.35\% + 5.04\% \\
 &= 5.39\%
 \end{aligned}$$

*The current GST is 5%.

In this example, we assumed that the trade cost was \$24 plus a GST of 5%, which results in a total fee of 5.39%. If we assumed a trade cost of only \$12+GST, John's total cost would be 2.52% + 0.35% = 2.87%.

Depending on the transaction costs, the total fee for an ETF can vary from anywhere between 2.87% and 5.39%.

Transaction fees can vary depending on the:

- a) discount brokerage firm
- b) investor's account size
- c) frequency of trades.

Example 2

A hypothetical example of how regular portfolio rebalancing can increase the cost of an ETF

The analysis in Example 1 does not include the cost of regular rebalancing, or the cost of advice received from a professional financial advisor.

Let's now compute the costs of regularly rebalancing a portfolio in order to keep the investor on track to his target investment objectives. Let's assume that John has the same investment scenario as in Example 1.

Quarterly investment = \$500 each into an equity ETF and a fixed income ETF to maintain a 50:50 portfolio mix.
MER = 0.35%

Transaction cost plus GST = \$25.20

As with the first example, as a percentage of his total investment, John's cost of buying ETFs for this portfolio is 5.39%, calculated as in Example 1.

However, to rebalance annually, John may have to sell one ETF and buy the other ETF in order keep his portfolio balanced at 50:50. This is considered two trades, which means he pays twice the commission - once to sell, and the second to buy, in turn, increasing his overall costs.

Incremental cost for rebalancing:

Cost of buying and selling ETFs to rebalance this portfolio = (1 annual rebalancing × (2 ETFs × \$25.20))

Cost increases by = \$50.40, or an additional 1.26%

John's total costs including rebalancing as a percentage:

Total cost	=	cost of investing in ETFs + cost of rebalancing
	=	5.39% + 1.26%
	=	6.65%

So, with just one rebalancing exercise, John's cost of investing in ETFs has increased by 1.26% in the first year.

In short, for a true comparison of the costs of investing in an ETF versus a mutual fund, investors must include the transaction costs incurred for each ETF trade and the applicable GST charge.

In a regular mutual fund, MERs includes transaction fees, professional management fee and the cost of advice. An advisor's fee for his professional advice would typically range from 0.5% to 1.0% per year.

Without a clear understanding of the cost structure, an ETF may end up being one of the most expensive investment vehicles in Canada. In short, ETFs are not suited for investors who trade or rebalance their portfolios frequently. For the active investor, ETFs can be a waste of time and money as they can get eaten alive by commissions.

2. CLAIM: ETFs Outperform Mutual Funds

Another common misconception about ETFs is that they tend to outperform the average mutual fund. When considering performance, remember that the true cost of an ETF is not factored into the performance numbers (i.e. transaction, rebalancing, advice and GST costs). When these costs are factored in, the actual performance of an ETF investment may be lower. With mutual funds, all costs are included in the MER and the mutual fund's performance numbers reflect this.

8 of 10 largest global equity mutual funds have outperformed the index

Fund	Assets \$Millions	10-year Annualized Return %	10-year Outperformance vs. Index
MSCI World Index (\$ Cdn)	–	-2.70%	–
Mackenzie Cundill Value 'C'	\$4,996	4.90%	7.60%
Trimark Select Growth	\$2,313	-0.10%	2.60%
Templeton Growth Fund Ltd.	\$2,193	-1.50%	1.20%
MD Growth	\$2,136	-1.40%	1.30%
Mackenzie Ivy Foreign Equity	\$1,997	2.10%	4.80%
Trimark Fund-SC	\$1,808	1.80%	4.50%
AGF Global Value	\$1,260	-2.60%	0.10%
8th Largest Fund (competitor)	\$877	-3.60%	-0.90%
9th Largest Fund (competitor)	\$704	-3.00%	-0.30%
Dynamic Global Value	\$594	1.40%	4.10%

Source: Mackenzie Investments, Globe HySales. Data to June 30, 2009.

Not every active manager will beat the index. But most experienced managers who use sound strategies have proven that they can produce favourable performance results for long-term investors relative to the performance on an index or an ETF.

3. TRANSPARENCY: ETFs Are Better Because They Offer Greater Transparency

ETF investors know what securities are held within their portfolio at all times. The transparency of a portfolio's holdings alone does not necessarily make it a better investment vehicle. Even top investors like Warren Buffett only disclose their complete holdings once a year when it's time to complete the regulatory filing.

What's more important than the knowledge of all the holdings in a portfolio is the ability for a manager to be active and to stick to an investment discipline. A key part of portfolio management is to have a sound understanding of security valuations and the investment sectors that the portfolio is invested in. This will allow for an active management of the holdings within the portfolio in order to mitigate overall portfolio risks.

As a point of note, mutual funds disclose their top 25 holdings quarterly and their entire holdings semi-annually in the fund's financial statements.

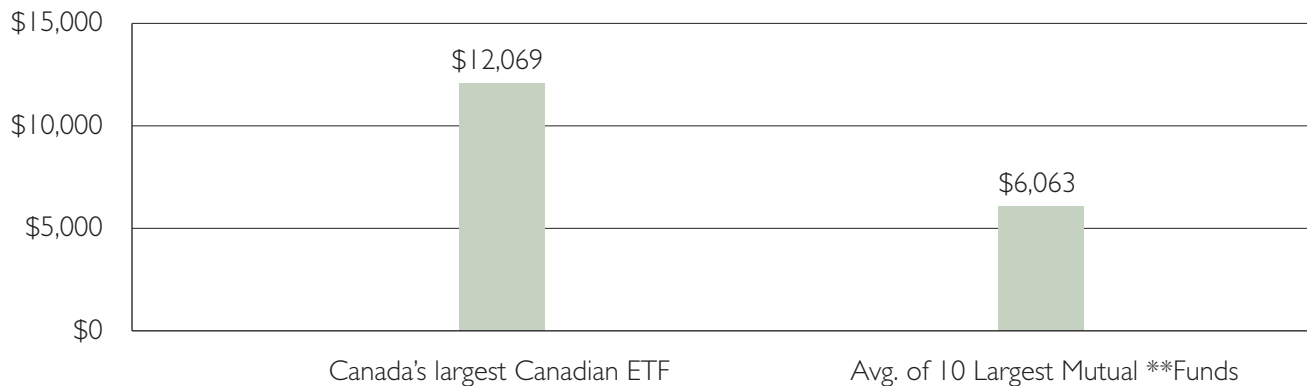
4. CLAIM: ETFs Are More Tax Efficient, Therefore They Are Better

Tax efficiency means trying to pay the least amount of tax possible. Too many times we let the tax tail wag the dog. Investing is about fulfilling a financial objective. Tax efficiency does matter, but risk management is more important. Over the last few years, many investors failed to re-allocate their investments because of the capital gains tax they would have had to pay. With the current level of market decline, they would not have this problem, as many investors may now have capital losses. So, by not taking the capital gains and being tax efficient when they could, has in the end not been in the best interests of the investor.

Nevertheless, let's understand the argument for the claim that ETFs are tax efficient. The argument is that ETFs generate little capital gains because the turnover in an ETF is generally lower. But, remember that an ETF mirrors the index and that the composition of the index can change regularly due to mergers and acquisitions, security delisting or new listings, among other factors. All these changes will require the ETF provider to sell, or buy, shares in accordance with changes to the index. The selling and buying of securities to mirror the index may lead to taxable distributions to investors.

Over the past 10 years, the largest Canadian ETF distributed more income in a less tax efficient manner to investors when compared to the average distribution by the 10 biggest Canadian equity mutual funds.

**Cumulative Distribution on \$10,000 investment
Sept. 1999 (incept. of ETF) to May 2009**



Source: Mackenzie Investments. **Globe Hysales. Mutual fund distributions is the average distributions of the 10 largest Canadian equity mutual funds from the Canadian Equity, Canadian Dividend & Income and Canadian Focused categories as of May 31, 2009.

5. CLAIM: ETFs Are More Diversified

Diversification means reducing the risk that may be associated to any one security. Because ETFs mirror indexes, they can be highly concentrated to a specific sector or security. For example, at its peak share price in 2000, Nortel Networks represented 45% of the S&P/TSX 60 Index.

Good diversification is about having an effective asset class allocation strategy and it aims to reduce the portfolio's overall risk. Good financial planning involves using good diversification strategies to meet financial objectives.

6. CLAIM: ETFs Are Less Volatile Than Mutual Funds

ETFs do not have the ability to allocate to more defensive areas of the market when the economy changes direction for the worse. As such, their ability to protect investors on the down side is not as good as a mutual fund. When all relevant costs are taken into account for an ETF, its performance can be considered more volatile.

Summary

1. ETF costs do not include transaction, advice and GST costs.
2. A large number of good and experienced managers do outperform ETFs.
3. Transparency is not necessarily a good indicator of better portfolio management.
4. ETFs are not immune to taxes. Tax efficiency alone should not be the driving force behind a sound investment strategy. Instead, it should include an understanding the investor's needs and objectives and the right selection of asset classes to meet those needs.
5. Good diversification is about having an effective asset allocation strategy to fulfill the investment objectives of an investor.
6. ETFs can be much more volatile than mutual funds.

ETFs are just one more investment “tool” that should be considered in the overall investment planning strategy. On its own, it may not always be the best solution for an investor. However, ETFs can be useful when used as part of a portfolio that is actively managed.

We believe that investors should always work with their advisors to understand the advantages and disadvantages of their asset choices before determining if a particular asset class would suit their individual investment needs.



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