

INVESTMENT EXECUTIVE'S

# ETF Guide



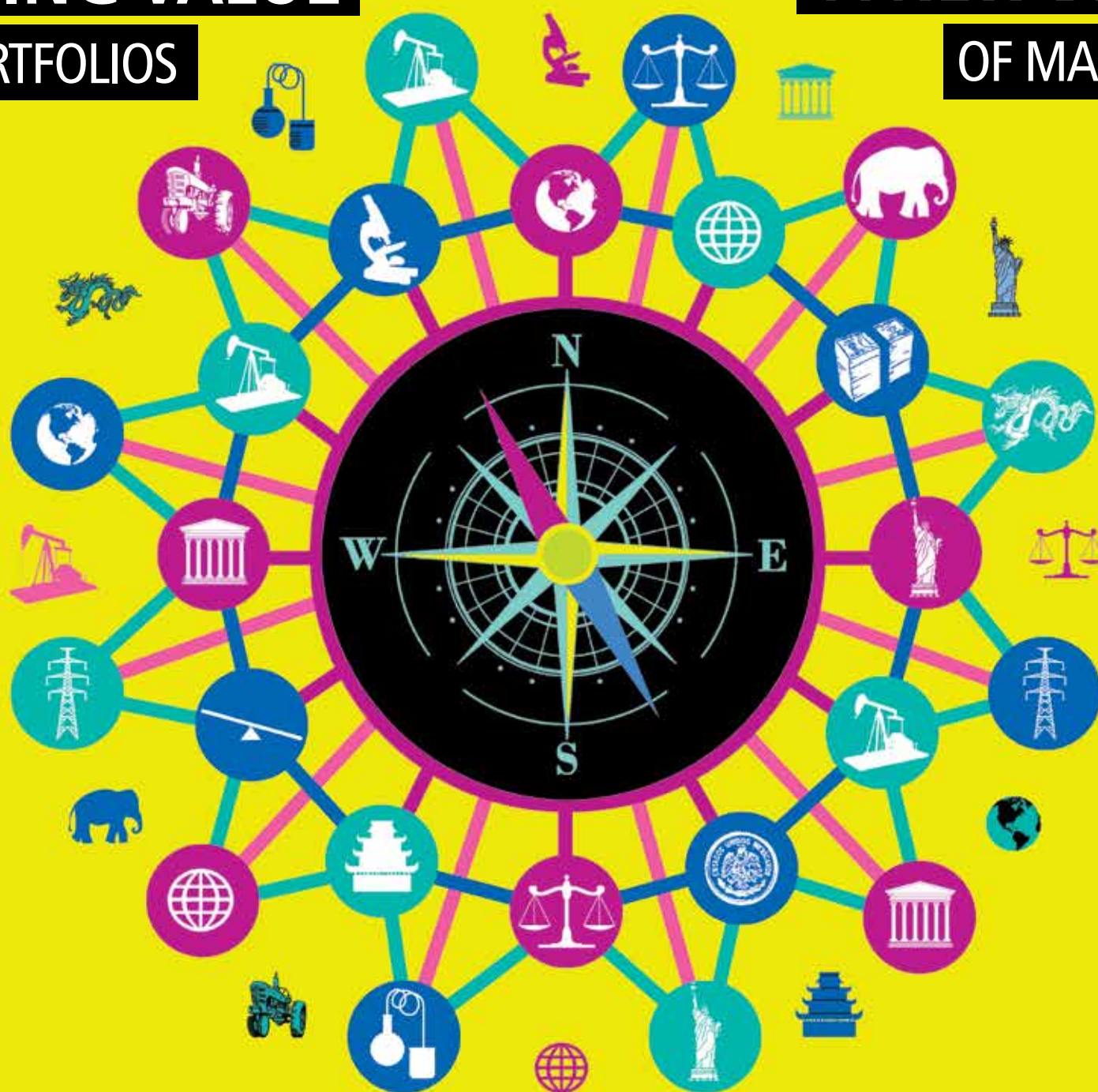
FOR FINANCIAL ADVISORS // 2014

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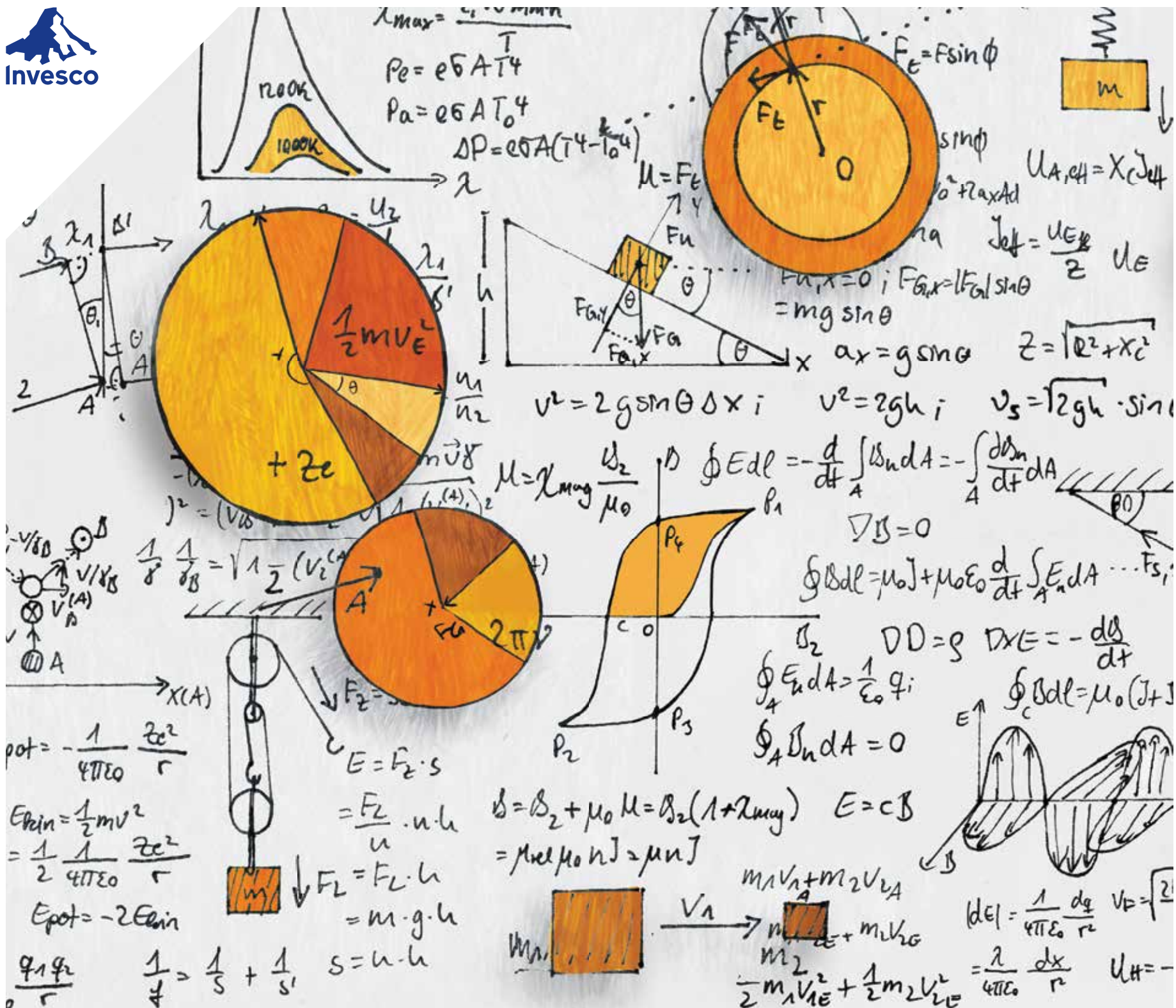
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## FROM THE EDITOR

It's hard to argue with the popularity of exchange-traded funds (ETFs). In the past decade or so, both assets under management held in ETFs and the number of products available have ballooned. And why not? The cost of ETFs is relatively small compared with that of mutual funds, and clients know that many mutual funds tend to underperform their benchmarks. But ETFs are not simple investments; and as more sophisticated ETFs are introduced, your clients will need your help to understand the ETF choices and how to integrate these products into their portfolios. We hope this guide supports your work in creating wealth for your clients.

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# THE DECADE OF THE EXCHANGE-TRADED FUND

ONCE A PASSIVE, INDEX-TRACKING PRODUCT, ETFs NOW MAKE UP A DIVERSE ARRAY OF INVESTMENT STRATEGIES



BY JADE HEMEON

**T**he burgeoning choices among exchange-traded funds (ETFs) are allowing clients, large and small, easy access to a multitude of financial assets, geographical locations and sophisticated investment strategies that once were the exclusive territory of high net-worth and institutional accounts.

“This decade is, and will be, the decade of the ETF,” says Barry Gordon, president and CEO of First Asset Investment Management Inc. in Toronto. “Mutual funds are not going the way of the dodo bird, but the advantages of ETFs are becoming apparent to more investors, including their simplicity, transparency, low cost and liquidity.”

Adds Pat Chiefalo, director of ETF research and strategy with National Bank Financial Ltd. in Toronto: “ETFs trade on the stock exchange — they are easy to buy, and they offer exposure to any asset class the investor could possibly want.”

The latest innovations in ETFs have moved beyond the passive, index-based investing strategies that characterized the original ETF offerings to include products that offer exposure to varying degrees of active management, ranging from automated, rules-based portfolios to fully active individual securities selection executed by a portfolio

manager or team based on specific criteria. The trend is toward increasingly active management packaged within an ETF wrapper.

The barrage of ETF products spells opportunity for financial advisors to help their clients assemble suitable portfolios by guiding clients through a marketplace that is rapidly becoming more complex. ETFs can access both developed and emerging markets, as well as a variety of geographical and industry sectors, such as agriculture, real estate, banks and utilities. These products also offer exposure to assets that are not correlated to traditional stock and bond indices, such as currencies and commodities. And some ETFs offer the potential for enhanced returns. In Canada, Horizons BetaPro Bull and Bear ETFs, for example, offer inverse and leveraged exposure to various stock, bond, commodity and volatility indices, allowing clients to capitalize on both upside and downside momentum by amplifying the returns of the underlying index by 200%.

Canada was a pioneer in the development of ETFs; the Toronto Stock Exchange (TSX) began listing Toronto 35 Index Participation units (TIPs) in March 1990, allowing investors to participate in the performance of the TSE 35 composite index without having to buy shares in each company on the index. And while total assets under management (AUM) of Canadian ETFs is still far less than the AUM of Canadian mutual funds, which recently hit \$1 trillion, the pace of ETF growth has been impressive in a short time.

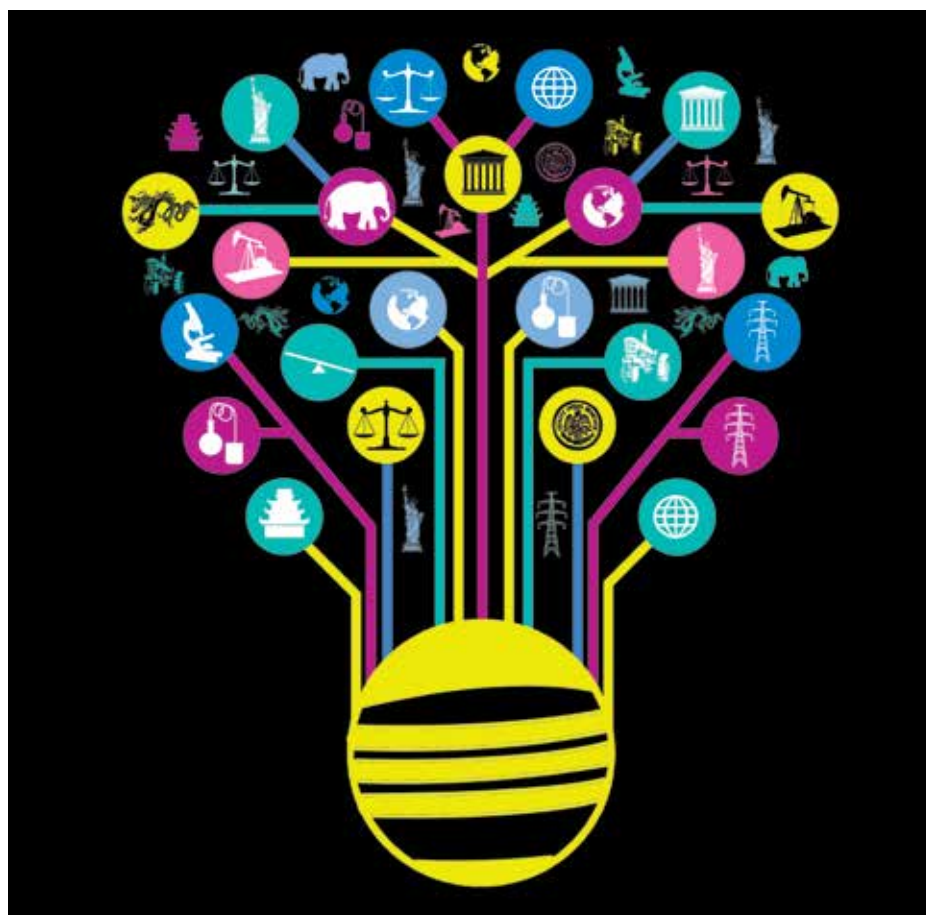
As of Jan. 31, 2014, Canadian ETF AUM stood at \$63 billion, according to the Canadian ETF Association, 11.5% above the level reached a year earlier, with the growth rate based on a combination of market appreciation and new ETF creations. The number of Canadian ETFs now totals roughly 297, up from just 50 in 2007; 36 new ETFs were listed on the TSX last year.

On a global basis, ETF AUM has grown to US\$2.4 trillion, spread among more than 5,000 ETFs — roughly double

**Canada was a pioneer in the development of ETFs, with AUM now standing at \$63 billion**



The largest ETF in Canada is iShares S&P/TSX 60 Index Fund, a broad-based index ETF, with AUM of \$12.2 billion and almost 20% of the Canadian ETF market. Canada's biggest seller in 2013 was BMO S&P/TSX Laddered Preferred Share Index ETF, an income-paying ETF that appealed to investors last year because of its attractive yield



**Much of the rising demand for ETFs is coming from dissatisfied mutual fund buyers, as well as from traders of individual stocks**

Some of the newer incarnations of ETFs are designed to improve index returns by creating a portfolio of underlying investments based on customized selection criteria rather than designed simply to track a traditional index. These more sophisticated ETF strategies — known as “intelligent



indexing,” “factor-based” or “smart beta” — differ from traditional, index-based ETFs that base the weighting of securities on their market capitalization.

“Factor-based or smart-beta strategies,” says Gordon, “seek to exploit inefficiencies in the traditional capitalization-weighted marketplace and generate a superior return.”

The most popular of First Asset’s 29 ETFs is First Asset Morningstar Canada Value Index, designed to invest in securities representing “good value,” based on characteristics such as low price/earnings and low price/cash flow ratios. As of mid-February 2014, this ETF had a two-year average annual return of 20.5%, which bettered the 12.1% return of the S&P/TSX composite total returns index, thus more than earning its annual MER of 60 bps.

Most smart-beta ETFs use a quantitative approach to manage their underlying portfolios, employing a rules-based, semi-active strategy that automatically screens securities for inclusion and does not rely on the analytical skills or subjective judgment of an active fund manager. Some of these ETFs offer access to fundamental indexing strategies, in which the weighting of individual companies is based on value measurements related to dividend yield, cash flow or earnings. Other smart-beta ETFs are designed to provide access to low-volatility, covered-call or momentum strategies.

“We’re seeing quasi-active, factor-based investment strategies being wrapped up in the ETF package,” says Chiefalo. “A lot of these new products have been introduced, and they’re getting strong take-up from investors.”

Although creativity and subjective decision-making may go into the development of a smart-beta ETF’s strategy, once the rules are formed, the selection and weighting of securities is automatic. Typically, portfolios are rebalanced on a quarterly basis, then the latest holdings disclosed to investors on the sponsoring company’s website. Because these portfolios are not actively managed in the traditional sense, the MERs tend to be lower than those charged by regular mutual funds but higher than those on passive ETFs that are based on a broad market index. This evolution blurs the line between ETFs and mutual funds, but presents more choice for clients.

“There are all kinds of intelligent indexing or smart-beta strategies out there, and each may have its day in the sun,” says Howard Atkinson, CEO of Horizons. “We will have to wait and see which strategies can outperform over time.”

Only a handful of ETFs in Canada are fully actively managed like a traditional mutual fund, whereby a portfolio manager makes decisions about when to buy and sell particular securities. The active segment of the ETF market is expected to gain traction in the next few years

**“There are all kinds of intelligent indexing or smart beta strategies out there, and each may have its day. We will have to see which strategies outperform”**

as more portfolio managers currently employed by mutual funds and private money-management firms package their securities-selection skills in the ETF format.

“For the most part,” says Chiefalo, “the low-cost, traditional, index-based product is well entrenched and has carved out the biggest share of the market. The ETF market was built on the plain-vanilla products with low fees. But, increasingly, there is a shift toward searching for incremental return. ETFs are just beginning to tap into active strategies, but eventually we will see more that go all the way to [being] purely active. There are some successful mutual funds out there with potential to put an arm of the fund into an ETF wrapper.”

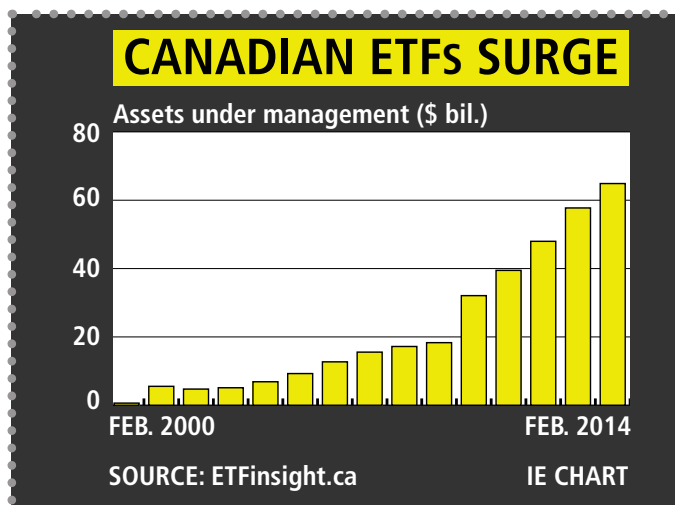
Horizons is the Canadian pioneer in the development of actively managed ETFs. Its entire family of income-oriented ETFs offers fully active management strategies — rather than basing returns on recognized bond indices. This active strategy allows the managers of the ETF portfolios to choose which securities to hold and trade, and to add value by making adjustments when the investing environment changes.

Horizons’ suite of actively managed, fixed-income ETFs includes products based on floating-rate bonds, corporate bonds, high-yield bonds and preferred shares. The firm also offers a selection of actively managed ETFs on the equities side, including an emerging-markets dividend ETF, a Canadian dividend ETF and a global dividend ETF, all offering the stock-picking skills of Toronto-based Guardian Capital LP as money manager within the ETF structure. Also part of the Horizons ETF family are a variety of actively managed covered-call ETFs and alternative-strategy ETFs employing hedging techniques.

“When you’re not just blindly following the index, there is an opportunity to add some alpha or outperform,” Atkinson says. “The difficulty of duplicating an index — particularly in some illiquid, fixed-income markets where there is no central exchange — is that some names are not easily tradable, especially if you’re buying in size.”

The portfolio managers of actively managed ETFs can enjoy the same freedom in choosing their strategies as mutual fund managers do — including holding a high level of cash if markets appear to be overvalued. The goal is to outperform market indices by the portfolio managers making their own decisions on the inclusion of individual securities, their weightings and the timing of trades, rather than merely track an index or adhere to a fixed set of rules.

“Over the next few years,” Atkinson says, “we will see more asset-management firms make the services of their high-profile [portfolio] managers available through ETFs along with their existing stable of funds to address different avenues of distribution.”





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# BONDS, WITH AN ETF TWIST



BY ANDREW ALLENTUCK

## THE STRATEGIC FOUNDATION FOR A FIXED-INCOME ETF PORTFOLIO IS BROAD-MARKET ETFs. BUT THERE ARE MANY ALTERNATIVES

**F**or the client or financial advisor who wants to take charge of fixed-income risk, exchange-traded funds (ETFs) offer a number of ways to tailor that exposure. There are, for example, ETFs that track ladders of bonds with sequential maturities to address interest-rate uncertainty, as well as ETFs based on specific nations' sovereign debt that seek to allay concern about credit quality.

With function-focused bonds — such as inflation-tracking, “real return” issues — or risk-specific, fixed-income ETFs — such as high-yield bonds — advisors can know exactly what is in a client's portfolio and make adjustments by adding to or reducing specific exposure.

“There is safety in going with an index rather than striving to beat it,” says Alfred Lee, vice president and portfolio manager of fixed-income managed funds and fixed-income ETFs with BMO Asset Management Inc. in Toronto. “You can aim to beat the index with a managed portfolio, but if the fees are average for the group — say, 1% or 2% — then they will tend to drag the mutual fund outperformance back to the index or even lower. To be frank, in fixed-income, most of the problem for a [portfolio] manager is to time his assets' sensitivity to interest-rate changes and his

**The shorter the term, the less a bond will suffer from rising rates. Clients pay for that safety with lower returns**

assets' credit risk. There are no managers who have timed both perfectly and consistently.”

The strategic foundation of an ETF-based, fixed-income portfolio for most clients is broad-market ETFs. The broadest of these are ETFs that track the FTSE TMX Canada bond universe index (a.k.a. the DEX universe). The DEX universe has 1,200 issues, with an average duration of 6.9 years. Corporate bonds account for 20% of assets under management (AUM); provincials, 30%; and federal bonds, 40%. The biggest corporate issues, such as utilities and banks, have the heaviest weightings.

“[The DEX universe] is the starting point,” Lee notes, “for any investor's fixed-income Canadian portfolio.”

### “THE WHOLE SECTOR”

The breadth of the DEX index eliminates timing decisions, credit-quality evaluations and macroeconomic questions. What it does not offer is non-investment-grade bonds. For that, you would have to look to high-yield ETFs.

The biggest Canadian fixed-income ETF, iShares Canadian Universe Bond Index ETF, replicates the DEX universe. It holds 100% investment-grade bonds, with 88.4% of AUM rated A or better. This ETF generated a 5.11% average return compounded annually for the five years ended Feb. 28, 2014; its management expense ratio (MER) is 0.33%.

“It's a ‘take it or leave it’ portfolio,” says Chris Kresic, senior partner and head of fixed-income at Jarislowsky Fraser Ltd. in Toronto, of this iShares ETF. “If you want Canadian investment-grade bonds, this is the product that delivers the whole sector.”

Advisors who want U.S. bond-market exposure for clients can use a low-fee Vanguard ETF. For example, Vanguard Total Bond Market ETF has a 0.10% MER, a 65.4% weighting in U.S. government bonds and a 4.84% average annual compounded five-year return to Feb. 28, 2014.

Risk management is critical in bond investing. As the length of time to maturity grows, increasing what your client may get in interest, duration (that is, the sensitivity to interest rate changes) grows, too. The shorter the term, the less a bond will suffer from rising interest rates. The client pays for that safety in lower returns. Given those lower returns, keeping costs down is important.

### SAFETY IN SHORT-TERM BONDS

ETFs that focus on short-term bonds, such as iShares Canadian Short Bond ETF, do not pay a great deal, but they offer safety and the assurance that they will roll the matur-



ing bonds that they hold into new issues with coupon rates in line with current market levels.

iShares Canadian Short Bond Index Fund has a 0.28% MER; 51% of its AUM is in government bonds, and all holdings are investment-grade — mostly rated A or better. The value of holding this ETF, as opposed to buying short-term bonds on the open market, is that its quite decent five-year performance — 3.14% compounded annually to Feb. 28 — has relatively little sensitivity to changes in the interest rate and thus is a safe place to park money to wait for rates to rise.

## FEDERAL AND PROVINCIAL ISSUES

Other ETFs focus on short-term federal and provincial bond issues. BMO Short Federal Bond Index ETF has a low 0.20% MER with zero default risk. This ETF generated a 2.39% average annual compound return for the three-year period ended Feb. 28. BMO Short Provincial Bond Index ETF has a 0.25% MER with almost no default risk. This ETF generated a 3.01% average annual compound return in the same period. That's a good boost for slight added risk.

There are ETFs that address the worries of clients who are concerned about upward movement in the interest rate over the short term. ETFs based on one- to five-year ladders of government bonds should put a lot of that fear to rest.

These ETFs reduce interest rate risk significantly by keeping the average term short and allowing rollovers into newer, higher-interest bonds as the current bond holdings mature. For example, iShares 1-5 Year Laddered Government Bond Index (Toronto Stock Exchange/symbol: CLF) has a 0.17% MER and generated a 2.93 % average annual compound return for the five years ended Feb. 28. A companion fund, iShares 1-5 Year Laddered Corporate Bond Index, has a 0.28% MER and generated a 4.40% average annual compound return in the same period.

Finally, for advisors who are worried about inflation, there are inflation-linked bonds for Canada, the U.S., Europe and parts of the Far East. Canadian inflation-linked bonds packaged in real-return bond (RRB) ETFs hold long-term issues with high sensitivity to movement in the interest rate. The value of these ETFs soars when inflation roars and suffers when it does not. For example, iShares Real Return Canadian Bond Index ETF has with a 0.39% MER and lost 13.4% in 2013 as inflation rates contracted, although it still produced a 7.84% average annual compound return for the five years ended Feb. 28.

## PROTECTION FROM INFLATION

The outlook for RRBs and other similar products is clouded by the lack of inflation in Canada. Yet, the commitment of the incumbent federal government to eliminate federal deficits implies that there will be reduced long-bond issuance and a premium paid by institutions for all long bonds, whether conventional bonds or linkers.

And that, in turn, suggests that RRB ETFs still have a place in conservative, fixed-income portfolios that are aimed at providing protection from inflation.

For clients willing to take on more risk, there are ETFs that track high-yield bonds. For example, iShares iBoxx \$ High Yield Corporate Bond ETF offers exposure to the U.S. junk-bond market. Its 0.50% MER is much higher than average for bond funds, but its returns can be volatile. Its 40.68% return in 2009, for example, repaired the 23.89% loss for 2008.

High-yield bond ETFs are not for the meek of heart. Indeed, these ETFs have equities-like returns with comparable risk. •



**RRB ETFs still have a place in conservative fixed-income portfolios that are aimed at protection from inflation**

## RULES OF THUMB

**Although ETFs expand investment choices for** fixed-income investors, the financial advisor who elects to use them takes on much more responsibility for these fixed-income investments.

In most cases, fixed-income ETFs don't feature active portfolio management, which is available with bond-based mutual funds to manage bond risk and return. Given that most fixed-income ETFs follow market indices, many of these ETFs are sitting ducks for adverse market changes. Government bond ETFs, for example, are bound to suffer if interest rates rise. So, the responsibility rests with the advisor and his or her strategic fixed-income choices.

The advantage of bond mutual funds — their ability to go to cash or shuffle assets to compensate for market disasters — is absent with index-based ETFs. Yet, over the long term, the difference between mutual funds' and ETFs' management expense ratios — often, two percentage points or more — can pay for a lot of macro-economic mayhem.

"Research and management of ETF portfolios are the investor's responsibility," says Rob Bechard, senior vice president and head of ETF portfolio management with BMO Asset Management Inc. in Toronto. "There are rules — or guidelines, if you will — that you should observe."

Here are a few of the guidelines on Bechard's list:

- Know the objectives of having a fixed-income portfolio.
- Select the types and terms of the bond ETFs that fit that plan.
- Be sure you are getting the credit risk and duration risk that you need.
- Don't take on more ETFs or other fixed-income exposure than you can handle.
- Keep in touch with the market, for you will have to be the active manager regarding the allocation of the asset class.

— ANDREW ALLENTUCK



# UNRAVELLING THE COST CONUNDRUM



BY SUSAN YELLIN

## BEFORE YOUR CLIENTS DECIDE TO INVEST IN ETFs, YOU SHOULD PUT FEES AND EXPENSES ON THE TABLE

**T**he relatively low expenses of exchange-traded funds (ETFs) compared with those of mutual funds are often top of mind for clients.

But management expense ratios (MERs) don't tell the full story. The cost of ownership of investments such as ETFs and mutual funds depends upon a variety of items, from acquisition costs and ongoing expenses to the cost of selling the units of a fund, according to a 2012 study by Toronto-based Investor Economics Inc. on behalf of the Investment Funds Institute of Canada. Other factors include the length of time the investment is held and how frequently fund units are bought and/or sold.

Before deciding to invest in one investment vehicle over another, financial advisors should assist their clients in understanding the respective costs of investing. And, in any event, advisors should stress that costs are but one factor that ought to be considered when making an investment decision.

"The important decision is around what kind of investment exposure your client needs and at what cost it can be obtained," says Dan Hallett, vice president and principal with HighView Financial Group in Oakville, Ont. "Whether it's an exchange-traded fund vehicle or a mutual fund vehicle should be meaningless because the structures are not that different at the end of the day.

"I think," he continues, "if you have the mindset of starting from a client's needs and letting everything flow from there, then that will help in being agnostic as to what vehicle the clients should be [investing] in."

**Advisors should stress that costs are but one factor to be considered when making investments**

Below is a look at one cost comparison, courtesy of Robert Armstrong, vice president and head of managed solutions and registered plans strategy, global structured investments group, with BMO Global Asset Management Inc., which sells both ETFs and mutual funds. This comparison highlights the costs associated with BMO S&P/TSX Capped Composite Index ETF (a Canadian ETF that tracks a TSX benchmark) and the actively managed BMO Equity Fund Series F (a mutual fund that aims to beat the same TSX benchmark).

The MER on BMO S&P/TSX Capped Composite Index ETF is 0.17%. In addition to the MER, do-it-yourself clients generally pay \$9.95 when they buy or sell units in an ETF at a discount brokerage. Note that ETFs also are available from full-service brokers, which charge higher commissions than discounters. Some full-service brokers base their commission on the size of the trade; others charge a flat rate that could range as high as \$50 every time an ETF is bought or sold.

If a client buys an ETF through a fee-based rather than commission-based advisor, Armstrong says, the costs generally are determined on a fee-for-service basis or are an annual flat percentage fee based on the entire amount of assets under management (AUM) in the client's portfolio (i.e., the ETFs and all other investments). A fee-based advisor is likely to add 0.75% to 1.5% for the management of the portfolio. Armstrong believes that advisors increasingly are moving to fee-based accounts.

Fee-based advisors who suggest a mutual fund as the best option typically buy the F-class version of the fund for a client. This class of fund charges a lower MER than the regular A-class version because the embedded commission found in the A-class fund has been stripped away in the F-class version.

In our example, the MER on BMO Equity Fund Series F is 0.9%; with a fee-based account, a client would expect to pay an additional 0.75% to 1.5%.

Armstrong notes that the fees associated with mutual fund are higher than those charged for the ETF. "But," he adds, "you are paying for active management with the mutual fund. When you go through a fee-based account, the client expects the advisor to add value."

Generally speaking, an ETF has an MER of about one percentage point less than that of a comparable mutual fund; often, it's even lower.

There are, however, many shades to the cost story. For example, do-it-yourself clients can buy ETFs at a discount brokerage for the usual \$9.95 a trade. They may — or may not — be charged by the discount brokerage for trading units in certain mutual funds and ETFs. Some discounters, such as Toronto-based RBC Direct Investing Inc., offer D-class versions of mutual funds from various fund families that covering various asset classes, which have reduced MERs and trailer fees.





# Innovation Stars.

Morningstar Category	ETF Name	Ticker	Morningstar Rating
Canadian Fixed Income	Horizons Active Corporate Bond ETF	HAB	★★★★★
Preferred Share Fixed Income	Horizons Active Preferred Share ETF	HPR	★★★★★
Canadian Short Term Fixed Income	Horizons Active Floating Rate Bond ETF	HFR	★★★★★
Canadian Dividend & Income Equity	Horizons Active Cdn Dividend ETF	HAL	★★★★★
US Equity	Horizons S&P 500® Index ETF	HXS	★★★★★

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# BEATING THE BENCHMARK



BY DWARKA LAKHAN

## ACTIVELY MANAGED ETFs SEEK TO BETTER BROAD MARKET RETURNS WITH STRATEGIC SECURITY SELECTION

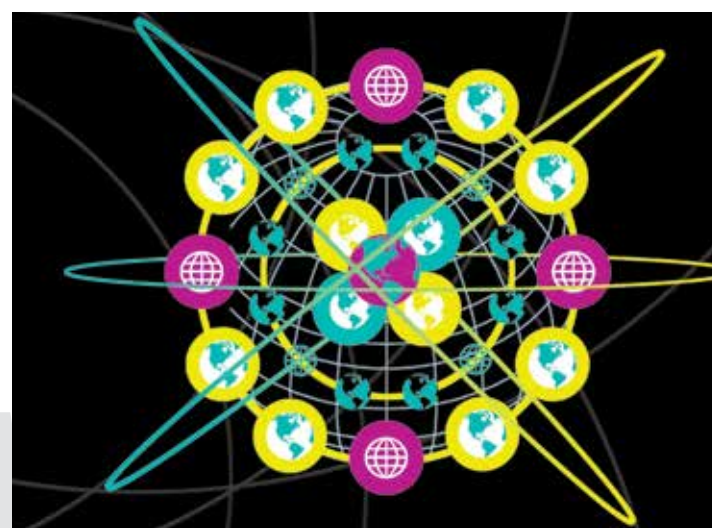
**A**ctively managed exchange-traded funds (ETFs) are gaining traction with some clients, as opposed to ETFs that simply track an index. This trend is especially true among clients looking for better risk-adjusted returns than those offered by the broader, overall market.

However, there's no consensus on what's considered to be an actively managed ETF, leaving financial advisors to choose which active strategies best meet the needs of clients.

The best approach is to look at the spectrum of strategies, ranging from fully passive indexing to fully active management and unconstrained strategies, says Mary Anne Wiley, managing director and head of iShares Canada, a division of BlackRock Asset Management Canada Ltd., in Toronto. Where a product lies on this spectrum depends on many factors, Wiley says, such as the size of the universe the ETF portfolio manager can invest in and which strategies work best within that world. It's also key to know whether the portfolio manager makes individual security selections or uses strategies, such as covered-call writing, that don't follow an official benchmark.

Jaime Purvis, executive vice president, national accounts, with Toronto-based Horizons ETFs Management (Canada) Inc., is more emphatic about what constitutes an actively managed ETF. "There has been considerable debate around whether enhanced index strategies or 'smart beta' should be considered active management," Purvis says. "Our view is those are still indexing strategies; all they're doing is playing around with the beta sensitivities so [the ETF] will perform differently in different market conditions. [Actively man-

**Active managers use their discretion to buy securities rather than simply following an index**



aged ETFs employ] portfolio managers that use their discretion as to what securities they will hold rather than simply holding the securities of an underlying index."

He notes that actively managed ETFs may even have lower risk profiles, because their portfolio managers are not forced to deal in securities that may have valuation or liquidity issues despite their position on an index.

However, this debate is likely to shift, says Barry Gordon, president and CEO of First Asset Investment Management Inc. in Toronto: "In the future, ETF portfolios are likely to be a blend of actively managed and passive index strategies in which investors choose the strategies that are best suited for a given asset class. In either case, performance will be the primary driver of the investment decision."

Putting aside the subtleties of the debate, Wiley suggests that there are two broad types of actively managed ETFs. Asset-allocation ETFs use different asset classes and combine them into diversified, balanced portfolios. "The manager is focused on setting the asset-allocation mix," says Wiley, "and not on picking individual winning companies."

Other actively managed ETFs are "more focused on security selection than on picking winners and avoiding losers from within a defined asset-class universe," Wiley says.

There are many criteria that can be used by active managers in constructing ETF portfolios. For example, the portfolio manager of BMO US Dividend ETF decides on the criteria for holding specific stocks — such as liquidity, dividend yield/growth and selection universe, says Kevin Gopaul, senior vice president and chief investment officer, ETFs, with BMO Global Asset Management Inc. in Toronto.

Active portfolio management means using skill to construct a portfolio to beat the benchmark, Gordon says. That skill is based on factors such as management style and conviction; not on factors such as high volume or high volatility. For example, First Asset Tech Giants Covered Call ETF invests in the 25 largest technology firms, as measured by market capitalization on an equal-weighted basis, on North American stock exchanges. Gordon considers this strategy to be active management.

In addition, contends Purvis: "many income markets, such as Canadian corporate bonds and preferred shares, are very opaque — not to mention that some of the benchmark indices are almost impossible to replicate due to low liquidity in some of the index constituents. There is a strong case to be made that a low-cost active [portfolio] manager should be able to outperform some of these inefficient benchmarks."

Some advisors use actively managed ETFs as core holdings and passive strategies as satellite holdings in their clients' portfolios, says Gopaul, just like a mutual fund portfolio.

Fees for actively managed ETFs generally are 80 basis points (bps) to 90 bps. These fees, says Purvis, are "slightly higher — usually 10 bps to 20 bps — than for an index-based ETF that invests in the same universe of securities but less than half the cost of most A-class mutual funds that invest in the same universe of securities."



# THE SURPRISING RETURNS OF LOW-VOLATILITY ETFs



BY DWARKA LAKHAN

## NEW RESEARCH SHOWS THAT ETFs STRUCTURED TO AVOID RISK DELIVER SUPERIOR LONG-TERM RETURNS

**A**s the name implies, low- or minimum-volatility exchange-traded funds (ETFs) are designed to protect investors from significant movements in equities markets. As a result, these kinds of ETFs should provide smoother rides for risk-averse investors, with the ETFs tending to underperform in rising markets but outperforming in dropping markets.

"Minimum-volatility ETFs can help assuage investor concerns about market uncertainty," says Mary Anne Wiley, managing director and head of iShares Canada, a division of Toronto-based BlackRock Canada Asset Management Ltd., "and provide that extra cushion against risk, without sacrificing return, access or exposure."

But low-volatility ETFs may have other, more surprising advantages. Although low-risk investing traditionally is associated with a trade-off in low returns for safety, investing experts are beginning to find that over the long term, low-volatility portfolios (of all kinds) can outperform higher-risk portfolios. In other words, missing out on the big dips may be more beneficial than reaping the big gains.

The evidence is more than anecdotal. A recent research report from S&P Dow Jones Indices LLC, published by McGraw Hill Financial Inc., reviews several academic studies on the low-volatility effect that supports this conclusion. The report notes that while this conclusion may be surpris-

ing, it is well supported: "Among the long-standing anomalies in modern investment theory, perhaps none are as puzzling and compelling as the low-volatility effect."

This finding, the report notes, challenges the common assumption that higher-risk securities should yield higher than expected returns and lower-risk assets should receive lower than expected returns. For example, the report notes, the S&P 500 low-volatility index returned 6.95% on an annualized basis over the 10 years ended March 31, 2012. The S&P 500, by contrast, returned 4.12% in the same period.

In most cases, low-volatility ETFs invest in a basket of stocks with a level of volatility lower than the broader market, as measured by traditional indices. Stocks are selected based on their "beta," which measures their sensitivity to broad market indices. A stock with a beta of 1.0 means that it moves in sync with the broader market. A stock with a beta of less than 1.0 means that it is less volatile than the broader market.

However, ETF providers use their own methodologies to construct the low-volatility ETFs that they offer, says Kevin Gopaul, senior vice president and chief investment officer with BMO Global Asset Management Inc. in Toronto. BMO Low Volatility Canadian Equity ETF, for example, uses a rules-based process to select the least market-sensitive stocks, based on their one-year beta. The 40 lowest-beta stocks from the 100 largest and most liquid securities in Canada then are selected for this ETF's portfolio.

Gopaul notes that beta is "the biggest determinant of volatility" and adds that low beta doesn't necessarily mean low returns. Using this method, investors are not stuck with stocks based solely on their size. For instance, selecting for low beta provides the ETF's investors with exposure to stocks that are not necessarily the largest on the index and that may belong to sectors that are less dominant on the benchmark index.

Wiley says that iShares Canada's suite of minimum-volatility ETFs are constructed to track the (global) MSCI minimum-volatility indices. That strategy provides investors with "access and comfort" within their preferred global asset allocations, she says. Wiley also points out that using low-volatility ETFs can give investors the confidence to take some risks in other parts of their portfolios, because investing in low-volatility ETFs potentially reduces overall portfolio risk.

First Asset Investment Management Inc. in Toronto also uses MSCI indices to construct low-volatility ETF portfolios — specifically, the MSCI risk-weighted indices. These ETFs provide broad market exposure to the geographical regions they represent while being weighted on the basis of low volatility.


"Individual stocks are based on volatility, with the lowest-volatility stocks having the highest weight," explains Barry Gordon, president and CEO of First Asset. This approach, he adds, is more consistent with a "broad market approach" because high-volatility stocks still are included, albeit with a lower weighting. This strategy, he says, allows the First Asset low-volatility ETFs to capture the performance of all stocks.

One caveat, says Michael Cooke, head of distribution with PowerShares Canada in Toronto, a division of Toronto-based Invesco Canada Ltd., is that low-volatility ETFs represent only about 20% of stocks on the underlying index, resulting in variation between the performances of the ETF and its underlying index. But, he adds, low-volatility ETFs are a step in the direction of their actively managed cousins and cater to a large segment of investors.

In general, investors can hold low-volatility ETFs that focus on core markets, such as Canada and the U.S., and diversify internationally by investing in ETFs that target developed markets such as Europe or emerging markets.

The management fees for low-volatility ETFs range from about 30 to 75 basis points. Gordon contends that these slightly higher fees are justified because these ETFs involve higher research, construction, maintenance and monitoring costs. •

**Low-volatility ETFs can give investors the confidence to take on more risk in other parts of their portfolios**



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\*On March 24, 2014, BlackRock Canada announced changes to the annual management fee for the fund. Please refer to [www.iShares.ca](http://www.iShares.ca) for more information. Effective March 24, 2014 the name of each fund was changed from: (XLB) iShares DEX Long Term Bond Index Fund to iShares Canadian Long Term Bond Index ETF; (XSH) iShares DEX Short Term Corporate Universe + Maple Bond Index Fund to iShares Canadian Short Term Corporate + Maple Bond Index ETF; (XEI) iShares S&P/TSX Equity Income Index Fund to iShares S&P/TSX Equity Income Index ETF; (XIC) iShares S&P/TSX Capped Composite Index Fund to iShares S&P/TSX Capped Composite Index ETF; (XSP) iShares S&P 500 Index Fund (CAD-Hedged) to iShares S&P 500 Index ETF (CAD-Hedged). Prior to November 15, 2005, the investment objective of each of XIC, XSB (formerly, XGV), XSP and XIN was to replicate, to the extent possible, the performance of, respectively: S&P® /TSX® 60 Capped Index; the return of a bond issued by the Government of Canada with a five-year term to maturity; S&P 500 Index; and MSCI EAFE Index. Prior to December 2004, the investment objective of XBB (formerly XGX) was to replicate the return of a bond issued by the Government of Canada with a ten-year term to maturity. Prior to December 15, 2006, the investment objective of XGD was to replicate the return of the S&P/TSX Capped Gold Index. Consequently, performance prior to November 15, 2005 for XIC, XSB, XSP and XIN, prior to December 16, 2004 for XBB and prior to December 15, 2006 for XGD may have been materially different than it would have been under the current respective investment objectives. Inception date is the date of the first subscription for units of the fund and the first calculation of net asset value per unit. Tax, investment and all other decisions should be made, as appropriate, only with guidance from a qualified professional. Standard & Poor's and S&P are registered trademarks of Standard & Poor's Financial Services LLC ("S&P"). Dow Jones is a registered trademark of



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A Closer Look at the iShares Core

Asset Class	Ticker	Fund Name	Management Fees	Projected MER*	Fund Category MER**	Potential Savings with iShares
Canadian Equities	XIC	iShares S&P/TSX Capped Composite Index ETF * <sup>1</sup>	0.05%	0.05%	0.82%	<b>0.77%</b>
	XEI	iShares S&P /TSX Equity Income Index ETF* <sup>1</sup>	0.20%	0.22%	1.01%	<b>0.80%</b>
Canadian Fixed Income	CAB	iShares High Quality Canadian Bond Index ETF*	0.12%	0.13%	0.87%	<b>0.74%</b>
	XSH	iShares Canadian Short Term Corporate + Maple Bond Index ETF* <sup>1</sup>	0.12%	0.13%	0.77%	<b>0.65%</b>
	XLB	iShares Canadian Long Term Bond Index ETF* <sup>1</sup>	0.18%	0.19%	0.76%	<b>0.58%</b>
US Equities	XUS	iShares S&P 500 Index ETF*	0.10%	0.10%	0.92%	<b>0.82%</b>
	XSP	iShares S&P 500 Index ETF (CAD-Hedged)* <sup>1</sup>	0.10%	0.10%	0.92%	<b>0.82%</b>
International Equities	XEF	iShares MSCI EAFE IMI Index ETF*	0.20%	0.20%	0.96%	<b>0.76%</b>
	XEC	iShares MSCI Emerging Markets IMI Index ETF*	0.25%	0.25%	1.67%	<b>1.42%</b>

\* Source: BlackRock. Management Expense Ratios ("MERs") are based on total fees and expenses (excluding commissions and other portfolio transaction costs) and is expressed as an annualized percentage of daily Net Asset Value during the period. Projected MERs are estimated based on adding the blended HST rates as of September 30, 2013 for each fund to the stated management fee.

\*\* Investor Economics Insight Monthly Update, July 2013. F-series Asset-weighted MERs for CIFSC categories as of 2012.

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# DIVING INTO LIQUIDITY



BY DAN HALLETT

## ETFs USE A UNIT STRUCTURE TIED TO, BUT DIFFERENT FROM, THE SECURITIES THEY HOLD

**T**he exchange-traded fund (ETF) industry often trumpets ETFs' cost advantage over mutual funds. There is little written about some of the finer points that are required knowledge for people wanting to use ETFs for investment exposure.

Liquidity is one of the most misunderstood aspects of ETFs.

Liquidity is the ease with which an investor can invest in or redeem an investment. Buying or selling highly liquid investments is done quickly and without any adverse impact on the market price. Securities that trade infrequently suffer from the opposite characteristics: it takes longer to trade illiquid securities, which could trigger some adverse price impact (i.e., bumping up prices before completing a buy or pushing down prices before a sell order is executed).

If, for example, the price of a security drops before a sell order can be filled or completed, the delay caused by this illiquidity can be costly. Having to execute an order by making several distinct trades also increases total trading commissions. As well, the fatter an ETF's bid/ask spread, the greater is the likelihood that trades will occur further away from the ETF's net asset value (NAV). Although this is an embedded cost that is difficult to quantify, it is nonetheless very real.

Because ETFs trade in the same manner as stocks do, clients and advisors look at trading volume to gauge liquidity. Although this makes sense for securities with a fixed number of securities outstanding, this is where ETFs' structure differs.

ETFs effectively offer an open-ended structure. Unlike buying stocks, buying ETF units does not require that an existing holder sell his or her units to the buyer. Although that can and does happen, the supply of ETF units is flexible

**Buying and selling ETFs can lead to embedded costs that are difficult to quantify but are nevertheless real**



in that more are created and issued to meet demand. When there is excess supply, units can be redeemed and “retired.”

Understanding this creation and redemption process will help in grasping that an ETF's ultimate liquidity has little to do with the ETF's trading volume but everything to do with the liquidity of the underlying securities.

An ETF's trading volume simply provides a snapshot of the demand for and the supply of units. If an investor wants to buy more units than the trading volume will support, the creation process will supply the additional units required. The ETF's market-maker and designated broker work together to monitor the market to establish whether there is a shortage or excess of an ETF's units. They then determine how many shares there are of each of the stocks held in the ETF. The next step involves delivering baskets of stocks to the ETF sponsor to create additional ETF units. Finally, these newly created ETF units are taken from the sponsor and used to fill the investor's order through his/her retail broker.

A sell order for more ETF units than investors are willing to buy — i.e., an excess of units — will set the redemption process in motion. Redemption, the reverse of the creation process, will prompt the market-maker and designated broker to buy the excess units and have those units redeemed for the underlying shares, which then are sold in the market for cash. This process happens very quickly.

Typically, 50,000 units of an ETF (or a multiple thereof) can be exchanged for its underlying securities. This is key to the creation and redemption process — and to keeping market prices close to NAV. If an ETF's market price drops too far below NAV, the market-maker will buy the cheaper ETF units, exchange them for the underlying securities, and sell those securities for a guaranteed profit — arbitrage.

The more liquid the underlying shares, the more efficient this process will be. But when the underlying securities are expensive to trade and tough to acquire — e.g., with less liquid securities — designated brokers will be less willing to arbitrage the spread away until the bid/ask spread gets really wide (to offset the higher costs in trading less liquid securities).

Liquidity assessments should focus on an ETF's underlying holdings. An ETF tracking a hedge fund index recently sported a bid/ask spread in excess of 100 basis points. This ETF's underlying assets are futures contracts — not the actual hedge funds — but the combination of long and short futures positions may not be as easily acquired or unwound in order to execute creation and redemption. Trying to trade such an ETF will involve additional costs.

On the other hand, an ETF that tracks large-cap U.S. stocks — which are very liquid — recently had a bid/ask spread of just four basis points and would incur significantly fewer embedded trading costs.

*Dan Hallett, CFA, CFP, is vice president and principal with Oakville, Ont.-based HighView Financial Group, which designs portfolio solutions for affluent families and institutions.*





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For Joseph Wu, associate portfolio advisor in the wealth-management division of Royal Bank of Canada (RBC) in Toronto, that means ETFs make the most sense for accessing markets that are liquid and well covered by research, such as Canadian and U.S. large-cap equities. “[Those market segments] are well known,” he says, “so the opportunity [for a mutual fund portfolio manager] to add significant value above the additional fees is relatively less compared with other areas of the market that aren’t as deep and are less liquid.”

Research indicates that many broad-based mutual funds have difficulty outperforming their benchmarks. For example, McGraw Hill Financial Inc., for its 2013 mid-year report, found only 45.7% and 30.4% of actively managed Canadian equity funds outperformed the S&P/TSX composite index over three- and five-year periods, respectively. The same trends are at play for foreign equities, McGraw Hill's researchers found: less than 12% of active international equity funds were able to outperform their benchmarks over a five-year period.





Less efficient or under-researched market segments may present better opportunities for active portfolio managers to find stocks that will outperform and thereby earn their management fees, which are relatively higher than those of ETFs.

Actively managed mutual funds tend to be considerably more expensive — annual management expense ratios (MERs) can be about 1.5 percentage points higher than those levied by ETFs, says Christian Charest, website editor at Toronto-based Morningstar Canada. Thus, an active portfolio manager needs to be able to cover that difference in MER and generate superior returns to justify the MER that they charge. “That’s a pretty hard proposition for most managers,” he says. “It’s unlikely those funds would be able to add enough value to make up for their [higher] fees.”

Clients and advisors are becoming more sensitive to the fees attached to portfolios, says Shawn Brayman, president of PlanPlus Inc., a Lindsay, Ont.-based financial planning software company that supplies advisors in about 30 countries. “Fees are the only verifiable or consistent aspect [of investing],” he says. “You can’t prove [portfolio] manager outperformance in any way, but you can prove that higher fees are a drag.”

Charest believes active management can show its strength in market segments such as micro-caps, small-caps, certain sector funds and emerging markets: “You can have an expertise in those markets and add value beyond what the indices can provide.”

For example, Charest says, an advisor who wants to build his or her client’s portfolio with a 60/40 equities/bonds split can allocate about 40% of the equities portion to broad-based coverage of U.S. and Canadian equities markets using ETFs. “It’s pretty unlikely you’ll be able to beat the market [with actively managed funds] in those kinds of asset classes,” he says. Then, the rest of the equities portion can go toward actively managed funds covering other market segments.

Clients can benefit from a “core and explore” approach to portfolio construction, Charest adds. The core portfolio elements, which incorporate broad market coverage that can be accessed through ETFs, don’t change much over time. Thus, these ETFs provide a stable base for the portfolio.

Among the funds being used by ETF portfolio managers for broad-based Canadian equities exposure are iShares S&P/TSX Canadian Dividend Aristocrats Index, iShares S&P/TSX Capped Composite Index, Horizons S&P/TSX 60 Index and BMO Canadian Dividend ETFs. For broad international exposure, some ETF portfolio managers are using Vanguard FTSE Europe, iShares MSCI All Country World Minimum Volatility Index, and Vanguard FTSE Developed ex North America Index ETFs.

However, the “explore” part can take advantage of market moves by focusing on narrow sectors or regions. Clients can complement their core holdings, Charest says, by exploring other assets in which active management may add value.

For example, if the advisor feels resources are undervalued or are poised to perform well and he or she is not happy with his or her client’s exposure from core ETFs, he or she can add an actively managed mutual fund from that sector. Another option is to seek out a favourite portfolio manager with a contrarian approach and place a small portion of the portfolio in that manager’s mutual fund.

ETFs also can be useful in achieving diversification on the fixed-income side and, with their lower fees, can offer a better net return for clients than investing in individual bonds or buying bond-based mutual funds.

A variety of ETF income strategies will allow clients to diversify with small amounts of money. Examples include ETFs investing in government bonds, corporate bonds, real estate income trusts, preferred shares, dividend-paying stocks or floating-rate bonds. ETFs also can offer more complex strategies, such as laddered bonds, preferred-share strategies and “target date” products that have a predetermined maturity date (much like an actual bond).

Core-and-explore can be a highly effective approach to managing fixed-income portfolios by using ETFs. The tax-efficient and low-cost advantages of ETFs, Wu says, are particularly appropriate in the current low-yield environment.

On the core fixed-income side, Pat Chiefalo, Toronto-based director of ETF research and strategy at National Bank Financial Ltd., is partial to iShares DEX Canadian Short Term Corporate Universe + Maple Bond Index, Horizons Active Corporate Bond, Horizons Active High Yield Bond and Vanguard Canadian Short Term Bond Index.

However, it should be noted that the ETF structure may not always be the most efficient for packaging assets that lack liquidity and transparency. For less liquid securities, such as corporate bonds and preferred shares, for which the case for active management is strongest, it generally makes sense to include active portfolio-management strategies to complement the low-cost, broadly diversified ETFs.

Wu’s team tells RBC’s advisors that ETFs are an excellent way of providing simplicity, transparency and diversity while keeping costs to a minimum. Says Wu: “For most investors, it’s far more important to avoid glaring mistakes than to make clever moves. For the most part, the harm caused by the blunders can outweigh the benefits from making a series of small clever moves, which is what a lot of investors are trying to do.”

Wu and his team follow three important steps in constructing a client’s portfolio.

The first is determining each client’s unique strategic asset allocation. The second is selecting implementation tools for that asset-allocation mix, including ETFs, mutual funds and individual securities and bonds. Third, a number of filters are put into place to narrow down the ever-expanding ETF universe to a manageable size for each sector that the client is looking at.

Depending on a client’s objectives, Wu says, there are many different approaches to evaluating and selecting ETFs. For example, those clients who use ETFs mainly as trading vehicles tend to place greater emphasis on factors related to liquidity, such as the average bid/ask spread and the liquidity of the underlying portfolio.

For buy-and-hold investors, emphasis should be placed on the core values of ETFs in general, such as cost effectiveness, transparency and diversification.

In assessing ETFs for their merit as long-term portfolio builders, look for those that provide comprehensive and transparent coverage of the investible universe of an asset class (such as ETFs that are tied to total market indices) and rank among the most efficient in terms of tracking, turnover and the ongoing cost of ownership.

Some basic filters include the MER and the long-term tracking difference. The nature and applicability of an ETF’s investment mandate is another important consideration.

ETFs have become increasingly popular with advisors over the past two years or so for their tactical and strategic advantages, Wu says, but these products are particularly favoured by fee-based advisors. With ETFs, there is less focus on picking individual securities or portfolio managers, thus freeing up advisors to focus more on financial planning.

“Many [advisors] have realized a lot of actively managed funds don’t outperform the market over the long term,” Wu says. “So, they can use ETFs to free up their efforts for other aspects of the wealth-management practice. They can focus on asset allocation or tax planning or estate planning.”



**ETFs can be useful for diversification on the fixed-income side. And with their lower management fees, they can offer a better return for clients than investing in individual bonds or buying bond-based mutual funds**

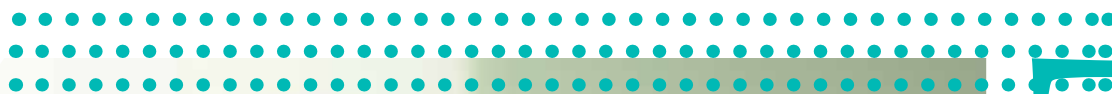


# MAKING SENSE OF THE MARKET

An increasingly varied ETF universe calls for a highly specialized strategist



BY JADE HEMEON



**T**he rapid proliferation of exchange-traded funds (ETFs) has given rise to a new breed of money manager known as an “ETF portfolio strategist.” These specialized money managers offer their expertise in assembling portfolios of ETFs. These portfolios are made possible by the rapidly expanding numbers and types of ETFs, which now include a wide range of core and niche asset classes. It is becoming increasingly challenging for ordinary investors and even financial advisors to analyze all the choices, then put together complementary ETFs and monitor those portfolios.

“There’s a dizzying array of ETF products in Canada, and even more listed in the U.S.” says Dan Hallett, vice president and principal with HighView Financial Group in Oakville, Ont. “Whenever there is such a large universe [of products], it creates the need and demand for someone who is able to sift through the universe and provide value-added analysis and insight.”

This new breed of wealth manager has expertise in constructing portfolios entirely of ETFs, although many of these managers also manage portfolios of traditional stocks and bonds, or portfolios that mix ETFs and other securities. Growth has surged so strongly in this niche that the iShares division of BlackRock Asset Management Canada Ltd. of Toronto, the giant among ETF providers in Canada, has introduced its quarterly *Canadian Guide to ETF Strategists* to track the array of ETF strategies and portfolio managers. In

addition, the Canadian ETF Association has created a membership category for professional investment managers who devise asset-allocation strategies focusing on ETFs.

ETF investment strategists typically have portfolio manager or investment counsellor credentials. These strategists usually manage money on a discretionary basis, offering a choice of model ETF portfolios along a risk spectrum that ranges from conservative to aggressive. The convenience of trading ETFs allows for strategies that once were inaccessible to retail investors, including access to globally diversified baskets of stocks, bonds, currencies, commodities and hedging vehicles.

"There are so many ETFs to look through, and it's a complex undertaking to understand all the products," says Ted Bader, director of iShares business development and author of the iShares quarterly guide. "These guys run the screens, talk to the [product] providers and navigate the ETF landscape."

The latest edition of the iShares guide, based on Dec. 31, 2013, numbers, tracks more than 30 ETF strategies by 16 ETF portfolio managers, with a combined \$4 billion in ETF assets under management (AUM), up from 11 portfolio managers and \$3 billion in AUM in June 2013, when the guide was introduced. Among the larger portfolio managers are Cougar Global Investments Ltd., HAHN Investment Stewards & Co. Inc. and ETF Capital Management, all based in Toronto.

"The more product there is, the more the need to discern what products can and can't do, and what they're suited for," says Yves Rebetez, managing director and editor with ETF Insight Inc. in Toronto, who maintains a website dedicated to Canadian ETFs. "And this presents an opportunity for people with the right skill set."

The profession of ETF portfolio strategist has been evolving for about 10 years, says Bader, but until recently hadn't been categorized as a separate advice channel. Morningstar Inc. of Chicago began to examine the ETF professional management industry about four years ago in the U.S., and now compiles a regular quarterly report; the latest issue lists 648 strategies managed by 153 firms with US\$96 billion in AUM.

John Gabriel, ETF research strategist with Morningstar in Chicago, says the "value added" offered by a portfolio manager is in the asset allocation or in "actively managing passive products," not in individual security selection, which is where traditional active portfolio managers strive to add value.

"The reality is that ETFs are tools that advisors and investment managers use to make active tactical bets," Gabriel says. "These bets can be anything from sector rotation strategies and boosting a portfolio's exposure to emerging markets to speculative and momentum-based strategies. [ETFs aren't] all blending a 60/40 equity/bond portfolio, and some shops manage only fixed-income."

Bader says ETF strategists target a mix of institutional and individual clients. Much of the recent growth has been driven by subadvisory relationships with individual financial advisors who want to delegate investment management or a portion of it. In some cases, financial services firms are looking to hire a subadvisor for separately managed accounts that hold ETFs. Other clients cultivated by ETF specialists include pension and endowment funds and multi-family financial advisory offices looking to add ETFs to their mix.

"A lot of people and organizations are looking for a third-party manager to pick ETFs and make independent allocation decisions," Bader says. "Usually, an ETF portfolio can be managed at a lower cost than actively managed mutual funds. Instead of trading 100 securities, the manager might be trading 10 ETFs. ETFs are liquid and transparent — you

can see what securities are in the underlying portfolios."

ETF strategists sift through about 300 ETFs that trade on the Toronto Stock Exchange and the more than 5,000 that trade globally that comprise the worldwide menu of ETFs. These strategists examine which ETFs are most liquid and offer the desired exposures, then determine the appropriate allocation mix.

"Much of the screening relates to liquidity issues," Bader says, "as there could be a need to get in and out quickly at large volumes."

ETF portfolio strategists, Bader says, are likely to need less "infrastructure" or business overhead than portfolio managers of actively managed mutual funds, which require detailed analysis of individual stocks and the expertise of research teams. Therefore, an ETF portfolio manager's fees are relatively lower.

For example, HAHN Investment's management fee is 1.5% a year for clients with accounts worth between \$100,000 and \$500,000, and this fee is added to any management fees charged by the underlying ETFs. For accounts of \$500,000 to \$1 million, HAHN Investment's fee is 1.15%. As accounts get bigger, the firm's fees drop as a percentage of AUM.

Traditional portfolio managers and investment counsellors often target high net-worth clients with accounts worth \$1 million and up. The simplicity of ETFs can make it economically viable for ETF strategists to offer their management skills to smaller investors. HAHN Investment accepts accounts as small as \$100,000. Wickham Investment Counsel Inc. of Hamilton, Ont., for its part, accepts a minimum of \$150,000.

For financial advisors, delegating investment management to an ETF portfolio manager can free up time to concentrate on financial planning and business building. But, Gabriel cautions, not all ETF portfolio strategists are created equal. It's important to conduct due diligence on track record, qualifications and methodology and to examine security measures for assets.

"It's still early in the development of the profession," Gabriel says. "A lot of firms are just starting out, and it's still the Wild West. There's a wide range of experience and expertise."

**"THE MORE  
PRODUCT THERE IS,  
THE MORE THE NEED  
TO DISCERN WHAT  
PRODUCTS CAN  
AND CAN'T DO"**

## BUILDING WITH THE BLOCKS

**Larry Berman, ETF portfolio strategist** and president of Toronto-based ETF Capital Management, says most of the outperformance (a.k.a. "alpha") in managed portfolios comes from asset allocation, and ETFs are the lowest-cost and most efficient way to allocate assets. Berman uses ETFs for exposure to both fixed-income and equities, then breaks it down further by such categories as geographical region, country and market capitalization.

As of Dec. 31, 2013, Berman's global balanced portfolio had 25% of assets in iShares DEX Universe Bond Index Fund, 25% in iShares MSCI World Index Fund, 15.6% in Vanguard FTSE Europe ETF, 15.6% in SPDR S&P 500 Trust, 12.5% in iShares MSCI All Country World Minimum Volatility Fund and 6.2% in iShares MSCI Emerging Markets Fund. "I can do whatever I want using 100% ETFs," Berman says. "And I can get exposure in any country around the world by using ETFs that trade in either Canada or the U.S."

When you know the ETF market well, you can zero in on products that meet spe-

cific objectives, says Tyler Mordy, president and CEO of HAHN Investment Stewards & Co. Ltd. For example, within the U.S. market, Mordy likes large, multinational companies that transcend borders and sell their products globally. He finds he can get better exposure to these companies through Vanguard Dividend Appreciation ETF than he could with another ETF that covers the broader S&P 500 index.

"We have abdicated individual security selection in favour of asset allocation, which we believe is the primary determinant of investment returns," Mordy says. "We are multi-asset class specialists. With ETFs, you can get exposure to Chinese bonds or to gold with a single click."

James Breech, president of Cougar Global Investments Ltd. of Toronto, analyzes the construction and methodology of the indices underlying ETFs, assessing liquidity and the ability of ETFs to track indices accurately.

Says Breech: "We want to know exactly which securities are in the ETFs we hold."

—JADE HEMEON





WHILE ETFs  
OFFER GREAT  
VARIETY, IT'S  
IMPORTANT TO  
UNDERSTAND  
THEIR FEATURES

# SELLING ETFs? DO YOUR HOMEWORK

BY CLARE O'HARA



An early adopter of exchange-traded funds (ETFs), Reg Jackson, vice president and portfolio manager with Montreal-based National Bank of Canada in London, Ont., remembers a time, about 15 years ago, when there were only a handful of ETFs available. Today, there are hundreds to choose from, offering investing vehicles for almost every sector, region and size of investor.

That remarkable growth has been driven by ETF features that appeal to clients and financial advisors alike, such as significantly lower fees and greater transparency of holdings compared with mutual funds. Units in ETFs also can be bought and sold on an intra-day basis, like stocks, making ETFs more liquid than mutual funds.

As a result, it is becoming much easier to start a conversation about ETFs when clients ask their advisor about alternatives to mutual funds. "Now," Jackson says, "there are a lot of players in the [ETF] space, and people want to learn more."

In addition to the lower fees charged by ETFs, many advisors find that these investment vehicles offer a convenient way to gain access to the investing strategies available to institutions, strategies that otherwise would be hard for the average investor to tap into.

"Certain strategies, like covered-call strategies on banks, can now be added to the average investor's portfolio," says Kevin Prins, vice president of BMO Exchange Traded Funds (Ontario), a division of Toronto-based BMO Global Asset Management Inc. "ETFs are allowing advancements to happen in portfolio construction."

Prins says many advisors use ETFs to add

diversification to their clients' portfolios without the effort or costs associated with individual stocks or mutual funds.

"[Clients] are using ETFs to pick up diversification," Prins says. "Instead of having the tech stock Apple Inc., for example, they are able to buy the NASDAQ ETF that has Apple in it and mitigate the single-stock risk."

There are several issues for advisors to consider before incorporating ETFs into their business:

- **Fees and commissions.** Most advisors who offer ETFs use a fee-based or discretionary portfolio-management business model. Portfolios can be built with a total average management expense ratio of 30 to 60 basis points in most cases, says Pat Chieffalo, director of ETF research and strategy with Montreal-based National Bank Financial Ltd. (NBF) in Toronto. Advisors who use other business models still can access A-class ETFs that incorporate a trailer fee.

"Very often," adds Chieffalo, "ETFs are the most cost-efficient product to gain access to various markets, such as U.S. and international equities."

Jackson, for one, prefers the fee-based model, with its lower costs and greater transparency; 50% of his clients are set up on a fee-based platform. Explains Jackson: "Clients will be 100% aware of what they are going to be paying."

For advisors not licensed by the Investment Industry Regulatory Organization of Canada, several ETF providers offer ETF portfolios in a mutual fund wrapper. Although the fees, at about 1%, are often higher than ETFs, they are still far lower than the fees for many mutual funds.

- **Transparency.** Transparency in holdings is one of the major benefits of using ETFs. Given the

wide variety of sector, style, industry and country categories available, investors and their advisors can see exactly what is owned.

"This tends to be one of the biggest features we focus on when it comes to education," says Chris Hogg, director of national accounts at BlackRock Asset Management Canada Ltd.'s iShares division in Toronto. "You can see at any given time of day what the underlying ETF owns, which is not the case with mutual funds."

Advisors often will buy an ETF for exposure that they can't easily access otherwise, says Hogg, or when they want exposure to specific sectors, styles, industries or countries in which they do not have expertise.

- **Liquidity.** The way that ETFs are bought and sold is complex and often not well understood. Many advisors still look at the average daily volume and assume that figure represents the liquidity of the ETF. This can be misleading. Generally, units of the ETF will be made available, depending on the demand. (For more on the liquidity of ETFs, see story on page 16.)

- **Making choices.** As the ETF marketplace continues to expand, advisors need to be cautious about what their clients are buying. It's not possible for advisors to know every ETF inside out, notes Bruno Mercier, an investment advisor with NBF in Montreal. He suggests advisors find out which securities an ETF holds and what sectors it favours.

"This is where you have to be careful, because those offerings are not identical," says Mercier. "One will follow the MSCI while another could follow the S&P 500. It doesn't mean that one is better than the other; but it is important to note for the advisors to know they are two different things." •

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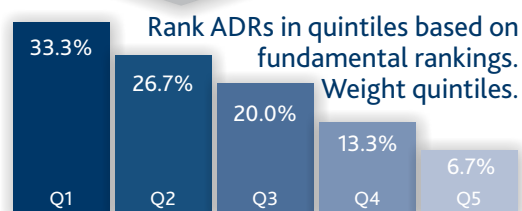
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PHOTO BY PAUL LAWRENCE

# AN ETF-CENTRED PRACTICE

BY DAVID ISRAELSON 

**TIM MORTON'S  
TEAM DEPLOYS  
ETFs TO REDUCE  
COSTS AND  
MOVE QUICKLY  
IN AND OUT OF  
MARKETS**

**T**hree important things have happened to Tim Morton since he began managing the wealth of high net-worth families, trusts and foundations more than 35 years ago. He has become friends with many of his clients; he has brought his sons, James and Daniel, into the business; and, in 2007, he began focusing on exchange-traded funds (ETFs).

"I'd say [ETFs] take up about 80% of our working hours," says Morton, who leads the Toronto-based Morton Group, which operates under the banner of CIBC Wood Gundy. This team serves clients with investible assets ranging from \$2 million to \$40 million. Morton serves about 30 of these clients, mostly families, himself.

Both sons serve clients with fewer investible assets — often the children or friends of Morton Sr.'s high net-worth clients. James works with clients who have investible assets of \$500,000 or more and he also manages the firm's technology tools. Daniel, who has joined the team more recently, takes care of clients in the \$100,000-plus category.

"That's basically our cut-off point," Tim Morton says. "We can't really work on a discretionary basis below that point."

Working as discretionary advisors suits the type of client whom the Morton Group attracts. "Our clients tend to be self-made," Morton says. "They tend not to need cash flow and they're generally not withdrawing funds monthly or



## MARTIN PELLETIER'S STRATEGY FOR BALANCING RISK AND RETURNS INCLUDES A RANGE OF ETFs



PHOTO BY CHRIS BOLIN

**A**fter the financial crisis of 2008-09, Martin Pelletier, managing director and portfolio manager with Calgary-based TriVest Wealth Counsel Ltd., started to research alternative investment options for his clients.

Pelletier, having previously worked in an institutional environment, decided to adopt investing strategies that place greater emphasis on controlling risk. "We felt there was a need for more conservative portfolio management," he says, "with a focus on managing risk and capital preservation while still achieving reasonable levels of growth over the longer term."

Part of TriVest's investment philosophy involves using exchange-traded funds (ETFs) to track markets that are fairly efficient. In these markets, much of the information is known and reflected in stock prices, and it's difficult to outperform the index by picking individual stocks.

"We find this [strategy] makes the most sense when dealing with large, liquid markets, such as [those in] Europe and the U.S.," Pelletier says. "We believe most firms, including ours, do not have the time or the resources to do a thorough job of researching companies and finding unrealized value opportunities within those markets."

However, in Canada, Pelletier says, his team can take advantage of certain market inefficiencies by using stock-picking.

# TO ETFs AND BEYOND



BY CLARE O'HARA

> CONTINUED FROM PAGE 24

quarterly. They're very entrepreneurial and good at decision-making. When they come to us, they have made a decision that they don't want to be involved in managing the money. As well, a lot of our clients travel extensively, so we can execute without having to speak to them."

ETFs are suitable investment vehicles for the Morton Group's clients, partly because of the wide diversification that ETFs offer, both geographically and by industry sector.

The Mortons also like ETFs' transparency, especially since James brought mathematical modelling into the team's analysis tool box, which, Morton believes, allows for more precise analysis: "We have identified about 1,300 ETFs that have enough liquidity and good sponsorship and aren't too 'niche' for us to consider."

Using James' computer models, the team looks at the funds that both performed best over a given period and are most consistent in their performance. "Rather than using my experience, we're picking them mathematically," Tim Morton

says. "It's really been a positive experience, which has increased returns."

This modelling process can lead to choices that might not otherwise have been identified as easily, Morton says. For example, at one point in 2013, ETFs that held companies making solar panels were a hot item, but the math suggested that this trend was peaking and it was time to look elsewhere for better investments. "[Using the model] enabled us to rebalance," Morton says, "rather than rely on Tim Morton's subjective picks."

Morton provides another example: on Nov. 1, 2013, the computer model "told us we should take a 4% position in U.S. defence and aerospace. My own analysis would say, 'Why would you want to hold these ETFs when the Afghanistan war is winding down, the U.S. military is cutting and so on?' Yet, it turns out, there's a growing interest in these [investments] among U.S. institutional investors. It's something I just wouldn't have ever thought about."

Another important difference between ETFs and mutual funds — and in Morton's view, an advantage for ETFs — is the way in which they

are traded. Mutual fund units are purchased and redeemed after the market closes; ETFs trade on stock exchanges throughout the day, offering the flexibility to get in and out of specific markets when events are unfolding.

"When there's a downturn," Morton says, "we typically go down [by] about half of what the markets go down." On the upside, for Morton Group clients: "The expectation of a 6% to 8% return [on an ETF portfolio] would be typical."

The Mortons like the transparency that ETFs offer. Generally, there are about 9,000 stocks represented in the Morton team's portfolios, and 22% of those portfolios are invested in financial services stocks.

"We can drill down," Morton says, "and see this [information provided by trading on an exchange] on a daily basis, and our clients can look at their portfolios online and see it live."

By comparison, mutual funds offer only quarterly statements, and unitholders cannot be sure that their fund's holdings haven't changed by the time they receive their statement.

For clients who want to learn more about ETFs, the Morton Group has published its own e-book, *The ETF Investing Revolution*, which clients and prospects can obtain by emailing James Morton through the team's website. The 21-page book is designed to help investors decide whether they want to manage their own ETF portfolios or turn the work over to a discretionary-management professional.

A second e-book is due out soon. It will explain the pros and cons of ETFs vs mutual funds.

**ETFs can be traded like stocks and therefore offer greater flexibility than other types of funds. "When there's a downturn," Morton says, "we typically go down [by] about half of what the markets go down"**

> CONTINUED FROM PAGE 25

As part of TriVest's risk-management process, Pelletier and his team have created an investment strategy that uses derivatives, including options, to help in managing the risk in clients' portfolios. The benefit of options strategies, Pelletier says, is that they can be "tilted" according to the firm's views of the market or of a specific security. And many ETFs have related options that trade, allowing TriVest to manage in risks inherent in these holdings as well.

## SAVINGS IN FEES

In addition to using ETFs to help mitigate risk, Pelletier uses them as a cost-effective tool for asset allocation and global diversification. In addition, Canadian equity mutual fund fees often are as high as 2.4%, Pelletier says, while fees for ETFs can be 50 basis points or less. "These savings in fees alone," he says, "when compounded, can have a material impact on performance."

Pelletier runs TriVest with his business partner, managing director and portfolio manager Craig Stanford. The firm is a fee-based, discretionary investment manager that is licensed as an investment counsellor, portfolio manager and investment fund manager.

Pelletier first entered the financial services sector in 1999 as an oil and gas research associate in Calgary with Toronto-based Canaccord Capital Inc. Over the next 10 years, he held various senior

equities-research roles at a number of boutique investment firms, including Canaccord, Blackmont Capital Inc. and GMP Securities Ltd. In these roles, Pelletier provided regular investment recommendations to a range of large institutional fund managers located in Canada, the U.S. and Europe.

When Pelletier and Stanford decided to launch TriVest in 2009, they expanded their clientele to include high net-worth families and entrepreneurs with complex financial situations, family offices, corporations, institutions, trusts, estates, endowments and foundations. The team also works with a family's legal and tax advisors and financial planner to ensure all these needs are met. The minimum investment required to establish a client relationship with TriVest is \$1 million in combined household investible assets, which can be a combination of cash, RRSP, trust and corporate accounts.

## WHAT IS BEST FOR THE CLIENT?

A majority of the firm's client portfolios include individual stocks, bonds and options, as well as ETFs. Fees are 1% for smaller portfolios and decline as portfolio size increases.

While ETFs don't pay financial advisors the high commissions that mutual funds pay, advisors still can benefit from using ETFs in client portfolios, Pelletier says: "If an advisor's mandate is to add value, then there are other ways of being compensated for their performance."

Although Pelletier advocates working on a

fee-based model, ETFs can still work for advisors who work on a commission-basis — especially if the product is adding value to a client's portfolio, he says: "If ETFs are a better option for your client, then you have to do what is best for your client. And if that means taking less in commissions, then so be it."

## NEW INDEX

At the same time, Pelletier adds, higher fees can be acceptable if they are properly disclosed: "As long as the advisor is transparent and discloses any additional fees the client may be charged, I think it is fair." This approach to fees may well be required in the future in any case, he says, due to regulatory changes. "Because of the disclosure agreements that are coming down the pipeline, things are going to start to change in this regard."

Among TriVest's other initiatives, the firm has launched the Canadian high yield energy index in May 2013, the first index to create a benchmark for Canada's high-yield energy sector. TriVest is in discussions with advisors about replicating the index, for a fee, rather than those advisors buying an ETF for a client's portfolio.

"A lot of traditional advisors like to [invest client money in] individual stocks, especially out West," Pelletier says. "So, we are offering a solution that allows these advisors to [invest in] the companies within the index itself rather than buying a financial product that replicates it."

# Stand Out

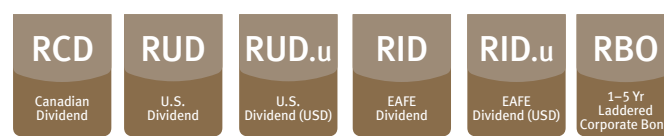
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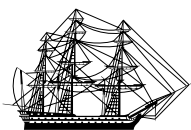
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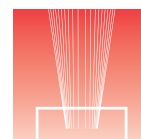
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