INVESTMENT EXECUTIVE
CANADA'S NEWSPAPER FOR FINANCIAL ADVISORS

The explosion of ETFs

Advisors can engineer globally diversified portfolios with customized exposures to markets

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Exchange-traded funds represent the greatest advance in managed money for individual investors since the launch of the modern mutual fund in 1928. ETFs allow the construction of highly diversified, cost- and tax-effective portfolios composed of diverse asset classes.

Like mutual funds, ETFs provide investors with access to a diversified basket of securities within a single vehicle. ETFs, however, trade on public stock exchanges and, because of their need for real-time transparency to minimize deviations between their unit price and the net asset value of their underlying securities, they are particularly suited for index products that replicate the returns of various asset classes.

Starting in 1989, ETFs focused on broad stock market indices such as the S&P 500; by 2000, bond indices were added. Since then, there has been an explosion in the quantity and variety of ETFs.

In Canada, as of June 2010, **Investor Economics Inc.** of Toronto reports there were 146 ETFs listed, with $33 billion in assets under management. In the U.S., the **National Stock Exchange** has reported there were 959 ETFs listed, with US$888 billion in AUM.

Of particular importance to financial advisors is the vast choice of ETFs that track various style and size indices in the stock markets as well as different credit and duration exposures in the bond markets, both domestically and globally. Research has found that small-company and value stocks have higher long-run expected returns than large-company and growth stocks. Similarly, in fixed-income instruments, longer durations and greater credit exposure offer the opportunity for higher expected returns.

Advisors can now engineer globally diversified portfolios with customized exposures to these factors in accordance with the risk and return requirements of their clients. The availability of real estate and commodities-based ETFs, as well as asset subclasses, such as emerging-markets bonds, add to the ability to build robustly diversified portfolios.

With today's low interest rates and uninspiring stock valuations, the structural cost advantages of ETFs over mutual funds should be vitally important to advisors. First, ETFs do not have the back-office costs of mutual funds, which must account for and report to their investors. ETFs also do not have the costs or liquidity requirements of funding unit holder redemptions. ETFs, in fact, externalize many of the costs of running a conventional mutual fund by transferring these functions to brokerage firms.

Second, the index specifications of most ETFs result in lower portfolio turnover than actively managed funds and, hence, lower trading costs. The same low turnover also contributes to greater tax efficiency for many ETFs. Finally, the management fees charged by most ETF providers are lower than those of Canadian mutual funds.

ETFs have their drawbacks. They aren't suitable for smaller investors. Their price volatility and potential tracking errors require more thoughtful trading. However, ETFs' unique combination of low cost, tax efficiency, and asset-class replication and diversity makes them game-changers. **IE**

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