EXCHANGE-TRADED FUNDS

PASSIVE INVESTING

Unbundling confusion

They can appear similar, and even hold the same securities, but ETFs and index mutual funds each suit different investors

JOSH O'KANE

Clients come to Dan Bortolotti all the time asking about the difference between exchange-traded funds and index mutual funds.

"Often, they're dealing with poor information and myths about the differences between the two," says Mr. Bortolotti, a financial planning consultant with PWL Capital Inc. and the brains behind the index-investing blog Canadian Couch Potato. Rather than focus on differences between the two instruments, he says, investors need to think about their own strategy.

ETFs can appear similar to index mutual funds, and sometimes they have the same securities in their baskets. "You pop the hood" on an ETF, Mr. Bortolotti says, "and it's a mutual fund."

He has seen plenty of positive coverage of ETFs because of their relatively cheap management fees. But for every index-focused investor – especially those seeking a passive strategy – it's a situational choice. "I love ETFs, but I've come to accept that they're not right for everyone," he says.

Index mutual funds operate like any other mutual fund, but rather than being actively managed, they track the performance of a given index – such as the S&P 500 or the S&P/TSX 60. ETFs take the same approach, each tracking an index, but trading like stocks, with their price fluctuating throughout the day.

ETFs can seem like a tempting alternative to index mutual funds, given their usually lower management expense ratios (MERs). Because they are bought and sold like stocks, ETFs can seem enticing and low-maintenance. But for someone looking for passive growth, they can be the opposite of that.

"Mutual funds are so much easier to transact," Mr. Bortolotti says. To be a do-it-yourself ETF investor, for instance, you have to open up an account with an online brokerage and place orders for ETFs just like you would a stock. If you want to invest $10,000, you would have to do the math to see how many you could buy – likely leaving some cash uninvested – plus be restricted by market hours and available shares.

With a mutual fund, though, you can work directly with a fund company, invest the exact amount you have, avoid the complexity of bid-ask spreads, and even set up automatic contributions.

They are also a better vehicle for smaller investments – for instance, for younger people looking to build a registered retirement savings plan. Even if the MERs are higher than those of similar ETFs, smaller portfolios are less likely to feel the burn of that cost since the fee is a percentage, Mr. Bortolotti points out.

Investors, too, need to consider the math with MERs. Just because ETFs can have smaller-percentage fees than index mutual funds doesn't mean they are cheaper on the whole. Like with stocks, trading ETFs almost always comes with a fee, and those can add up quickly. "I generally find people are more comfortable with mutual funds," Mr. Bortolotti says.

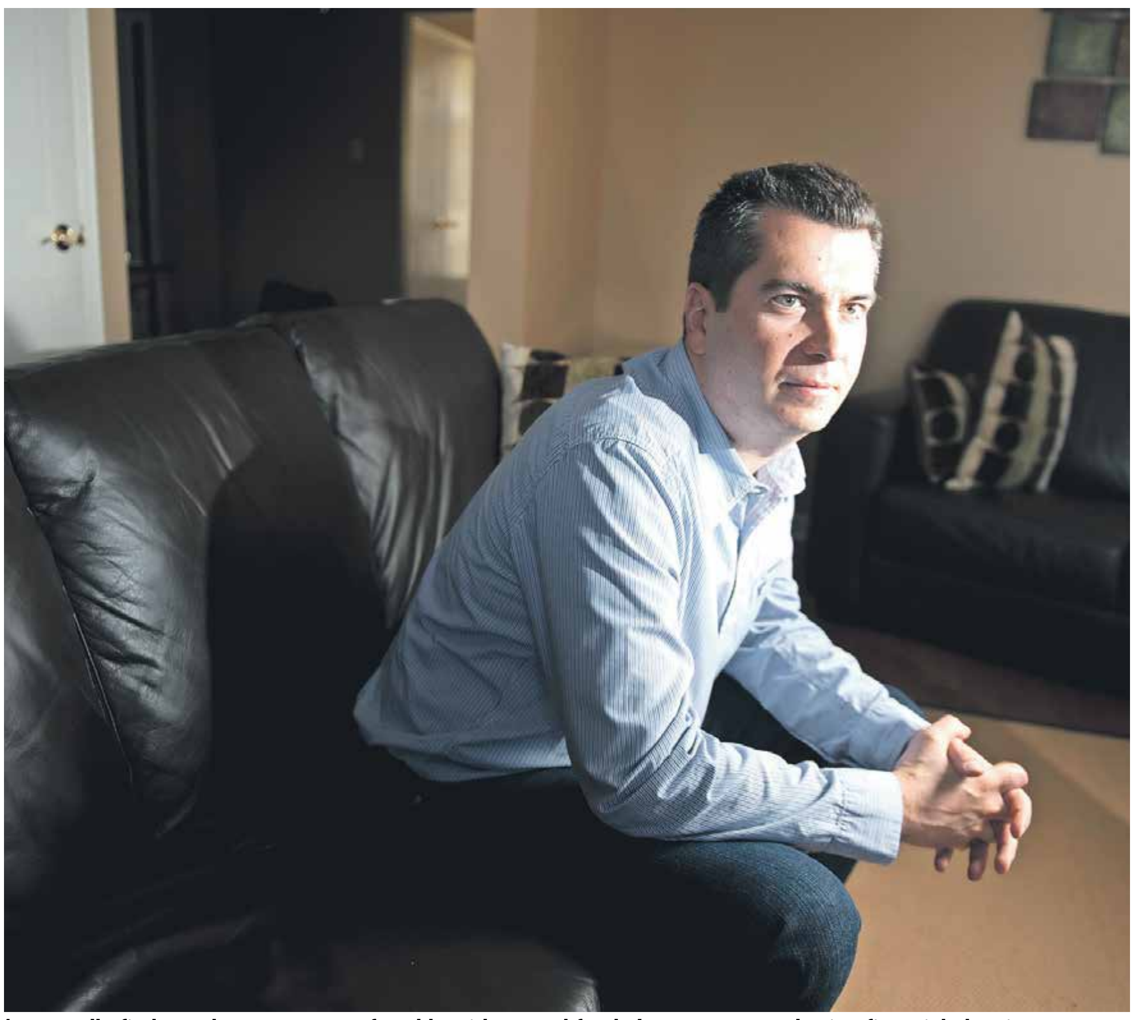
Shelley Smith, a financial planner with TD Wealth in Toronto, says that a long-term financial road map should be what investors worry about most – not individual instruments. "It's important that my clients feel that their investments match their financial goals," she says.

That requires talking through bigger-picture dreams with them.

"You can have someone walk in and say, 'I'm interested in this index fund, what do you think?' We can talk all day about it, but it doesn't mean it's going to be the right investment for that client," she says.

Especially for new investors, Mr. Bortolotti says, having help – in the form of a mutual-fund company doing the heavy lifting – gives you the freedom to save regularly and easily.

"The most important thing is you're saving your money," he says, "and building good habits."



'I generally find people are more comfortable with mutual funds,' says Dan Bortolotti, a financial planning consultant with PWL Capital Inc. SARAH DEA FOR THE GLOBE AND MAIL

TWO KINDS OF FUNDS: HOW TO DO THE MATH

There is a math to figuring out whether index mutual funds or exchange-traded funds work best for you. Both have management expense ratios (MERs), which can be cheaper for ETFs. But because ETFs are traded like stocks, you will likely pay a trading commission.

These fees used to be more expensive, ranging from about $10 to $30 a trade, but some brokerages now have commission-free options, or they charge only a small fee upon selling. Even so, it is worth including any fees in your calculations.

Financial planners such as Dan Bortolotti of PWL Capital like to run people through this math to see which investment is best.

First, figure out the weighted MER for each fund in your portfolio by multiplying the MER by the percentage of your portfolio it takes up. Adding those up gives you your portfolio's total MER. Apply that percentage to the total value of your portfolio. Say you've got $50,000 in index mutual funds. If your total MER is 0.40 per cent, that's $200 in management fees for a year.

Let's say the same-size portfolio was made up of ETFs with a total MER of 0.35 per cent. That's $175 a year. But if you made any trades to rebalance that portfolio – let's say 10 trades at $5 per sell – those add to your costs.

Suddenly you're at $225 annually, and the more trades you make, the more it will add up.

Josh O'Kane

REITS

The case for and against real estate ETFs

REIT owners might not reap strong gains, but these investments can be valuable as diversifiers in a portfolio

GUY DIXON

Real-estate investment trusts are popular among investors, which, depending on how you look at it, could be a reason to buy, or a reason to stay away.

"Buying anything that is popular is generally the worst thing you can do, whether you do it through an ETF or some other vehicle," argued senior financial adviser Chris Horan at Assante Wealth Management in Toronto. The time to reap strong gains was a couple of decades ago, he added.

The opposite view is that REIT ETFs are a way to add diversity to an investment portfolio by having extra exposure to real estate, primarily the commercial real-estate industry. REITs can be volatile, however, as seen last year.

REIT ETFs are easily tradable portfolios of REITs. Market watchers generally point to the iShares S&P/TSX Capped REIT Index ETF (XRE), introduced in 2002, as the bellwether among Canadian REIT ETFs.

The fund is large, with about $1.2-billion in assets, and its weighted holdings include heavy investment in the large Riocan REIT, for instance.

A popular competitor, representing a different investment strategy, is the BMO Equal Weight REITs Index ETF (ZRE), launched in 2010. It has equally weighted holdings, as its name stipulates. So while XRE will be pulled this way or that by the larger REITs and larger market movements, ZRE has more of a mid- to small-cap flavour, swaying in value due to more localized, sector-specific conditions, explained Daniel Straus, ETF analyst at National Bank Financial in Toronto.

The market for REIT ETFs isn't a new one, and interest among investors is steady, he added. "I think that the demand for REIT investments in a kind of one-ticket, easily accessible product – which is what ETFs offer – has been there for a long time."

This development in Toronto is part of the Riocan REIT, which in turn makes up part of the iShares S&P/TSX Capped REIT Index ETF, which is a bellwether among Canadian REIT ETFs. JENNIFER ROBERTS FOR THE GLOBE AND MAIL

Still, REITs can be affected by larger market conditions. "We're of two minds when it comes to REIT investing," Mr. Straus said. "At National Bank, we have an asset allocation strategy team and an economics team, that encourages investors to have – in addition to their bond and equity holdings – a small weight in what we call alternative investments." This can include exposure to real estate, thereby adding diversity.

However, the larger REITs are already part of the S&P/TSX composite index, so mainstream Canadian equity ETFs will already have some REITs in them, he said. "So you don't really need to branch out of those ETFs in order to be assured that you have some REIT exposure, if you see them as an essential building block of a portfolio."

Another factor to consider is that REITs can be doubly affected by interest rates. The dividends they pay are less enticing when interest rates go up. At the same time, REITs borrow to finance their operations, and so REITs tend to do worse in a rising interest-rate environment. However, a regional focus or the unique characteristics of some REITs can help shelter them from moving purely in tandem with rates, Mr. Straus said. "So, we find that they can be useful as diversifiers, and we do use them for that purpose," he said.

Ultimately, it pays to look under the hood to see what assets the REITs hold.

"Commercial real estate is, from an investment point of view, a bond within a box. And bonds are as overpriced as they've been in my lifetime. So you're buying an overpriced asset that's sitting on a piece of dirt," said Mr. Horan at Assante. By comparing REITs with bonds, he's talking about the cash flow from rental income.

"Lots of REITs have been around for a long time. Some of them are well run, and some of them aren't," he said.

"But the whole ETF fashion … facilitates trading," he noted, adding, "very, very few people make money trading this stuff."

This shouldn't completely discourage longer-term investors, even though the already strong real-estate market may not see the returns it once did.

"A REIT is a fine vehicle, because real estate should be a buy-and-hold thing. And REITs' costs are generally not too far out of line," Mr. Horan said. "It's more the underlying asset that you're buying, rather than the vehicle that you're buying it in."

This is similar to Mr. Straus' view at National Bank, who said that real estate is perhaps best seen as a buy-and-hold investment, not as a quick trading vehicle, which some perceive ETFs as being.

"If there a correction in the real estate market, we do believe that still, in the very long term, these do make sense as small allocations in a buy-and-hold context," Mr. Straus said.

OUTLOOK ON REITS

Tempered optimism – that's how analysts describe their outlook for Canadian REITs after a strong first half of the year. Here's why:

Low interest rates

A continued low-interest-rate environment keeps REITs looking attractive. The yield spread between the S&P/TSX Capped REIT Index may undulate with both the 10-year government bond and BBB-rated corporate bonds, but they're still well above their long-term averages, according to Desjardin Capital Markets.

Steady performance

The majority of REITs continue to show stability and meet analysts' expectations, despite a moderate outlook for earnings growth. RBC Capital Markets noted that about 70 per cent of REITs hit expectations, with only a few missing – and conversely beating – forecasts.

Guy Dixon

EXCHANGE-TRADED FUNDS

PORTFOLIO MIX

Low fees, fixed-income options good for retirement

Innovation in exchange-traded fund products gives investors more options for preserving and building wealth for later years

PAUL ATTFIELD

The popularity of exchange-traded funds has never been higher. The industry just passed the $100-billion mark in assets in Canada, and a recent poll conducted by the Journal of Financial Planning and the Financial Planning Association Research and Practice Institute indicated that ETFs were the most popular retirement product among advisers.

Eighty-three per cent of 283 advisers said they currently use or recommend ETFs to clients, while 80 per cent of advisers said the same about mutual funds.

Moreover, 46 per cent said they plan to recommend ETFs more frequently over the next 12 months, compared to stocks and mutual funds, which came in at 23 and 21 per cent, respectively. (The percentages do not add up to 100 as advisers may recommend different products simultaneously.)

"One thing to think about is that the institutions that are generally hired to manage your pensions or retirement portfolios are making extensive use of ETFs, so individuals should also definitely consider them in their portfolios," says Kevin Gopaul, senior vice-president and chief investment officer, global structured investment, for BMO Global Asset Management in Toronto.

Mr. Gopaul talks of the investment considerations facing people planning for retirement in the current climate, such as low expected returns, low yields and increased volatility. Innovation in fund products means that there are now more tools to build specific exposures in a portfolio to help people plan for retirement, he says.

If investors are looking at fixed-income exposure, when it comes to diversifying their portfolio he recommends that they consider buying emerging market debts to do so.

"Fixed income is still going to be a very large portion of retirement planning, but maybe diversification of fixed income can help increase the yields and increase the diversification of the portfolio," he says.

For instance, given our longer life expectancies, and the resultant higher health-care costs, Mr. Gopaul says some clients are hedging themselves by buying health-care-focused ETFs, such as BMO's Equal Weight US Health Care Hedged to CAD ETF (ZUH).

"Individuals say, 'Well, if I'm going to face higher costs, those companies are going to earn more money and I'm going to try and get more money from my investment,'" he says.

According to Atul Tiwari, the Toronto-based managing director and head of Vanguard Investments Canada Inc., the number one reason to include ETFs in a retirement portfolio is simply lower fees.

Many studies suggest that nothing is a better predictor of future performance than cost, he adds.

"Every year those additional costs eat away at your returns and that compounds over a lifetime, so when you get to retirement, if you've created a portfolio with low-cost instruments, you're going to have more money in your pocket at the end of it all," he says.

Mr. Tiwari also says that when it comes to long-term planning, such as for retirement, indexed investing will always do better than active investing because over the long haul, no person can make decisions that are consistently going to beat the market. "There's definitely an advantage to sticking to low-cost indexed ETFs over the long term."

Planning for retirement is rarely easy, and worrying about financial security does not make it any easier.

Pat Chiefalo, managing director and head of iShares Canadian Product at BlackRock in Toronto, says that people on their way into retirement still have a need for equity-like returns to build their portfolio, but that is countered with a desire to reduce risk.

For that purpose, Mr. Chiefalo recommends looking into low-volatility ETFs.

He adds that over a market cycle these products have performed well for investors, but over a short one-, two-, or three-month period when the market cranks higher, they do not keep pace as well.

"What they are really aimed to do is over a full market cycle deliver you very strong equity returns and at the same time make the risk profile of that exposure much more modest and much more palatable to investors more sensitive to risk," he says.

For investors either in retirement or approaching it, Mr. Chiefalo says fixed income is an important asset class to consider for a couple of reasons. One is that it helps reduce the overall risk of the portfolio, providing balance when equity markets become a little more volatile. Second, it can provide some income.

Mr. Chiefalo says that an ETF is one of the best vehicles to gain exposure to fixed income.

"What you get is a very broad, diversified basket of fixed-income securities, as opposed to buying individual bonds yourself, which can be extremely costly and time consuming and it's really hard to get the diversity you can get in a broad, liquid ETF."

Fixed income ETFs help reduce the overall risk of a portfolio and provide balance when equity markets become volatile, says Pat Chiefalo of BlackRock Inc. CHRIS YOUNG FOR THE GLOBE AND MAIL