SELF-DIRECTED INVESTING

LOW FEES

What's better: index or exchange-traded funds?

Though both hold a variety of securities, investors should be aware of key differences between the two

DAVID ISRAELSON

If you are an investor looking for lower-fee funds, you have likely come across advice to invest in ETFs or index funds. But which is better – an index mutual fund or an exchange-traded fund?

The choice will vary. But before anything, investors need to consider their individual situations, and to understand the similarities between the two types of funds – and the differences.

"The main take-away is, 'It depends.' In fact, some investors may prefer to hold both in their portfolio," says Justin Bender, portfolio manager with PWL Capital Inc. in Toronto.

While they share many characteristics, they are not the same. An index fund is a mutual fund that tracks the performance of an index, say, the S&P 500; an ETF can also track an index, but unlike a mutual fund, you can buy and sell an ETF just like stock.

"Index funds in general benefit more from lower volatility in rising markets than in the choppy markets we've been seeing of late," says Markus Muhs, investment adviser with Canaccord Genuity Wealth Management in Edmonton.

Since last year and continuing so far through 2016, markets have been particularly turbulent, buffeted by slowing growth in China and low oil and commodity prices.

The difference between how index funds and ETFs respond to volatility has to do with the way different funds are managed, Mr. Muhs explains.

Index funds are passively managed, rather than having a manager pick securities. Though early ETFs in the nineties were more passive, simply tracking the index, some ETFs are now actively managed.

Active management makes more of a difference in volatile markets, Mr. Muhs says.

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Markus Muhs, investment adviser with Canaccord Genuity Wealth Management in Edmonton: 'Index funds in general benefit more from lower volatility.' JASON FRANSON FOR THE GLOBE AND MAIL

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>
> **George Christison**
> *founder, IFM Planning Services*

benefit all stocks – in other words, even badly run companies go up in value, so the stock pickers out there putting all that effort into analyzing stocks and trying to find the gems see less alpha in return for their efforts," he says.

"When markets get choppy, though [as they are now], good stock pickers can find the gems more easily. So all else being equal, low volatility benefits passive investing while high volatility benefits [actively] managed funds."

Investors seeking to choose between index funds and ETFs need to look closely at the particular funds, says George Christison, a British Columbia-based retirement and investment planner and founder of IFM Planning Services.

"Investors should understand how changes are made to the index or investment. They also should ask: 'Has the fund gone through a complete investment cycle, a bull and bear market?' " he says.

Mr. Christison worries that too many investors are "absolutely blind" when it comes to looking at all kinds of indexed investments.

"They don't look past the investment's marketing material or sales pitch. Initially these products were created to mimic established indices that had a long established and observable history and a rigid set of management rules."

Mr. Christison says this has changed as ETFs developed specialized indexes – for example, ones that track a particular sector and are more actively managed than the traditional passive funds.

"Over the past few years, instead of creating an investment product that tracks an established index, investment companies commonly design and create an index first and then create the product they want to market to investors. The horse now pushes the cart," he says.

This doesn't necessarily mean that investors should shy away from one type of fund over the other. It simply means that they should understand the investment they are considering, says Neville Joanes, portfolio manager and chief compliance officer at WealthBar Financial Services Inc., a Vancouver-based robo-adviser.

"Historically ETFs were index tracking and developed a reputation as low-cost products. Today there are over 400 ETFs in Canada from many providers. These encompass both passive index tracking as well as active management," he says.

The size of an investor's account can also make a difference in which type of fund to invest, says Kurt Rosentreter, senior financial adviser for Manulife Securities Inc. in Toronto.

"It is an issue when you want to trade regularly. The cost of purchases and selling for ETFs, the same as stocks, can add up," he says.

This can be significant for do-it-yourself traders who seek to adjust their portfolios often. For investors who pay their advisers for each trade the adviser makes, it can also be an issue.

For those investors, Mr. Rosentreter says, "we will still do trades in smaller accounts but try to accumulate the money to do fewer trades. It is more a case of the number of trades than the size of trades."

Mr. Joanes says he looks at a number of factors when considering whether to recommend an index fund or an ETF.

"We look at total cost – the MER [management expense ratio], TER [total expense ratio, total costs of the fund divided by its total assets]," he says. He also considers "if the ETF is trading at a premium or a discount and the bid/ask spread. We then compare this to the total cost of [a comparable] mutual fund."

Mr. Joanes adds that investors with smaller amounts to invest might consider mutual funds because it is easy to get on board with as little as $500.

For ETFs, the starting amount depends on the number of ETFs the investor holds. An investor with seven or more will probably need to start with $5,000, he suggests.

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