



The ETF evolution

New boutique funds let you dabble in gold, real estate and alternative indexes

niche ETFs read on, and we'll fill you in on what this next generation of ETFs offers and how you can use them in your portfolio.

What's your weight?

The earliest ETFs followed well-known benchmarks, such as the S&P 500 in the U.S. and the S&P/TSX 60 in Canada. These major market indexes include only the largest and most frequently traded companies, and each company's weight in the index is based on its market capitalization. (The "market cap" is found by multiplying a corporation's stock price by the number of shares outstanding.) Most of today's ETFs ►

When exchange-traded funds were first introduced more than a decade ago, they were designed to simply track the major stock indexes. Fast-forward 10 years and the ETF landscape is decidedly different. These days investors are no longer confined to using

broad-market index funds. Now you can employ a variety of short- and long-term strategies using a huge array of ETFs covering everything from plain vanilla index trackers to specialized niche funds.

While all of these new ETFs can make the investment process seem overwhelming, they also offer investors the ability to fully customize their portfolios. To find out how you can harness the power of specialty and

Illustration by Peter Ryan

EXCHANGE-TRADED NOTES (ETNs)

The popularity of exchange-traded funds has recently prompted the introduction of a whole new exchange-traded investment product: the ETN

1. What is an ETN?

ETNs are not investment funds, but rather debt obligations issued by a bank. Like ETFs, they are bought and sold on an exchange. But instead of holding a basket of physical assets such as stocks or bonds, an ETN is simply a note that promises to pay investors a return based on the performance of a specific index or other benchmark.



2. The ETN advantage

There are four main advantages to using ETNs:

- **Tax efficiency:** Since ETNs make no interest or dividend distributions, investors can defer paying tax on any gains until they sell the note
- **No tracking errors:** Tracking an index is not as easy as it sounds, and most ETFs fall short of their benchmarks. However, the issuers of exchange-traded notes are obligated to deliver the total return of their indexes, minus only their fee, which is known to investors in advance.
- **Liquidity:** Since ETNs are bought and sold on exchanges they are much more liquid than other structured investments. Investors can also track the performance of their ETN easily.
- **Access to specialized markets and strategies:** ETNs provide retail investors with access to hard-to-reach market segments, such as commodities. Many also use leverage to increase exposure to their underlying indexes.



3. ETN risks

ETNs are subject to what is called counterparty risk—there is a possibility that the bank issuing the note will not honour the debt. “It sounds unlikely, but let’s not forget that before its collapse Lehman Brothers had issued ETNs in Europe,” says Richard Ferri, author of *The ETF Book*. Another consideration is the relatively high cost—often close to 1%.



still follow these “cap-weighted” indexes.

“Cap-weighted ETFs are the easiest and cheapest to manage,” says Dan Bortolotti, author of *The MoneySense Guide to the Perfect Portfolio*. “Unless a company is added or deleted from the index, the fund doesn’t need to make any changes to the portfolio. That low turnover also makes them extremely tax-efficient.”

However, there is one problem with cap-weighted indexes: they may become dominated by a small number of very large companies. For example, a popular cap-weighted ETF that tracks the Canadian financial sector includes 26 stocks, but it is dominated by just three names: Royal Bank, TD and Scotiabank account for more than half of the index.

The concern with cap-weighted funds is that a few individual stocks could become dramatically overvalued and leave the index vulnerable to a bubble. “One only has to look at Nortel to understand the potential

dangers,” says Mark Yamada, president and CEO of PÜR Investing, a firm that specializes in constructing ETF portfolios. Nortel alone made up more than one third of the S&P/TSX Composite Index in mid-2000. During the dot-com craze of the 1990s, stock prices for technology companies soared and the tech sector went from 5% of the S&P 500 to almost 30%. Then the bubble burst and cap-weighted funds plummeted.

“For that reason, many cap-weighted indexes now impose a limit on the weight any individual company can carry,” explains Yamada. This cap is usually 10% for broad-market indexes and 25% for sector ETFs.

A fundamental solution

In part to address some of the drawbacks of cap-weighted indexes, a number of alternative index structures have since sprung up. Among the most popular are equal and fundamentally weighted indexes.

HOW RISKY ARE *derivatives*?

A growing number of ETFs use derivatives to get exposure to the stock, bond or commodity markets, rather than holding those assets directly. For example, some ETFs use a derivative called a swap, which tracks an index indirectly, but perfectly and cheaply. "Not having to buy and sell the underlying asset makes them far more tax-efficient," says Mark Yamada of PÜR Investing. All the gains are tax-deferred until you sell the ETF. However, there is a small risk the counterparty will default. Commodity ETFs may use futures contracts when holding the asset directly is impractical. Yamada says these ETFs are not nearly as tax-efficient, and they may have significant fees and transaction costs.

Equal weighted indexes assign the same weight—or importance—to every stock. This helps avoid the heavy concentration of large companies that can occur in cap-weighted indexes when stock prices rise. The strategy works particularly well in sector ETFs that often hold only a small number of stocks. But this strategy also requires more turnover than cap-weighted funds and, as a result, can mean higher transaction costs.

Another alternative is the fundamentally weighted index, which breaks the link between a company's stock price and its weight in the fund. Rather than relying on market capitalization, fundamentally weighted indexes assign proportions based on a company's fundamentals, such as its dividend payout, free cash flow, book value and total sales. Fundamental indexes (which go by the trade name RAFI, for Research Affiliates Fundamental Index) tend to measure a company's footprint in the economy, rather than its footprint in the stock market.

"These alternative weighting styles can result in higher returns, but these indexes do take on more risk," explains Richard Ferri, author of *The ETF Book* and founder of Portfolio Solutions, a U.S.-based low-cost investment firm. "If you choose to go with an alternative weighting—either fundamental or equal—you're really deciding to put different risks in your portfolio."

For instance, fundamental indexes tend to move money away from growth stocks

and into value stocks. "Buying a fundamentally weighted fund is really a decision to make a play on value investing," says Ferri. "When you move into value investing, you're taking on a riskier proposition." That's because value stocks are usually made up of companies in struggling industries or sectors that have lower growth rates. "This equates to more risk, and more risk should mean a better return, all things being equal."

Equal weighted indexes, on the other hand, give less influence to large-cap companies and more to small and mid-sized companies. "We know that small and mid-cap companies carry more risk, as these are the companies with fewer products, and they aren't as globally diversified," says Ferri. For that reason, equal weighted funds should also offer potentially higher long-term returns. "If you don't understand these additional risks you may end up making the wrong move at the wrong time, and that usually means losing money," says Ferri.

You should also realize that in general, fees tend to be a bit higher for equal and fundamentally weighted indexes. "Cap-weighted funds almost always have the lowest fees and the least turnover," explains Yamada. In addition, while cap-weighted ETFs usually come close to matching the returns of their benchmarks, alternative indexes are harder to track, and the ETFs may not always deliver what they promise.

This doesn't mean you shouldn't consider equal or fundamentally weighted indexes, however. After all, they do offer potentially higher returns. You just need to understand what it is that you're buying, so you're prepared for how they respond to different market conditions.

A new breed of ETFs

One reason for the explosion of exchange-traded funds in recent years is that there is only space for so many broad-market products. Most of the growth in the marketplace in ►

WATCH *your costs*

Not all ETFs have low fees any more. Before 2005, the average ETF expense ratio was 0.40%. Since then the average MER has jumped to 0.60%, with some new funds charging more than 1%. Since you also pay commissions and bid-ask spreads, it's especially important that you minimize costs.

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THE ETF ADVANTAGE: PART IV

LEVERAGED AND inverse etfs

Leveraged ETFs magnify gains in the indexes they track, in the same way that buying a stock on margin can amplify a surge in price. But they also increase losses.

If you invest in a leveraged ETF that rises or falls at double the rate of its underlying index, and that index rises by 1% on a given day, then your fund will rise by 2%. If the index falls 1%, your fund will drop by 2%. But watch out: because of the way they behave, if the index drops by 2%, then rises by 2%, you'll end up with less than you started.

Inverse ETFs move in the opposite direction of the markets so you can profit when an index goes down. "These are not buy-and-hold funds," says Yamada. They are usually best left to professional investors.

the last few years has been in specialty or sector funds that fill in the gaps.

Some specialty ETFs passively track a benchmark, but they use embedded strategies that select stocks with certain characteristics, such as high dividend yields. Others follow investments other than stocks. There are ETFs that follow all of the major currency indexes, as well as ETFs following the price of commodities such as oil, natural gas, gold, silver, wheat, sugar and corn.

Sector ETFs, on the other hand, focus on a single economic sector, such as real estate, energy, health care or financials—or even a sub-sector such as the Canadian oil sands. They have fewer holdings and thus may be more volatile than the overall market. Investors may choose specialty or sector ETFs when they believe a particular strategy or industry will perform better than the overall market over a period of time. These ETFs let you use an active strategy or make a sector play while spreading your money over the whole sector you're betting on.

Both specialty and sector ETFs are typically more expensive than broad-based funds. But for investors with larger portfolios—say \$300,000 and up—they can be a great way to add more diversification, or to attempt to gain an advantage in the market. "One reason to introduce sector ETFs into your portfolio is because you're underrepresented in a particular sector," says Yamada.

For instance, technology and health-care companies are all but absent from Canada. Add a U.S. or global sector ETF and you'll increase your portfolio's exposure to these important industries. "Remember, you can get as sophisticated as you want," says Yamada, "but you have to assess your level of comfort, and you need to understand the product: both the risks it adds and how it impacts your portfolio."

ETFs that act like mutual funds

A fairly recent innovation in the exchange-traded fund marketplace is the introduction of ETFs that have fund managers who actively pick stocks. In the mutual fund world, this kind of active management is the norm, but it's still unusual in the ETF space. Of the \$40 billion invested in Canadian ETFs, only about \$1 billion is in actively managed ETFs.

A drawback to active ETFs is their higher costs. One of the primary reasons traditional ETFs gained popularity was their low expense ratios, but many active ETFs charge fees that are just as high as mutual funds.

Still, there is one type of active ETF that has become extremely popular with investors: funds that use covered call strategies. These ETFs buy a portfolio of stocks and then sell call options to generate additional income. (A call option gives the buyer the right to buy a stock at a specified price at any time before the expiration date.) The management fees for these funds are often quite low (0.65% or so), but there will be transaction costs that eat into your returns. | M

Want to learn more about ETFs? Look for the first three parts of our ETF Advantage series at: moneysense.ca/etfadvantage

WHERE TO FIND more information

TMX Money

http://www.tmxmoney.com/en/sector_profiles/exchange_traded_funds/index.html

Morningstar

<http://www.morningstar.com/Cover/ETFs.aspx>

U.S. Securities and Exchange Commission

<http://www.sec.gov/answers/etf.htm>

Bloomberg

<http://www.bloomberg.com/markets/etfs/>