Imagine an investment that provides many of the advantages of mutual funds—but it’s easier to buy and sell, and it has lower fees too. If that sounds good, then it’s time to meet one of the hottest investment products out there: the exchange-traded fund, or ETF. Since the first one hit the market 20 years ago, these nimble investment funds have taken investors by storm. In late 2010, ETF assets reached $1 trillion (U.S.) and there are more than 915 different ETFs to choose from in North America.

**Easy trader**

If you’ve ever invested in mutual funds, you’re well aware of their advantages. Rather than dealing with a broker or choosing stocks to invest in on your own, you can buy one mutual fund and let a professional money manager put together a diversified portfolio of stocks or bonds for you.

But while mutual funds can be a great way to start investing, they also have some drawbacks. Buying or selling a mutual fund can take several days. The fees can be high, and while fund managers can add value, they don’t always make good stock picks.

ETFs offer a quicker way to buy and sell funds. When you buy an ETF, as with a
mutual fund, you get an instant portfolio of dozens, even hundreds, of stocks or bonds. But instead of buying the fund through an adviser and waiting several days for the transaction to take place, you can buy an ETF instantly on the market, just like a stock—they even have ticker symbols. Traditional ETFs also differ from mutual funds in that their managers do not choose the individual stocks or bonds in an attempt to beat the market. Instead, they follow indexes, usually created by third parties, that are designed to give investors the returns of overall markets. This means you can’t underperform a market by much, and it helps keep the cost of ETFs low.

Evolution of a market marvel
The world’s first successful ETFs were launched by the Toronto Stock Exchange back in 1990. Originally called Toronto Index Participation Shares, they tracked the TSE 35 index (and later the TSE 100). The success of the participation shares prompted two executives from the American Stock Exchange, Nathan Most and Steven Bloom, to develop a similar investment product for the American market called Standard & Poor’s Depositary Receipts, or SPDRs (pronounced “spiders”) for short. This ETF,

WHAT IS an index?
You know when they refer to the S&P 500 on the news? That’s an index. In short, an index is a selection of stocks or bonds that represents a given market. Each index has rules about how many securities are included and how they are weighted. Indexes are mainly used to measure changes in the market they represent.
which still trades with the ticker symbol SPY, tracks the S&P 500 index of large U.S. companies.

Both the Canadian and American ETF products were created to allow investors to easily get the same return as the indexes they tracked. For instance, if an investor bought the SPY ETF, she would get the same performance (before fees) as she would get if she took her money and split it up among each of the 500 stocks that make up the S&P 500 index (as long as she weighted her investments the same as the index does). The aim was to create a simple investment that could easily give you performance similar to that of an entire market.

Low, low fees

With a mutual fund, you have to pay your fund manager to choose the individual stocks that go in your fund. But ETFs don’t have fund managers because they automatically include the same stocks with the same weighting as their underlying index. Because ETF providers don’t have to do stock-picking research and analysis, the fees for ETFs tend to be lower. For instance, the annual fee for the ETF that follows the main index in Canada (the S&P/TSX Composite Index), is about one quarter of one percent. Typical equity mutual fund fees, on the other hand, tend to fall somewhere between 2% and 3%

“Mutual funds have to issue quarterly statements, annual prospectus reports and issue proxies and circulars,” explains Richard Ferri, CEO of Portfolio Solutions, and author of The ETF Book. “On top of that, they need to educate brokers and keep their administrative side up to date and all this takes money. ETFs, on the other hand, are more cost-effective. That’s translated into lower management fees.”

How do you buy ETFs?

That’s not to say there are no fees at all with ETFs, of course. In addition to paying a fee to cover operating expenses (known as the management expense ratio or MER), whenever you buy or sell an ETF, you have to pay a commission, just like you do when you buy or sell an individual stock.

The most cost-efficient way to buy and sell ETFs is through a discount brokerage. These allow you to set up online accounts where you can buy and sell stocks, bonds, mutual funds and ETFs yourself without having a broker do it for you. There is no one to provide advice on what to buy or sell, but the trading fees are much lower. All the big banks have discount brokerage arms, and there are a few independents too (see “How to open a discount brokerage account,” above left). The cost of buying and selling ETFs is typically between $5 and $29 a trade, depending on your brokerage, the amount of money you have in your account, and

The ETF universe

Most ETFs follow equity indexes, but fixed income, asset allocation and alternative ETFs, some of which include active management, are growing fast.

THE ETF universe

<table>
<thead>
<tr>
<th>Amount</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>$8,179,099</td>
<td>22%</td>
</tr>
<tr>
<td>$292,306</td>
<td>1%</td>
</tr>
<tr>
<td>$3,148,345</td>
<td>9%</td>
</tr>
<tr>
<td>$25,205,855</td>
<td>68%</td>
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</tbody>
</table>

Source: Morningstar
**THE ETF ADVANTAGE**

### HOW DO ETFs compare TO MUTUAL FUNDS AND STOCKS?

<table>
<thead>
<tr>
<th></th>
<th>ETFs</th>
<th>MUTUAL FUNDS</th>
<th>STOCKS</th>
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<tbody>
<tr>
<td><strong>Diversification</strong></td>
<td>Usually offer instant diversification</td>
<td>Usually offer instant diversification</td>
<td>You must diversify manually</td>
</tr>
<tr>
<td><strong>Fees</strong></td>
<td>The fees on ETFs are low. The average management fee (or MER) is just 0.40%</td>
<td>The fees on mutual funds are higher. The average MER on a Canadian equity fund is 2.56%</td>
<td>There is no management fee. As with ETFs, however, there is usually a commission of $5 to $29 per trade</td>
</tr>
<tr>
<td><strong>Transparency</strong></td>
<td>High (for broad-market index ETFs). The individual holdings are reported daily</td>
<td>Lower. Many mutual funds report holdings quarterly or semi-annually</td>
<td>Highest. You always know what you’re holding</td>
</tr>
<tr>
<td><strong>Flexibility</strong></td>
<td>High. ETFs can be used for almost any investing strategy, from buy-and-hold to day trading</td>
<td>Lower. Mutual funds are generally only suited for buy-and-hold strategies. Unit values are set just once a day</td>
<td>High. Stocks can be used for almost any investing strategy, from buy-and-hold to day trading</td>
</tr>
<tr>
<td><strong>Tax-efficiency</strong></td>
<td>High. ETFs tend to have lower turnover and their special structure reduces taxable capital gains</td>
<td>Lower. Frequent trading of securities and investor redemptions can trigger capital gains</td>
<td>Varies. Depends on your investing strategy and what type of account your stocks are held in</td>
</tr>
</tbody>
</table>

### THE **top 3 ETF RISKS**

Exchange-traded funds (ETFs) carry risks, just like any investment. Before buying ETFs, keep in mind:

- There’s no guarantee that you’ll make money with an ETF, as no one can predict how a market or sector will perform in the future.
- ETFs that track narrow sectors (such as oil or gold), or use complex strategies (such as leveraging) are more volatile than traditional index ETFs. This volatility increases your risk of suffering losses.
- ETF costs can be high when using dollar-cost averaging strategies (automatically investing small amounts on a scheduled basis) to build your portfolio. Your trading commissions can eat away at your total return.

How frequently you trade.

After you buy, your ETFs rise and fall in value along with the index they follow. You make money if you sell your ETF for more than you bought it for, and you lose money if you have to sell it for less. Some ETFs pay you regular dividend income as well.

**Tax-efficient, too**

The final reason many investors like ETFs is because they are tax-efficient. Whenever a fund sells stocks or bonds at a profit, it generates capital gains, and these gains usually mean a higher tax bill for investors. ETFs tend to have a lower turnover than mutual funds, because they hold on to their stocks for as long as the companies remain in the index. They also use an innovative structure that allows them to avoid having to sell the underlying securities whenever investors redeem units in the ETF. “This makes the ETF basket much more tax-efficient than a mutual fund,” says Ferri. In fact, many ETFs have managed to entirely avoid passing on taxable capital gains to their investors.

Today there are hundreds of ETFs following every imaginable sector in the stock and bond markets. There are ETFs following commodities, precious metals and currencies. ETFs now follow different types of index structures, some have leverage built in, and some don’t even directly buy the stocks they follow. In May, look for the next booklet in our four-part series on ETFs, where we’ll take a closer look at how to trade ETFs effectively.

### THE benefits OF ETFs

- Quick and cost-effective diversification
- Easily bought and sold, like stocks
- Usually simple and transparent
- Tax-efficient

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