Illustration by Peter Ryan

How to use ETFs

Three strategies to help you get more out of your exchange-traded funds

Investors around the globe currently have more than $1 trillion invested in exchange-traded funds, thanks to their low fees, instant diversification and versatility. In Part I of this series we wrote about what ETFs are and how they work, and in Part II we wrote about how they trade on the exchanges (you can find both parts at MoneySense.ca/etfadvantage). Now it's time to address perhaps an even more important topic: How do you use ETFs?

It's important to understand that ETFs are an investment product. They are not a strategy in and of themselves. As with stocks and mutual funds, depending on how you use them, they can be low risk or high risk. You can use them for short-term gambles, or to build a conservative nest egg that will last you a lifetime. It all depends on your investing style, your goals and your personality. Read on and we'll walk you through three investing strategies, including the benefits and risks involved in each. We'll also help you use ETFs to build a portfolio that suits your own unique needs and objectives.

Strategic asset allocation

The majority of individual ETF investors use a passive investment strategy known as strategic asset allocation. This involves selecting a consistent mix of stocks and bonds suited to your goals and risk tolerance. The investor then uses index ETFs to build his or her portfolio accordingly. The key is that ➤

WHAT TO LOOK FOR *when buying an ETF*

Management expense ratio
An ETF's management expense ratio (MER) includes the fee paid to the fund's manager, as well as taxes and other costs. To maximize your returns, look for ETFs with MERs that are less than 0.7%. "While you can't control returns, you can control costs," explains Mark Yamada, president and CEO of PUR Investing. Keep your MERs low and you'll keep more of your fund's returns year after year.

Trading commissions
Every time you buy or sell an ETF you'll pay a trading commission to your broker. These transaction costs can be relatively small at discount brokerages, starting as low as $5 per trade, but can climb to well over $100 at full-service brokerages.

Tracking error
The tracking error is the difference between the performance of an ETF and that of its benchmark. Consider it the cost of buying a particular ETF in relation to its index. Look for ETFs with the smallest possible tracking error.

Tax efficiency
If you're investing outside of your RRSP (or other tax-sheltered account), you'll need to pay attention to your ETF's tax efficiency. Funds that have a lot of turnover (buying and selling of securities) are likely to result in a higher tax bill at the end of the year.

Diversification
Just because an ETF is well diversified doesn't mean it will help diversify your portfolio. Examine whether your ETF holdings overlap in their exposure to different industries or sectors. The more overlap, the less diversification.

Liquidity
Some ETFs have wide spreads between their buy and sell prices. This can happen when the ETF is very thinly traded, or when the fund's underlying holdings are not very liquid (such as small-cap stocks). Look for ETFs with tight bid-ask spreads to reduce your costs.

Illustration by Peter Ryan

the target allocation stays the same regardless of market conditions. So if you decide that your ideal portfolio consists of 60% stocks and 40% bonds, you would keep rebalancing your portfolio back to that original split, no matter what the market does.

The underlying belief is that it's extremely difficult to beat the market on a long-term basis by trying to forecast which market sectors will perform best. Passive ETF strategies like this are suitable for investors looking to take advantage of lower costs and greater tax efficiency, as well as those who believe that tinkering with a portfolio based on market trends can do more harm than good.

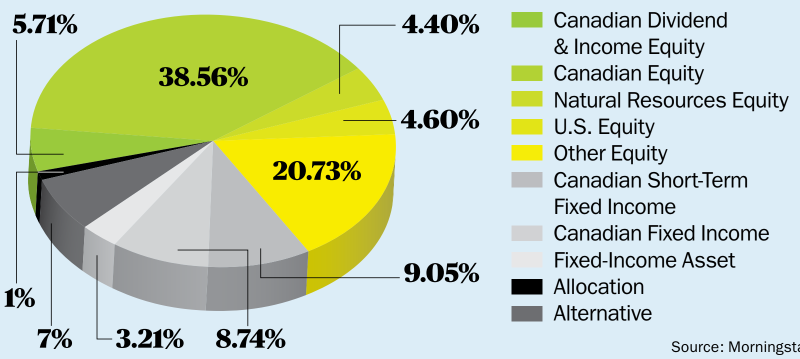
Critics counter that this strategy is problematic because it can only achieve market averages, with no opportunity for superior returns. "And the critics are correct," says Richard Ferri, author of *The ETF Book* and *The Power of Passive Investing*. "Passive portfolios will never beat the markets." But Ferri quickly points out that the vast majority of active strategies tend to underperform the markets too—often by significantly more.

If you're a low-maintenance, buy-and-hold investor who wants a portfolio of well-diversified holdings designed to capture market returns while keeping costs to a minimum, and you have little desire to tinker, then a strategic asset allocation strategy using ETFs may be perfect for you.

A key benefit is that passive investing is remarkably straightforward. "Long-term investors should start with a plain-vanilla portfolio using a passive approach," suggests Preet Bannerjee, a financial writer and former financial adviser. For instance, you might invest in just four ETFs: one that follows the Canadian bond market, one that follows Canadian stocks, one that follows American stocks, and one that follows stock markets in developed countries around the world. In "The perfect core" on

THE ETF *universe*

There are more than 200 ETFs available to investors through Canadian market exchanges. More than one third of invested capital is in Canadian Equity ETFs



Source: Morningstar

page 4, we'll tell you more about how to build such a portfolio.

Tactical asset allocation

But what if you're the type of person who religiously reads the business section looking for investment opportunities? If that describes you, then a tactical asset allocation approach may be a good fit. As with strategic asset allocation, you start with an asset mix that makes sense for your investment goals and time horizon. But with this strategy, you can actively pursue market sectors or asset classes that you believe will provide superior returns to the overall market when you see opportunities.

For example, if you think the price of gold will rise, you could temporarily overweight an ETF that follows the price of gold. If you think Brazil's economy is about to take off, you could invest in an ETF that follows the market in Brazil. You could also actively overweight or underweight bonds, or real estate, or the pharmaceutical sector. Some ETFs even allow you to short the market so you profit if it drops.

While active strategies using ETFs and stocks are similar, there is one major difference: the instant diversification inherent with ETFs. When you invest in an oil ETF, for example, you can invest in the overall oil market, rather than a particular oil company.

Proponents of active strategies believe the biggest benefit to this strategy is that there is at least the potential ability to outperform the broad market indexes. Mark Yamada, president and CEO of PR Investing, a firm that specializes in constructing ETF portfolios, agrees, adding that tweaking a portfolio's asset mix can also help to mitigate potential losses. "For instance, it would have saved your bacon in 2008 and early 2009," he says.

Still, investors should remember that active investing is always more expensive. It requires much more research, and you may have to pay for advice. You'll also incur higher transaction costs. Even if you pursue tactical asset allocation as a do-it-yourselfer, you'll pay more in commissions and trading costs because of the higher turnover in your portfolio. The higher turnover could also mean paying more in taxes, which eats into your returns.

Core and explore

If the thought of always trying to time the market is overwhelming, but the idea of passively waiting for the markets to provide a decent return also leaves you frustrated, there is another option: the "core and explore" strategy. This involves investing the bulk of your portfolio (the "core") using a strategic asset allocation strategy, while pursuing a more active approach with the "explore" portion, which might account for 10% or 20% or your holdings.

One variation of this strategy involves holding broad-market ETFs in the core portion of the portfolio and exploring with niche ETFs that follow specific market sectors, commodities or currencies. For example, you might use your "explore" holdings to make a concentrated bet on one or more of the major market sectors—consumer discretionary, consumer staples, energy, financials, health care, industrials, materials, technology, telecommunications and ➤

FINE-TUNE YOUR *asset allocation*

Asset allocation is a way of making sure all of your eggs aren't in one basket. By spreading your money across different asset classes—such as bonds, stocks, real estate and commodities—you can lower your portfolio's risk and potentially boost your returns over the long term. ETFs make asset allocation much simpler, because they are transparent and offer pure exposure to specific asset classes, so it's easy to build a broadly diversified portfolio. Just remember to verify the strategy, allocation and holdings of every ETF that you plan to purchase.

utilities—depending on market conditions. Let's say you want to take a strong position in the biotech industry. Rather than hand-picking a couple of stocks, you could invest in an ETF that tracks the whole biotech sector—a major advantage considering that 50% of the companies in this industry fail.

Another technique is to build a core that uses passive ETFs in asset classes you believe are highly efficient, such as government bonds and large-cap stocks. Then you use a more active approach to overweight asset classes where you think there's a greater chance of market-beating returns, such as emerging markets or small-cap stocks.

The largest benefit of the core and explore approach is that you get the market-tested benefits of a core passive portfolio along with the potential to add higher returns. But to pursue these superior returns you will have to pay more in trading costs. This means you'll have to achieve better than market returns just to break even. "Explore strategies have to make up their higher expenses before delivering a benefit to your portfolio," says Ferri.

Because of that, introducing an "explore" component only makes sense if your portfolio is large enough, explains Yamada. "If you have a $100,000 portfolio it doesn't make sense, as the transactional costs alone will negate any gain in your returns." He suggests implementing a core and explore approach when your portfolio reaches $300,000 or higher. As your portfolio grows then you can continue to look for additional active investment opportunities.

The perfect core

Whether you choose strategic asset allocation or core and explore, you'll want to know how to create a solid passive portfolio. The first step is to determine what you want out of your investments. Then it's a matter of constructing the portfolio to meet those particular goals. "Not taking this first step is like stepping on an airplane without a destination," says Yamada. "You may be really keen to go on vacation but you have no idea where you're going, you don't know how to get there, and may actually run out of gas. The planning part is the most important part of portfolio construction."

There are five basic strategic allocations you can use to start building your core portfolio, depending on your circumstances: income, conservative, moderate, moderate growth and aggressive. The mix between fixed income and equity will vary within each strategy—pick the one best suited to you.

For example, if you have built up a substantial portfolio and you're getting close to retirement, then you need to take less risk, says Yamada. Choose a conservative or income allocation, with more fixed income and a smaller equity portion. If, however, the portfolio is meant to grow your wealth over the long term, or enhance your retired life, then take a bit more risk with the moderate, moderate growth or aggressive allocations, which are tilted toward equities. Once you know your objectives and your investing time line, you can then pick the ETFs that suit your needs. To get you started, go to MoneySense.ca and search for our Couch Potato portfolio. M

UNDERSTANDING *active and passive* STRATEGIES

An active investment strategy involves selecting individual securities or asset classes and timing their purchase and sale in an effort to beat the market. Assets may not be held long, and transactional costs may be higher.

A passive strategy usually involves investing in entire asset classes (often by tracking an index) without trying to time the market. Passive investors focus on broad diversification and minimizing their investing costs, rather than trying to beat the market.

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