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Understanding exchange traded funds (ETFs)

Investing fundamentals series

Let's begin

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Exchange traded funds (ETFs): a definition

An ETF is a pooled investment vehicle that allows investors to buy and sell units in a single security that represents a fractional ownership of a portfolio of securities. ETFs can be bought and sold on a stock exchange like individual stocks. They can contain a diversified portfolio of securities designed to track specific indices or portfolios. This diversification means financial professionals and investors can use ETFs as another alternative to gain the exposure and diversification they want for their portfolios, quickly and simply.

What is diversification? "Don't put all of your eggs in one basket" is especially good advice when it comes to investing. Each individual stock or bond comes with its own unique risk – and potential reward.

Holding a variety of different investments can help lower the overall risk of your investment portfolio. When some holdings decline in value, others may rise, offsetting the potential loss.

Exchange traded funds have garnered a great deal of attention around the world in recent years. These versatile investment vehicles were first traded in Canada in 1990 and have steadily evolved to include more than 8,600 ETFs globally as of 2021.[1]

Investors are taking greater comfort in knowing they can manage risk and volatility effectively with ETFs, whether it's liquidity management, transition management, strategic asset allocation or tactical allocation. The sheer versatility of ETFs opens the eyes and interests of investors.

How are ETFs different from mutual funds?

Most of the differences between ETFs and mutual funds relate to how investors buy and sell fund units. With mutual funds, units are bought and sold through an investment or mutual fund dealer at a net asset value (NAV) calculated at market close once a day. That ability to trade at the daily NAV may offer sufficient flexibility for many investors.

However, others may want the greater flexibility and transparency offered by ETFs, which are listed on an exchange and can be traded at their market price, at any time during the trading day. With ETFs, you would enter the specific number of securities you want to buy or sell. With mutual funds, you would enter a set dollar amount and your trade would remain pending until the fund's net asset value is calculated at the close of trading.

[1] Statista: Development of assets of global exchange traded funds (ETFs) from 2003 to 2021

How they differ: ETFs vs mutual funds

	ETFs	Mutual Funds
Access	Units bought and sold through a stock exchange.	Units bought and sold directly through the fund company.
Price accuracy	Market price of an ETF is based on the fund's holdings, plus marketplace supply and demand. ETFs may trade at a premium or discount to net asset value (NAV) in periods of volatility.	Reflects net asset value (NAV), based on last traded price of the mutual fund's holdings.
How to buy/sell	Through an advisor or through a self-directed account.	Through an advisor or through a self-directed account.
Trading flexibility	Trades are executed throughout the trading day; large trades can also be executed at end-of-day price (NAV).	Trades are executed at the end-of-day price (NAV).
Management fees	Typically lower fees compared to mutual funds.	Typically higher relative to ETFs
Transaction costs	The ETF buyer or seller bears the trading costs; all other investors are not impacted.	All purchase and sale transactions costs are shared among all unitholders.
Year-end distributions	Capital gains are reinvested (this is common practice in the ETF industry); this results in phantom income distributions.	Capital gains are not reinvested unless an investor requests it.

Cost considerations: ETFs vs mutual funds

	ETFs	Mutual Funds
Management fee	Yes	Yes
Admin fees	No	Yes
Spread cost	Observable, paid by individual investor	Not observable, shared among all investors
TER	Yes/lower for in-kind transfer	Yes
Premium/discount	Yes	No
Trailing fees	No	Yes, for certain series

Even for similar or the same mandates, mutual funds tend to have higher MERs due to admin costs (note: MER = management fee plus admin cost plus HST).

The biggest difference is that for most ETFs the buyer/seller bears the transaction costs, while for mutual funds transaction costs are mutualized (shared) among all investors in the trust.

Certain ETFs, including but not limited to ETF series, also mutualize transaction costs.

Operational considerations: ETFs vs mutual funds

	ETFs	Mutual Funds
Trading	Intraday — market hours	End of day
Price	Certain when entering the trade. Buy at ask, sell at bid. The price fluctuates with the market, which means that investors pay different prices based on the time of the day they traded.	Yes
Investment minimums **Fractional shares**	No No	Yes Yes
Automatic reinvestment/ withdrawals	No	Yes
Secondary market	Yes	No
Year end capital gains	Reinvested — results in phantom income distributions	Capital gains are not reinvested unless an investor asks to do so. This depends on the series as most are reinvested unless the investor turns to cash.
Tax forms	Generated by the dealer or broker	Generated by the fund company

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ETF management styles

Traditional index/beta ETFs

Also known as passive ETFs, these funds track an index, along with the rules that the index follows. Traditional index ETFs allow investors to achieve diversification, as well as access to nearly every investment space, from broad geographic exposure to sectors, sub-sectors and different asset classes.

The availability of these products has brought a degree of democratization to the investing public. A few decades ago, access to these spaces was available only to institutional money managers.

Index ETFs are low cost and offer daily transparency, providing investors with the ability to know exactly what they own, at any given time. Their value also depends on how they are used, which can range from pure building blocks of a portfolio to a more tactical use, such as for rebalancing.

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Strategic beta ETFs

Also referred to as smart beta, these ETFs tweak the indices based on a set of rules, in order to improve performance compared to the traditional index (known as delivering alpha), lower risk or increase diversification at a cost lower than traditional active management or marginally higher than straight index investing.

Strategic beta defines a set of investment strategies that emphasize the use of alternative index construction rules to traditional market capitalization-based indices and emphasizes capturing investment factors or market inefficiencies in a rules-based and transparent way. The increased popularity of strategic beta is linked to a desire for portfolio risk management and diversification along factor dimensions, as well as seeking to enhance risk-adjusted returns above cap-weighted indices.

Smart beta strategies seek to passively follow indices, while also considering alternative weighting schemes such as volatility, liquidity, quality, value, size and momentum. That's because smart beta strategies are implemented like typical index strategies, in that the index rules are set and transparent. These funds don't track standard indices, such as the S&P 500 or the Nasdaq 100 Index, but instead focus on areas of the market that offer an opportunity for exploitation.

Actively managed ETFs

These ETFs are managed by a portfolio manager and follow their active strategies: they can represent fixed income, equity and balanced, alternative mandates and also different geographical regions.

Portfolio managers of active funds generally seek to beat or outperform the traditional indices, rather than track them. Skillful managers do this consistently, even when taking into account fees, which are naturally higher, given the management requirement strategies involved with these funds. With these ETFs, you're focused on the skill level of the portfolio manager.

Types of ETFs

The popularity of ETFs has led to the expansion of their range beyond developed market equities and traditional fixed income. Investors may now be able to find an ETF to fit any investment niche, sector or theme including:

- Asset allocation
- Equities
- Fixed income
- Commodities
- Real estate
- Emerging markets
- Sustainable (environmental, social, governance [ESG])
- Infrastructure
- Alternative currency/ cryptocurrency

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Selecting an ETF: Due diligence framework

There are four key areas to assess as an investor when selecting an ETF:

1. Exposure

- Does the index truly track the segment of the market you want to track?
- Is the investment objective clearly stated?

2. Product structure

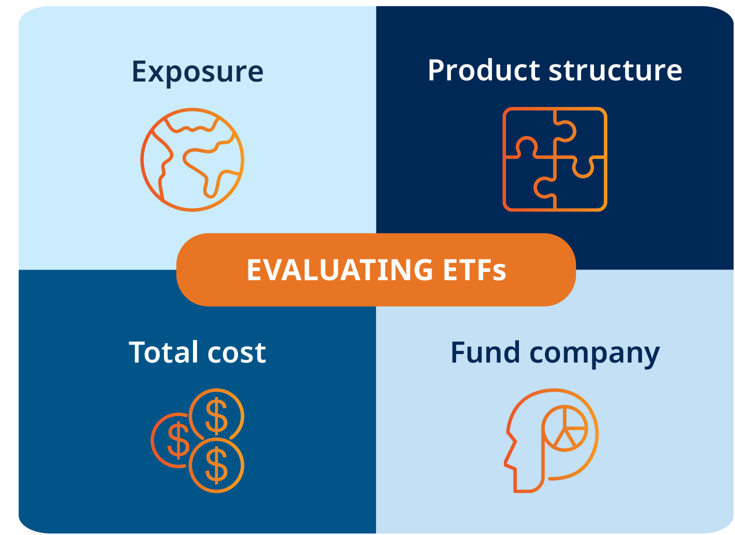
How does the ETF structure impact your investment experience? Considerations include tax implications of structure, method for index tracking, types of securities held and use of derivative.

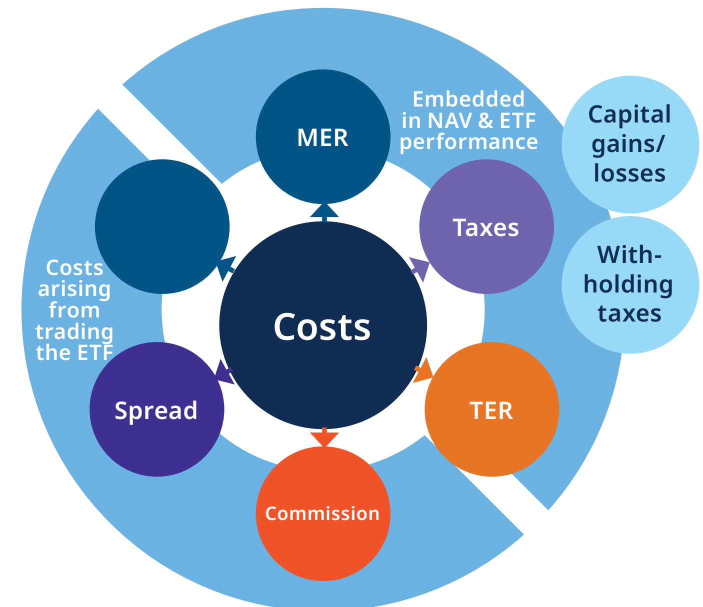
3. Total cost

What is the total cost of ownership? Considerations include MER, taxes, TER, commissions, spread, premium/discount, capital gains/losses and taxes.

4. Fund company

- How well do you know the fund company?
- What is the firm's level of investment professional expertise, experience and commitment to the ETF industry?
- How experienced is the firm in developing, managing and supporting ETFs?





Why invest in ETFs?

The merits of investing in ETFs go beyond access to an entire universe of ETFs that can meet investors' risk tolerances, personal values, diversification and exposures needs.

Exchange-traded funds:

- Can be efficient, low-cost investment vehicles.
- Offer transparency, with performance and fee reporting.
- Offer diversification, having expansive investment options with a broad range of asset classes, sectors and geographies, as well as thematic categories.
- Are easily accessible, providing trading flexibility, with intra-day trading and real-time pricing.
- Can be more liquid than individual securities.
- Can offer greater tax-efficiency, because redemptions don't necessarily require the ETF to sell securities, which may otherwise cause it to incur a taxable capital gain.
- Have evolved to include a considerable depth and breadth of methodologies.

Broad asset allocation	Cost-effective access to a broad asset classes to build a strategic core portfolio
Diversification	Achieve desired tilts in a portfolio
Active-passive combinations	Benefits of active management in certain asset classes or market cycles
Portfolio completion	Use ETFs to fill gaps in your portfolio
Tax optimization	Possible tax-loss harvesting

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ETF myth busting

Myth 1: Low ETF trading volumes and assets under management (AUM) translate into low liquidity

An ETF can have low trading volume and low AUM yet still have high liquidity

- Similar to a mutual fund, an ETF's liquidity is not established by its trading volume but by its underlying holdings. At minimum, an ETF or mutual fund will be as liquid as its underlying holdings.

ETFs trade differently than stocks

- Unlike stocks, which have a fixed amount of shares outstanding, ETFs are open-ended investment vehicles and are able to issue new shares or withdraw existing shares in the market to meet investor supply and demand.
- An ETF that invests in large companies will have relatively higher liquidity, as these stocks trade millions of shares daily. ETFs that invest in less liquid stocks or in securities that trade over the counter (OTC) may experience relatively lower liquidity, which may increase price swings. This would be no different within a mutual fund structure.

Determining liquidity of an ETF

- An advisor should evaluate an ETF's underlying holdings to determine liquidity, not its trading volume or AUM. If there is no liquidity concern with a mutual fund that invests in similar securities as an ETF, there should be no concern with regards to liquidity in an ETF.
- Volume is not indicative of liquidity, regardless of the fund structure.

Reviewing exchange order books

- Advisors may also attempt to evaluate an ETF's liquidity by reviewing exchange order books, which reflect price and number of shares available.
- However, market makers only reflect a fraction of the volume they are willing to trade in an ETF to better manage risks associated with significant market movements throughout the day.

Myth 2: Secondary market ETF liquidity is entirely reflected on screen

- Market makers only display a fraction of the volume they are willing to trade.
- Investors access ETF shares through the secondary market (that is, stock exchanges) so it is understandable that investors assume that what they see is the total volume available to trade.
- However, ETFs are different from stocks and mutual funds in that market makers can add new ETF shares into circulation or take shares out of circulation via the primary market. They do so by working with the ETF provider (for example, Mackenzie Investments).
- This process helps keep the price of the ETF close to the ETF's underlying net asset value (NAV).

Myth 3: Trading at a premium or discount to the NAV is a shortcoming of the ETF mechanism

- The fact that ETFs are designed to transact both in the primary market (creating and redeeming shares at net asset value, or NAV) and on an exchange at prices established by the secondary market, is a benefit and allows investors to access real-time market prices when trading.
- The existence of both a primary and secondary market increases overall pricing efficiency and enhances liquidity.

Myth 4: ETFs are only for day traders and short-term investors

- Like mutual funds, ETFs are effective tools for building portfolios for investors.
- While ETFs are often used by active investors as trading vehicles, they can be used effectively as buy-and-hold investments for long-term investors.
- Whereas one investor may purchase a particular ETF to hedge, another may buy the same ETF for a completely different strategy, such as to grow capital.
- The product design of ETFs allows investors with similar or different investment objectives to own the same product and still accomplish their respective goals.

Myth 5: All ETFs replicate their underlying indices

- Most, but not all, ETFs are designed to provide investment results that generally track the performance of an underlying benchmark index by holding a portfolio of securities that mirror this performance.
- The majority of ETFs around the world use one of three techniques to achieve this goal: full replication, optimization-based tracking and synthetic replication.
- However, not all ETFs are replication-based, and a growing number of actively managed ETFs have been launched that leverage the expertise of portfolio managers to execute security selection and trading decisions.

Full replication

- In this approach, an ETF holds all of the securities in the same weightings as its associated index. Over time, the manager adjusts the portfolio to reflect changes in the index and manages cash flow from dividends or income generation. This strategy tends to provide very close tracking with the underlying index.

Optimization-based tracking

- This strategy is designed to control trading costs and promote liquidity. It uses a sampling process to create a representative or optimized portfolio of securities that closely matches the characteristics of the underlying index. While this approach may be more cost-efficient, it tends to carry a higher potential for tracking error than ETFs that use full replication.

Synthetic replication

- These ETFs attempt to replicate index returns by purchasing derivatives such as swap agreements with one or more counterparties, such as a bank. Typically, the counterparty will agree to deliver the performance of the associated index (minus a small spread), including capital gains and dividends, in exchange for the value of the performance generated by a pool of physical securities held by the ETF. This allows the ETF to mirror the performance of an index without having to own the actual securities. This can be advantageous when it is difficult or expensive to trade in certain markets or sectors.

Actively-managed

- This category of ETFs, including Mackenzie active ETFs, allows managers to apply their own expertise in overseeing portfolio construction and trading decisions, similar to actively managed mutual funds. While the ETF will have a benchmark index, its managers will generally attempt to outperform that index's returns rather than simply match it.
- The main difference between actively managed ETFs and mutual funds is that actively managed ETFs are priced and traded intraday, while active mutual funds can only be purchased or sold at their NAV after the market closes.

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Talk to a financial advisor to learn more about which investments meet your financial goals.

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