FROM YOUR ADVISOR

INVESTING WITH ETFs

Most ETFs track the returns of stock market indices, but some newer varieties are actively managed

Exchange-traded funds (ETFs) have surged in popularity in recent years. Both large and small investors can take advantage of the convenience, transparency and low cost that ETFs offer.

An ETF is a single security that trades on a stock exchange, but this one security represents ownership of a broadly diversified market index or a basket containing multiple securities. These underlying holdings can be made up of stocks, bonds, commodities or currencies. ETFs allow investors to reap returns based on the portfolio of underlying securities at a lower cost and with greater tax efficiency than investing with most mutual funds.

The choice of ETFs covers a variety of asset classes, industry sectors and geographical regions. The bulk of ETFs have passively managed portfolios and track the returns of a broad market index, such as Canada's S&P/TSX composite index or the U.S.-based S&P 500 composite index. But ETFs have evolved to include actively managed, customized portfolios designed to achieve a specific investment objective — such as low volatility, value, income or growth — rather than merely tracking an index.

"ETFs are a hybrid that combines some of the features of regular mutual funds with those of stocks that trade on an exchange," says Som Seif, CEO of Toronto-based ETF provider Purpose Investments Inc.

ETFs can also be used to gain exposure to a favourite market sector, such as emerging markets or small-capitalization firms. On the commodities side, ETFs give investors convenient exposure to a variety of products — including agricultural products, natural gas, oil and gold bullion — without having to navigate complex futures markets. Some ETFs invest in multiple asset classes, offering instant exposure to a balanced portfolio. Many ETFs that offer exposure to foreign securities are available in hedged versions to insulate investors from currency movements.

The lion's share of ETFs are stock-based, with equity-based ETFs accounting for 65% of ETF assets under management (AUM) in Canada. Fixed-income ETFs, which are based on such securities as government bonds, preferred shares, corporate bonds and treasury bills, comprise 32% of ETF AUM. Some ETF fixed-income portfolios have laddered maturities, while others focus on short-term or floating-rate bonds.

ETFs trade on stock exchanges and units in ETFs are bought and sold throughout the day, giving investors flexibility to trade quickly. Canadians are not restricted to the Canadian market for ETFs. On a global basis, there are more than US$3 trillion trading in some 6,000 ETFs on stock exchanges all over the world.

The costs of managing ETFs generally are lower than for mutual funds. For example, basic ETFs with exposure to the broad Canadian stock market can be obtained for an annual management fee of as little as five basis points, based on a percentage of the ETF's AUM.

However, investors should remember that management fees are not the only cost, and trading commissions also may be charged when ETFs are bought and sold.

ETFs can give investors exposure to commodities such as agricultural products, oil and gold bullion

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