

## Investing in Exchange Traded Funds (ETFs):

DIAMONDS, SPDRs, Qubes, HOLDRs, VIPERs, BLDRs, iShares, iUnits and Frescos

**They are simple and valuable investments with strange sounding names!** Exchange Traded Funds (ETFs) essentially are mutual funds that trade like a stock. They are baskets of securities held in a trust (just like mutual funds) and can be traded as a listed security on a stock exchange (just like a stock).

### Differences between mutual funds and ETFs

- Securities held in most mutual funds are actively managed. Securities held in ETFs track an index established by a stock exchange. Selection of securities is predetermined (i.e. passively managed). Accordingly, the cost of managing Exchange Traded Funds and their corresponding **Management Expense Ratios (MERs) are significantly less than mutual funds.**
- Mutual funds are priced once a day based on their net asset value at the end of the trading day. **ETFs are priced in the market during the trading day** based on their tracking value of the index that they represent.
- Mutual funds hold securities that are actively bought and sold during the year by managers who are using their expertise and experience to improve portfolio returns. **ETFs**, by definition, hold securities that are infrequently changed, and therefore **tend to have lower capital gains distributions at the end of the year.**

### Differences between listed securities and ETFs

- Buying a diversified portfolio of individual securities, that approximately represents the market, can be time consuming and expensive. In contrast, **buying an ETF, that holds a diversified portfolio of securities representing the market, can be completed easily in one trade.**
- **Transaction costs normally are lower for ETFs than for individual securities** (particularly on broadly based ETFs) because bid/ask spreads for ETFs frequently are less.

### Why the strange sounding names?

**The names frequently are an acronym for an Exchange Traded Fund:**

- **SPDRs** (also called SPYDRS): Standard & Poor's 500 index **Deposit Receipts**
- **DIAMONDS**: Dow Jones Industrial Average tracking unit.
- **VIPERS**: Vanguard Index Participation Equity Receipts
- **Qubes**: based on symbol for the NASDAQ 100 tracking units: QQQQ.
- **HOLDRs**: Holding Company Depositary Receipts

### **An Example using SPYDRs**

SPYDRs are an Exchange Traded Fund that tracks the S&P 500 Index. SPYDRs trade approximately at  $1/10^{\text{th}}$  the value of the Index. If the S&P 500 Index is trading at 1200, SPYDRs (Symbol: SPY) will trade at almost exactly \$120 per unit. The cost of 100 units will be  $\$120 \times 100 = \$12,000$  U.S. If the S&P 500 Index rises to 1300, the price of SPYDRs will increase to \$130. The value of 100 units will improve to \$13,000.

### **Types of Indices Tracked by ETFs**

Five types are available:

- ETFs on broadly based indices (e.g. S&P 500 Index, Dow Jones Industrial Average, S&P/TSX 60 Index)
- ETFs on sector indices (e.g. health care, high tech, financial services)
- ETFs on style indices (e.g. growth, value, small cap, medium cap)
- ETFs on indices of countries or regions outside of North America (e.g. the Euro 350 Index, the EAFE Index)
- ETFs on bond indices.

Currently, 125 U.S. equity based ETFs, 8 bond based ETFs, 48 international based ETFs, two commodity based ETFs, and 13 Canadian equity based ETFs trade on North American exchanges. A complete list is provided at the end to this report.

### **Reasons to own ETFs**

- Easy to understand and to follow. The media frequently comments on events that influence the performance of broadly based indices such as the S&P 500 Index, the Dow Jones Industrial Average and the S&P/TSX 60 Index. Their comments also apply to performance of ETFs that track broadly based indices.
- A convenient way to build a diversified portfolio. Each ETF owns a basket of securities. For example, iUnits in the S&P/TSX 60 Index holds a diversified portfolio of Canada's top 60 companies. Risks associated with ownership of individual securities in the basket are reduced.
- A low Management Expense Ratio (MER) relative to actively managed investments. The average MER on a broadly based Canadian or U.S. mutual fund actively managed by a Canadian based investment firm is 2.72%. In contrast, the MER on iUnits on the S&P/TSX 60 Index is only 0.17% and the MER on SPYDRs is only 0.10%.
- More tax efficient than actively managed investments. Capital gains distributions at year-end from U.S. traded ETFs currently are nil due to their legal structure. Capital gains distributions at year-end from Canadian traded ETFs are low and frequently are nil. The reason: changes in indices are infrequent and, therefore, chances of realizing a capital gain for tax purposes due to index changes are low. In contrast, a portfolio of actively managed investments frequently is adjusted and is more likely to distribute taxable capital gains at the end of the year.
- Easily bought and sold (particularly ETFs on broadly based indices). SPYDRs were the most actively traded equity security in the world in 2004 based on value of trading. Qubes were the most actively traded security in the world in 2004 based on the number of shares that traded. Volumes in both ETFs rose in 2004. Average daily volume in i60s, Canada's most

actively traded ETF was approximately one million per day in 2004. In addition, bid/ask spreads on broadly based ETFs frequently are \$0.10 per unit or less.

- Better performers relative to most actively managed investments. History shows that most actively managed investments have been unable to exceed the performance of their benchmark index over an extended period of time.

### **Other features of ETFs**

The following information was obtained from publicly available web sites and from Howard Atkinson's book entitled, "The New Investment Frontier II: A guide to Exchange Traded Funds for Canadians":

- ETFs listed on the Toronto Exchange are 100% eligible as Canadian content in tax deferred accounts (e.g. RRSPs and RRIFs) including iUnits on the S&P 500 Index and iUnits on the International Index.
- ETFs listed on U.S. exchanges also can be held in a tax-deferred account, but as part of the foreign content of their portfolio.
- Most ETFs pay a quarterly dividend.
- Dividends paid by ETFs listed on the Toronto Exchange are eligible for the Dividend Tax Credit.
- Trading hours correspond with the regular trading hours of the Toronto Exchange and U.S. exchanges (normally 9:30 AM – 4:00 PM eastern time).
- All ETFs have redemption features. Holders with large positions in ETFs are allowed to exchange their units for shares that underlie the unit. Net result: units consistently trade at or near their net asset value.
- Many ETFs have listed options and LEAPS.
- ETFs are marginable.
- ETFs can be shorted. They are exempt from the "up tick" rule in the U.S. and the "last trade" rule in Canada.
- ETFs are sponsored by well-known financial institutions. Barclays Global Investors is the sponsor of Canada's actively traded ETFs.

### **Portfolio Strategies**

#### *Core and satellite investing.*

One of the more popular strategies! Investors place a large portion (i.e. the core) of their equity portfolio into Exchange Traded Funds. This portion acts as the anchor for the portfolio, ensuring that portfolio performance will approximate stock market returns. Size of the core depends upon the amount of stock market risk that the investor is willing to assume. Investors, who are satisfied with realization of returns that approximate the market, will place a larger portion of their portfolio into ETFs (say 40%-80%). Investors, who are willing to take more risk in order to improve their chances of "beating the market", will place a smaller portion into ETFs. The remainder of the portfolio is invested into "special situations" with the potential to outperform the market. Choices include attractive equities, specialty mutual funds, sector ETFs, hedge funds, etc.

### *Portfolio Rebalancing.*

ETF positions can be adjusted easily when equity, fixed income and cash weights in a portfolio need to be rebalanced due to changing market conditions. With one trade in an ETF of a broadly based index, equity positions can be increased or reduced.

### *Sector Investing.*

Investors can choose, based on time, to over weight sectors that have better potential. Investors can choose between six Canadian sector ETFs and over 60 U.S. sector ETFs.

### *Seasonal Trend Investing.*

North American equity markets tend to be strongest from the end of October to the end of March or April. Investors can take advantage by owning broadly based ETFs during the period of seasonal strength and by switching into treasury bills during the remainder of the year. Sectors in equity markets also have seasonality and can be traded accordingly.

### *Risks.*

By definition, an investor holding an Exchange Traded Fund will never outperform the market. The investor will track the market (less a small MER). Some ETFs have a high percent of their portfolio invested either in a sector or an individual security. Concentrations can influence the volatility and performance of the ETF. One possible solution is to own a “capped” version of the ETF where maximum weight in the portfolio is established. Several “capped” ETFs are available on the Toronto Exchange. A small number of ETFs hold a basket of securities that are known to be volatile. Most hold high tech securities with a history of significant price swings.

*This document provided as a courtesy by Don Vialoux. He regularly comments on Exchange Traded Funds. He has a separate website at [www.dytechtalk.com](http://www.dytechtalk.com).*