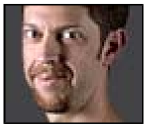
PERSONAL FINANCE: INVESTING

The benefits, and harsh realities, of ETF investing



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A bevy of new exchange-traded funds are being introduced to Canadian investors at the same time investors are being taught a lesson about ETF frailties.

The new ETFs are from Barclays Global Investors and, when they're listed on the Toronto Stock Exchange on or about Dec. 19, they'll offer a way to invest in the broad income trust sector, real return bonds, Canadian dividend stocks and stocks in the materials sector, which would include the likes of Alcan, Inco and Nova Chemicals.

Another new face is the TSX-listed, Canadian-dollar version of the iShares Comex Gold Trust, which is also traded on the American Stock Exchange. This ETF is designed to be a proxy for owning gold bullion and it began trading last week.

These new funds are great additions to the ETF lineup available on the TSX and a sign that Canadians are finally starting to benefit from the kind of selection of exchange-traded funds that American investors have.

The new funds also provide a good news story for Barclays at a time when it is about to unleash an unpleasant surprise on investors who bought some of its funds for taxable, non-registered accounts. Earlier this week, Barclays announced some very hefty year-end distributions that could cause a significant tax hit for current owners of these ETFs.

There are many advantages to choosing ETFs over mutual funds -- the fees are much lower and you're sure to get the same return as the stock index your ETF tracks, whereas actively managed mutual funds frequently undershoot the index. Another is that ETFs are efficient in that they own the stocks in the index and thus don't have to do a lot of buying and selling that can generate year-end distributions of capital gains.

"In absolute terms, ETFs generally distribute far less income than most actively managed funds," Howard Atkinson, head of public funds for Barclays Global Investors Canada, wrote in a recent book called *The New Investment Frontier II*. ". . . Because ETFs do so little buying and selling within the fund, ETFs are remarkably good about keeping their gains to themselves and not troubling investors with large distributions."

This is correct in most years, but not in 2005 for people who own the iUnits Composite Canadian Equity Index Fund, which until a recent reorganization was called the iUnits S&P/TSX 60 Capped Index Fund.

This fund conversion was a positive development because it gives investors a way to track the broader, more diversified S&P/TSX composite index rather than the smaller S&P/TSX 60. The down side is that there was a flurry of buying and selling as part of the conversion that will leave unitholders with an estimated year-end distribution equal to a heavy 7.1 per cent of the fund's net asset value, or about $4.86 a unit.

You won't receive any cash if you own this ETF in a non-registered account because it's reinvested in the fund (registered accounts are unaffected). You won't see your holdings increase, either, for accounting reasons. All you're really left with is a taxable capital gain of roughly $711 on a $10,000 investment and, with luck, an increase in the value of the ETF holdings in your account.

Note that only 50 per cent of this amount is taxable because it's a capital gain, which means your true liability is $350. At a 43-per-cent tax rate, the taxes owing would be $150.

An unusually brisk level of index housekeeping this year will create a large distribution of 6.12 per cent of net asset value for the iUnits S&P/TSX MidCap Fund, and 4.6 per cent for the iUnits S&P/TSX Capped Energy Index Fund, which has been a pipeline into the soaring oil and gas sector.

The worst hit of all will affect any investors unlucky enough to have recently bought the iUnits International Equity C$ Index Fund, which is a way to get exposure to stock markets outside North America along with hedging to protect against the ravages of a rising Canadian dollar.

Originally, this ETF was designed for registered retirement savings plans through tweaking that made it count as domestic rather than foreign content. But with the elimination of the RRSP foreign content limit in the 2005 budget, the fund underwent a reorganization last month that will necessitate a whopping distribution of about 10.7 per cent of net asset value for unitholders. Worse, because of this fund's construction, the distribution will be in the form of straight income and not more lightly taxed capital gains.

What all of this tells us is that while ETFs are generally benign when it comes to year-end distributions, you can't take this as a given.

Another lesson is that ETFs shouldn't be bought late in the year, so that you're in line to receive a distribution even though you've only owned a fund for a short while.

No, ETFs aren't quite the wonder investment they're sometimes made out to be. But a growing selection does make them an ever more interesting alternative to mutual funds and individual stocks.

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The ups and downs of ETFs

Exchange-traded funds typically don't provide much in the way of taxable year-end distributions to investors with non-registered accounts, but this year some ETFs from Barclays Global Investors are packing some nasty surprises. Here's a summary of some of the distributions that will be made at year's end.

TSX symbol	iUnits	Estimated annual capital gain	Net asset value (NAV) at Nov. 30, 2005	Estimated annual capital gain as a percentage of NAV
XIU	iUnits S&P/TSX 60 Index Fund	$0.35	$61.41	0.58%
XMD	iUnits S&P/TSX MidCap Index Fund	$4.56	$74.43	6.12%

XEG	iUnits S&P/TSX Capped Energy Index Fund	$3.40	$74.58	4.56%
XFN	iUnits S&P/TSX Capped Financials Index Fund	$0.15	$45.85	0.33%
XGD	iUnits S&P/TSX Capped Gold Index Fund	$0.00	$56.75	0.00%
XIT	iUnits S&P/TSX Capped Information Technology Fund	$0.00	$6.45	0.00%
XRE	iUnits S&P/TSX Capped REIT Index Fund	$0.02	$13.28	0.16%
XBB	iUnits Canadian Bond Broad Market Index Fund	$0.37	$29.30	1.25%
XIC*	iUnits Composite Canadian Equity Index Fund	$4.86	$68.36	7.11%
XSB*	iUnits Short Bond Index Fund	$0.11	$28.84	0.36%
XSP*	iUnits S&P 500 C$ Index Fund	$0.00	$15.69	0.00%
XIN*	iUnits International Equity C$ Index Fund	$2.42	$22.62	10.71%

* Converted to new investment objective on November 15, 2005

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