ETFs vs. mutual funds

Is the current interest in passive investing justified? *MarketPulse* looks at the facts behind the popularity of ETFs.

In some minds, the recent sharp sell-off in the markets has undermined the credibility of the active approach to investing. If even the brightest investment minds could not guard against the downturn, the argument goes, would it not be better to simply put your faith in the markets and take a passive investing approach?

To test this proposition, we'll compare actively managed mutual funds to an increasingly popular passive investment, the exchange-traded fund (ETF). ETFs are designed to track a benchmark index and provide similar returns. They are available in an increasing variety, which investors can use to generate returns and, so far at least, they generally have low fees. Many are asking, could ETFs be a better investment vehicle than traditional mutual funds?

To find out more, let's examine five of the most popular arguments in favour of ETFs.

1. Do ETFs perform as well or better than mutual funds?

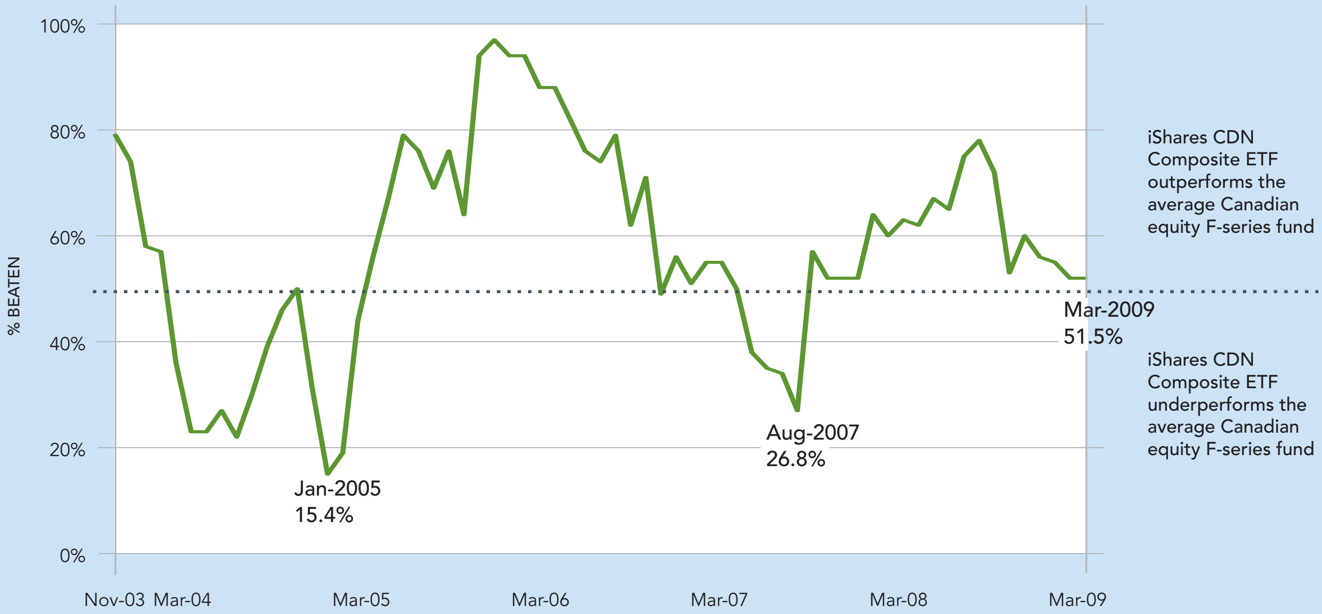
Assertions about ETFs' performance are often based on simple comparisons between ETFs and mutual funds. This is not an appropriate comparison, however, because while both ETFs and mutual funds require investors to pay management fees, the ETF usually does not pay advisor compensation.

But most advisors are not prepared to offer their advice and guidance for nothing, so they will likely find some other method of compensation, such as a fee for service. (Do-it-yourselfers, of course, can invest on their own and pay only brokerage fees – more about those shortly.) So comparing an actively managed fund that pays a trailer fee with an ETF that pays no trailer fee is an apples-to-oranges comparison.

An apples-to-apples comparison would pit ETFs against F-series mutual funds used by fee-for-service advisors. For example, the chart on the next page shows the performance of iShares CDN Composite ETF, which is by far the largest and broadest Canadian equity ETF and the only ETF in that category that can be appropriately compared to traditional mutual funds. On a 12-month rolling basis, the iShares ETF outperformed a little over half the F-series funds in the same asset class category. That's pretty good, but not an argument for abandoning active management. Moreover, in some periods, the ETF considerably underperformed, beating only 15% of F-series Canadian equity funds.

Do ETFs outperform mutual funds?

% of F-series funds in the Canadian Equity category beaten by the iShares CDN Composite ETF



Source: Morningstar EnCorr. 12-month rolling returns.

In a more detailed comparison below, several Fidelity Funds (Series F) are matched with iShares ETFs in the same category. In all cases, the actively managed funds outperformed the ETF in the same category.

Recently, more sophisticated ETFs have emerged that offer hedging possibilities, and in some cases these have performed well. One of the difficulties of evaluating ETF performance, however, is that most have not been in existence

iShares vs. selected Fidelity Funds – Series F

AS AT MARCH 31, 2009	LAST 3 MONTHS (PERIOD) RETURN	LAST 1 YEAR (ANNUAL) RETURN	LAST 3 YEARS (ANNUAL) RETURN	LAST 5 YEARS (ANNUAL) RETURN	SINCE INCEPTION
Fidelity Canadian Large Cap Fund	-0.17%	-28.37%	-5.45%	4.57%	3.47%
iShares CDN LargeCap 60 Index	-1.59%	-30.40%	-6.07%	4.21%	
Fidelity Canadian Disciplined Equity® Fund	-0.06%	-32.38%	-6.95%	3.29%	3.59%
Fidelity True North® Fund	-0.02%	-30.83%	-5.79%	4.32%	3.55%
iShares CDN Composite Index	-2.08%	-32.42%	-7.98%	3.10%	
Fidelity American Disciplined Equity® Fund	-5.62%	-26.79%	-10.36%	-1.99%	-2.66%
iShares CDN S&P 500 Index	-12.08%	-41.95%	-15.94%	-8.69%	
Fidelity International Disciplined Equity™ Fund	-9.11%	-36.39%	n/a	n/a	-14.83
Fidelity Overseas Fund	-8.74%	-36.50%	-15.19%	-5.87%	-6.13%
iShares CDN MSCI EAFE Index	-12.18%	-38.64%	-16.89%	-6.25%	

Note: iShares U.S. and EAFE ETFs are hedged.
Source: Morningstar EnCorr.

long enough to provide a meaningful comparison to other forms of investment. And in many cases, there is no easy comparison between the more elaborate ETFs and a traditional mutual fund. But these newer, more complex ETFs use leverage and tend to be more volatile, and a quick review suggests that so far, the results are mixed.

What may be even more important than the performance issue, however, is whether ETFs are really as cheap as they initially appear, given the typical needs of investors.

2. Are ETFs cheaper?

The answer is yes – but only if investors don't trade.

One of the widely acknowledged downsides of ETFs is that while they do have lower management fees, their costs can mount rapidly if investors wish or need to trade. And, of course, most investors do.

ETFs trade like stocks, and this has cost implications that investors need to take into account.

- **Diversification and rebalancing**
  The sensible investor will want to have a diversified portfolio of ETFs. However, each ETF purchase will require the payment of a trading fee, typically between $10 and $30. Similarly, keeping a portfolio balanced will add costs as the investor buys and sells ETF units to maintain the desired asset allocation. With mutual funds, rebalancing is likely to be automatic, or at least an option, depending on the type of fund or product.
- **Systematic investing**
  Regular saving can become quite expensive if ETFs are the designated investment. For example, suppose an investor puts an automatic contribution of $400 into ETFs twice a month. Assuming a $10 per trade commission, over one year the investor would rack up fees of $240, or 2.5% in fees, on a total of $9,600 in savings. Add that cost to the management fee charged by the ETF itself, and the costs could be greater than the MERs of many funds.
- **Bid-ask spreads**
  Unlike mutual funds, there is a bid-ask spread whenever an ETF is bought or sold. This creates the potential for incremental trading losses that can mount up, especially if trading volumes are low. For example, if an ETF is trading with a bid/ask spread of $9.98/$10.00, 1,000 shares would cost $10,000 (plus any brokerage fees). But later, if the investor must sell, he or she will receive $9,980 – a $20 difference. With wider spreads, the difference can amount to hundreds of dollars.

So while ETFs are initially cheaper than mutual funds, they will only remain so if investors resolve to trade as little as possible – which means they may prove too inflexible to meet investors' needs.

3. Are ETFs tax efficient?

Again, ETFs are tax efficient *only* if investors buy and hold.

For example, investors who want to switch from one ETF into another must process a sell order, which could trigger a taxable event. Similarly, investors who are looking to their ETFs for monthly income could wind up with an unpleasant tax bill.

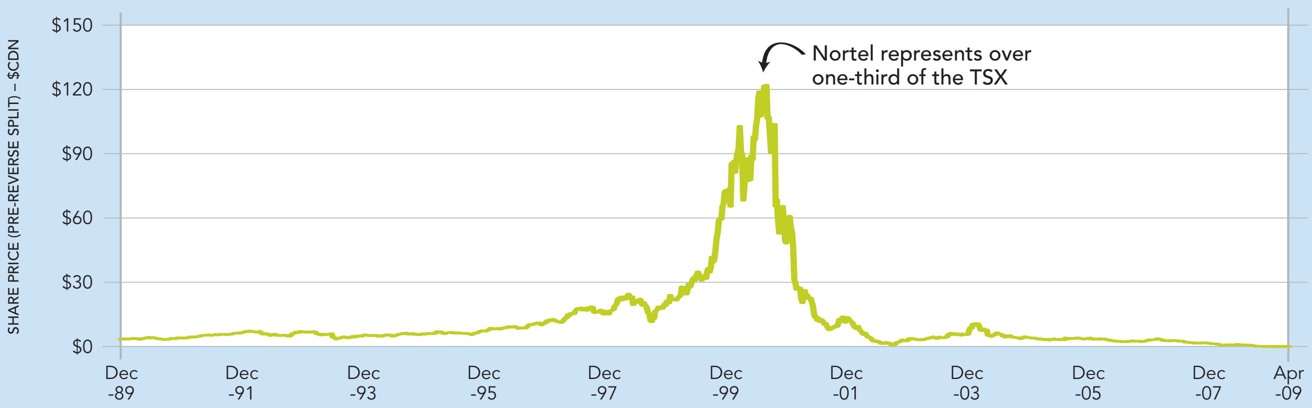
Mutual funds in a corporate structure, on the other hand, provide the flexibility to switch and rebalance non-registered investments without triggering immediate tax consequences. They can also provide tax-efficient cash flows for investors seeking predictable monthly cash distributions.

4. Do ETFs provide automatic diversification?

Most ETFs simply mirror the index they are tracking, which can make them very well diversified – or not. The problem occurs when certain companies begin to dominate an index.

A good example is Nortel Networks. At its peak, Nortel represented over one-third of the Toronto Stock Exchange and, therefore, an oversized portion of any TSE ETF. Investors seeking diversification found themselves heavily overweighted in one company. Moreover, while active managers were dumping Nortel from their

ETFs must follow their index – even when it's dominated by one stock
Nortel Networks Corp. share price history



Source: Thomson Datastream.

portfolios as it crashed, ETF investors inevitably rode the stock all the way down, until the company finally declared bankruptcy in early 2009.

5. Are ETFs an easy way to invest?

On the surface, ETFs may appear simple and relatively trouble-free. But they tend to push all of the money management responsibility back onto the advisor.

The advisor must create appropriate portfolios and strategies for each client from scratch, without many of the features and services available with mutual funds, such as rebalancing, free switching, tax efficiency or the inherent diversification of a balanced or asset allocation fund. And product solutions such as target-date funds are generally not an option.

All of this takes away from the time advisors have to work directly with clients and potential clients, a key factor in the most successful and profitable practices.[1] Moreover, ETF sales support, in the form of enhanced reporting, market commentary, continuing education and investor materials, tends to be limited.

This becomes particularly problematic during periods of market volatility similar to those we've seen lately. It is up to the advisor to provide hedging strategies against potential future market corrections, and to counsel clients and persuade them to persevere when that time comes.

In short, ETFs may prove a useful tool for specific situations or for talented, knowledgeable, do-it-yourself investors. But they do not necessarily offer the performance, flexibility, diversification or services that most advisors and their clients need.

1 See "Clearing up the RRSP Blues," January 2009, for a brief discussion of how being client focused, instead of investment focused, can increase advisor profitability.

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