Understanding Exchange-Traded Funds

A Primer for Investors

Delivering tax-efficiency, equity-like attributes and access to virtually all sectors of the market, exchange-traded funds (ETFs) have grown significantly in popularity over the past 10 years. The appealing qualities of ETFs allow investors to build high-calibre portfolios, often with lower costs and better transparency than other investments such as mutual funds.

Despite their immense growth and adoption, many investors may be at a loss when it comes to truly understanding the benefits of ETFs or their basic structure. To increase your understanding, this article explains the key features and benefits of EFTs and discusses how they can be used within an investment portfolio.

ETFs defined

ETFs combine the benefits of mutual funds with the trading flexibility of equities. Each unit of an ETF represents an investment in a basket of securities, similar to a mutual fund. However, unlike a mutual fund, ETFs can be traded throughout the day at a price very close to the net asset value (NAV) of the underlying securities.

Most ETFs track specific market indices, such as the FTSE TMX Canada Universe Bond, S&P/TSX 60, S&P 500 or the NASDAQ-100 indices. They're designed to perform in accordance with the index that they track. For example, a five per cent increase in the value of the S&P 500 should result in an approximate five per cent increase in an ETF that tracks the S&P 500, before any applicable fees and expenses.

ETFs may also employ strategies to gain exposure to specific factors such as low volatility or dividends, known as smart beta. Smart beta refers to a weighting methodology that tilts towards a specific factor versus a weighting based on market capitalization of an applicable index. Alternatively, ETFs can be actively managed like a mutual fund.

While ETFs trade on exchanges similar to individual securities, they are open-ended securities and there is no limit to the number of shares that can be issued or redeemed on a daily basis, much like a mutual fund.

Benefits of ETFs

ETFs provide a number of key features that benefit investors, including:

- **Diversification** – Generally ETFs aim to track the performance of an index, and as such are often well diversified within a particular asset class and across sectors. For example, by making a single purchase in an ETF that tracks the S&P/TSX 60, investors are instantly diversified across 60 Canadian companies.
- **Lower cost** – Many ETFs charge lower management fees than mutual funds, mainly due to their predominantly passive investment process.
- **Transparency** – ETF investors typically know what they're invested in, since most passive ETFs disclose their full holdings. ETF providers typically post the fund's daily holdings on their website, compared to mutual funds that typically publish their full holdings on a semi-annual basis.
- **Reduced manager risk** – Passively managed ETFs simply track an underlying index, eliminating exposure to manager risk versus actively managed investments.
- **Liquidity** – ETFs can be bought and sold any time the market is open. In addition, the creation and redemption process provides liquidity beyond the number of ETF shares traded.
- **Tax efficiency** – The securities that comprise the underlying index tracked by an ETF typically change less often over time; as a result, ETFs generally have low portfolio turnover.

Because of low turnover, ETFs have fewer taxable events, or realized capital gains, versus other investment products, allowing the capital of an ETF to compound over time.

Comparing ETFs and mutual funds

When describing the features of ETFs it's useful to compare them to mutual funds, as they share important similarities and differences. The following chart highlights the major differences between the two investments.

Feature	ETFs	Mutual Funds
Cost/ Management fees	Generally lower (Management Expense Ratios), because of passive management style	Generally higher (Management Expense Ratios), because of active management style
Pricing	Market-determined unit price set throughout the trading day based on net asset value of the underlying securities	Net asset value determined at end of trading day, following market close
Transparency	Holdings typically published daily	Holdings typically published semi-annually
Preauthorized contribution capability and systematic withdrawals plans	Typically not available	Available
Diversification	Potential for a high level of diversification	Potential for a high level of diversification
Tax efficiency	Higher, due to lower turnover of holdings	Lower, due to higher turnover of holdings

How to use ETFs in your portfolio

ETFs can be used by investors as a core component of their portfolio or as complementary holdings within their portfolio.

As a core position, ETFs can be held on a long-term basis to achieve diverse investment objectives, through broad market exposure. ETFs can also be used tactically to complement a portfolio by providing exposure to desirable asset classes or sectors. Investors may also use ETFs to implement a short-term strategy for a particular index, sector or underlying asset, and trade ETFs frequently with the intention of maintaining a position for only a short period of time.

BMO Financial Group – A leader in ETFs

BMO Financial Group offers the most comprehensive line-up of ETFs in Canada and has gathered the most net new assets of any ETF provider in Canada for each of the last five years, with assets under management (AUM) of $24.4 billion.[1] BMO is also among the top 10 largest fixed income ETF providers and top 15 largest smart beta ETF providers in the world – with ETF products listed in London and Hong Kong, as well as Canada.

For a complete list of BMO ETFs, visit etfs.bmo.com.

! With the increasing number of ETF options to choose from it's important to consult with your BMO Nesbitt Burns Investment Advisor to ensure you fully understand the features of individual ETFs and to discuss how to most appropriately utilize ETFs in your portfolio.

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[1] As of February 29, 2016

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