

## Chapter 1

# The (Sort of Still) New Kid on the Block

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### *In This Chapter*

- ▶ Discovering the origins of ETFs
  - ▶ Understanding their role in today's world of investing
  - ▶ Tallying their phenomenal growth
  - ▶ Looking at the biggest names in ETFs
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No doubt, a good number of pinstriped ladies and gentlemen in and around Bay Street exist who froth heavily at the mouth when they hear the words *exchange-traded fund*. In a world of very pricey investment products and very well paid investment-product salespeople, ETFs are the ultimate killjoys.

Since their arrival on the investment scene in the early 1990s, more than 1,500 ETFs have been created — including about 250 in Canada — and ETF assets have grown faster than those of any other investment product. That's a good thing. ETFs enable the average investor to avoid shelling out fat commissions or paying layers of ongoing, unnecessary fees. And they've saved investors oodles and oodles in taxes.

Hallelujah.

### *In the Beginning*

What do basketball, snowmobiles, insulin, and ETFs have in common? They were all invented in Canada. Yes, you read that correctly. Though our southern neighbours created the stock market, the mutual fund, and many other investment products, the Toronto Stock Exchange developed the first

exchange-traded fund. The Toronto 35 Index Participation fund — the first ETF — was listed in March 1990. It tracked the TSE 35 Composite Index, an index made up of the 35 largest and most liquid stocks on the TSX.

As important as the ETF has become, the story behind its development isn't quite as exciting as, say, the story behind the gas mask or hockey, two other Canadian inventions. As one Toronto Stock Exchange insider explained, "We saw it as a way of making money by generating more trading." Thus was born the original ETF, best known as TIP. The TSE 35 Composite Index was then the closest thing that we had to America's Dow Jones Industrial Average index. Some of the companies on the index included Bell Canada, the Royal Bank, and the now-defunct Nortel.

## *Enter the traders*

TIP was an instant success with large institutional stock traders who could now trade an entire index in a flash. The Toronto Stock Exchange got what it wanted — more trading. And the ETF got its start.



TIP has since morphed to track a larger index, the so-called S&P/TSX 60 Index, which — you probably guessed — tracks 60 of Canada's largest and most liquid companies. The fund also has a different name, the iShares S&P/TSX 60 Index Fund, and it trades under the ticker XIU. It is now managed by BlackRock, Inc., which, upon taking over the iShares lineup of ETFs from Barclays in 2009 (part of a juicy \$13.5 billion deal), has come to be the biggest player in ETFs in the world. We introduce you to BlackRock and other ETF suppliers in Chapter 3. (A completely different BlackRock-managed U.S. ETF now uses the ticker TIP, but that fund has nothing to do with the original TIP; the present-day TIP invests in U.S. Treasury Inflation-Protected Securities.)

## *Moving south of the border*

As much as we may not want to admit it, Canadians have invented a lot of things that Americans have then perfected. Think about the BlackBerry and the iPhone. While the ETF was born in Canada, and was popular, this index-tracking product is as widespread as it is thanks to the U.S. market. The ETF took three years to get to the States, but like most things American, when it launched, it launched big.

The mother of all U.S. ETFs was born on January 22, 1993, and listed on the American Stock Exchange (which, in January 2009, became part of NYSE Euronext). The first U.S.-based ETF was called the S&P Depository Receipts Trust Series 1, commonly known as the SPDR (or Spider) S&P 500, and it traded (and still does) under the ticker symbol SPY.

## SPDRs, DIAMONDS, Qubes . . . why the plurals?

Many ETFs have names that end in an *s*. We don't refer to ETFs this way in this book because doing so can be confusing, but you will often hear people talk about the DIAMONDS and the Qubes. Why is that? After all, you would never refer to Fidelity's Canadian Disciplined Equity Fund as *Disciplines*. So why the plural when talking about a single ETF? The convention

refers not just to the fund but also to the components of the fund. Thus, *DIAMONDS* refers to the 30 companies that make up the Dow Jones Industrial Average index. *Qubes* refers to the 100 companies that make up the NASDAQ-100 Index. But rest assured that when brokers talk about DIAMONDS and Qubes, they're talking about a single ETF.

The SPDR S&P 500, which tracks the S&P 500 index, an index of the 500 largest U.S. companies, was an instant darling of institutional traders. It has since branched out to become a major holding in the portfolios of many individual and institutional investors — and a favourite of favourites among day traders.

## *Fulfilling a Dream*

ETFs were first embraced by institutions, and they continue to be used, big time, by banks and insurance companies and such. Institutions sometimes buy and hold ETFs, but they're also constantly buying and selling ETFs and options on ETFs for various purposes, some of which we touch on in Chapter 18. For us noninstitutional types, the creation and expansion of ETFs has allowed for similar juggling (usually a mistake for individuals); but more important, ETFs allow for the construction of portfolios possessing institutional-like sleekness and economy.

## *Goodbye, ridiculously high mutual fund fees*

The average mutual fund investor with a \$150,000 portfolio filled with actively managed funds likely spends \$3,750 (2.5 percent) or so in annual expenses. By switching to an ETF portfolio, that investor may incur trading costs (because trading ETFs generally costs the same as trading stocks) of perhaps \$100 or so to set up the portfolio, and maybe \$50 or so a year thereafter. But now his ongoing annual expenses will be about \$375 (0.25 percent). That's a difference, ladies and gentlemen of the jury, of big bucks. We're looking at an overall yearly savings of \$3,375, which is compounded every year the money is invested.

## *Hello, building blocks for a better portfolio*

In terms of diversification, portfolios should include large stocks; small stocks; micro cap stocks; Canadian, U.S., European, and Chinese stocks; intermediate-term bonds; short-term bonds; and real estate investment trusts (REITs) — all held in low-cost ETFs. We discuss diversification and how to use ETFs as building blocks for a class A portfolio in Part II.

Yes, you can use other investment vehicles, such as mutual funds, to create a well-diversified portfolio. But ETFs make diversifying much easier because they tend to track very specific indexes. They are, by and large, much more “pure” investments than mutual funds. An ETF that bills itself as an investment in, say, small growth stocks is going to give you an investment in small growth stocks, plain and simple. A mutual fund that bills itself as an investment vehicle for small growth stocks may include everything from cash to bonds to shares of General Electric (no kidding, and we give other examples in the next chapter).

## *Will you miss the court papers?*

While scandals of various sorts — hidden fees, “soft-money” arrangements, after-hours sweetheart deals, and executive kickbacks — have plagued the world of mutual funds and hedge funds, the ETF industry has far fewer court dates to make. That’s because the vast majority of ETFs’ managers, forced to follow existing indexes, have very little leeway in their investment choices. Unlike many investment vehicles, ETFs are closely regulated and they trade during the day, in plain view of millions of traders — not after hours, as mutual funds do, which can allow for sweetheart deals when no one is looking. Of course, anything can happen and there has been legal action around leveraged ETFs, but, for the most part, these funds haven’t been “judged” nearly as much as other securities.

In Chapter 2, we discuss in greater detail the transparency and cleanliness of ETFs.

## *Not Quite as Popular as the Latest Teen Idol, but Getting There*

ETFs have a lot going for them, so we’re not surprised that they have spread like a Justin Bieber video on YouTube. (Fun fact: Bieber also was created in Canada.) From the beginning of 2000, when there were only 80 ETFs on the

U.S. market, to the end of 2012, when there were about 1,300 ETFs, the total assets invested in ETFs rose from \$52 billion to just about \$1.3 trillion. In Canada, the ETF industry had just \$3 billion in assets under management in 2000; that's climbed to \$54 billion in 2012.

Certainly, \$54 billion pales in comparison to the \$811 billion or so invested in Canadian mutual funds. But if current trends continue, ETFs may indeed become as popular as the Biebs.

Part of ETFs' popularity stems from the growly bearish market of the first decade of this millennium. Investors who had been riding the double-digit annual returns of the 1990s suddenly realized that their portfolios weren't going to keep growing in leaps and bounds, and perhaps it was time to start watching investment costs. There has also been a greater awareness of the triumph of *indexing* — investing in entire markets or market segments — over trying to cherry-pick stocks. Much more on that topic in Chapter 2.

## *Moving from Bay Street to Main Street*

In the world of fashion, trendsetters — movie stars or British royals — wander out into public wearing something that most people consider ridiculous, and the next thing you know, everyone is wearing that same item. Investment trends work sort of like fashion trends, but a bit slower. It took from 1990 until 2001 or so for this newfangled investment vehicle to really start moving. By about 2003, insiders say, the majority of ETFs were being purchased by individual investors, not institutions or investment professionals.

BlackRock, Inc., which controls about 45 percent of the U.S. market and about 75 percent of the Canadian market for ETFs, estimates that approximately 60 percent of all the trading in ETFs is done by individual investors. The other 40 percent is institutions and fee-only financial advisors.

*Fee-only*, by the way, signifies that a financial advisor takes no commissions of any sort. It's a very confusing term because *fee-based* is often used to mean the opposite. Check out Chapter 20, where we talk about what kind of financial professional can help you to build and manage an ETF portfolio, or whether you need one at all.



Actually, individual investors — especially the buy-and-hold kind of investors — benefit much more from ETFs than do institutional traders. That's because institutional traders have always enjoyed the benefits of the very best deals on investment vehicles. That hasn't changed. For example, institutions often pay much less in management fees than do individual investors for shares in the same mutual fund. (Fund companies often refer to *institutional class* versus *investor class* shares. All that really means is "wholesale/low price" versus "retail/higher price.")

## The little kid is growing fast: ETFs' phenomenal growth

Following are a few facts and figures that indicate how the ETF market compares with the mutual fund market and how rapidly ETFs are gaining in popularity.

The amount of money invested in Canada-based ETFs and mutual funds as of September 2012:

- ✓ **ETFs:** \$54 billion
- ✓ **Mutual funds:** \$811 billion

The total number of Canadian-based ETFs and mutual funds as of September 2012:

- ✓ **ETFs:** 250
- ✓ **Mutual funds:** About 5,000

Increase in Canada-based ETFs since 2006:

- ✓ **2006:** 32
- ✓ **2012:** 250
- ✓ **Percentage change increase:** 681%

Increase in Canada ETF providers since 2006:

- ✓ **ETF providers in 2006:** 2
- ✓ **ETF providers in 2012:** 7
- ✓ **Percentage change increase:** 250%

Total net assets growth in ETFs between 2006 and 2012:

- ✓ **2006:** \$15 billion
- ✓ **2012:** \$54 billion
- ✓ **Percentage change increase:** 250%

## *Mutual funds versus ETFs*

You may think we sound like we're pushing ETFs as not only the best thing since sliced bread but also a replacement for sliced bread. Well, not quite. As much as we like ETFs, good old mutual funds still enjoy their place in the sun. That's especially true of inexpensive index mutual funds, such as the ones offered by TD Canada Trust or CIBC. Mutual funds, for example, are clearly the better option when you're investing in dribs and drabs and don't want to have to pay for each trade you make . . . although some Canadian brokerage houses, such as Scotia iTrade and Qtrade, allow customers to trade certain ETFs for free.

One of the largest purveyors of ETFs is The Vanguard Group, the very same people who pioneered index mutual funds. While the company doesn't offer its mutual funds in Canada, it did start selling ETFs at the end of 2011. Still, because it offers both index funds and ETFs, making an apples-to-apples comparison of ETFs and index mutual funds by looking at Vanguard's American offerings is easy. But rest assured — a point we make over and over in this book — this ain't rocket science. For most buy-and-hold investors, ETFs are almost always the better choice, at least in the long run. We look more closely at the ETFs-versus-mutual funds question when we design specific portfolios and give actual portfolio examples in Chapters 15 and 16.

## *Ready for Prime Time*

Although most investors are now familiar with ETFs, mutual funds remain the investment vehicle of choice by a margin of 15:1. The reasons for the dominance of mutual funds are several. First, mutual funds have been around a lot longer and so got a good head start. Second, largely as a corollary to the first reason, most company retirement plans and pension funds still use mutual funds rather than ETFs; as a participant, you have no choice but to go with mutual funds. And finally, the vast majority of ETFs are index funds, and index funds aren't going to become the nation's favourite investment vehicle anytime soon. They should, but they won't. People just aren't that logical.

Index mutual funds, which most closely resemble ETFs, have been in existence since 1976 when Vanguard first rolled out the Index Investment Trust fund. Since that time, Vanguard and other mutual fund companies have created hundreds of index funds tracking every conceivable index. (TD Canada introduced its popular e-Series index funds in 1999.) Yet index funds remain relatively obscure. According to figures from the Investment Company Institute, index mutual funds in the U.S. hold less than 8 percent of all money invested in mutual funds.

Why would anyone want to invest in index funds or index ETFs? After all, the financial professionals who run actively managed mutual funds spend many years and tens of thousands of dollars educating themselves at places with real ivy on the walls, like Harvard and the University of Toronto. They know all about the economy, the stock market, business trends, and so on. Shouldn't we cash in on their knowledge by letting them pick the best basket of investments for us?

### **The ripple effect: Forcing down prices on other investment vehicles**

You don't need to invest in ETFs to profit from them. They are doing to the world of investing what Chinese labour has done to global manufacturing wages. That is, ETFs are driving prices down. Thanks to the competition that ETFs are giving to mutual funds, fund providers have been lowering their charges. Many companies have cut their management expense ratios (MERs) over the years to help keep mutual funds

attractive. Investors Group, one of Canada's largest fund companies, said in May 2012 that it would start reducing its MERs by 0.4 percent per year on two-thirds of its funds, which is about \$4 per \$1,000 of assets. Part of the reason for the reduction, said the company's CEO, was that Canadians are simply more aware of fund costs these days. Thanks to the ETFs, people know that they can fork over less for fees.

## Can you pick next year's winners?

Okay, study after study shows that most actively managed mutual funds don't do as well in the long run as the indexes. But certainly some do much better, at least for a few years. And any number of magazine articles will tell you exactly how to pick next year's winners.

Alas, if only it was that easy. Sorry, but studies show rather conclusively that it is anything but easy. Morningstar, on a great number of

occasions, has earmarked the top-performing mutual funds and mutual fund managers over a given period of time and tracked their performance moving forward. In one representative study, the top 30 mutual funds for sequential five-year periods were evaluated for their performance. In each and every five-year period, the "30 top funds," as a group, did worse than the S&P 500 in subsequent years.

Good question! Here's the problem with hiring these financial whizzes, and the reason that index funds or ETFs generally kick their ivy-league butts: When these whizzes from Harvard and the University of Toronto go to market to buy and sell stocks, they are usually buying and selling stocks (not directly, but through the markets) from *other* whizzes who graduated from Harvard and the U of T. One whiz bets that ABC stock is going down, so he sells. His former classmate bets that ABC stock is going up, so she buys. Which whiz is right? Half the time, it's the buyer; half the time, it's the seller. Meanwhile, you pay for all the trading, not to mention the whiz's handsome salary while all this buying and selling is going on.

Economists have a name for such a market; they call it *efficient*. It means, in general, that so many smart people are analyzing and dissecting and studying the market that the chances are slim that any one whiz — no matter how whizzical — is going to be able to beat the pack.

That, in a nutshell, is why actively managed mutual funds tend to lag behind the indexes, usually by a considerable margin. If you want to read more about why stock pickers and market timers almost never beat the indexes, pick up a copy of the seminal *A Random Walk Down Wall Street* by Princeton economist Burton G. Malkiel (W. W. Norton). Or check out this website — [www.indexfunds.com](http://www.indexfunds.com) — that's run by something of an indexing fanatic (hey, there are worse things to be) that is packed with articles and studies on the subject. You could spend days reading!

## *The proof of the pudding*

One study, done in 2010 by Wharton finance professor Robert F. Stambaugh and University of Chicago finance professor Lubos Pastor, looked back at 23 years of data. The conclusion: Actively managed funds have trailed, and will likely continue to trail, their indexed counterparts (whether mutual funds or ETFs) by nearly 1 percent a year. That may not seem like a big deal, but compounded over time, 1 percent a year can be *huge*.



To show you how only 1 percent can make a big difference over time, we'll plug in a few numbers: An initial investment of \$100,000 earning, say, 7 percent a year, would be worth \$386,968 after 20 years. An initial investment of \$100,000 earning 8 percent for 20 years would be worth \$466,096. That's \$79,128 extra in your pocket, all things being equal, if you invest in index funds.

Moving from the world of academia and theory to the real world, we now look at that very first ETF introduced in the United States, the SPDR S&P 500 (SPY). Since its inception in January 1993, that fund has enjoyed an average annual return of 8.53 percent — not bad, considering that it survived two very serious bear markets (2000–2002 and 2008–2009). Very few actively managed funds can match that record. (You can find some performance specifics in the next chapter.)

By the way, SPY, as well as it has performed, has several flaws that make it far from our first choice of ETF for most portfolios; we will divulge these in Chapter 5. But despite its flaws, SPY remains by far the largest ETF on the market, with total assets of \$131 billion. (The largest fund of any kind is the PIMCO Total Return mutual fund (PTTRX), with total net assets of \$288 billion.) In terms of number of shares traded daily, nothing even comes close to SPY.

## *The major players*

In Parts II and III of this book, we provide details about many of the ETFs on the market. Here, we want to introduce you to just a handful of the biggies. You will likely recognize a few of the names.

In Table 1-1, we list the six largest Canadian ETFs on the market as of mid-October 2012, as calculated by assets under management.

**Table 1-1 The Six Largest Canadian ETFs by Assets**

<i>Name</i>	<i>Ticker</i>	<i>Assets (in billions of dollars)</i>
iShares S&P/TSX 60 Index	XIU	\$11.50
iShares DEX Short Term Bond Index	XSB	\$2.24
iShares DEX All Corporate Bond Index	XCB	\$2.02
iShares DEX Universe Bond Index	XBB	\$1.92
iShares S&P 500 Index C\$-Hedged	XSP	\$1.77
iShares S&P/TSX Capped Composite Index	XIC	\$1.42

In Table 1-2, we list the six largest U.S. ETFs based on their assets.

**Table 1-2 The Six Largest American ETFs by Assets**

<i>Name</i>	<i>Ticker</i>	<i>Assets (in billions of dollars)</i>
SPDR S&P 500	SPY	\$131.1
SPDR Gold Shares	GLD	\$60.7
Vanguard MSCI Emerging Markets ETF	VWO	\$57.1
iShares MSCI Emerging Markets Index	EEM	\$44.9
iShares Core S&P 500	IVV	\$40.9
iShares MSCI EAFE Index	EFA	\$40.6

## *Commercialization is tainting a good thing*

Innovation is a great thing. Usually. In the world of ETFs, a few big players (BlackRock, State Street Global Advisors, Vanguard) jumped in early when the going was hot. Now, in order to get their share of the pie, a number of new players have entered the fray with some pretty wild ETFs. “Let’s invest in all companies whose CEO is named Fred!” Okay, no Fred portfolio exists, but the way things are going, it could happen.

## RIP these ETFs

New ETFs are being born every week, but at the same time, others are dying. Hundreds of products during the past several years have been zipped up, closed down, folded, and sent to that Great Brokerage in the Sky. No need to shed tears for the investors; they are okay.

If you're holding shares in a particular ETF that closes down, you will usually be given at least several weeks' notice. You can sell, or you can wait till the final day and receive whatever is the value of the securities held by the ETF at that point. It isn't like holding a bond that goes belly up. You may have a bit of a hassle redoing your portfolio, and you may face sudden tax consequences. If the ETF tracks a very small segment of the market, a bit of investor panic may depress prices. But you won't go broke.

As for the purveyors of the ETFs that have closed, we may shed only a crocodile tear or two. Most of the ETFs that have gone under are exactly the kinds of ETFs that we try to steer you away from in this book: They tracked narrow segments of the market (companies based in Oklahoma, for example); or they tracked somewhat silly and complex indexes (dividend rotation); or they were highly leveraged, exposing investors to excessive risk; or they were overpriced; or all of the above! The public simply would not buy. Bravo, public.

Here is just a small sampling from 2012's ETF graveyard:

- ✔ Horizons GMP Junior Oil and Gas Index ETF (HJE)
- ✔ Horizons BetaPro NYMEX Crude Oil Inverse ETF (HIO)
- ✔ Horizons BetaPro NYMEX Long Natural Gas/Short Crude Oil Spread ETF (HNO)
- ✔ Horizons BetaPro NYMEX Long Crude Oil/Short Natural Gas Spread ETF (HON)
- ✔ Horizons BetaPro COMEX Gold Inverse ETF (HIB)
- ✔ Horizons BetaPro U.S. 30-year Bond Bull Plus ETF (HTU)
- ✔ Global X Fishing Industry ETF (FISN)
- ✔ Global X Waste Management ETF (WSTE)
- ✔ FocusShares ISE-Reverse Wal-Mart Supplier ETF (WSI)
- ✔ Russell 2000 Low Beta ETF (SLBT)

On the Internet, a blog exists for anything and everything, including potential ETF closures. ETF Deathwatch lists any U.S. ETF that is at least six months old and has an "average daily value traded" of less than \$100,000 for three consecutive months — or has assets under management of less than \$5 million for three consecutive months. You should probably not get overly attached to these ETFs. To find the Deathwatch blog, go to [www.investwithanedge.com](http://www.investwithanedge.com), and type "deathwatch" in the search box.

We tend to like our ETFs vanilla plain, maybe with a few sprinkles. They should follow indexes that make sense. And, above all, their expense ratios should be loooooow. At present, plenty of ETFs carry expense ratios of 0.20 percent or less. Some of the newer, more complicated ETFs, however, have expense ratios edging up into the ballpark of what you usually see for mutual

funds. Several dozen ETFs that charge 0.75 percent a year or higher now exist, and some even carry net expense ratios of 1 percent or more.

Not all ETFs must follow traditional indexes — the ETF format allows for more variety than that. (Actually, when we think about it, some of the traditional indexes, like the Dow, are darn dumb. We explain why in Chapter 3.) But the ETF industry has lost some of its integrity over the past few years with higher expenses and some awfully silly investment schemes.

The rest of this book can help you to sidestep the greed and the silliness — to take only the best parts of ETF investing and put them to their best use.