

## IN THIS CHAPTER

- » Discovering the origins of ETFs
- » Understanding the role ETFs play in today's world of investing
- » Tallying ETFs' phenomenal growth
- » Looking at the biggest names in ETFs

# Chapter **1**

# No Longer the New Kid on the Block

**Y**ou can tell how much the conversation around ETFs has shifted in the way traditional mutual fund firms now talk about these securities. In 2006, when Bryan got his first job writing about investing and finance, even just a mention of an ETF sent conservative money managers and their public relations teams into denial. Now, almost all of the stalwart investment firms are selling and marketing ETFs, while their communication teams are more than happy to arrange interviews with experts willing to espouse the benefits of these funds.

The sheer number of ETFs has skyrocketed, too. At the end of 2021, there were 965 ETFs in Canada — up from 250 when we last wrote this book — and about 9,700 ETFs available for purchase around the world. In 2019, net sales for ETFs outpaced net sales for mutual funds for the first time, and while mutual funds still hold most retail assets in Canada, ETF assets are rapidly rising with each passing year. (Mutual funds aren't losing their dominance anytime soon, though — mutual fund sales outpaced ETF sales on a year-over-year growth basis in 2021.)

These are all good things. 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 (short for Toronto Index Participation). 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.



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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. You get an introduction 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. Although 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.

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, 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 are touched on in Chapter 23. For 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 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 around \$3,000 (2 percent) or so in annual expenses. By switching to an ETF portfolio, that investor might incur — if they incur any trading costs at all — perhaps \$50 or so to set up the portfolio, and maybe \$20 or so a year thereafter. But now their ongoing annual expenses will be about \$308 (0.2 percent). That's a difference, ladies and gentlemen of the jury, of big bucks. You're looking at an overall yearly savings of almost \$2,700, 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. You can find out about diversification and how to use ETFs as building blocks for a core portfolio in Parts 2 and 3.

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 you find 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.

Chapter 2 covers the transparency and cleanliness of ETFs in greater detail.

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

ETFs have a lot going for them, so it’s not surprising that they have spread like a Justin Bieber Timbiebs ad. (Fun fact: Bieber was also created in Canada.) From the beginning of 2000, when there were only 80 ETFs on the U.S. market, to the end of 2021, when there were about 2,300 ETFs, the total assets invested in ETFs rose from \$52 billion to just about \$5.4 trillion. In Canada, the ETF industry had just \$3 billion in assets under management in 2000; that’s climbed to \$323 billion in 2021. Globally, assets in ETFs broke the \$10-trillion mark in December 2021.

Certainly, \$323 billion pales in comparison to the \$2 trillion or so invested in Canadian mutual funds. But if current trends continue, and there’s no reason they won’t, then ETFs will become as popular as the Biebs.

ETFs’ popularity among investors stems from the aftermath of the Great Recession, when people lost a bundle of money in actively managed portfolios.

The financial crisis did two things: it made people realize that fund managers can't protect their clients against catastrophic events, which then made them realize they were paying too much for no protection. At the same time, more research was coming out indicating that most active managers don't beat their benchmarks after fees are accounted for. So, if you can't beat the index, then why not join it? Much more on that topic in Chapter 2.

## 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 December 2021:

- **ETFs:** \$348 billion
- **Mutual funds:** \$2 trillion

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

- **ETFs:** 965
- **Mutual funds:** About 5,000

Increase in Canada-based ETFs since 2012:

- **2012:** 250
- **2021:** 965
- **Percentage change increase:** 286%

Increase in Canada ETF providers since 2012:

- **ETF providers in 2012:** 7
- **ETF providers in 2021:** 40
- **Percentage change increase:** 471%

Total net assets growth in ETFs between 2012 and 2021:

- **2012:** \$54 billion
- **2021:** \$348 billion
- **Percentage change increase:** 544%

## Moving from Bay Street to Main Street

In the world of fashion, trendsetters — movie stars or British royals — wander out in 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 do, but at a slower pace. 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 more than a third of the U.S. market and more than a quarter of the Canadian market for ETFs (by assets), estimates that approximately 60 percent of all the trading in ETFs is done by individual investors. The other 40 percent of all trading in ETFs is carried out by 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. You can check out Chapter 26 to find out whether you need a financial professional (and what kind you need) to build and manage an ETF portfolio.



REMEMBER

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.”)

## 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 Wealthsimple, National Bank, and Questrade, allow customers to trade many ETFs for free.

## THE RIPPLE EFFECT: FORCING DOWN PRICES ON OTHER INVESTMENT VEHICLES

You don't need to invest in ETFs to profit from them. Why? Because 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. However, Canada's mutual fund firms haven't moved as quickly to cut their costs, with a 2019 Morningstar report finding that the country had the third-highest MER — 1.98 percent — for equity funds out of the 26 countries it studied. At some point, that number will fall — the average MER in the U.S. is 0.49 percent — or the ETF will eat the mutual fund industry's entire lunch, not just its sides.

One of the largest purveyors of ETFs is The Vanguard Group, the very same people who pioneered index mutual funds. In the case of Vanguard, shares in the company's ETFs are the equivalent of shares in one of the company's index mutual funds. In other words, they are different share classes of the same fund — the same representation of companies but with a different structure and generally slightly lower management fees for the ETFs.



TIP

Because Vanguard funds allow for an apples-to-apples comparison of ETFs and index mutual funds, and because the company presumably has no great stake in which you choose, Vanguard may be a good place to turn for objective advice on which investment is better for you. But rest assured, this ain't rocket science (a point that is repeated elsewhere in this book). For most buy-and-hold investors, ETFs will almost always be the better choice, at least in the long run. You look more closely at the ETFs-versus-mutual-funds question when you see actual portfolio examples in Chapter 16.

## Ready for Prime Time

Although most investors are now familiar with ETFs, mutual funds remain the investment vehicle of choice by a wide margin. Mutual funds are still dominant for several reasons. First, they've been around a lot longer and so they got a good head start. (The first mutual fund, called the Massachusetts Investors Trust, was founded in 1929.) Second, largely as a corollary to the first reason, most company retirement plans and pension funds still prefer mutual funds to ETFs; as a participant, you have no choice but to go with mutual funds. And finally, the vast majority of ETFs, unlike mutual funds, are index funds, and index funds have only fairly recently — after a long, uphill battle — caught the eye of millions of investors.

Index mutual funds, which most closely resemble ETFs, have been in existence since 1976 when Vanguard, under visionary John Bogle, 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. But it has taken a long time for them to catch fire.

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 you cash in on their knowledge by letting them pick the best basket of investments for you?

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 they sell. Their former classmate bets that ABC stock is going up, so they buy. 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.

## CAN YOU PICK NEXT YEAR'S WINNERS?

Okay, study after study shows that most actively managed mutual funds don't perform 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 and websites 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.

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 the website, <https://ifa.com>, which is run by something of an indexing fanatic (hey, there are worse things to be) and is packed with articles and studies on the subject. You could spend days reading!

## The proof of the pudding

Every year, S&P Dow Jones Indices releases a report looking at how active managers fared against their benchmarks. In 2019, a whopping 64.5 percent of large-cap funds underperformed the S&P 500. If that number sounds bad, then look at the 10-year and 15-year figures: after a decade, 85.1 percent of large-cap funds failed to beat the S&P 500, while 91.6 percent underperformed it after 15 years.

A lot of people still say that active management works best in volatile markets, where managers can mitigate risks. Well, guess what? In 2020, with the pandemic causing all kinds of volatility, Morningstar found that out of the 3,000 actively managed funds it analyzed, just 47 percent outperformed their average passive index between June 2020 and 2021. That's no better than a coin flip. S&P found that over that same time period, 58 percent of large-cap, 76 percent of mid-cap, and 78 percent of small-cap mutual funds trailed their respective benchmarks (the S&P 500, S&P MidCap 400, and S&P SmallCap 600, respectively).

Let's plug in a few numbers to show you what underperformance can mean. These calculations are based off a 2010 study by Wharton finance professor Robert F. Stambaugh and University of Chicago finance professor Lubos Pastor, who looked over 23 years of data and found that 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*.

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 to a real-ETF-world example, let's 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 (as of mid-2021) of 10.4 percent — not bad, considering that it survived several very serious bear markets (2000–2002, 2008–2009, and 2020). Very few actively managed funds can match that record. (You'll find some performance specifics in the next chapter.)

SPY remains by far the largest ETF on the market, with total assets of \$396 billion. In terms of average number of shares traded daily, nothing even comes close to SPY: 83 million shares.

## The major players

Parts 2 and 3 of this book provide details about many of the ETFs on the market. Here, you are introduced to just a handful of the biggies. You will likely recognize a few of these names.

Table 1-1 lists the six largest Canadian-listed ETFs on the market as of January 2022, as calculated by assets under management.

**TABLE 1-1**

### The Six Largest Canadian ETFs by Assets

Name	Ticker	Assets (in billions of dollars)
BMO S&P 500 Index ETF	ZSP	\$13.79
iShares S&P/TSX 60 Index ETF	XIU	\$11.51
iShares Core S&P/TSX Capped Composite Index ETF	XIC	\$9.98
iShares S&P 500 Index ETF (CAD-Hedged)	XSP	\$8.21
BMO S&P/TSX Capped Composite Index ETF	ZCN	\$7.37
Vanguard S&P 500 Index ETF	VFV	\$6.54

Table 1-2 lists the six largest U.S. ETFs based on their assets.

**TABLE 1-2**

### The Six Largest American ETFs by Assets

Name	Ticker	Assets (in billions of dollars)
SPDR S&P 500 ETF	SPY	\$363
iShares Core S&P 500 ETF	IVV	\$278
Vanguard Total Stock Market ETF	VTI	\$239
Vanguard S&P 500 ETF	VOO	\$220
Invesco QQQ ETF	QQQ	\$160
Vanguard FTSE Developed Markets ETF	VEA	\$97

## 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.

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. When ETFs first hit the market, most had expense ratios that hovered in the 0.20 to 0.40 percent range. Strangely, the growth in the market has created a big divide. The more basic ETFs, such as those that track the S&P 500 or S&P/TSX Composite Index, have, due to a lot of competition, come down in price. At present, there are dozens upon dozens of ETFs that carry expense ratios of 0.10 percent or less.

Conversely, many of the newer, more complicated ETFs (and we don’t use “complicated” as a compliment), have expense ratios edging up into the ballpark of what you would pay — even what you would’ve paid several years back — for mutual funds. In the U.S., approximately 140 ETFs now carry net expense ratios of 1 percent or more; 19 of these have an expense ratio of over 2 percent.

Not all ETFs must follow traditional indexes — the ETF format allows for more variety than that. (Actually, when you think about it, some of the traditional indexes, like the Dow, are pretty dumb. You find out 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.

