The Stan Clark Financial Team's

PERSPECTIVES

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Investing

Exchange traded funds: They're not all good anymore

By Michael Chu - Investment Advisor

Exchange traded funds (ETFs) combine some of the best features of mutual funds and individual stocks. Like mutual funds, ETFs present a diversified portfolio. Like stocks, they trade on an exchange and can be purchased or sold throughout the day.

We often use index exchange traded funds: They're a low-cost and efficient way to get exposure to an index such as the Canadian TSX Composite. In our International ETF strategy, we also use country ETFs, which invest in the indexes of countries such as Germany, Australia or South Korea.

However, over the last few years, the number of ETFs has grown substantially. ETFs were first designed to track broad market indexes. But they soon began tracking sectors, currencies, bonds and even commodities. There are also ETFs that use leverage and derivatives to get long and short exposure. With all these features, the ETF world is getting much more complex – and it's not always low-cost. Now we have to be more discerning; and aware that just because it's an ETF, it's not necessarily good.

The key to evaluating ETFs is first to look at what we are trying to accomplish. For example, if we wanted exposure to Japan, we would look for a Japanese country ETF. This would give us a diversified portfolio of hundreds of Japanese companies. But there are a few different Japanese ETFs available. So, we would then further evaluate them to look at things such as their costs, liquidity, size and investment methodology. We would want to keep the overall cost of investing low. That would mean we favour funds with low fees, good liquidity and sizable assets. We would also want to make sure the methodology of how they invest is sound.

There are other factors that we would review, such as the ETF's performance difference and tracking error. *Performance difference* is how the ETF performs compared to its benchmark. For example, the return on the Standard and Poor's 500 Index since 1993 has been 8.77% per year. The ETF that we would use for this index has had a return of 8.64%. That's very good, with an extremely low difference of 0.13% in performance. There will always be some difference because of costs.

The factor called *tracking error* measures how consistently the fund matches its benchmark. Again, a lower number is better, as you would prefer not to have swings of under or over-performance for this purpose.

In summary, the ETF world has expanded tremendously and things aren't as simple as they used to be. At the Stan Clark Financial Team, we will generally be sticking with the more traditional ETFs – those that are low-cost, transparent and do the job we want. ■

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