Evaluating ETFs

The exchange traded fund (ETF) market in Canada has expanded significantly over the last five years. Not only has the number of new products and investment niches expanded, but additional products have been launched that offer exposure to exisiting market segments. These new products can offer different replication structures, diverse portfolio construction methodologies, or simply lower management fees. With over 250 Canadian ETFs currently available to investors, it has become increasingly important to learn how to evaluate ETFs.

1. Choose your exposure

First, review the merits of diversification available through a wider exposure ETF against the precise targeting allowed by an industry ETF. As an example, an investor looking to invest in Canadian banks could use broad market equity ETFs, dividend ETFs, financial sector ETFs, or a bank specific ETF.

2. Choose how the portfolio is weighted

While ETFs may target the same market segment or industry, they could use a different weighting scheme such as market capitalization, equal weighting, or factor weighting. The appropriate choice may differ across asset classes or through the preferences of specific investors.

3. Choose how to access the exposure

The majority of Canadian ETFs attain exposure by holding physical securities. A subset of ETFs use total return swaps to get market exposure. These ETFs receive the return of an index from a financial institution. An investor should analyze the added counterparty risk and additional fees against the advantages offered through the swap.

4. Choose a trusted provider

It's important to look at the track record, product shelf, and financial soundness of a provider. As the industry matures, fund closures may occur, putting greater importance on using established providers.

Also consider the service and support that the provider dedicates to their ETFs. A responsive, locally based team can help with research and provide support documents.

Return Considerations:

Total Cost

The total cost of transacting in an ETF includes the management expense ratio (MER), the trading expense ratio (TER), and the trading spread on the exchange. The MER will include management fees and taxes. The TER will include portfolio expenses such as commissions paid and withholding tax on foreign income. The trading spread will reflect the liquidity of the underlying portfolio and will decrease as the ETF matures and is more heavily traded in the secondary market.

A key consideration in evaluating total cost of ETFs against other investment vehicles is the time horizon of the investment. The longer the holding period, the greater the impact of the low MERs on ETFs. The shorter the holding period, the greater the impact of possible spread costs on ETFs.

Tracking Error

A key measurement of success is the ETF's ability to closely track its index. Tracking error can be both positive and negative, however, even positive tracking may not be favourable, as it indicates the possibility of negative tracking in the future. While the expected tracking error may widen on more difficult to access asset classes compared to plain vanilla Canadian equities which are very liquid, a fair comparison can be made across similar ETFs.

With the increasing selection of ETFs now available, these factors will help investors clarify the most appropriate ETF solutions to match their investment objectives.

10/12-1391b

BMO Exchange Traded Funds