The ABC's of ETF's:

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ETF's, Indexing, or passive investing – whatever the name, you can't get away from it lately. I bet there's been more articles written about indexes or ETF's in the past 24 months than there have been since they were first invented in the early 1990's.

ETF's are Exchange Traded Funds. They are an investment portfolio that trades like a stock on an exchange. Most are focused on a basket of securities designed to track the performance of an index with a specific objective. With the popularity that's boomed in the past 24 months, more have been created and there is now a wide breadth of product and providers on the markets. This is great for choice in the ETF market, but can make choosing the right one a very confusing task.

For example, you can target TSX 60, with dividends or without, or target a specific sector or even bonds. Global ETF's are quite varied as well, representing many indexes, and alternatives, such as "agriculture" or "water". Obviously, just as stock returns vary, so do the returns of indexes. A few months ago, one source quoted the total number of indexes available for purchase as1,800. I know more have been created since, so at this time, we can consider the list virtually limitless.

What makes ETF's so great? They are a simple vehicle that identifies exactly what you're holding, and has full disclosure at all times. There is no "special purchase" that will help to generate your returns. They have lower costs than many typical actively-managed funds, with most MERs ranging from 0.15% to 0.65%. (MER= Management Expense Ratio and it's the fees that are deducted behind the scenes to cover the cost of running the product)
They are available in a broad host of areas, so it's easy to target a sector, or geographical region that you're most interested in, or even a type of investment such as trust units, REIT's or bonds.
They can generally be bought and sold throughout the trading day, helping you to react to market shifts & maximize (or minimize) price points for buys and sells.
They also allow you quick diversification, without taking on individual stock risk.
As they trade like a stock, additional strategies can be used, such as stop loss orders. This means that if you want to sell if the index drops by 10% as you want to limit your risk, you can put an order in to sell if it hits that price. Keep in mind, in an open market, while you may want to sell at 10% less, once it hits that price; your order could fill at any price under that! This means in extreme situations, you could sell for significantly less if the market drops very rapidly.

Why are indexes not for everyone? You need to monitor them. There is no manager choosing what and when to buy and sell stocks to keep things in check. While managers don't always get it right, they are trying to manage the risk. Nobody does this when you purchase an index. You simply need to trim when profits are high, and buy when it dips, and keep to your gameplan.

As ETF's track the index, they also get both the upside and the downside. In my experience, most people say they're willing to accept this, but when the index actually drops close to 50%, most people are not! The volatility really can be a challenge if you cannot tolerate it and react at the wrong time.

Currently, with the rapid addition of so many new indexes and ETF's there could be a liquidity issue. Generally, many of the larger ones are actively traded and if you are willing to take the market price, it can fill quickly. However, for certain specialty ETF's, or even some of the more mainstream ones, in a difficult market, there can be a delay and you may not be able to get the price you want. Keep this in

mind, and review the amount that's traded daily and how consistently. By noting # of trades, and volume of units, it will help you to get a better sense of the liquidity of the item. When comparing these to mutual funds, the mutual fund issuer has a requirement to purchase back the units at the Net Asset Value based on the closing day's price. While there have been a few rare situations where this hasn't applied, liquidity is almost never an issue for mutual funds.

The spread between buys and sells is wider than with typical stock trades. The brokerage that's behind the scenes trying to work at getting all orders filled is called the market maker and they wish to make a profit on these items. This means there can be more rapid swings in the price if you're not careful, especially when markets open and close. This means you need to be careful about placing orders to ensure you get a fair price that you're willing to pay.

Indexes tend to have a growth bias. While this sounds great in an up market, it tends to add volatility over the long-term. An example of this is if a stock is increasing in value, but isn't necessarily doing anything different, then that valuation will carry up the index. If it's decreasing and is really cheap, and undervalued, the index owns less as a % of the representation. Think of Nortel in 2000 when it became almost 33% of the TSX index. Most managers had sold the stock too early and didn't ride it to the peaks of over $120/share. However, while they lagged on the upside, they were also protected on the downside, and didn't plummet as much as the index did either. Who analyzes the balance sheet of a stock on the index, and decides when it's too risky? Nobody.

It's for this reason alone, I strongly recommend using indexing with other strategies. I also suggest avoiding indexes for certain areas where there's a huge variety of what can be held in the index. Small cap stocks, for example, are known for being high risk with huge diversification and a wide variety of potential for growth, and the index will capture all of this, both good and bad. In this case, do you want to own the index? What if 30-40% of the companies have balance sheets with too much debt and businesses that could be in trouble in 12-24 months. This may not be the case, but it's an example of what can happen in extreme markets. Small caps is one area where I prefer active management.

One recent addition to the index product line up is called "Intelligent Indexing". It combines the reduced cost of indexing with some of the benefits of implementing a few strategies to better enable "downside" protection. By using a combination of screening items, it will further screen the stocks for inclusion. Measurements such as "cashflow, total sales, book equity value and dividends are all factored in for a more strict screening process. These indexes to date have captured most of the upside than the traditional indexes, yet reduced the downside. While it's not foolproof, the concept helps make indexing a better vehicle for more prospects as the risk is managed more effectively. For more information on these types of vehicles, go to www.claymoreinvestments.ca and www.powershares.com, both companies have a variety of options that incorporate these additional screening strategies using the RAFI (Research Affiliates) process.

Just like any investment that has no guarantees, make sure it fits your timeline, your risk tolerance and really complements your portfolio. Don't just chase returns, as they're seldom repeated. The biggest investment mistake people often make is too many assumptions, too little homework and too little diversification. This error can be made with ETF's, just like any other investment vehicle.

ETF's are here to stay, but many will come and go. So choose wisely, don't assume they are foolproof, and hopefully, you'll find one that may be right for your portfolio.
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