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Understanding exchange traded funds (ETFs)

Investing fundamentals series

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Exchange traded funds (ETFs) have garnered a great deal of attention around the world in recent years. These versatile investment vehicles were first traded in Canada 30 years ago and have steadily evolved to include more than 8,000 ETFs globally.[1]

The concept of an ETF is similar to a mutual fund in that both serve as a basket of individual investments that offer a mix of different assets, (typically stocks and/or bonds) with the added benefit of portfolio diversification.

How are ETFs different from mutual funds?

Most of the differences relate to how investors buy and sell fund units. With mutual funds, units are bought and sold directly from the fund (through a financial advisor) at a net asset value (NAV) calculated once a day.

That ability to trade at the daily NAV may offer sufficient flexibility for many investors. Others may want the greater flexibility offered by ETFs, which may be bought and sold on an exchange at their traded market price.

Similar to a mutual fund, ETF investors buy a fraction of the overall portfolio, measured in "units". Sometimes there are enough units for sale on the exchange to satisfy buyers' demand. When there isn't, new units are created by a "market maker" which buys the underlying securities of the ETF on the open market.

The market maker delivers these securities to the ETF in exchange for new units. The market maker then sells the ETF units on the stock market to investors.

When supply is greater than demand, the process is reversed, with the market maker buying ETF units, delivering them back to the ETF itself and receiving the underlying securities in exchange.

It may sound complicated, but this is meant to ensure the ETF's price doesn't stray too far from the actual value of its underlying portfolio. It also protects existing unitholders from bearing the costs of other investors moving in or out of the ETF.

[1] Source: ETFgi, as at May 2020.

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	ETF	Mutual Fund
How it's traded	Units bought and sold through a stock exchange	Units bought and sold directly through the fund company
Price accuracy	Market price of an ETF is based on the fund's holdings, plus marketplace supply and demand. ETFs may trade at a premium or discount to net asset value (NAV) in periods of volatility	Reflects net asset value (NAV), based on last traded price of the mutual fund's holdings
How to buy / sell	Through an advisor or through a self-directed account	Through an advisor or through a self-directed account
Trading flexibility	Trades are executed throughout the trading day; large trades can also be executed at end-of-day price (NAV)	Trades are executed at the end-of-day price (NAV)
Management fees	Typically lower relative to mutual funds	Typically higher relative to ETFs
Transaction costs	The ETF buyer or seller bears the trading costs; all other investors are not impacted	All purchase and sale transactions costs are shared among all unitholders
Year-end distributions	Capital gains are reinvested (this is common practice in the ETF industry); this results in phantom income distributions	Capital gains are not reinvested unless an investor asks to do so

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ETF management styles

Passive broad-index ETFs

The first ETFs offered investors the chance to track well-known stock indices, such as the TSE 35 (the original ETF) and later the S&P 500. The ETF would passively follow the index, without the day-to-day input from a portfolio manager.

Today, these are often called "plain vanilla" ETFs and a multitude of alternative flavours have come to market.

Strategic beta

Also known as "smart beta" or "factor-based" these passive strategies generally seek to either outperform the "plain vanilla" indices and/or reduce risk. They follow a strictly defined set of rules to select and weight the securities they hold, rather than simply following the market-cap weighting of a traditional index.

Actively managed

More recently, ETFs have been listed that are actively managed by professional portfolio managers. These generally seek to beat, or outperform the passive indices, rather than track them.

Types of ETFs

The popularity of ETFs has led to the expansion of their range beyond developed market equities and fixed income. Investors may now be able to find an ETF to fit any investment niche, including:

Asset allocation

Alternatives

Commodities

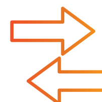
Currency

Real estate

Environmental, Social and Governance (ESG)

Emerging markets

Leveraged investing



Inverse returns

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Why invest in ETFs?

There are several benefits to the ETF structure:

ETFs can be efficient, low-cost investment vehicles

ETFs offer transparency with performance and fee reporting

ETFs offer diversification, having expansive investment options with a broad range of asset classes, sectors and geographies as well as thematic categories

ETFs can be more liquid than individual securities

ETFs are easily accessible, providing trading flexibility, with intra-day trading and real-time pricing

ETFs can offer greater tax-efficiency, because redemptions don't require the ETF to sell securities, which may otherwise cause it to incur a taxable capital gain

ETFs have evolved to include a considerable depth and breadth of investment strategies

Talk to a financial advisor to learn more about which investments meet your financial goals.

Commissions, management fees, brokerage fees and expenses all may be associated with Exchange Traded Fund investments. Please read the prospectus before investing. Exchange Traded Funds are not guaranteed, their values change frequently and past performance may not be repeated.
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