

Active Debate Over

ETFs allow for picking and choosing strategies, mixing risk, reward and cost

BY SCOT BLYTHE

There's a new set of ABC's in Canada: alpha, beta and cost, or so suggest a panel of experts at June's seventh annual Canada Cup of Investing.

In the early days of indexing in Canada, the selling point was cost. In the background was the theory that buying and holding the entire market was the most efficient way to proceed: lower distributions, no regrets over market-timing, all this with stripped-down management fees and trading commissions.

Indeed, it led to the notion of a simple couch-potato portfolio: 40% bonds, 20% TSX Composite, 20% S&P500 and 20% EAFE for the rest of the world. That portfolio could be implemented with index funds offered by the banks, along with Altamira. Or later, it could be structured using exchange-traded funds based on a specific stock index.

But, as markets do with regular efficiency, the indexes disappointed. There was the massive weight

of Nortel in particular, and tech in general, whose cloudy earnings forced sky-high stocks back to earth abruptly in 2000.

That's when Howard Atkinson, then in charge of ETFs at Barclays's Global Investors Canada, and now president of Horizons Beta Pro, started promoting the iUnits ETFs.

"Back in 2000 when I got involved with ETFs," he remembers, "first the market kind of did its thing, with a little bit of a top, you might recall, and I thought a few months after I got to Barclays, 'what the hell have I done. I'm in long-only indexing and this isn't going to be pretty.'"

But assets grew every year. And with the headwind of the market falling 50% from peak to trough in the U.S. through that period, he argues "As returns went from double digits to single digits, negatively as was the case in those years, costs really mattered."

But it's not just costs – or not only costs.

"The iShares program has around the world really changed the landscape of investing; it's driven cracks into the status quo, and the transparency," suggests Heather Pelant, head of ETFs at Barclays. (Barclays now calls its ETFs iShares instead of iUnits in Canada.)

"Risk, cost and return have to come together in every portfolio. There's an interplay between these three things. A lot of the conversation has been about return without bringing in the cost or risk part of the conversation."

Adds Som Seif, president and CEO of Claymore Investments, "At the end of the day, they're popular because they are good for investors." He suggests that ETFs offer "the ability to get exposure to the marketplace and to use these products in multiple ways, whether it's asset allocation, whether it's a complement to your portfolio against an active money manager or against a stock, or for hedging strategies."

Still, despite the various uses of ETFs, which Atkinson once likened to the versatility of a Swiss army knife, Pelant says "There has

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not really been a robust indexing conversation with the Canadian retail investor. This is a very heavy active mutual funds world. I think that's a legacy issue. "

But it isn't just about retail, nor is the conversation solely about costs, Pelant adds.

"One of the fastest trends I've seen is this conversation around indexing, or you can call it beta. I think the advisor in the future in Canada is going to become adept about talking how to source out a beta, how to source out an alpha, and even more importantly, how do you blend those two together."

Indeed, blending seems to be the theme. Dale Powell, an institutional consultant at Morningstar, argues that "ETFs are an excellent way to fill holes in a portfolio." So much so that the traditional debate between passive and active management seems to be over.

Certainly, that's Atkinson's view.

"It's not either/or; it's how do you intelligently combine the two in a portfolio to deliver risk-adjusted returns and satisfy your clients."

Each of the three panellists offers a different perspective on risk, and cost-adjusted returns.

Pelant points to the high cost of bond-fund management. Fees are 169 basis points versus 30 for a bond ETF. Indeed, her fastest-growing product is the real return bond ETF.

Adds Powell, "We view them as a cost-effective way to get beta exposure. We are particular fans of bond ETFs, it's pretty difficult to get a meaningful sort of return out of a bond fund investment. I would put it to individual investors that it's pretty tough to build a diversified portfolio of bonds on your own."

While Horizon BetaPro offers leveraged ETFs, Atkinson says advisors need not leverage. Since his ETFs offer double the market exposure, one product can free up half the money for other assets, while still maintaining a market weight.

Apart from that, "it's interesting that our products do become more popular in volatile markets," he says. In today's sideways market, he suggests, "You can put money in directional markets; but if you're a buy and hold investor, your returns at the end of the day are going to look pretty poor." With ETFs, he explains, investors will lose some of the upside, but trim the downside, and it's the downside that causes investors to bolt.

Atkinson thinks that global equity movements are increasingly correlated. But some ETFs can offer diversification, whether by weighting markets differently or targeting specific sectors.

"What we're really trying to bring is products that are designed around giving a view on the market that somebody wants to tilt toward, whether it's water, agriculture, global mining," explains Seif. "I think a lot of investment advisors are using our business as core asset allocation tools, as complements to actively managed stocks, complements to pure beta products, as well as for sector-based strategies in areas of the market that they want to tilt their strategies to."

But the very variety of ETFs presents a problem, and an opportunity for advisors.

In the early days of ETFs, they were perfect for a couch-potato portfolio. Now there are so many of them – 1,300 by Pelant's count – that, says Atkinson, clients need advisors to sort through them.

Fund Wrap

The mutual fund industry managed to post modest net sales in the month of May, according to the Investment Funds Institute of Canada (IFIC), with net new money estimated at between \$2.2 billion and \$2.71 billion.

Fortunately, strong market performance

helped boost industry AUM. Net assets of the mutual fund industry at the end of May were estimated to be between \$717 billion and \$722 billion.

What helped to boost those returns was strong growth in energy and materials prices and precious metals-oriented funds – all of which were top performers in May, according to Morningstar Canada.

Even at the low end of IFIC's estimate, net new sales were well higher than April's total of just over \$560 million. But May's sales were highly concentrated among a handful of firms.

Even non-resource-related portions of the Canadian indexes did well. This was mainly the result of the strong performance of market heavyweight Research in Motion. **AER**

MORNINGSTAR FUND INDEX

As of May 31, 2008	1M	YTD	As of May 31, 2008	1M	YTD
Natural Resources Equity	8.5	14.2	Japanese Equity	1.0	-1.0
Precious Metals Equity	6.0	-1.4	2010 Target Date Portfolio	0.9	1.6
Canadian Equity	5.6	6.9	Global Neutral Balanced	0.8	-0.1
Cdn Small/Mid Cap Equity	4.2	0.8	Emerging Markets Equity	0.7	-3.0
Canadian Income Trust Equity	4.0	7.0	Global Fixed Income Balanced	0.7	1.5
Canadian Focused Small/Mid Cap Equity	3.9	-2.4	Canadian Fixed Income Balanced	0.5	1.4
Science & Technology Equity	3.7	-4.1	US Equity	0.4	-5.0
US Small/Mid Cap Equity	3.5	-3.0	Canadian Money Market	0.2	1.4
Canadian Dividend & Income Equity	3.2	2.4	European Equity	0.2	-3.2
Canadian Focused Equity	3.1	2.2	High Yield Fixed Income	0.2	0.6
Canadian Inflation-Protected Fixed Income	2.7	5.9	US Money Market	0.2	1.2
Canadian Equity Balanced	2.5	2.3	Canadian Short Term Fixed Income	0.0	2.5
2020+ Target Date Portfolio	2.4	1.5	Global Equity	0.0	-3.9
Tactical Balanced	2.0	0.2	Canadian Long Term Fixed Income	-0.1	-0.2
North American Equity	1.9	-0.8	Canadian Fixed Income	-0.2	1.7
Canadian Neutral Balanced	1.8	2.5	International Equity	-0.4	-4.7
2020 Target Date Portfolio	1.5	1.6	Real Estate Equity	-1.3	0.1
Health Care Equity	1.4	-4.9	Asia Pacific Equity	-1.5	-6.5
Global Equity Balanced	1.3	0.2	Financial Services Equity	-1.5	-7.3
Global Small/Mid Cap Equity	1.3	-4.5	Global Fixed Income	-1.7	2.5
2015 Target Date Portfolio	1.2	0.9	Asia Pacific ex-Japan Equity	-2.2	-7.9