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PUR Investing Inc., is a Toronto-based software development firm registered as a portfolio manager with the OSC that engineers disruptive investment and pension strategies for Gen X/Gen Y/ Gen F, and mass affluent investors by combining and leveraging new technologies with innovative investment products and ideas.

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Getting Tax Back With ETFs

Mark Yamada / January 06, 2011

My colleague is always on the lookout for deals and bargains. Growing up in Saint Petersburg during a transitioning Russian economy made everyone resourceful. She and her family have used coupons to clean out stores, with the clerk paying her at checkout! She applies the same frugal approach to constructing core-and-satellite structures for taxable portfolios, and saves money by systematically harvesting tax losses using ETFs.

Core-and-Satellite Portfolios

Core and satellite refers to a combination of assets originally designed as an alternative to balanced funds (a combination of stocks, bonds and other assets).

Once upon a time, pension funds invested primarily in balanced funds. Larger plans simply added more balanced funds. Then, somebody figured out that this approach inevitably resulted in overlapping holdings, styles, or other factors, which led to index-like performance at full fees.

The economical approach was to build a passive or indexed core portfolio plus a satellite portfolio of individual securities and/or specialty funds seeking to add alpha; that is, returns in excess of the benchmark.

Today, core-and-satellite portfolio construction is well established in the institutional world and, thanks to the cost, liquidity and risk efficiencies of exchange traded funds (ETFs), is rightfully gaining a retail investor following as well.

Born of cost efficiency, core-and-satellite construction is not only an intelligent approach, it can also improve investment results. Lowering costs is the only sure way to increase returns, other than trading on good, material, non-public information — an increasingly scarce commodity and, alas, illegal!

While retail investors can benefit from this innovation, it stops short. Most institutional portfolio managers don't deal with one aspect of personal investing that's critical and pervasive: TAX. The largest training grounds for portfolio managers — pension funds, mutual funds and insurance companies — don't care much about taxes at the investor level. Advisors can add value to their clients' portfolios by providing what these professional portfolio managers don't: An effective way to shelter capital gains.

Core-and-Sputnik Portfolios

The core should reflect the client's strategic asset mix at low cost. The satellite, meanwhile, should strive to generate excess returns. However, the core could be designed to capture tax losses to be applied to the capital gains of the satellite. We refer to taxable core-and-satellite portfolios as core and sputnik.

A simple example of a 60% equity / 40% bond core portfolio is shown on the left side of the first table (see "Sample core portfolio with tax substitutes").

Assume the Canadian equity market fell. Selling HXT would capture a tax loss, but to avoid the superficial loss rule that would void the loss for tax purposes, HXT could not be repurchased for 30 days, leaving the portfolio underexposed to Canadian equities.

So, one could sell HXT and immediately buy an equal dollar amount of XIU (which has the identical underlying index as HXT, the S&P TSX 60), XIC or ZCN, and maintain exposure to the asset class while harvesting the loss to be applied to gains in the current tax year, carried back three years, or forward indefinitely.

Theoretically, with different sponsors and different structures — Horizon Betapro for HXT using swaps and Blackrock for XIU using full replication — this pair are ideal substitutes for each other. However, there are some who feel the Canada Revenue Agency may disallow swaps of identical underlying indices. So ask your tax advisor before executing this tax-loss trade, or any other trade that involves tax.

Tax-loss harvesting is an imprecise science. While the Canadian equity substitutes shown have an R2 of about 98%, indicating they generally move together, short-term returns can be different.

Other Ideas

International equity exposure through XWD could be swapped simultaneously for equal parts of ZDM and ZUE. The bond swap out of ZCM into either 50% XCB/ 50% XSB or into CBO illustrates that there are creative ways to replicate exposure using ETFs.

The transparent nature of ETFs and their dampened volatility means finding risk equivalents to swap is easier. The results can be worthwhile. Tax efficiency ranks right up there with insider trading as a certain way of boosting returns, or at least protecting them.●

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‘Don’t Ask, Don’t Tell’ Mindset Hurts ETFs

Mark Yamada / February 18, 2011

Twenty -one years ago the Toronto Stock Exchange launched the world’s first exchange-traded fund, the Toronto 35 Index Participation Units (TIPS). The advantages that ETFs offer have since been well chronicled. Support for low-cost, passive investing is broad and includes big names such as Warren Buffett, Peter Lynch, and Charles Schwab.

Despite these endorsements and growth to over 3,182 ETFs globally (through Q3 2010), these funds represent only 5% of mutual fund assets in Canada. Some observers thought ETFs would replace mutual funds altogether, so what happened?

Don’t Ask, Don’t Tell

ETFs are terrific for the investor but advisors perceive them as less terrific for themselves, and, more importantly, less terrific for most of the major banks. Through their branches and wholly owned brokerage subsidiaries, banks control over 60% of lucrative mutual fund distribution in Canada. So while ETFs offer clear advantages, advisors sell other vehicles with higher or more well-defined compensation. If clients don’t ask about ETFs, advisors don’t talk about them.

Vlad Tasevski, of Claymore Investments Inc., one of four ETF sponsors in Canada, suggests industry insiders and sophisticated investors understand the benefits of ETFs, but advisors (stockbrokers) and financial planners (mutual fund salespeople), who largely control client investing, aren’t talking about them much — and that’s creating an information barrier.

Advocates for the individual investor, including the Ontario Securities Commission, haven’t been able to remove these barriers. Self-regulating organizations like the Mutual Fund Dealers’ Association (MFDA) have neither a duty nor motivation to inform consumers of alternative products, although better disclosure rules have been proposed. Investors must increasingly rely on their own devices and need better information.

Are there any reasons for an intelligent and informed consumer to buy a mutual fund? (See sidebar “When mutual funds make sense”) The principle behind the U.K. and Australian ban on embedded commissions

WHEN MUTUAL FUNDS MAKE SENSE

There are two circumstances under which using mutual funds makes sense:

FIRST Monthly deposits under $1,800 (about the $22,000 maximum contribution limit to an RRSP). Because a commission is required to acquire ETFs, smaller deposits get expensive. Assuming a $20 per trade commission minimum, this is a 1.11% per annum cost. Buying index mutual funds, monthly, and trading into an ETF periodically is the right thing to do. Alternatively, Claymore offers a commission-free way to invest in their ETFs through certain brokers that is worth exploring to push the threshold for ETF use lower.

SECOND When investors need lots of liquidity, mutual funds provide it. Normally, a trader is the only person who wants this liquidity to move from fund to fund quickly. Curiously, this trading advantage is not encouraged by fund companies. The trade-off is an extraordinarily high cost and restriction to a single NAV per day, less than ideal for the trader. Non-traders should reassess mutual funds altogether.

addresses this information gap and more importantly goes to the heart of the problem: aligning the interests of the industry with the interests of the investor.

Other industry practices are also questionable, such as systematic leveraging, DSCs and new issue closed end funds, as pointed out by Harper Fraze (see AER, "Compensation debate rages on," November 2010). Requiring advisors to treat client monies as if it were their own is direct. Fee-based asset management and fee-only financial planning are logical results.

Compensation drives behaviour, so aligning payment with client interests isn't just one of the issues with which regulators must deal. It is the key issue.

Unbundling

Investors benefit from an unbundling of services and fees because transparency exposes comparative costs. Toronto-based fee-only planning experts Weigh House Investor Services know all about that. Weigh House takes no trailer or referral fee for product placement so clients know they are getting the firm's unbiased opinion. Not a single financial planning firm that is compensated through trailing commissions can make this claim, whether fully disclosed or otherwise. Relationships are always tainted by compensation from product vendors.

ETFs will never completely replace mutual funds as long as advisor compensation favours funds and the banks control product distribution. However, the main competition to the advisor is the do-it-yourself investor with online tools and services that break down the knowledge barrier. The next twenty years will be interesting.●

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Final Score: ETFs 1, Leafs 0

Mark Yamada / March 30, 2011

Too much success can be a bad thing.

The Toronto Maple Leafs don't need to put a competitive team on the ice. Season ticket holders already compete for 90% of all seats, broadcasting revenues are maxed and virtually every game is sold out.

The Leafs represent a clear distortion in the marketplace. There is little incentive to win because fans act irrationally.

The popularity and institutional success of passive investing in general (replicating the performance of an index), and exchange-traded funds (ETFs) in particular, have led some to believe that distortions result because investors act rationally.

"ETFs are radically changing the markets to the point where they, and not the trading of underlying securities, are effectively setting the prices of stocks of smaller capitalization companies, or the potential new growth companies of the future," write Harold Bradley and Robert R. Litan in a 2010 paper for the Kauffman Foundation.

The authors are concerned about ETFs and other influences they feel discourage new issues and impede the efficiency of capital markets. They believe the popularity of ETFs has led to trading volumes that overwhelm the liquidity of underlying securities, thus distorting valuations.

Fundamental to the authors' argument is the dominance of passive over active investing. Dominance that overrides the arbitrage of individual stocks gives their argument credibility.

The Case For Indexing

In an analysis for Vanguard research, "The Case for Indexing in Canada," authors Philips, Walker and Kinniry restate in a Canadian context what others have observed elsewhere: that costs are difficult for active managers to overcome. The asset-weighted expense ratio for actively managed Canadian equities funds was 2.29% (May 31, 2010) versus 0.87% for Index funds, a difference of 1.42%. Cap-weighted Canadian equity ETFs have expense ratios between 0.07% (HXT) and 0.25% (XIC) for a difference of 2.04-2.22%.

Active management can occasionally overcome this disadvantage in the short term but has difficulty over the long term. A recent Vanguard study shows the consistency with which actively managed funds underperform their benchmarks, and somewhat alarming median annual return shortfalls.

The (Weak) Case For Active Management

1. The most popular argument for active management is a desire to beat the market. Advisors say the only way to guarantee you won't beat the market is to index. It is possible to pick an outperforming stock but difficult to do so consistently, and really difficult to pick a portfolio of winners. If investors selected only a few stocks, watched them closely and kept trading costs low, they would have more success because high turnover costs kill

returns. Picking active, outperforming mutual funds is a low-probability activity. Nevertheless, investors try to pick winners because they think it is possible.

2. Fun. Indexing isn't. There is no question that passive investing is the intelligent choice. Lower costs boost returns, but talking about stock picks is more fun. People do it even if they aren't quite sure what they are doing. There is higher entertainment value to active management.

3. Special knowledge. In most professional endeavours, specialized education is a barrier to entry. With no apology to my portfolio manager colleagues, picking stocks is not neurosurgery. Anybody can do it. Results may not be consistent and the methodology may at times resemble picking horses at the track, but anybody can open an online account and get some kind of return. In bull markets they are likely to be successful. Less so in bear markets. Investing is egalitarian.

   Current SEC investigations aside, material non-public information is difficult to obtain and illegal to use, so potential access to inside information is no longer an advantage for Street veterans. Twenty-four-hour business news media has given the public access to the same information as the professionals, on as timely a basis. The poor record of investment professionals—reflected in the mutual fund numbers—suggests that educated and experienced pros find outperforming difficult. Despite what should be a discouraging record, mutual funds have 20 times the assets of ETFs in Canada. This is hardly the overwhelming dominance to which the Kauffman paper alludes.

4. The superstar. Western society has a fascination with the superior individual. The U.S. Naval Academy graduate with a Harvard MBA and PhD in Quantitative Finance from Wharton must be a superior human being and should be able to build portfolios that outperform on any basis. If such a person exists, she is working at a hedge fund and couldn't care less about your money or mine!

5. Not-so-smart people do it. Hubris is a huge motivator. The annoying neighbour, the chatty dentist, and Uncle Fred the blowhard all talk about how they picked the stock of the decade. Maybe they did, but you will also notice that only lottery winners are interviewed, not the hundreds of thousands of losers. Ask Uncle Fred about his portfolio's total return over five years for a reality check.

There's not much of a case for active management. In Canada, however, a $12 billion-a-year gorilla of an investment industry stands between the retail investor and the door containing common sense. Greed will always create the motivation to arbitrage the valuation of underlying securities in an index. This may not happen as instantly as the Kauffman authors would like, but if there is an opportunity to squeeze a penny from the market, it will be done.

In the face of all this illogical behaviour, investors can still efficiently participate in the long-term growth of an economy, sector or industry using ETFs at low cost and with full transparency. Unlike the long-suffering, irrational Maple Leafs fan, an ETF investor may appear to perform in mediocre fashion throughout the season but in the long run will beat 90% of the competition.

Stanley Cup? Who cares, because someone other than the owners will be laughing their way to the bank: you.

The Opposing View

According to Bradley and Litan, the dangers posed by ETFs can be mitigated if the U.S. Securities and Exchange Commission were to:

- Require more transparency about the liquidity of the underlying securities or instruments represented by an ETF
- Compel ETF sponsors to explicitly describe ETF creation and destruction processes in product registration and disclosure documents, including hard rules that govern creation processes based on short interest as a percent of shares outstanding, with hard caps (e.g. 5%) on short interest
- Immediately subject ETFs to the post-flash crash liquidity “time-outs”
- Require ETFs to obtain opt-in consent from smaller-cap companies (or from the exchanges where they are listed) whose stocks are relatively thinly traded
- Require securities holders to opt in to securities lending agreements rather than the current opt-out agreement
- Require all market and algorithmic orders to have a minimum price of sale
- Seek assistance from the Federal Reserve in requiring custodial banks to report each week their fails-to-receive and fails-to-deliver of equity and ETF securities, in an analogous fashion to the requirements imposed by the Fed on U.S. primary dealers for debt securities.●

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Pension Investing Using ETFs . Part I

Mark Yamada / May 11, 2011

This column is part one in a three part series

Joe and Sally joined the same company right out of school and enrolled in the registered group savings plan. Sally was three months older than Joe and retired September 1, 2008 with a $600,000 portfolio. Joe's portfolio was worth only $480,000 when he received his simulated gold watch a few months later.

Had they been members of a defined benefit (DB) pension plan — DB plans determine a pension usually based on a percentage of salary, with the benefit being the employer's obligation — Joe and Sally would be drawing identical pensions, all things being equal.

They made identical contributions — with identical employer matches — to buy identical funds in the identical proportion for forty years. The difference in outcomes because of something as uncontrollable as a birth date seems incredibly unfair. Something is wrong here.

Different Than DB plans

DC and RSP benefits are completely a function of contributions and the actual investment result for each employee. Employees are responsible for the outcome, not employers, and the pension amount is unknown until retirement. High costs, poor investment decision-making and lack of scale are documented problems with DC plans, which have generally experienced returns 1% lower than DB plans over time, according to a recent Towers Watson study.

DB plans need to match long- duration liabilities to pay pensions of existing and future workers, so they usually invest with a very long-term view. Mutual funds, following the objectives in their prospectuses, similarly invest with a long-term view and often a perpetual duration. As a result, establishing and rebalancing portfolios to a fixed asset allocation is popular with DB plans because short-term market variability is theoretically evened out over time. Perpetually long investing horizons always have time to make back losses. In reality, Sally, Joe and every RSP and capital accumulation plan investor has an investing time horizon that is shrinking and shortening every day, whether due to retirement or death.

Constructing a portfolio that does not recognize this fact is at best irresponsible, and at worst negligent. Yet most advisors, registered reps and educational sessions for DC plans promote the same basic strategies that were designed for DB plans: diversify, buy, hold and rebalance. The exception is the “target date fund” that automatically reduces equity exposure over time on a fixed glide path. Early generations of this increasingly popular approach have not escaped controversy, a subject we will examine next month.

Conclusions

DB plans invest to match perpetually long-dated liabilities, while DC and RSP investors have investing horizons that are shrinking every day. By building portfolios that have fixed-asset mixes without regard for individual requirements,

the industry is ignoring what investors need. Trimming risk from a portfolio as retirement approaches is one effective tactic. A simple way to do this is to introduce ETFs to build in an increasing proportion of stable, low risk. The table "ETF investing options" on the left shows some low-risk choices that can be introduced at least five years before retirement, ranked by cost.

If returns are 1% below DB plans, using passive or indexed vehicles can help make up the difference. ETFs are appropriate to use if RSP contributions are made once a year. If deposits are made more frequently, as they often are with DC plans, the commission cost of buying ETFs may be prohibitive despite their low fees.

Buying index mutual funds and making a transfer at the end of each year to one or two ETFs is the most cost-effective approach. Claymore offers a commission-free way to buy their ETFs through certain brokers, an option worth exploring for some investors. ●

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Pension Investing Using ETFs . Part II

Mark Yamada / July 13, 2011

This column is part two in a series on pension investing using ETFs

Target-date or lifecycle funds (TDFs) simplify investing by automatically reducing equity exposure as a target retirement date or a student's anticipated university enrolment approaches. TDFs are the hottest segment of a rapidly growing defined-contribution (DC) pension market. Eighty percent of DC plans in the U.S. and U.K. offer TDFs, with global uptake increasing rapidly. Impressively, two-thirds of all new money in American DC plans is flowing into TDFs. In Canada, most DC plans looking to add choices have TDFs on their wish lists, according to Mercer.

Registered representatives (RRs) should pay attention. TDFs challenge the RR's traditional role of managing asset allocation, and do it reasonably well. The appeal of TDFs is no asset-mix decisions are required. It's no surprise investors are embracing these one-decision products in capital-accumulation plans. If product manufacturers get their act together, retail investors could learn to love them.

TDF Principles

The principles of TDFs are:

- Broad diversification
- Reduce equity exposure to or through the targeted date
- Low cost

There are three types of TDFs: 1.0: basic; 2.0: conservative, moderate, and aggressive for each target date; and 3.0: a proprietary goals-based version that addresses what pension investors really want — a no-hassle personal solution that increases the probability of a reliable income in retirement. (See my article "Target Date Funds 3.0" on BenefitsCanada.com.)

Fixed Glide Path

TDF 1.0 and 2.0 feature fixed glide paths that systematically reduce equity exposure to or through a target date. Many TDFs got into trouble between 2008 and 2009 by holding too much in equities (50% to 60%) for near-dated (2010) funds, losing 25%-30% of their value within a year.

Wrong Assumption

TDF 1.0, a first-generation approach, is suboptimal. It uses a fixed glide path that assumes market volatility stays pretty much constant. Witnesses of market meltdowns in 1987, 2000 and 2008 know this assumption is wrong. Furthermore, TDF 1.0 lacks the flexibility to accommodate personal risk preferences or actual cumulative investment results. Nevertheless, RRs need to offer something at least as competitive.

Disciplined asset mix shifts are one aspect of TDFs that beat most RR-based models and wrap accounts that have naive buy-hold-rebalance strategies. Cost is a key driver for portfolio construction.

TDF 1.0 for Smaller Portfolios

Simplicity is the key for these investors. Ioulia Tretiakova, director of Quantitative Strategies at PUR Investing, rightly points out that "getting the broadest diversification for the money should be a primary goal.

"Investors and advisors who lack the tools to maintain consistent volatility in their portfolios (a feature of TDF 3.0) could use, as a core holding, Claymore's Balanced Growth Core Portfolio (CBN), which includes BRIC (Brazil/Russia/India/China) and gold exposure with a 17.4% fixed income weight," she says. "The iShares Growth Core Portfolio Builder (XGR) offers better diversification at a lower fee (0.60% vs. 0.82% for CBN) but with 60% equities and 40% bonds, it's too conservative for long-dated TDFs."

Some investors retire when markets are weak. It's prudent to cash-match needs five years before funds are needed – to pay for college, for example. Zero-coupon bonds are ideal, but availability can be an issue. BMO's Corporate Bond Target Maturity series helps. Adding these ETFs both pre- and post-retirement is a good way to preserve capital and match cash needs. Income ETFs can be added post-retirement to generate regularly distributed cash. ●

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Pension Investing Using ETFs . Part III

Mark Yamada / September 12, 2011

This column is part three in a three part series

In the now-iconic scene set in Katz's Delicatessen in New York City, a woman of some years mischievously asks her waiter to bring her the rye and pastrami sandwich she assumes was responsible for Meg Ryan's character Sally's head-turning display of euphoria. Portfolio envy is a lesser-known form of a similar syndrome.

In pension terms, Sally has a defined-benefit (DB) portfolio. Harry has a defined-contribution (DC) plan, but overestimates his ability to distinguish real money management from fake management.

DB plans are managed by professionals and are meant to provide members with reliable income in retirement. DC plans, including RSPs, are managed by reluctant plan members from a bewildering array of mutual funds not designed for DC pensions. No wonder people want what Sally is having. Professionals have not done that well with DB plans, either. Plans were only 73% funded at the end of 2010 in Canada, according to Mercer.

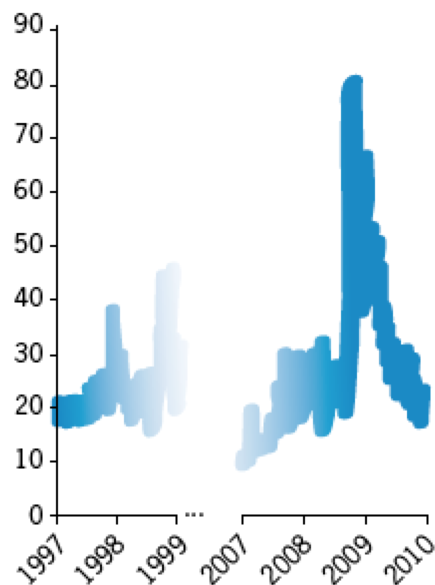
One-hundred-percent funding means they can meet their obligations. As well, Mercer predicts pension scheme deficits overall are expected to more than double, from about $20 billion to just under $50 billion.

Investment professionals are not solely to blame. Employees and unions push for better benefits, asset managers lobby for more equities — which bring them higher fees — and employers take more risk in the hope that higher returns will lead to contribution holidays. In the financial crisis, inadequate risk controls penalized even the best DB plans.

Building the fool-proof portfolio

Exchange-traded funds (ETFs) give individuals and their advisors the tools to build sophisticated portfolios. Maintaining appropriate risk and reducing volatility as a target date approaches are the flavourful rye bread and richly smoked pastrami of retirement solutions.

Maintaining consistent risk can save investors a bundle. The chart to the right shows the daily VIX — the implied volatility of S&P 500 options — is a readily available proxy for risk. Levels higher than 20 were good times to become cautious — 1997 to 1998 and 2007. Levels above 30 were good times to hide (1999 and 2008). Conversely, periods of stable or declining VIX — levels under 20 — would have been good times to own stocks.



Ioulia Tretiakova, Director of Quantitative Strategies at PUR offers this example using a hypothetical portfolio consisting of iShares' S&P TSX Capped Composite Index Fund (XIC) and iShares DEX Universe Bond Index (XBB). If VIX is under 20, the portfolio shifts to 100% XIC. If VIX is between 20 and 30, the asset mix is 50% XIC and 50% XBB. If VIX is over 30, the portfolio shifts to 100% XBB.

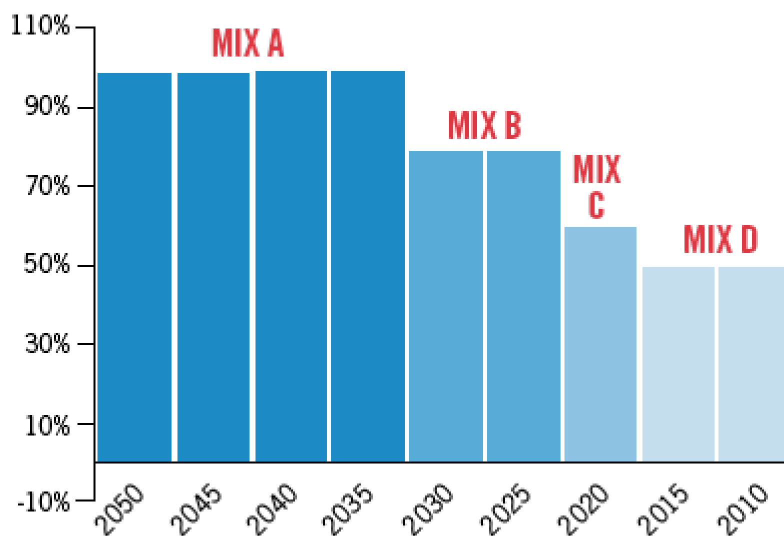
The strategy improved the return not only of the all-equity portfolio, as expected, but also of a diversified 60/40 balanced portfolio while maintaining similar risk.

Most investors would find a portfolio that moved from 100% stocks to 100% bonds too active. An alternative is to apply the same rules to the equity portion of a portfolio. Table A shows corresponding equity weights for balanced portfolios at 80/20, 60/40, and 50/50. We believe wider asset allocation shifts than those many investors have become accustomed to are the future of investing in volatile markets. This suggests a more active role for knowledgeable advisors and registered reps.

Mustard: a dynamic glide path

Today's target date mutual funds are fundamentally flawed. All have static glide paths that reduce equity exposure as the target date approaches (see "Chart 3"). It sounds like the portfolio's risk is reduced over time, but risk is not static. Equity risk can change dramatically over a working lifetime so that 60% equity means something very different at the peak of the technology boom than it does at the bottom of the financial crisis in 2009.

CHART 3 Different portfolios with declining equity exposure as target date approaches



Source: PŪR Investing Inc.

Indeed, observing the relative performance of three portfolios — a hypothetical Constant Risk Canadian Equity, S&P/TSX Composite, Morningstar Canadian Equity Balanced Index — from February 2001 (when XIC data became available) to April 2011 shows large gaps after 2009. The remedy is to manage a portfolio to have declining risk over time.

Examples shown in this article are based on daily VIX, but a monthly approach would also be beneficial. PUR will post updated risk data monthly on its website (www.purinvesting.com) for those interested in following along.

The pickle

A kosher dill is essential to finishing off the dish. In a similar way, diversification will help to dampen risk further. Our simple stock-and-bond model is a guideline only.

This approach is theoretically better than anything available today for DC plan investors. Maybe both Harry and Sally will want what you are having! ●

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ETFs: The teenage years

Mark Yamada / October 07, 2011

The Canadian exchange-traded fund (ETF) market has reached adolescence, and hair is starting to sprout on its chin.

Profit potential

The Canadian ETF market has matured with sufficient size ($45 billion) and momentum (30% annual growth) to get the attention of the major banks. According to BNY Mellon, the U.S. ETF market will double through 2015 — and Canada's could match it. Banks and investment companies smell profit potential, and a chance to protect and grow their retail base despite massive books of profitable mutual funds.

They may also fear others will crowd them out of a lucrative market that is, apparently, here to stay.

Heavy hitters RBC and Vanguard have declared their intention to enjoin iShares, Bank of Montreal, Horizon Beta/Al-phaPro, Claymore, a newcomer to Canada, Invesco, and rookie XTF Capital Corp. in the battle of sponsoring ETFs here. A major Korean fund manager's interest in BetaPro Management confirms the stakes are changing. Deep pockets and sophisticated distribution are changing the landscape.

New offerings

Unlike early plain-vanilla indexes that got simple ETF wrappers, competing sponsors now race to represent different asset classes, occasionally using derivatives to replicate them. Regulators are concerned these structures may lead to another subprime crisis, or a "flash crash" like in May 2010.

The Financial Services Authority (FSA) in the UK is considering banning swap-based ETFs from retail use altogether. The FSA is the UK's version of Canada's cluster of securities commissions.

These products offer an exciting array of tools to enhance and enable new methods of portfolio construction, but registered representatives need to understand the underlying composition of all ETFs not only to use them effectively, but to manage the liability if a structure goes bad.

Digital-age disclosure

Blindsided by collateralized mortgage products, regulators are determined to prevent similar problems with ETFs. Although prospectus disclosure has been the regulatory focus for retail products, veteran fund executive Paul McKenna of One Financial reminded me that ETFs trade in the secondary market where prospectuses are available but issuance to buyers is not mandatory.

Most registered reps know that prospectuses are a legal crutch few people read. Regulators need to rethink the principles and practicality of disclosure in a digital age and speak to consumers with a new voice. Perhaps making all advisors fiduciaries is part of the answer.

Will the ETF market grow up to look like the mutual fund market?

Duplication is costly and confusing, yet every mutual fund family feels it needs at least an equity, fixed income, and money market fund. ETFs compete for market share based upon a different and more useful set of metrics.

Sponsors market ETFs based upon index construction, liquidity, diversification and other risk characteristics rather than how a manager happened to outperform his or her benchmark last year.

While the conversation has been elevated to issues that really impact portfolios, it's not as much fun as talking about whether RIM's quarter will beat analyst expectations. However, getting money into investors' pockets through lower costs is a powerfully persuasive pitch.

Each bank may want a complete stable of asset classes for their clients, but there may not be enough room for a seventh or eighth ETF based on the S&P/TSX 60. Watching RBC and Vanguard position their Canadian equity offerings will be interesting.

BMO's ETF launch in 2009 signaled the return of banks to a space vacated by TD in 2006. Critically, taken with RBC's filing of eight target maturity fixed-income ETFs this summer, the product category has been validated.

Vanguard, the dominant index fund player in the U.S., will launch a series of funds in Canada by year-end. This is important and intriguing because Vanguard's reputation for delivering straightforward passive products at low cost will challenge everyone. Will there be a refocusing on passive low-cost ETFs, or will active strategies finally gain traction?

Six per cent…for now

ETFs represent only 6% of Canadian mutual fund assets — a rounding error. Unquestionably, ETFs offer investors more effective, low-cost delivery of capital market exposure than mutual funds. Only two things stand between the consumer and a superior product: smarter investors and the entrenched investment advisor.

Because information is ubiquitous, investors are getting smarter. Savvy RRs are already using ETFs, and as clients get better informed, other advisors will follow. Peer pressure works in trading rooms as well as high school lunchrooms. Advisors waiting for the ETF fad to subside are going to be left behind. ●

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Improving Pensions with ETFs

Mark Yamada / October 24, 2011

Accumulating enough money to retire with a 60% replacement income is great — unless you were planning to retire with 70%. Keeping the client on track for a 70% income is where an advisor can add value.

Personal Alpha(TM) means achieving a goal beyond a target, like saving money and earning extra years of retirement income.

Accountants and financial planners, particularly fee-only planners who consider their client's interests unbiased by product trailers and incentives, have been doing this successfully for some time. But new products like ETFs and services like discount and online brokerages have ushered in a new reality.

As consumers become more knowledgeable, financial advisors will have to develop and expand their value proposition beyond trading and research.

ETFs allow investors access to instant diversification and relatively inexpensive exposure to a large and rapidly growing list of asset classes, regions, countries, styles, capitalizations, sectors, and industries.

As retail investors discover the flexibility that ETFs offer, their expectations from other financial products will change. One consequence of an informed public is the growing acceptance of the principles of passive or index investing as the efficient way to access market or beta exposure.

The debate over active or passive will rage on as investment professionals protect the turf that pays their bills. But most active managers concede a role for passive investing, particularly in a multi-fund, multi-manager environment when overlap yields market returns at full fees.

At the very least, more investors understand that adding returns above the market is not easy and that few can do it consistently. Advisors may find building a core business around this kind of activity to be frustrating at best.

Managing risk

An investment professional's definition of risk — volatility — is different than most retail clients who fear absolute losses. An alternative definition, based on the reality of clients' lives, is the risk of not achieving a goal.

Let's use retirement investing as an example. Defined-benefit (DB) pension plans, given to Members of Parliament and civil servants, are tenaciously guarded by unions and some large corporations. They are professionally managed and, in retirement, pay a percentage of final year's salary depending upon each plan. DB plans are administered by expert committees and employers are obliged to pay or, in the example above, the taxpayers are.

While both employer and employee contribute, investment decisions are left to the committee. Mandatory valuations every three years assess how the fund measured up to the theoretical liability to pay all those folks their pensions

currently, if retired, or in the future, if still working. Any shortfall or funding deficit must be made up over time by the employer or taxpayers.

DC plans like registered plans

In contrast, defined-contribution (DC) plans are like registered retirement plans. The employee makes contributions, usually with employer matches, but the responsibility for investment decisions is the employee's.

Importantly, there is no target income in retirement and no triennial valuations assuring that the program is tracking towards success or failure. In fact, no targeted percentage of income like a DB plan is required. Over several decades, many DB plans have switched to DC or stopped admitting new members in an attempt to control corporate liabilities.

Financial advisors have a great opportunity here. By targeting a percentage of salary as retirement income, a DC or RRSP portfolio can be managed like a DB plan. Investors benefit by focusing on a stream of income in retirement rather than short-term performance, and improve the chance that they receive what they want from a retirement plan — a reliable income.

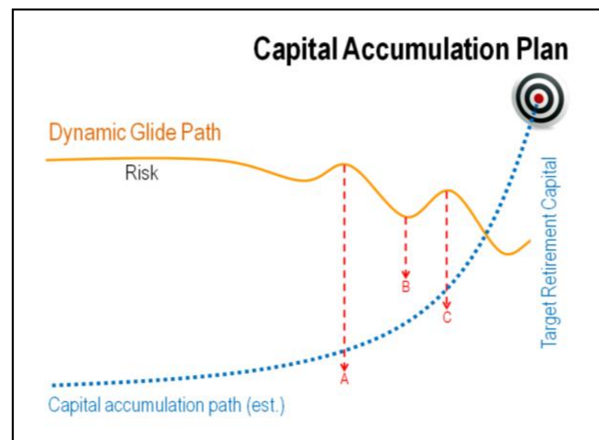
Here's how to do it

If your client wants to replace 70% of her annual income through her retirement, the advisor calculates the capital required to fund an immediate annuity that would pay this amount in today's dollars at retirement.

Using the investor's contribution rate and assumptions for inflation and something reasonable for returns, the advisor establishes a capital accumulation path towards the target retirement capital.

Actual performance will be above or below this path as

indicated by A, B and C in the chart. By matching the risk of a portfolio to the capital accumulation path, the advisor makes decisions based upon progress towards the goal.



Source : PŮR Investing Inc.

The target may change modestly over time as interest rates change or dramatically as the investor's circumstances change, such as a big promotion, more children than expected, family illness, inheritances or a lottery win.

This is an important function missing in DC and RRSP management today. Advisors can help investors work on a solution that is useful and valuable. ●

For more on this topic, see Mark's whitepaper in the Rotman International Journal of Pension Management called "What DC Plan Members Really Want."

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Adapting to Changing Needs

Mark Yamada / November 29, 2011

ETFs are primarily associated with indexed or passive products, so the idea of combining them with active management seems as logical as U.S. Tea Party Republicans working with Democrats in Congress.

But institutional portfolio managers are pragmatic. They're always looking for ways to improve performance, and ETFs offer an expanding arsenal.

Opportunities to improve portfolio function come under two categories: liquidity and diversification.

Liquidity

ETFs are changing the rules of portfolio management, and have added a dictum of their own—"it's all about the underlying." ETFs are a function of their underlying holdings. If these holdings trade well, the ETF should be liquid, which should be reflected in a lower bid-ask spread from market makers and a lower tracking error from the index it follows.

However, ETFs also offer a unique creation and redemption feature that allows market makers to create more ETF units if demand exceeds supply, and vice versa. This boosts liquidity beyond the traditional daily trading volumes that are reported.

To portfolio managers, this means an added element of liquidity for moving into or out of markets or sectors quickly with minimal trading impact. This function is useful if a manager has portfolio exposure to individual holdings that may not be liquid and wants to gain or shed exposure quickly. Exposure to other assets can be realigned later.

During the financial crisis of 2008-2009, when financial stocks could not be shorted, financial sector ETFs could be, adding liquidity to a market that desperately needed it. The sidebar "How U.S. asset managers use ETFs" shows institutions use ETFs primarily for the liquidity they provide.

Trend-following strategies (formerly known as market timing) have become increasingly sophisticated with the aid of computers. Some of these strategies form part of the algorithmic trading subculture. Traders need volatility to make money. Theoretically, because traditional ETFs dampen volatility, they are only useful for hedging.

How U.S. asset managers use etfs

- *Cash equitization 75%*
- *Transitions 45%*
- *Rebalancing 40%*
- *Tactical adjustments 40%*
- *Hedging 30%*
- *Portfolio completion 20%*
- *ETF overlay liquidity 10%*

Source: Greenwich Associates LLC., Blackrock

However, leveraged ETFs are popular because of their added risk and often account for over 50% of all daily ETF trading volumes on the TMX. If active management involves aggressive trend following, leveraged ETFs can offer the needed juice.

Diversification

Diversifying to manage risk can be problematic, as the tech wreck of 2000-2001 and the financial crisis of 2008-2009 proved. Nevertheless, identifying the next uncorrelated asset class occupies the time of many professionals.

ETFs offer fertile ground for prospecting. Domestic and international equities draw the most institutional interest. In a 2011 Greenwich Associates study of asset managers using ETFs in the U.S., 89% used ETFs in their domestic equity portfolios and 94% accessed international equity exposure in whole or in part using ETFs.

Given recently elevated levels of market volatility, there is increasing buzz around exchange-traded products that represent volatility, like the iPath S&P 500 VIX Short-Term Futures Exchange Traded Note (VXX), the Horizon Betapro S&P 500 VIX Short-Term Futures ETF (HUV) and leveraged version (HVU). Because volatility tends to expand in declining markets, buying these ETNs can partially offset losses. Caveat: Extended periods of volatility may mean that shorting leveraged versions would be preferred, so seek expert advice first.

Advisors can use ETFs for all the liquidity functions listed in the chart, like cash equitization and transitioning from an old to a new portfolio. Portfolio completion involves finding assets that round out a portfolio based on the manager's criteria. They may include hard-to-access regions like emerging markets or a particular maturity segment of the yield curve. Some tools allow advisors to enter an existing portfolio of mutual funds and/or stocks and bonds, and yield a list of ETFs that can replace the funds or improve the diversification properties of the portfolio.

Building a passive core using ETFs that represents the client's long-term goals can also combine passive with active. Individual stocks, bonds, ETFs or funds can be chosen that represent active satellite bets. The core will reliably deliver the return of the long-term asset mix while the tactical pieces can be alpha-seeking, with costs optimized for the investor.

Money management is evolving to accommodate changing capital market demands. Passive buy-hold-rebalance strategies, while still defensible for pension and institutional portfolios with long investing time horizons, are proving to be inappropriate for individuals who face perpetually shortening horizons.

ETFs offer institutions, advisors and individual investors an effective and economical way to shift assets to tactically adjust for these evolving circumstances. ●

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Safety Tips for Synthetic ETF Use

Mark Yamada / December 31, 2011

Lesson 1 – Select the right tools for the job

Derivatives offer useful and cost-effective ways for investors to manage risks. In the ETF world, derivatives have democratized investor access to asset classes like commodities and currencies, and to strategies like covered-call writing, use of leverage and short selling.

Derivatives were previously the sole domain of professional and sophisticated investors. Now accessible to the masses, this freedom has come with the expected consequences of misuse and plain ignorant use of some or all of these products.

Three questions arise from the increasing use of synthetic structures in retail products.

1. Are the benefits and costs associated with these products adequately understood by users?
2. Are there potential systemic risks arising from the growing popularity of these instruments?
3. Who's best equipped to determine if investors should have access: regulators, investment professionals, or investors?

THE RIGHT TOOL FOR THE JOB

Having a plan is as basic to portfolio construction as it is in the workshop. What will the portfolio have to do? What characteristics must it have?

Selecting the appropriate tools and materials and understanding the capabilities and inherent risks with each is simply common sense. While possible to drive a nail with a screwdriver, it isn't always as effective as using a hammer. Selecting ETFs is no different.

Returns are difficult to predict, but costs are different. The ETF Screener on the TMX Money website offers two basic ETF classifications: those using passive strategies and those using embedded strategies and costs are behind each.

Passive

These are straightforward ETFs that replicate an index and hold the actual components or a stratified sampling of the index holdings.

Embedded strategies

All other ETFs fall into this category, suggesting additional analysis may be required. We have broken these into three subsets with additional costs associated with each.

Strategic: Holding equal dollar amounts of index components is one example. Proponents claim reduced large capitalization company bias in an index allows smaller faster-growing companies to contribute equally. Whether or not you believe this (there is research supporting both sides), more frequent rebalancing incurs more trading costs. This holds true for so-called fundamentally weighted indexes and active ETFs. Investors must decide if the costs are justified by the strategy.

Exchange-traded derivatives: These ETFs can involve options and futures and introduce time as a more critical investment factor. Covered-call ETFs, for example, alter risk over time; modestly for ETFs overwriting a small portion of underlying holdings (e.g. FXF) to those that overwrite all of the holdings (e.g. ZWB).

Commodity ETFs can hold the underlying commodity, but many use futures. This subjects these ETFs to liquidity, basis, contango and backwardation risk. ETFs using exchange-traded derivatives introduce some elements of additional cost from liquidity, basis, timing (backwardation/contango) in addition to possibly higher management costs. Leveraged-long and leveraged-short ETFs also fall into this category.

Over-the-counter derivatives: OTC derivatives are based upon total return swaps. A dealer commits to pay the return of an index over a particular time period in exchange for collateral. This introduces a potential cost as credit risk because the dealer or counter-party is promising to pay. It also introduces potential liquidity risk related to the collateral.

Investors and advisors have a duty to understand the risks inherent in these products and their potential impact on broader markets. Do regulators know better than advisors or clients whether these products have a place in retail portfolios? We'll address these issues in future columns.

TYPES OF ETFS

PASSIVE	TICKER	MER
BMO Aggregate	ZAG	0.50%
Claymore S&P/TSX Canadian Dividend	CDZ	0.60%
Claymore Gold Bullion	CGL	0.50%
iShares S&P/TSX 60 Index	XIU	0.17%
iShares S&P/TSX Capped Energy	XEG	0.55%
iShares S&P 500	XPS	0.24%
PowerShares Canadian Dividend Index	PDC	0.50%
PowerShares QQQ (CDN Hedged)	QQC	0.32%
PowerShares Ultra DLux Long Term Government Bond	PGL	0.25%
RBC 2013 Target Corporate Bond	RQA	0.30%
RBC 2014 Target Corporate Bond	RQB	0.30%
RBC 2020 Target Corporate Bond	RQH	0.30%
EMBEDDED STRATEGIES – STRATEGIC		
BMO S&P/TSX Equal Weight Oil & Gas	ZEO	0.55%
Claymore Canadian Fundamental	CRQ	0.65%
Horizons Dividend	HAL	0.70%

EMBEDDED STRATEGIES – EXCHANGE-TRADED DERIVATIVES	TICKER	MER
BMO Covered Call Canadian Banks	ZWB	0.65%
Horizons S&P/TSX 60 Bull	HXU	1.15%
XTF Can 60 Covered Call	LXF	0.65%
XTF Can Financial Covered Call	FXF	0.65%
XTF Tech Giants Covered Call	TXF	0.65%
EMBEDDED STRATEGIES – OVER-THE-COUNTER DERIVATIVES		
Horizons S&P/TSX 60 Index (swap fee 0.0%)	HXT	0.07%
Horizons S&P 500 (swap fee 0.30%)	HXS	0.15%