LEARNING MADE EASY

2nd Edition

ETFs For Canadians

for dummies®
A Wiley Brand

Navigate Canada's booming ETF market

Get a handle on the top ETFs in Canada and beyond

Construct a long-term portfolio with ETFs

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by Bryan Borzykowski and
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ETFs For Canadians For Dummies®

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Introduction

Every month, it seems, Bay Street comes up with some newfangled investment idea. The array of financial products (replete with 164-page prospectuses) is now so dizzying that the old lumpy mattress is starting to look like a more comfortable place to stash the cash. But there's one product that continues to be worth looking at: the *exchange-traded fund.* Over the last decade (and certainly since we wrote the first edition of this book), the ETF, which is something of a cross between an index mutual fund and a stock, has taken the investment world by storm.

Just as computers and fax machines were used by big institutions before they caught on with individual consumers, so it was with ETFs. This made-in-Canada product (it's true!) was first embraced by institutional traders — investment banks, hedge funds, and insurance firms — because, among other things, ETFs allow for the quick juggling of massive holdings. Big traders like that sort of thing. During the past several years, millions of North American investors have poured their savings into ETFs.

We like and use ETFs, too. They have grown exponentially in the past few years, and they will surely continue to grow and gain influence. Although we can't claim that our purchases and recommendations of ETFs account for much of the multi-trillion-dollar ETF market, we're happy to be a (very) small part of it. After you've read *Exchange-Traded Funds For Canadians For Dummies,* you may decide to become part of it as well, if you haven't already.

Since the First Edition…

Many changes have taken place in the investment world, on both Bay Street and Main Street, since the first publication of this book in 2010. For one thing, a much larger pot of money (dollars, euros, yen) is now invested in ETFs: more than $10 trillion as of this writing (up from a mere $1 trillion in 2010).

The world has changed dramatically, too, as we have noted. Within the financial industry, innovations such as robo-advisors make investing as easy as ordering an Uber. (Imagine reading that sentence a decade ago, before ride-hailing apps and robos were a thing.) People are also paying more attention than ever to investment fees, and ETFs are almost always cheaper to hold than mutual funds. At the same time, advisors are being asked to spend more time on financial planning than on investing (as you'll learn, the ETF makes focusing on planning easier for them to do).

There have been times when people haven't been so sure about ETFs, which were blamed for the the infamous "flash crash" of May 6, 2010, and a lot of experts thought that they wouldn't withstand a major downturn, but that's turned out to be mostly nonsense. Not only did ETFs continue to perform in line with markets during the pandemic crash and subsequent rebound, but the ups and downs also helped investors see the benefits of passive investing, which I discuss here.

One very positive change in the past several years is that investors now have access to ETFs that cover most areas of the market. A decade-and-a-half ago, you couldn't buy an ETF that would give you exposure to high-yield bonds. Or international bonds. Or international real estate investment trusts (REITs). All that has changed. There are ETFs that represent all those asset classes, and many more, including Bitcoin, robotics, and space-related funds. Building an entire well-diversified portfolio out of ETFs was not humanly possible several years ago; now, it’s being done every day.

Another very positive development: ETFs are being used more and more in Registered Retirement Savings Plans (RRSPs) and Tax-Free Savings Accounts (TFSAs), where many of Canada’s hard-working people store the bulk of their savings. And they’re used in Registered Education Savings Plans (RESPs), too. Insurance companies have also jumped into the fray, offering ETFs in some of their annuity plans (which, unfortunately, are still often overpriced).

Although having more products to choose from is great on the surface, some ETFs are bad investments, pure and simple. More recent products were introduced to take advantage of the popularity of ETFs. They are overly expensive, and they represent foolish indexes (extremely small segments of the market, or indexes constructed using highly questionable methodologies). In this book, we help you separate the good from the bad.

Many of the newer ETFs are also specifically designed for short-term trading, and short-term trading usually gets small investors into big trouble.

A scary number of the newer ETFs are based on back-tested models: They track whatever indexes, or invest in whatever kinds of assets, have done the best in recent months or years. These ETFs (or the indexes they track) have shining short-term performance records, which induce people to buy. But past short-term performance is a very, very poor indicator of future performance.

Several new ETFs are focused on “meme stocks” — those stocks most highlighted on social media, often ballyhooed in memes as surefire ways to get rich. (Remember GameStop, the company Reddit investors sent soaring in January 2021?) Buying what’s most fashionable — by investing directly in the meme stocks or in an ETF filled with meme stocks — is not a wise investment move.

Actively managed ETFs have been slower to take off than Bay Street had hoped, but they are starting to make significant inroads. These ETFs differ radically from the original index ETFs. They don’t track any indexes at all, but instead have portfolios built and regularly traded by managers attempting to beat the indexes. As study after study has shown, active management usually doesn’t work all that well for investors, while fees accruing to the managers can add up to a princely amount. (Read more on active management in Chapter 18.)

About This Book

As with any other investment, you’re looking for a certain payoff in reading this book. In an abstract sense, the payoff will come in your achieving a thorough understanding and appreciation of a powerful financial tool called an exchange-traded fund. The more concrete payoff will come when you apply this understanding to improve your investment results.

What makes us think ETFs can help you make money?

- **ETFs are intelligent.** Most financial experts agree that playing with individual stocks can be hazardous to one’s wealth. Anything from an accounting scandal to the CEO’s sudden angina attack can send a single stock spiraling downward. That’s why it makes sense for the average investor to own lots of stocks — or bonds — through ETFs or mutual funds.

- **ETFs are cheap.** At least 250 ETFs, both in Canada and the U.S., charge annual management expenses of 0.10 percent or lower, and a few charge as little as 0.00 percent a year! In contrast, the average actively managed Canadian mutual fund charges around 2 percent a year. Index mutual funds generally cost a tad more than their ETF cousins. Such cost differences, while appearing small on paper, can make a huge impact on your returns over time. We crunch some numbers in Chapter 2.
- **ETFs are tax-smart.** Because of the very clever way ETFs are structured, the taxes you pay on any growth are minimal. We crunch some of those numbers as well in Chapter 2.
- **ETFs are open books.** Quite unlike mutual funds, an ETF's holdings are readily visible. If this afternoon, for example, we were to buy 100 shares of the iShares S&P/TSX 60 Index Fund, we would know that exactly 7.99 percent of our money was invested in Royal Bank, 6.77 percent was invested in TD Bank, and 3.86 percent was invested in Shopify. You don't get that kind of detail when you buy most mutual funds. Mutual fund managers, like stage magicians, are often reluctant to reveal their secrets. In the investment game, the more you know, the lower the odds you will get sawed in half.

  (News flash: North American regulators are still debating just how open the portfolios of the newer actively managed ETFs will have to be. For the time being, however, most ETFs track indexes and the components of any index are readily visible.)

And speaking of open books, the one you are holding has similarities to an ETF:

- ***Exchange-Traded Funds For Canadians For Dummies* is intelligent.** We don't try to convince you that ETFs are your best investment choice, and we certainly don't tell you that ETFs will make you rich. Instead, we lay out facts and figures and summarize some hard academic findings, and we let you draw your own conclusions.
- ***Exchange-Traded Funds For Canadians For Dummies* is cheap.** Hey, top-notch investment advice for only $29.99 (plus or minus any discounts, shipping, and tax) … . Where else are you going to get that kind of deal? *And* if you come to the conclusion after reading this book that ETFs belong in your portfolio, you'll likely get your $29.99 (plus any shipping costs and tax) back — in the form of lower fees and tax efficiency — in no time at all.
- ***Exchange-Traded Funds For Canadians For Dummies* is an open book.** We've already established that!

If you've ever read a *For Dummies* book before, you have an idea of what you're about to embark on. This is not a book you need to read from front to back. Feel free to jump about and glean whatever information you think will be of most use. There is no quiz at the end. You don't have to commit it all to memory.

Foolish Assumptions

We assume that most of the people reading this book know a fair amount about the financial world. Why else would you have bought a book that is entirely focused on exchange-traded funds?

If you think that convertible bonds are bonds with removable tops and that the futures market is a place where fortune tellers purchase crystal balls, we help you along the best we can by letting you know how to find out more about certain topics. However, you may be better off picking up and reading a copy of the basic nuts-and-bolts *Investing For Canadians All-In-One For Dummies* by Tony Martin and Eric Tyson (published by John Wiley & Sons, Inc.). After you spend some time with that title, c'mon back to this book. You'll be more than welcome!

Icons Used in This Book

Throughout the book, you find little pieces of art in the margins called *icons.* These admittedly cutesy but handy tools give you a heads-up that certain types of information are in the neighbourhood.

TIP Although this is a how-to book, you also find plenty of whys and wherefores. Any paragraph accompanied by this icon, however, is guaranteed pure, 100 percent, unadulterated how-to.

WARNING The world of investments offers pitfalls galore. Wherever you see the exclamation mark, be aware that this point highlights risk and where you might lose money — maybe even Big Money. Don't skip the passage.

REMEMBER

Read twice! This icon indicates that something important is being said and is really worth putting to memory.

TECHNICAL STUFF

If you don’t really care about the difference between standard deviation and beta, or the historical correlation between value stocks and REITs, feel free to skip or skim the paragraphs with this icon.

GREED ALERT

The world of Bay Street (and Wall Street) is full of people who make money at other people’s expense. Where you see the starburst, know that we’re about to point out an instance where someone will likely be sticking a hand deep in your pocket.

Beyond the Book

Aside from the information in this book, you have access to even more help and information online at `Dummies.com`. There, you can find information on all manner of topics.

`Dummies.com` is also where you’ll find the *Exchange-Traded Funds For Dummies* Cheat Sheet, which suggests topics to discuss with your financial professional, tells you how to choose the best ETFs, and succinctly explains how ETFs differ from mutual funds.

Where to Go from Here

Where would you like to go from here? If you want, start at the beginning. If you're interested only in stock ETFs, hey, no one says that you can't jump right to Part 2. Bond ETFs? Go ahead and jump to Part 3. It's entirely your call.

Part 1

The ABCs of ETFs

IN THIS PART …

Delve into the early history of ETFs and their development ever since.

Find out what makes ETFs so special, and what makes them such darned good investments.

Discover where and how ETFs are created and traded.

Chapter 1

No Longer the New Kid on the Block

IN THIS CHAPTER

- » **Discovering the origins of ETFs**
- » **Understanding the role ETFs play in today's world of investing**
- » **Tallying ETFs' phenomenal growth**
- » **Looking at the biggest names in ETFs**

You can tell how much the conversation around ETFs has shifted in the way traditional mutual fund firms now talk about these securities. In 2006, when Bryan got his first job writing about investing and finance, even just a mention of an ETF sent conservative money managers and their public relations teams into denial. Now, almost all of the stalwart investment firms are selling and marketing ETFs, while their communication teams are more than happy to arrange interviews with experts willing to espouse the benefits of these funds.

The sheer number of ETFs has skyrocketed, too. At the end of 2021, there were 965 ETFs in Canada — up from 250 when we last wrote this book — and about 9,700 ETFs available for purchase around the world. In 2019, net sales for ETFs outpaced net sales for mutual funds for the first time, and while mutual funds still hold most retail assets in Canada, ETF assets are rapidly rising with each passing year. (Mutual funds aren't losing their dominance anytime soon, though — mutual fund sales outpaced ETF sales on a year-over-year growth basis in 2021.)

These are all good things. ETFs enable the average investor to avoid shelling out fat commissions or paying layers of ongoing, unnecessary fees. And they've saved investors oodles and oodles in taxes.

Hallelujah.

In the Beginning

What do basketball, snowmobiles, insulin, and ETFs have in common? They were all invented in Canada. Yes, you read that correctly. Though our southern neighbours created the stock market, the mutual fund, and many other investment products, the Toronto Stock Exchange developed the first exchange-traded fund. The Toronto 35 Index Participation fund — the first ETF — was listed in March 1990. It tracked the TSE 35 Composite Index, an index made up of the 35 largest and most liquid stocks on the TSX.

As important as the ETF has become, the story behind its development isn't quite as exciting as, say, the story behind the gas mask or hockey, two other Canadian inventions. As one Toronto Stock Exchange insider explained, "We saw it as a way of making money by generating more trading." Thus was born the original ETF, best known as TIP (short for Toronto Index Participation). The TSE 35 Composite Index was then the closest thing that we had to America's Dow Jones Industrial Average index. Some of the companies on the index included Bell Canada, the Royal Bank, and the now-defunct Nortel.

Enter the traders

TIP was an instant success with large institutional stock traders who could now trade an entire index in a flash. The Toronto Stock Exchange got what it wanted — more trading. And the ETF got its start.

TECHNICAL STUFF TIP has since morphed to track a larger index, the so-called S&P/TSX 60 Index, which — you probably guessed — tracks 60 of Canada's largest and most liquid companies. The fund also has a different name — the iShares S&P/TSX 60 Index Fund — and it trades under the ticker XIU. It is now managed by BlackRock, Inc., which, upon taking over the iShares lineup of ETFs from Barclays in 2009 (part of a juicy $13.5-billion deal), has come to be the biggest player in ETFs in the world. You get an introduction to BlackRock and other ETF suppliers in Chapter 3. (A completely different BlackRock-managed U.S. ETF now uses the ticker TIP, but that fund has nothing to do with the original TIP; the present-day TIP invests in U.S. Treasury Inflation-Protected Securities.)

Moving south of the border

As much as we may not want to admit it, Canadians have invented a lot of things that Americans have then perfected. Think about the BlackBerry and the iPhone. Although the ETF was born in Canada, and was popular, this index-tracking product is as widespread as it is thanks to the U.S. market. The ETF took three years to get to the States, but like most things American, when it launched, it launched big.

The mother of all U.S. ETFs was born on January 22, 1993, and listed on the American Stock Exchange (which, in January 2009, became part of NYSE

Euronext). The first U.S.-based ETF was called the S&P Depositary Receipts Trust Series 1, commonly known as the SPDR (or Spider) S&P 500, and it traded (and still does) under the ticker symbol SPY.

The SPDR S&P 500, which tracks the S&P 500 index, an index of the 500 largest U.S. companies, was an instant darling of institutional traders. It has since branched out to become a major holding in the portfolios of many individual and institutional investors — and a favourite of favourites among day traders.

Fulfilling a Dream

ETFs were first embraced by institutions, and they continue to be used, big time, by banks, insurance companies, and such. Institutions sometimes buy and hold ETFs, but they're also constantly buying and selling ETFs and options on ETFs for various purposes, some of which are touched on in Chapter 23. For noninstitutional types, the creation and expansion of ETFs has allowed for similar juggling (usually a mistake for individuals); but more important, ETFs allow for the construction of portfolios possessing institutional sleekness and economy.

Goodbye, ridiculously high mutual fund fees

The average mutual fund investor with a $150,000 portfolio filled with actively managed funds likely spends around $3,000 (2 percent) or so in annual expenses. By switching to an ETF portfolio, that investor might incur — if they incur any trading costs at all — perhaps $50 or so to set up the portfolio, and maybe $20 or so a year thereafter. But now their ongoing annual expenses will be about $308 (0.2 percent). That's a difference, ladies