OPINION

Busting the top myths about ETFs

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The COVID-19 pandemic has brought on significant levels of volatility in the stock market that have had ongoing effects on investors and their portfolios. As a result, financial advisors have had to ensure their clients' portfolios are more resilient and able to withstand any potential market shocks. In turn, many discovered the value that exchange-traded funds (ETFs) provide in terms of portfolio diversification and as a source for long-term growth.

ETFs are among the world's fastest-growing investment products. In fact, Canada's ETF industry attracted record-breaking inflows in 2020. They're proving to be useful portfolio building blocks during these unique times. That's because they offer a high degree of versatility, precision and trading efficiency, which can enable investors to align their portfolios to very specific investment objectives, like target risk, monthly cash flow, volatility management or inflation protection.

While 2020 was the most successful year yet for ETFs in Canada, the following myths continue to persist among advisors and investors alike:

Myth: ETFs are more risky investments than mutual funds

Truth: There is no research that demonstrates ETFs are riskier than mutual funds.

The risk or volatility associated with any investment fund structure – whether it's an ETF or a mutual fund – is influenced by various factors, such as the performance characteristics of the underlying securities, the portfolio manager's investment style and strategy, and the inherent risk and volatility in the markets.

Myth: All ETFs are index-tracking and fully replicate their underlying indexes

Truth: Most, but not all, ETFs are designed to provide investment results that generally track the performance of an underlying benchmark index by holding a portfolio of securities that mirror this performance.

The majority of index-tracking ETFs around the world use one of three techniques to achieve this goal: full replication, optimization-based tracking and synthetic replication. In some cases, optimization or synthetic exposure can provide more efficient, cost-effective exposure. However, not all ETFs track an index, and a growing number of actively managed ETFs utilize the expertise of portfolio managers to execute security selection and trading decisions.

Myth: ETFs are only for day traders and short-term investors

Truth: While transactional investors often use ETFs as trading vehicles, they can be used just as effectively as buy-and-hold investments for long-term investors.

One investor may purchase a particular ETF to hedge risk, whereas another may buy the same ETF for a completely different strategy, such as to grow capital. The versatile product design allows investors with different investment objectives to own the same product and still accomplish their respective goals.

Myth: Low ETF trading volumes and assets under management (AUM) equal poor liquidity

Truth: An ETF can have low trading volume and low AUM, yet still have good liquidity. Similar to a mutual fund, an ETF's liquidity is not established by its trading volume but by its underlying holdings. At minimum, an ETF or mutual fund will be as liquid as its underlying holdings.

It's also important to remember that ETFs are fundamentally different from individual stocks that trade on an exchange. This difference can have a meaningful impact on liquidity.

Unlike stocks, which typically have a fixed number of shares outstanding, ETFs are open-ended investment vehicles similar to open-ended mutual funds. ETFs are able to create new units or redeem existing units in the market to meet investor supply and demand. That can be done very efficiently if the underlying portfolio of securities is itself liquid. This helps explain why metrics like ETF AUM or trading volume are not the only measures of ETF liquidity.

Myth: There is no difference between investing in Canadian or foreign domiciled ETFs

Truth: A recent study found that more than 60 per cent of Canadian investors prefer to buy from a Canadian-based ETF provider – and for good reason. There are advantages to buying Canadian-domiciled ETFs, including potential tax efficiencies, impact of

currency exposure and the ability of the provider to anticipate and respond to the often unique needs of local investors.

Myth: Trading at a premium or discount to the net asset value (NAV) is a shortcoming of the ETF mechanism

Truth: NAV is not an executable price for ETF users. ETFs are designed to transact both in the primary market (creating and redeeming shares at NAV, plus or minus a transaction fee) and on an exchange at prices established by the secondary market. In both instances, ETF buyers and sellers absorb their own transaction costs as opposed to existing ETF unitholders.

These features provide the benefits of transparency of costs while allowing investors to access real-time market prices when trading. The existence of both a primary and secondary market increases overall pricing efficiency and enhances liquidity.

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