



PORTFOLIO STRATEGY:

Rob Carrick's ideas for managing your investments

Too many ETFs, too little time

With over 1,700 exchange-traded funds listed on global exchanges, here's some tips to find the strong and weed out the weak

Every day it gets harder for investors to put together a simple, sensible portfolio of exchange-traded funds.

Literally.

There were 180 new ETF products introduced globally in the first half of 2009, virtually one a day. Some 1,707 ETFs are listed on exchanges around the world, almost 900 of them easily available to Canadian investors on either the TSX or U.S. exchanges. Wondering how to find a few good ETFs for your portfolio?

Help is at hand. In this edition of the Portfolio Strategy column, we build an ETF screener using the same criteria as professional money managers. Use it to help evaluate any ETF you're considering for your own portfolio.

STEP ONE: FEES

The main reason that people use ETFs to build portfolios is that they are a very cheap way to create a fully diversified portfolio. But the proliferation of ETFs in recent years means that some ETFs are much cheaper than others.

“There are often 10 ETFs tracking the same index,” said Tyler Mordy, director of research for money manager Hahn Investment Stewards. “We'll take the cheapest one, thank you very much.”

Mark Yamada, president of PUR Investing, said low fees are paramount to him as well: “We're looking for the cheapest exposure.”



Hahn Investment's Tyler Mordy likes ETFs with strong trading volumes.
JEFF BASSETT FOR THE GLOBE AND MAIL

Needles in the haystack

Here are some sources of information to help you screen the almost 900 ETFs available to investors on Canadian and U.S. stock exchanges to find the ones that are most suitable for you.

For a master list of ETFs	Use the Filter function on Globeinvestor.com (globeinvestor.com/v5/content/filters). Choose the stock exchange you're interested in and then select "ETF" from the pull-down menu labelled "Security."
For ETF trading volumes	Get a quote for an ETF on Globeinvestor and then click on the "price history" link to get trading data for the previous month and a half or so.
For information on fees	ETF company websites ca.ishares.com claymoreinvestments.ca hbpetfs.com bmoetfs.com
For info on diversification	ETF company websites update fund holdings on a daily basis
For info on index construction	ETF company websites offer fact sheets and prospectuses
For info on the use of hedging	ETF company websites

Narrowing the field

How many ETFs do advisers actually use?

Firm	No. of ETFs used
Hahn Investment Stewards	120
PUR Investing	150

**for this example, portfolio size is considered to be in the low six-figure range*

Note: You don't automatically buy the lowest-fee ETF, period. Instead, Mr. Mordy and Mr. Yamada go for the lowest-cost ETF that meet their other investing criteria.

STEP TWO: TRADING VOLUME

There are two reasons to pay attention to the number of shares an ETF trades in a typical day, one of them being that thinly traded funds can be terminated. This could tie your money up for a while, although you will, in the end, receive the net asset value per share.

Another reason to pay attention to trading volumes is that buy and sell pricing gets less competitive for unpopular funds. Worst case, you have to accept less than the market price to get out of an ETF you own, or pay extra to buy.

Mr. Mordy said his firm only looks at ETFs that have an average daily volume of 50,000 shares over the previous three-month period, and that have a market capitalization (that's shares outstanding multiplied by share price) of \$100-million or more.

Doesn't that eliminate a huge number of ETFs? “Totally,” he said. “You strip out all the esoteric crap. That's what you should be doing.”

Chris Young, a financial adviser with Manulife Securities, said he looks only at ETFs that have an average daily trading volume of 100,000 shares. “If you're looking to filter the number of ETFs down, that's a good way.”

This is true. Of the 120 ETFs listed on the Toronto Stock Exchange, only a few dozen may trade 100,000 shares a day.

STEP THREE: DIVERSIFICATION

ETFs are a great diversification tool because they allow you to invest in an entire index of stocks or bonds through the purchase of a single exchange-traded security. But some indexes, particularly those in sectors of the broader market, are dominated by a few particular stocks. If these stocks get hammered, the entire index could fall hard.

At Hahn Investment Stewards, they have a rule that no one stock or bond can account for more than 10 per cent of the total portfolio. PUR Investing specifies that the Top 10 holdings of a fund should account for no more than 20 per cent of total assets.

STEP FOUR: INDEX CONSTRUCTION

Traditional indexes weight stocks according to their market capitalization, which is to say the biggest companies dominate an index. In an effort to provide a more effective mix, newer fundamental indexes factor in revenues, dividends, book value and cash flow when weighting stocks.

Both Hahn Investment Stewards and

PUR Investing prefer traditional indexing for their core holdings, although they may at times use fundamental indexing. Hahn's Mr. Mordy said a market-cap-based ETF tends to have lower fees, and generate less portfolio turnover. Fewer changes in an index over a year should mean fewer taxable year-end distributions for investors with non-registered accounts.

Mr. Mordy said he will examine the actual holdings of an index tracked by an ETF to make sure they truly deliver the kind of exposure he wants. This helps avoid a situation where, for example, a so-called infrastructure ETF holds a lot of utility stocks.

Mr. Yamada keeps tabs on just about all ETFs in the marketplace, but views niche products with skepticism. "We'll read about them because they're entertaining," he joked. "Like the one for Wal-Mart suppliers." Note: the FocusShares ISE-Revere Wal-Mart Supplier Index Fund was closed last fall after less than year.

STEP FIVE: USE OF HEDGING

Hedging is a term that here means using financial tools called derivatives to prevent fluctuations in the value of the Canadian dollar against other currencies from having an impact on the value of your foreign investments. If the loonie

were to rise against the U.S. dollar, for example, that would erode your returns in a U.S.-market ETF unless it was hedged.

A common question for Canadian ETF investors: Do I buy a TSX-listed global ETF with currency hedging, or buy a cheaper unhedged version of the same product on the New York Stock Exchange?

"I normally buy the hedged version because that way we kind of take the currency fluctuation out of the equation," said Mr. Young of Manulife Securities.

Ioulia Tretiakova, vice-president of PUR, said hedged ETFs are typically used at her firm for investors with an investing horizon of up to three to five years. Longer-term clients are put in cheaper non-hedged ETFs on the expectation that currency ups and downs will neutralize each other over a period of years.

"In the short term, because currency impact can be significant, it's beneficial to use hedged ETFs," she said. "Longer term, the cost outweighs the benefit."

On the broader question of buying U.S.-listed ETFs instead of domestic funds, Mr. Mordy said the high cost of currency conversion means using TSX-listed ETFs get the nod where possible. "Avoid currency translations," he said. "They're horrific, especially for the retail investor."