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Exchange-traded fund strategies

According to Credit Suisse, there are nearly 1,000 exchange-traded products in the US representing approximately $846.6 billion in assets under administration. Although the Canadian market is considerably smaller, the popularity of these investment vehicles has been growing at a rapid pace as investors demand trading flexibility, transparency, and cost efficiency.

Exchange-traded funds (ETFs) are open-ended funds combining the benefits of both stocks and mutual funds but without many of the downsides of mutual funds. ETFs trade on the exchange; can be bought or sold at any point during market hours; can be shorted or purchased on margin; and can be managed with techniques such as stop loss and limit orders.

Because they represent broad portfolios of securities, ETFs lower volatility and minimize company-specific risk. They can track indices or represent specific types of investments such as stocks, bonds, commodities, or currencies. They trade at prices closely linked to the net asset value of their underlying assets and are required to disclose the exact holdings of the fund on a daily basis.

According to The Vanguard Group, if you analyze why portfolio returns vary from one period to the next, asset allocation is more important than either picking the right stock or getting your timing right. In this regard, ETFs are extremely versatile and can be used as building blocks in an asset allocation program. By using ETFs to construct the core of the portfolio, one can easily achieve broad exposure to market segments. Investors simply buy ETFs from the different asset classes (e.g. cash equivalents, fixed income, equity) and rebalance them according to their long-term allocation program.

Another tactic is to use a core/satellite investment strategy that builds on the asset allocation approach. Once the core has been built with index investments, investors can add satellites to achieve outperformance and enhance returns, using riskier non-core asset classes to provide exposure to specific styles or sectors. For example, satellites might be used to access real estate, emerging markets, small caps, commodities, or currencies.

Building on the idea of risk and segmentation, investors can employ an equity risk pyramid strategy. Investors construct a base portfolio comprised of conservative investments such as bonds, money market, and broad market indices. They then add layers to the portfolio, with each successive layer containing riskier investments but smaller weightings. For instance, a basic pyramid strategy might start with a conservative core and then build by adding growth and value ETFs, mid- and small-cap ETFs, sector/industry ETFs, followed by single stock exposure as the highest risk/reward.

ETF investors can also use a portfolio completion strategy. By adding ETFs to a portfolio, they can quickly gain targeted access to a specific sector or style. This strategy is commonly used by investors who do not have sufficient proficiency in a sector or style but wish to have broad exposure. For instance, if investors wanted access to the emerging markets but were wary of taking on any single stock risk, they could purchase an ETF and obtain diversified exposure.

Disgruntled by high cost, underachieving portfolio managers, some investors have opted to use buy-and-hold ETF strategies with the aim of realizing low cost market returns. These investors will simply purchase

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an ETF that follows an index such as the S&P/TSX Composite Index. Alternatively, they might opt for an ETF that represents a balanced portfolio of stocks and bonds. Either option provides a very passive form of investment, yet in a sufficiently diversified manner.

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