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The advantages of Exchange-Traded Funds

Investors have enjoyed many benefits with ETFs

The popularity of exchange-traded funds (ETFs) has grown exponentially. Today, there are nearly 1,000 ETFs globally and the numbers continue to rise. In both bear and bull markets, investors have enjoyed the benefits of ETFs through diversification and proper asset allocation. They have many advantages:

Diversification. Many investors find it difficult to achieve proper diversification with individual equity positions. ETFs offer a solution because they provide exposure to a basket of securities tracking an index. A good example is the iShares S&P/TSX 60 Index (TSX: XIU). In that one ETF, investors gain exposure to the 60 largest and most liquid companies listed on the TSX.

Trading flexibility. Since ETFs trade on an exchange, their per-unit value is always known and they can be bought or sold at any point during market hours. This enables investors to use sophisticated trading strategies typically granted to equities, such as limit and stop orders as well as short sales. ETFs can be bought on margin; in any quantity; and without any holding period restrictions. Investors can even apply options strategies to many ETFs.

Sector rotation and asset allocation flexibility. One can easily overweight sectors or rebalance portfolios through ETFs. For instance, when the markets are volatile, investors can sell their equity ETFs in a few quick transactions and purchase fixed income ETFs. Consider investors who own the iShares S&P/TSX 60 Index. If they wished to increase their government bond exposure instead, they could shift into the iShares DEX All Government Bond Index (TSX: XGB) with over 200 different government bonds. Likewise, investors wishing to overweight a specific sector of their portfolio can easily add a sector-specific ETF, such as a commodity ETF, to achieve their goal.

Transparency. ETFs are extremely transparent investment vehicles because they are required to disclose their holdings on a daily basis. This is vastly different from a mutual fund, which is only required to disclose its top ten holdings once a month.

Reduced fees. ETFs are much more cost efficient than other diversified products such as mutual funds. Although ETFs come with Management Expense Ratios (MERs), they are very reasonable. The MERs for most ETFs range from 0.25% to 0.75%, whereas many actively managed mutual funds have MERs exceeding 2.75%.

Tax efficiency. Due to the structure of ETFs, investors are not affected by the taxable actions of other shareholders. ETFs are also more passively managed and therefore subject to generally lower turnover.

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Selection and availability. With nearly 1,000 ETFs on the market, investors have ample options to choose from. For instance, investors can purchase broad sector ETFs or very specific types such as emerging markets, commodity, currency, and private equity.

Varied management styles. By their nature, traditional ETFs are passively managed; they are designed to track an index. As the popularity of ETFs has grown, so too have the offerings and there are now many actively managed ETFs available to investors. However, they should not be viewed as a route to carefree investing. Monitoring and discipline applies to purchasing ETFs just as it does with other investments.

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