

ETFs dominate Canada Cup -- and a looming threat to Canada's mutual funds

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[ETFs](#), [MERs](#), [Fees](#), [Mutual Funds](#), [Advisors](#)

Unlike the second edition of IMN's Canada Cup Of Investment Management, the seventh edition that wrapped up Friday was not specifically dedicated to indexing or exchange-traded funds (ETFs). However, ETFs still made up a significant portion of the content.



Barclays' Heather Pelant

The heads of the three major Canadian ETF players -- Barclays Canada, Claymore Investments and Horizon Betapro -- were featured panelists on both days. The advisor-oriented session I attended on using ETFs in retail portfolios included Barclays' Heather Pelant, Claymore's Som Seif and Betapro's Howard Atkinson, along with Morningstar Research's Inc.'s Dale Powell and moderator Larry Berman of ETF Capital Management.

Asked why ETFs have grown so popular, Pelant said it was largely spawned by the mutual fund market-timing scandals in the U.S. and by the investigations of Eliot Spitzer. But it was also because there was little innovation from the mutual fund industry since 1940. Seif said ETFs are popular because they're good for investors: "They provide the ability to get exposure to the market and use them in multiple ways, whether for asset allocation or as a complement to stocks or active managers."

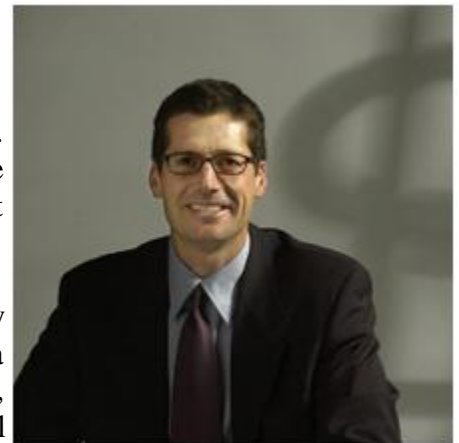
Near the end of the session Seif took a direct shot at traditional mutual funds: "High-fee index-hugging general mutual funds charging 2.5% a year that underperform the market just don't cut it any more. That's the reality." Berman dug the knife deeper when he quipped, "They're called bank mutual funds."

Here to stay

Atkinson said that when he first got involved with them in 2000, he knew that "long-only indexing" wouldn't be pretty during the bear market of 2000 to 2003. But assets of ETFs grew each of those years even as the market fell 50% peak to trough. That's when he realized ETFs "were not a fad or a trend but were here to stay." At BetaPro, about two thirds of sales come from the Bear Plus ETFs, which give investors double profits when the stock market index they track falls. For more on the bull and bear ETFs, see [this video interview](#) with Atkinson. Incidentally, one of the most popular handouts at the show were the bull and bear plastic animals at the Horizons BetaPro booth. Atkinson joked they were moving faster than his ETF brochures.

But based on asset growth, ETF brochures are also a growth industry. Moderator Berman said there is now \$800 billion invested in ETFs and the number will soon pass \$1 trillion. "The message to advisors is if you don't know how to use them, your clients are smarter than you are."

Morningstar's Powell said "we're fans of ETFs. They're a cost-effective way to get beta exposure ... We think ETFs are an excellent way to fill holes in a portfolio." While Powell still likes regular actively managed mutual funds, he said ETFs can be a worthwhile substitute for "index-hugging" mutual funds. He's particularly fond of bond ETFs. Given the current level of



Betapro's Howard Atkinson

interest rates, he said, it's tough for retail investors to get a meaningful return from bond mutual funds.

...but not a panacea

However, "we don't view them as a panacea. We don't view the world as having to be all mutual funds or all ETFs. We don't see why the two can't coexist. ETFs are not ideal in every situation for every investor, especially small investors." They aren't well suited to dollar cost averaging or systematic withdrawal plans, both of which are strengths for mutual funds. Powell also poked a little fun at some of the newer superspecialized ETFs, such as one that specializes in infectious diseases and another on nuclear energy, neither of which he feels would be appropriate for most retail investors. Berman chimed in with the example of one ETF that invests only in small-cap emerging cancer companies.



Claymore's Som Seif

While Canadians have access to 24 TSX-listed iShares, they have also invested \$6 billion in some of the 170 iShares listed on U.S. stock exchanges, Pelant said. When you include all ETF manufacturers there are now 1300 ETFs around the world, and "not all will make it." The current proliferation stage of the industry will be "followed by a period of consolidation," Pelant said, "That's Business 101." For advisors, this means an opportunity to build due diligence into a their fund-selection process.

Vanguard eyeing Canadian market?

You'll notice that index fund and ETF giant Vanguard Group of Valley Forge, PA didn't have anywhere near as much profile at this conference as the three players with operations in Canada. But one attendee I chatted to was Michael De Flavia, a Vanguard International Sales Executive who appears to be focused on the Canadian market. As with Barclays and Claymore, Canadians are free to buy Vanguard ETFs trading on U.S. exchanges - I own a few myself. Canadians can't buy Vanguard index funds or American mutual funds in general but they are perfectly free to buy American ETFs. It would be a big deal if Vanguard decided to market index funds here, if only because Vanguard MERs are lower than any other mutual fund company or ETF maker on the planet. The discrepancy between Canada's world-beating fund MERs would appear even more egregious if Canadian retail investors could directly compare local fund MERs with Vanguard's.

A direct Vanguard ETF presence here would also be welcome, particularly by institutional investors and fee-based advisors who are motivated to keep costs low for clients. To succeed, it would have to build custom products for this market, like the currency-hedged units of Claymore and Barclays, or the bear ETFs of BetaPro. To the extent Vanguard is still making its mind up, Canada's mutual fund companies have a temporary stay of execution. They should take advantage and cut fees preemptively rather than be forced into it when it's too late to matter.