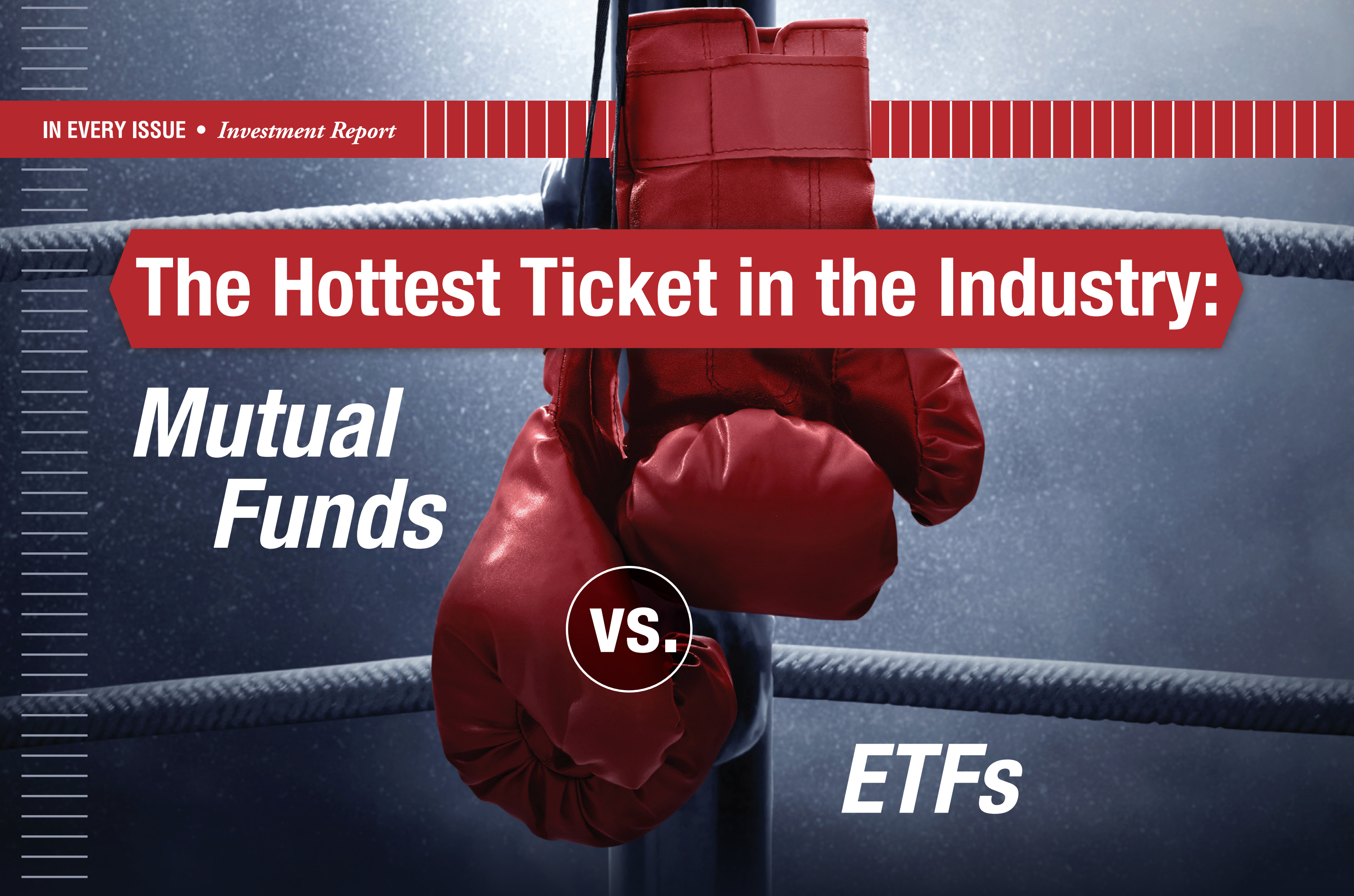

The Hottest Ticket in the Industry: *Mutual Funds* vs. *ETFs*

By Charlene Birdsall, CPA, CMA, CIM, CFP, National Bank Financial – Wealth Management

On the cards tonight, introducing the mutual fund. This opponent has been around since 1774, created during the financial crisis by a Dutch merchant who pooled money from subscribers to form an investment fund. This fund lowered and spread the risk by diversifying across European countries and American colonies and was backed from plantation income. The mutual fund's technique was modernized in 1929 by the Vanguard Wellington Fund, which included stocks and bonds. As mutual funds caught the eyes of the promoters, the referees or government regulators came into play with the enactment of the *Securities Exchange Act of 1934*, to safeguard investors from some unscrupulous promoters.

In the opposite corner of the ring is the relatively younger Exchange Traded Fund (ETF). ETFs were introduced in 1989 with the Index Participation based on the S&P 500 Index, but was short lived with a lawsuit that stopped all sales. In 1990, Toronto Index Participation Shares was born and traded on the Toronto Stock Exchange. Not to be outdone by the Canadians, the Americans launched the Spyders Index on the S&P 500 in 1993, which has become the largest ETF in the world.

Round one: cost

Mutual funds have higher costs called Management Expense Fees (MER), which are imbedded in the fund. They throw an upper cut which impacts the net performance to the client. These fees pay for administration costs, management fees to the fund managers, and trailers (commissions) paid to the brokers/bank. The fees range from .78 per cent for a fee-based mutual fund (F Class) to over five per cent for funds performing well (some fund managers are paid a per centage of performance based on a scale, the more the fund makes, the greater the MER). Fund managers buy and sell individual securities, which have trading costs, within the mutual fund and these costs are spread across all investors in that fund.

ETFs have jabbed their way growing assets in recent years as investors like paying lower annual expense ratios. According to Promoter Daniel Straus, from National Bank of Canada Financial Markets, "the average MER for ETFs in Canada is in the neighbourhood of .4 per cent, at least two per cent less than the average mutual fund MER. This two per cent difference can add up to significant saving, especially when considering the impact of compounding over a very long holding period." One point to note with ETFs though is that the investors must "pay their own way" with buy and sell transaction costs.

Round two: trading

When investors purchase mutual funds, they receive the price or Net Asset Value (NAV) at the end of the day. The mutual fund managers must deploy that cash by purchasing additional securities on the stock exchanges, which incurs additional costs that are spread amongst all the individual investors. For mutual funds, the more inflows or outflows in the mutual fund the more internal costs there are to be shared with the investors.

ETFs are purchased on the stock market exchanges, and prices vary between the difference of the bid and ask on those markets. Daniel Straus indicates that "ETFs are truly 'mutual' investment vehicles that fully democratize the investment process and allow institutional pricing and liquidity to be passed fairly to all participants." The NAV of the ETF is not impacted for existing unitholders with other investors entering or exiting the ETF, because the transactions costs incurred are external (paid by the investor).

Round three: popularity

In Canada, mutual funds have been knocked down for the last three years as ETFs have outsold mutual funds. Since 2018, purchases have only accelerated compared to the previous years. According to Daniel Straus, "ETF assets are only 12 per cent of the $2 trillion held within Canadian mutual funds, but they outsold mutual funds by $13 billion as of November 31, 2020. Traditional mutual funds have suffered net redemptions from balanced and equity funds in 2020." In the United States, ETFs have been outselling mutual funds for the last 10 years!

And the winner is...

It's a draw!

Mutual funds possess many great attributes, such as being actively managed by picking and choosing the portfolio within existing mandates. Since May 2016, the Canadian Securities Administrators mandated that advisors must disclose all fees and risk by presenting a Fund Facts prior to purchase, so you know exactly what you are buying.

Investors have been flocking towards ETFs because they have punched a blow to the mutual funds with their many advantages, such as low cost, tax efficient, easy to access, liquid, and highly diversified compared with mutual funds. But when buying index ETFs, you are buying the good stocks with the bad.

With over 1,000 ETFs in Canada, it is now more important for investors to do their due diligence and verify that the ETF is everything it claims to be. Therefore, it is important to work with an advisor who can help you duck and shoeshine through the many mutual funds and ETFs out there. ◗

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