

Practice Essentials[®] Canada

Through the Looking Glass: Insights into Indexing

What is Indexing?

An index is a list of securities selected and weighted (according to a set of rules) that measure the performance of a market or a specific segment of a market. An index provider, such as S&P Indices, creates and maintains indices that track a variety of securities including stocks, bonds as well as other assets (commodities, for example), across countries, regions and sectors.

An index is what drives investment products including index-linked mutual funds, closed-end funds and exchange-traded funds (ETFs). Understanding the similarities and differences between various indices allows investors and their financial advisors to more precisely identify and select the desired exposure—and thus the performance—to achieve their investment goals.

An index investor's goal is to receive the same returns as the index.

Indexing allow investors to choose investment products that track or mirror an index. The goal of investing in an index-linked product is to achieve returns similar to an index. ETFs are one of the most widely available index-linked products for investors.

Benefits of Indexing

Compared with actively managed funds, ETFs generally have fewer associated costs, more-frequent performance updates and less reliance on the performance of individual securities.

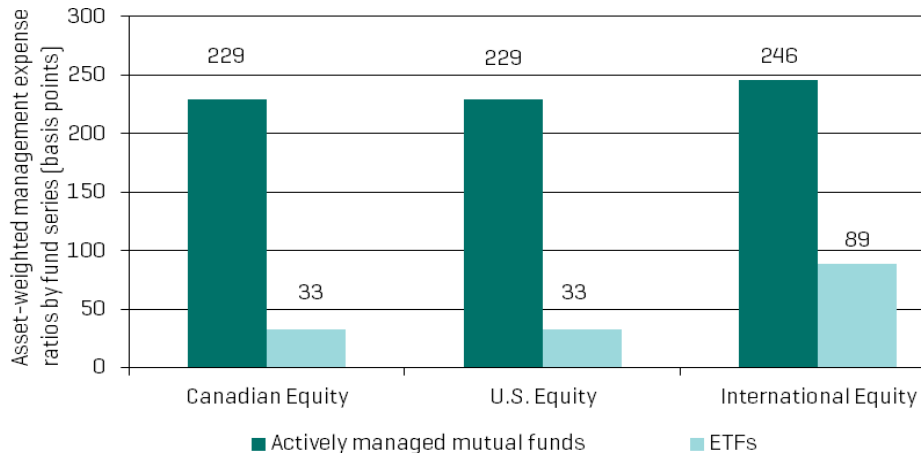
1. Reduced Investment Costs

- **Low fees:** ETFs are often less expensive than actively managed mutual funds. There are no costs associated with performing ones own research on an index-linked investment because the investment simply follows the index. As a result, the fee, or management expense ratio, charged by an index-linked fund tends to be lower than that of an actively managed mutual fund. Equity mutual fund management expense ratios in Canada average 2.4% a year¹ (see Exhibit 1 on the following page). Most ETF management expense ratios are less than 0.5%, according to the Investor Education Fund. Over time, this approximately 1.9% in cost savings could add up to extra money in an investor's portfolio.

¹ Investor Education Fund, "What does it cost to invest in an ETF?"

(<http://www.getsmarteraboutmoney.ca/managing-your-money/investing/mutual-funds-and-etfs/Pages/what-does-it-cost-to-invest-in-an-etf.aspx>)

Exhibit 1: Fee Comparison: Actively Managed Funds versus ETFs



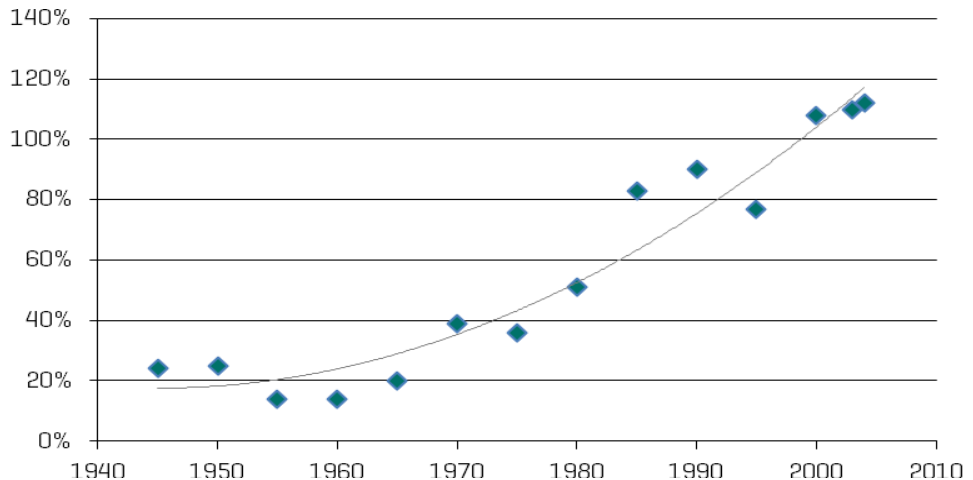
Source: Investor Economics “ETF and Index Funds Report.” Data as of December 2010. Charts and tables are provided for illustrative purposes. Past performance is not a guarantee of future results.

ETFs have fewer trades than actively managed funds because the fund only changes when the matching index changes.

- Fewer Trades:** Changes in ETF holdings are limited to changes made within the tracked index. This doesn’t happen very often, which means that fewer trading costs are passed along to investors. The most common reason for removing an issue from an index such as the S&P/TSX 60 is merger or acquisition. Other common reasons include bankruptcy, restructuring or other corporate actions.

For example, the average turnover in the average U.S. actively managed equity fund in 2004 was 112%, a number that has been steadily increasing from a low of 24% in 1943 (see Exhibit 2 below). Conversely, the average turnover for the S&P 500 between 1992 and 2010 was 4.68%.²

Exhibit 2: U.S. Mutual Fund Turnover Rates 1945-2004



Source: Bogle, John C., “The Mutual Fund Industry 60 Years Later: For Better or Worse?”, *Financial Analysts Journal*, January/February 2005, Vol. 61, No. 1: 15-24. Charts and tables are provided for illustrative purposes. Past performance is not a guarantee of future results.

²S&P Indices, “Capitalization Weighted Turnover”, 1992-2010.

- **Lower Taxes:** Less trading also means fewer taxable events such as capital gains distributions. Fewer taxes mean more of a portfolio's returns stay in the investor's pocket. For taxable accounts, this could mean substantial savings over time.

2. Accessibility

- **Portfolio Holdings Transparency:** Most index providers update indices' performance, price changes and constituent lists every trading day on their websites. (Constituent data for S&P Indices is available at www.standardandpoors.com/indices). Mutual funds, for example, publish their top 25 holdings on a quarterly basis. When investors can readily access their portfolio information, not only do they have the ability to monitor how closely their investment is tracking the stated objectives but they can quickly and easily make necessary changes.
- **Intraday Liquidity:** Just like individual stocks, ETFs can be bought and sold on stock exchanges during market hours, based on intraday prices. However, unlike common stocks or closed-end mutual funds, an ETF's liquidity is not based on the number of shares that trade. Instead, it's based on the liquidity of the constituent stocks in the index being tracked. When building an index, index providers consider liquidity carefully and often stipulate minimum liquidity requirements for its constituents as part of the index's rules. These requirements ensure that the securities in the index can be bought and sold easily, helping the product provider follow the index more accurately and with relative ease. What does this mean for investors? Even if an ETF has low trading volume, as long as its underlying securities are liquid, the liquidity of the investment is preserved, allowing investors greater ability to access their money.

Daily updates on index performance allow investors to always know how closely their ETF is tracking their investment objectives.

3. Diversification

- **Reduced dependence on single investments:** Buying an ETF puts money in the same group of investments that an index follows. Each index can track hundreds—even thousands—of securities, which means results do not depend on one investment. Choosing index-linked products that invest in different industries or asset classes, such as bonds or commodities may provide even more portfolio diversity.
- **Geographic, Sector and Asset Class Exposure:** Indices track securities across asset classes, countries, regions and sectors, which may provide variety when selecting exposures for a portfolio. Indices can even grant access to asset classes that were previously available to institutional investors only. Through index-linked products, investors can now allocate to individual commodities or difficult-to-research spaces such as emerging markets.

Differences among Investment Products

ETFs as well as actively managed investments have many specific characteristics investors should consider when determining what’s best for their portfolio (see Exhibit 3 below). In addition to the benefits of ETFs described in this paper, investors should know how these characteristics stack up against other investment options.

Exhibit 3: Characteristics of Index-Linked and Actively Managed Investments

	ETFs	Individual Stocks	Actively Managed Mutual Funds	Closed-End Funds
Investment Costs				
Low fees	x	x		
Fewer trades	x	x		
Tax efficient	x	x		
Professional management			x	x
Transparency				
Portfolio holdings transparency	x	x		
Intraday liquidity	x	x		x
Diversification	x		x	x

Source: Claymore Investments Inc.

Summary

There are many benefits to indexing available to investors through index-linked products such as ETFs. ETFs can provide the flexibility, accessibility and transparency of individual stocks while offering a lower-cost alternative to actively managed products such as mutual funds due to minimal research, fewer trades and greater tax efficiency.

Additional Resources

To understand more about how the performance of index-linked investment compares with that of actively managed mutual funds, check out “Practice Essentials Canada: Indexing 101: [Three Reasons Why Indexing Works](#)”

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The imposition of these fees and charges would cause actual and back-tested performance to be lower than the performance shown. In a simple example, if an index returned 10% on a US \$100,000 investment for a 12-month period (or US\$ 10,000) and an actual asset-based fee of 1.5% were imposed at the end of the period on the investment plus accrued interest (or US\$ 1,650), the net return would be 8.35% (or US\$ 8,350) for the year. Over 3 years, an annual 1.5% fee taken at year end with an assumed 10% return per year would result in a cumulative gross return of 33.10%, a total fee of US\$ 5,375, and a cumulative net return of 27.2% (or US\$ 27,200).

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