Modern day ETFs offer a world of choice & styles

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Today 's ETFs offer exposure to a diverse variety of markets. iStock 2015

Not long ago, investors seeking to replicate equity index returns on a low cost basis only had a handful of options including SPDRs (State Street Global Advisors S&P500 depository receipts), a collection of WEB offerings (MSCI World Equity Benchmark Series country index securities), or perhaps even owned Canada's own TIPs (Toronto 35 Index Participation Units). Exchange Traded Funds (ETFs) have come a long way since the early 90's. The original TIPs 35 security held 35 Toronto Stock Exchange listed equities (tracking the original TSE 35 Composite Index), and with an MER of just 5 bps (0.05%) provided economical diversification to Canadian large cap stocks. The introduction of TIPS in 1990 helped propel the development of a market that now exceeds $85 billion in domestic ETF assets and over $2.9 trillion globally [*ETF Trends – March 10, 2015 (ETF assets as of February 2015)*].

Modern day ETFs have evolved to offer exposure to all kinds of asset classes, geographical markets and strategies ranging from passive index replication to those that incorporate "smart beta", low volatility, equal-weighted versus original market weighted, and even reverse leverage options for those who prefer to bet against market movements. Let's explore some of the more common of these with the hope that it helps provide insight into the best course of action for those seeking a low cost wealth creation strategy.

In a plain vanilla ETF, securities are selected from an index (let's focus on Canada's Toronto Stock Exchange (TSX) for illustrative purposes) and are either replicated by market weight or equal weight.

You may recall the problem encountered with market weighting during the 2000 "tech wreck" whereby Nortel Networks and JDS Uniphase accounted for close to 50% of their respective indexes, and what goes up, well…sometimes goes down! Unfortunately, many investors jumped on board this runaway freight train long after the initial increase in value, or never trimmed their positions as valuations escalated, and they paid the price when it derailed.

Equal weighting restricted exposure to the number of and exposure to securities held in the fund. However, if a particular stock or stocks were doing very well, they were continually trimmed to retain equal weighting, thus limiting the upside as well as downside. This was seen as more conservative and, while adopted in many sectors aside from the TSX as a whole, such as with Real Estate Investment Trusts (REIT's), some saw it as a punitive approach at times.

Enter **smart beta**! Thought to be the best of both worlds, this approach provides a modification to the standard equal or capitalization weighted index by overlaying a set of prescribed factors that determine security weighting in an effort to not only enhance returns but reduce risk. Managers may choose to create a screen for excessive valuations, weak earnings, dividend payouts or book values, for example. Another may take a thematic approach based on mispriced securities to try to exploit inefficiencies. There is no one "correct" approach to pursuing smart beta, as each has appeal to different investors seeking different styles depending on their specific needs and objectives. These additional inputs have a price, which means a smart beta ETF is generally going to have a cost somewhere between a traditional index ETF and an actively managed mutual fund.

Take the approach of First Asset exchange-traded funds which use Morningstar's proven CPMS screening to develop an effective and efficient "smart beta" methodology. First Asset's smart beta ETF strategies typically have a 60 bps (0.6%) management fee cost, but have a track record of beating their benchmarks, as well as the median mutual fund universe, according to First Asset and Paltrak data to February 2015. Taken a step further, First Asset offers Core ETFs that incorporates several strategies (momentum, dividend, value, low volatility) in equity versions (First Asset Core Canadian Equity ETF and First Asset Core U.S. Equity ETF) and a balanced version (First Asset Core Balanced ETF), the latter incorporating 40% fixed income for an all-in-one, single-ticket solution.

New low volatility ETFs seek to reduce standard deviation while enjoying a rate of return similar to the index as a whole. A concern cited by some analysts is that one gives up some of the downside but also some of the upside. However, if this reduced volatility allows you to stay in the game – which is necessary to achieve those long-term rates of return – then this may be another good option. Some smart beta ETFs, like Invesco's PowerShares series and BMO's Canadian Low Volatility ETF have done very well against their benchmarks and peer classification.

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