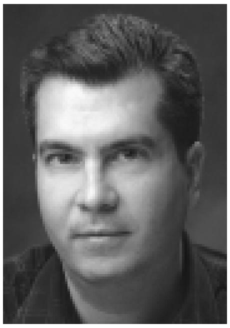

The Cheapskate's Portfolio

Dan Bortolotti

I always shake my head when I hear American investors complain about the cost of mutual funds in the U.S. It's not unusual to hear them grumble that some equity funds charge outrageous fees of, say, 1.5% annually. Of course, that would be a bargain in Canada, where it's not unusual for investors to pay 2.5% or more.

When it comes to exchange-traded funds (ETFs), our neighbours to the south enjoy some remarkably low fees. Investment firms such as Schwab and Vanguard now offer ETFs with no trading commissions and annual fees as low as 0.06%. One financial journalist in the U.S. recently created what he called "The World's Cheapest ETF Model Portfolio", which gave investors exposure to thousands of stocks and bonds in six broad asset classes for all of 0.125% annually. That's 20 times less than many Canadian mutual fund investors pay.

Canadian ETF investors cannot hope to match those low costs, but I thought it would be interesting to see how close we could get. It turns out that by selecting the least expensive funds in each asset class, including some U.S.-listed ETFs, it's possible to build a Canadian-focused but globally diversified index portfolio with an annual fee of just $18.20 per $10,000 invested (Table 1).

All experienced ETF and mutual fund investors know that the first step in comparing costs is to look at the fund's management fees. But there are other factors to consider as you assemble your own low-cost portfolio.

TABLE 1 - THE CHEAPSKATE'S ETF PORTFOLIO

Asset class	Allocation	Exchange-traded fund	MER
Canadian equity	20%	iShares S&P/TSX 60 (TSX: XIU)	0.18%
U.S. equity	15%	Vanguard Total Stock Market (NYSE: VTI)	0.07%
International equity	15%	Vanguard Europe Pacific (NYSE: VEA)	0.14%
Emerging markets	5%	Vanguard Emerging Markets (NYSE: VWO)	0.27%
Gold	5%	iShares Gold Trust (NYSE: IAU)	0.25%
Corporate bonds	20%	Claymore 1-5 Yr Laddered Corporate Bond (TSX: CBO)	0.27%
Government bonds	20%	Claymore 1-5 Yr Laddered Government Bond (TSX: CLF)	0.17%
	100%		0.182%

The MER isn't the same as the management fee

ETF providers crow about their low fees, but they all engage in a frustratingly deceptive practice. While it's standard practice for mutual funds to disclose MERs (management expense ratios) on their fact sheets and websites, all four Canadian ETF providers now list only their management fees. The terms are not synonymous, yet they are often used interchangeably, even by the media who should know better.

The management fee covers all of the ETF's administrative costs, the manager's compensation, the index licensing fee, fees paid to the custodian, registrar and transfer agent. These make up the vast majority of an ETF's expenses. However, the management expense ratio also includes some additional costs, such as the 13% Harmonized Sales Tax (for funds based in Ontario) and the fees payable to the fund's independent review committee. The only way to discover the true MER is to look in the semi-annual Management Reports of Fund Performance. (These can be found at www.sedar.com.)

The difference between the management fee and the full MER is often just a few basis points, but not always. Several commodity ETFs from Horizons list management fees of 0.65%, but the true MERs are more than double that. Claymore's CorePortfolios – which bundle several ETFs in to a single fund – advertise the management fee as 0.25%, but this does not include the MERs of the underlying funds. You have to dig into the paperwork to learn that the true annual cost is 0.70%, almost three times more.

The true cost of an ETF is its tracking error

For index investors, the ultimate goal is to achieve returns as close as possible to the fund's benchmark. The difference between the index return and the fund's actual return is called tracking error, and at the end of the day, that's the true measure of an ETF's cost. In most cases, lower fees mean smaller tracking error, but that's not a slam-dunk. If two ETFs or index funds track the same index, the one with the lower MER isn't necessarily the least expensive.

Here's why. Some indexes are very large and hard to replicate fully, so fund managers may use "a representative sampling". If they don't do a good job at this, their fund can show significant tracking error. For example, the MSCI Emerging Markets Index is tracked by ETFs from both Vanguard (NYSE: VWO) and iShares (NYSE: EEM). The Vanguard fund holds some 840 stocks, while the iShares version holds about 670. Even though the iShares fund charges 0.72% — almost half a point more than Vanguard — it has had a slightly smaller tracking error over the last five years, and therefore has outperformed VWO. It's impossible to know whether that edge will continue, but it's a reminder that the MER isn't the only reason an index fund can lag its benchmark.

Liquidity matters

In theory, ETFs are infinitely liquid. Like an open-ended mutual fund, an ETF creates additional units any time it receives new money, and market makers (called designated brokers) are supposed to ensure that ETFs always trade very close to their net asset value. But in practice, thinly traded ETFs can have significant bid-ask spreads that cost investors money when they buy or sell units.

I did not include BMO's Dow Jones Canada Titans 60 (TSX: ZCN) for the Canadian equity portion of the Cheapskate Portfolio, even though it undercuts the iShares S&P/TSX 60 (TSX: XIU) by a couple of basis points in the MER. The reason is that XIU is the granddaddy of Canadian ETFs and has about 50 times the assets and a thousand times the daily trading volume of the BMO upstart. To its credit, ZCN seems to keep its bid-ask spread tight, but the vastly greater liquidity of XIU is still worth the extra two or three basis points.

Excessive trading negates the cost advantage of ETFs

One of the biggest mistakes ETF investors make is ignoring the cost of trading. The discount brokerages owned by the big banks charge as much as $29 per trade, and these commissions can quickly eat up any savings that ETFs offer. (If your account is large, or if you use one of the independent brokerages, you can get that down to $9.95 or less.) In addition, while U.S.-listed ETFs are generally much cheaper if you're holding for the long term, currency exchange fees will overwhelm that advantage if you trade them too often.

If you invest $100,000 in the Cheapskate Portfolio, the annual fee would be just $182. But at $29 a trade, it would cost over $200 to set up the portfolio, and another $200 to add money to each fund just once a year. That means the true annual cost would be more than double the MER.

If you plan to contribute new money or rebalance frequently, make sure you use a discount brokerage with low commissions. If you have a small portfolio (under $50,000 or so), consider using index mutual funds instead of ETFs. Even with their higher MERs, they are likely to be less expensive overall because they eliminate trading commissions altogether.

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