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'Don't ask, don't tell' mindset hurts ETFs

Mark Yamada / February 17, 2011

Twenty-one years ago the Toronto Stock Exchange launched the world's first exchange-traded fund, the Toronto 35 Index Participation Units (TIPS). The advantages that ETFs offer have since been well chronicled. Support for low-cost, passive investing is broad and includes big names such as Warren Buffett, Peter Lynch, and Charles Schwab.

Despite these endorsements and growth to over 3,182 ETFs globally (through Q3 2010), these funds represent only 5% of mutual fund assets in Canada. Some observers thought ETFs would replace mutual funds altogether, so what happened?

Don't ask, don't tell

ETFs are terrific for the investor but advisors perceive them as less terrific for themselves, and, more importantly, less terrific for most of the major banks. Through their branches and wholly owned brokerage subsidiaries, banks control over 60% of lucrative mutual fund distribution in Canada. So while ETFs offer clear advantages, advisors sell other vehicles with higher or more well-defined compensation. If clients don't ask about ETFs, advisors don't talk about them.

Vlad Tasevski, of Claymore Investments Inc., one of four ETF sponsors in Canada, suggests industry insiders and sophisticated investors understand the benefits of ETFs, but advisors (stockbrokers) and financial planners (mutual fund salespeople), who largely control client investing, aren't talking about them much — and that's creating an information barrier.

Advocates for the individual investor, including the Ontario Securities Commission, haven't been able to remove these barriers. Self-regulating organizations like the Mutual Fund Dealers' Association (MFDA) have neither a duty nor motivation to inform consumers of alternative products, although better disclosure rules have been proposed. Investors must increasingly rely on their own devices and need better information.

Are there any reasons for an intelligent and informed consumer to buy a mutual fund? (See "When mutual funds make sense." below) The principle behind the U.K. and Australian ban on embedded commissions addresses this information gap and more importantly goes to the heart of the problem: aligning the interests of the industry with the interests of the investor.

Other industry practices are also questionable, such as systematic leveraging, DSCs and new issue closed end funds, as pointed out by Harper Fraze (see AER, “**Compensation debate rages on,” November 2010**). Requiring advisors to treat client monies as if it were their own is direct. Fee-based asset management and fee-only financial planning are logical results.

Compensation drives behaviour, so aligning payment with client interests isn’t just one of the issues with which regulators must deal. It is the key issue.

Unbundling

Investors benefit from an unbundling of services and fees because transparency exposes comparative costs. Toronto-based fee-only planning experts **Weigh House Investor Services** know all about that. Weigh House takes no trailer or referral fee for product placement so clients know they are getting the firm’s unbiased opinion. Not a single financial planning firm that is compensated through trailing commissions can make this claim, whether fully disclosed or otherwise. Relationships are always tainted by compensation from product vendors.

ETFs will never completely replace mutual funds as long as advisor compensation favours funds and the banks control product distribution. However, the main competition to the advisor is the do-it-yourself investor with online tools and services that break down the knowledge barrier. The next twenty years will be interesting.

When Mutual Funds Make Sense

There are two circumstances under which using mutual funds makes sense:

- Monthly deposits under $1,800 (about the $22,000 maximum contribution limit to an RRSP). Because a commission is required to acquire ETFs, smaller deposits get expensive. Assuming a $20 per trade commission minimum, this is a 1.11% per annum cost. Buying index mutual funds, monthly, and trading into an ETF periodically is the right thing to do. Alternatively, Claymore offers a commission-free way to invest in their ETFs through certain brokers that is worth exploring to push the threshold for ETF use lower.
- When investors need lots of liquidity, mutual funds provide it. Normally, a trader is the only person who wants this liquidity to move from fund to fund quickly. Curiously, this trading advantage is not encouraged by fund companies. The trade-off is an extraordinarily high cost and restriction to a single NAV per day, less than ideal for the trader. Non-traders should reassess mutual funds altogether.

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