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## Scanning ETFs and their bag of tricks

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*Market exploding with new entrants and choice is becoming overwhelming*

Exchange-traded funds have always been the do-it-yourself investor's best friend: Low-cost, passively invested index funds that give you the same returns as the market. No muss, no fuss, and no worrying about how your fund manager is performing.

But look at the growing ranks of ETFs and you'll notice a big change: there's a new generation of funds on the Canadian market, forging a path no ETF has trodden before. These new offerings have opened up a whole new landscape of investing possibilities for ETF investors.

You can buy ETFs that boost your returns by writing options on the stocks they hold, ETFs that deliver your returns on a chosen target date, even ETFs that delve into exotic territories such as convertible and emerging market bonds.

Just as significantly, many of these funds are actively managed, not just passively accepting market index returns as the funds-of-old did.

"I look at the ETFs that were launched in the past year, and 40 per cent of them I consider strategy-focused," says Kevin Gopaul, vice-president and chief investment officer with BMO ETFs. "If you look at the same period, the year before, it was only 10 per cent."

The biggest hit among the wave of actively managed ETFs has been funds using the covered-call-options strategy. BMO, Horizons AlphaPro and new player XTF Capital Corp. all have entries in the category, and BMO's version, the Covered Call Canadian Banks ETF (ZWB), has attracted \$532 million in assets since it launched in February.

The draw is easy to see: by writing, or selling, call options on the stocks they hold and adding the premiums to the regular dividends, these ETFs can produce twice or even three times as much income as most dividend ETFs.

The BMO ETF, which invests in the six major Canadian banks, writes call options on half its exposure each month, Gopaul says. That produces a yield that hovers around 10 per cent.

The Horizons AlphaPro ETFs are more aggressive. Fund manager Eden Rahim says he writes calls on all the fund's holdings each month, but varies the "strike," price depending on each stock's volatility.

That produces even higher yields: the Horizons AlphaPro Enhanced Income Equity ETF (HEX), which invests in a basket of 30 large-cap Canadian stocks, can yield from 12 to 18 per cent, depending on the market's volatility.

Horizons also has covered-call funds on the financials, energy stocks and gold producers. The latter, with its high volatility, can produce annualized yields ranging from 16 to 28 per cent.

"For us, volatility is not a bad thing," says Rahim.

In fact, the extra premiums can actually offer a little extra support when the markets fall, making these ETFs less volatile than ordinary ETFs in the same sectors. However, there's a downside: the call options, which allow the buyer to purchase the underlying stock when it hits a set price, effectively put a ceiling on the ETF's gains in rising markets.

Gopaul and Rahim say they can counter this by "rolling over" the options to the next month, so they won't be exercised when prices go up.

John Gabriel, Canadian ETF strategist at Morningstar, says the limited upside with these ETFs may pose problems. "For somebody who's bullish on the banks, a covered-call ETF probably isn't the one they want to go with," he says. "But in a downtrending or a sideways market, they can be great."

A second new wrinkle in the ETF world is one familiar to many mutual fund investors: Target-maturity bond funds. BMO launched four target-maturity ETFs in February, and RBC is now preparing to launch a flight of eight.

Target date funds are structured to provide a return on a specific date in the future, for example, the start of your child's first year of university. As the date approaches, their portfolios become more conservative to preserve capital.

Unlike target date mutual funds, however, target maturity ETFs are bond funds (no equities). Rather than increasing their bond weightings as the target date approaches, they shorten their average terms and turn into money-market funds.

BMO's target maturity ETFs use a portfolio of corporate bonds to provide monthly income and a relatively sure payoff, but they haven't been big sellers so far. Gopaul says they're in an "education phase" as investors get used to them.

In fact, the new popularity of fixed-income ETFs this year has produced a wave of new ETFs that delve into the farthest reaches of the bond market.

One of the latest entries is the Canadian Convertible Liquid Universe ETF (CXF), Canada's first convertible bond ETF. Launched in June by XTF Capital, the fund invests in convertible bonds of Canadian companies, and recently offered a yield of more than 14 per cent.

Another new variation is emerging market bond funds. BMO's Emerging Markets Bond Hedged to CAD Index ETF (ZEF) offers diversification into fast-growing economies such as Russia, Korea, Mexico and Brazil - whose bonds, amazingly, are now considered lower-risk than those of developed countries. At time of writing, the fund had a 5.2 per cent yield.

If those don't suit you, you could try a bond-ladder ETF, a tactical bond ETF, a floating-rate bond ETF, a U.S. high-yield bond index, or a HYBrid bond ETF, which holds a mixture of investment-grade and non-investment-grade corporate bonds.

Then there are volatility funds such as the Horizons BetaPro S&P 500 VIX Short-Term Futures ETF (HUV), which rises and falls with the movement of the U.S. VIX volatility index.

There are ETFs that give you double exposure to the gains or losses of different sectors.

And there are ETFs that hold a foreign currency, such as Australian or U.S. dollars. However, Gabriel points out, these effectively charge you a management fee for holding your money in cash.

Some of the first actively managed ETFs, however, were equity funds, including Horizons' AlphaPro Seasonal Rotation ETF (HAC), which invests in different market sectors during their periods of seasonal strength.

"We were one of the first ones, about 21 months ago, and subsequent to that a lot of additional ones have come to market," says Don Vialoux, co-manager of the Seasonal Rotation ETF.

"Canada has led the actively managed ETF market, and Horizons has been the leader in this area."

Horizons' product list includes 18 actively managed ETFs, including the Seasonal Rotation fund and the AlphaPro Gartman ETF, which follows the investment strategies of Dennis Gartman's popular Gartman Letter.

Investors have taken to the trend, Vialoux says. So far, the Seasonal Rotation ETF has attracted \$41 million from Canadian investors.

Not all actively managed ETFs are successful, however. It helps to have something special, either a high-profile manager or a unique investing style. Vialoux and co-manager Brooke Thackray are frequently in the media, as is Dennis Gartman, and other ETFs boast well-known managers such as Sri Iyer, of Guardian Capital.

One of the challenges with actively managed ETFs is to maintain the low management fees that give ETFs an advantage over mutual funds. Many actively managed funds have low fees - around 0.75 per cent is typical - but add a performance fee that kicks in once the fund surpasses a certain threshold.

Investors should look at each ETF critically, says Gabriel. In some cases, the combined management and performance fees can come close to the 2 per cent that many mutual funds charge.

Innovative funds

New players are making the ETF market more crowded.

For most of its history, the Canadian ETF market has been dominated by big names such as iShares, Claymore and Horizons. But new players are appearing on the scene, bringing with them a load of new and innovative funds.

BMO Exchange Traded Funds, an arm of BMO Financial Group, added a major presence in 2009 when it launched its first funds. It now has 40 ETFs, and has been a leader in introducing new products, including covered-call ETFs.

It will soon be joined by another of Canada's big banks: RBC has filed a prospectus for eight target maturity bond funds, which will hit the market soon. And the door is open for the other banks to join the competition, says John Gabriel, Canadian ETF strategist at Morningstar.

As ETFs become more popular with investors, he says, it makes sense for the banks to issue their own, in order to reclaim some of the money that's bypassing their lucrative mutual funds.

"Do you let those dollars walk out the door and go with someone else or do you keep them in house?" he says.

The big U.S. ETF companies are also making their presence felt. In June, PowerShares launched its first Canadian funds, and now offers six ETFs on the S&P/TSX index. Since then, ETF giant Vanguard has announced it will also enter the Canadian market this fall.

PowerShares' new ETFs are a conservative combination of fixed-income and equity funds, constructed with its "intelligent-indexing" techniques, while Vanguard's first six offerings will be a mix of Canadian, U.S. and foreign equity and bond ETFs.

Although those aren't exactly ground-breaking, observers believe Vanguard's trademark low fees could pressure other Canadian issuers to lower theirs. And it may shake up the market in another way, as well.

"Vanguard's business model is to target the fee-based financial advisors," says Gabriel says. "If they're successful in that and the rest of the industry follows suit, that could be a big change for Canada."

Another new player joined the ETF fray in June when Toronto-based XTF Capital Corp. launched its first five ETFs, four of which use the covered-call strategy to generate extra income.

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