BMO Wealth Institute™

Special/Report

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Special Report: Enhancing Retirement Planning with ETFs

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Getting to your goal faster and having your money last longer

The definition of retirement has changed over the years. People are living longer, and many boomers are seeking a lifestyle in retirement that differs from that of the boomers' parents and grandparents. This evolution of retirement is demanding more from retirement savings than ever before. Moreover, the path to retirement can be challenging, and there are a number of investing considerations that could have an impact on how long one's retirement savings last.

Studies have shown that having a financial plan is a key step for an investor to be satisfied with his or her retirement. Sixty-four per cent of Canadians have a financial plan, and an overwhelming majority of them (80%) said that having a financial plan has helped them achieve their financial goals.[1] Beyond having a financial plan, it is important to be aware of some common concerns when investing. This is particularly important if you are 10 years or less from retirement, or have recently retired. The closer the retirement date, the higher the impact of an investment decision on people's lifestyle in retirement.

A number of investment decisions can affect a retirement plan. Often these decisions are made in the execution of a financial plan. The implementation of a plan may require the use of a wide range of investments to develop a portfolio. The portfolio is designed to reflect one's risk tolerance, time horizon and liquidity needs, and also to adjust to the occurrence of life events. Understanding the type of investments that are used is an important aspect in adopting a financial plan. One type of investment product that is becoming more and more popular are exchange-traded funds (ETFs). ETFs can help to address some of the challenges in investing, while providing key features that can help to enhance a financial plan.

While the demand for ETFs is growing worldwide, most investors are still in the early phases of becoming aware of these products. Investors are often least knowledgeable about ETFs, compared with traditional investments such as guaranteed investment certificates (GICs) or mutual funds.[2] Yet once they hear about the benefits of ETFs, almost 60% would likely invest in them.[3]

What are exchange-traded funds (ETFs)?

- An open-ended fund that is listed and traded on a stock exchange, which can be bought or sold directly during trading hours, much like a stock.
- A basket of securities which may consist of stocks, bonds, or other assets such as commodities.
- The asset mix of an ETF generally aims to track the performance of an index or provide exposure to an asset class.
- The different types can be broadly classified as equity, bond, and commodity ETFs.

Canadian investors are most knowledgeable about GICs (58%) and mutual funds (55%), and least knowledgeable about ETFs (19%).

ETFs' key features include

- a diversified basket of stocks, bonds or commodities
- significantly lower costs than other investment products
- easy buying and selling, as they are traded like a stock on the stock exchange
- transparency of holdings, so that you always can see what you own
- targeted investment approach; beyond the broad markets, ETFs are also associated with particular regions, markets, sectors or themes
- tax efficiency, given lower portfolio turnover

60% of investors are poised to add ETFs to their portfolios.

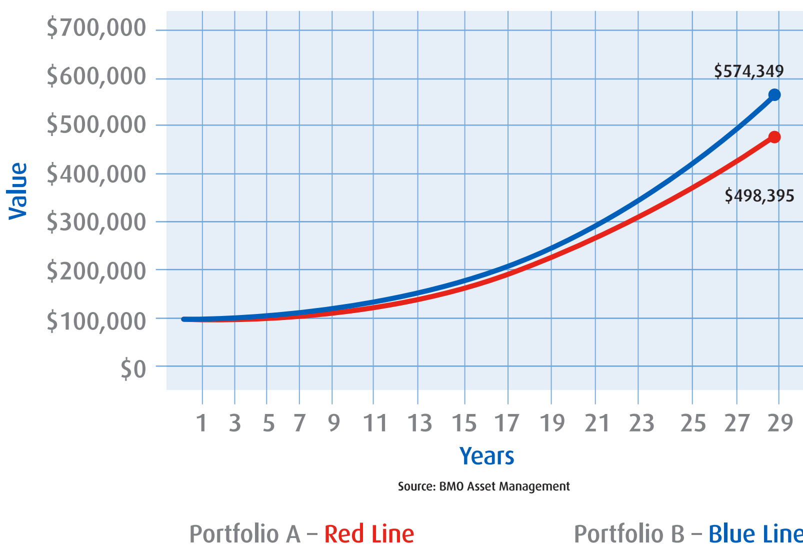
ETFs can be a key aspect of financial planning

Canadians are living longer, and more than half of Canadians who are middle or high net-worth are at risk of being financially unprepared for retirement today and in coming decades.[4] A financial plan is the most important aspect to being prepared for retirement, and setting aside enough money to maintain the desired lifestyle in retirement is equally important. With these key aspects covered, it is then important to look at the cost of the investments within the portfolio, both while accumulating assets and in retirement. Reducing investment costs can contribute to attaining one's goal faster or having one's money last longer. This is where ETFs have become a valuable tool when implementing a financial plan, as they are a low-cost investment option for investors.

ETFs are a low-cost investment option for investors.

The following chart shows the value of lower management fees. *In this example, a client invested in Portfolio B, paying 50 basis points less per year in management fees than a client invested in Portfolio A. This example is based on an initial $100,000 investment that grows at 6% annually for 30 years. The lower costs have provided additional accumulated savings of more than $75,000. Effectively, this provides an opportunity for one's investment resources to last longer.*

Paying less fees can really add up



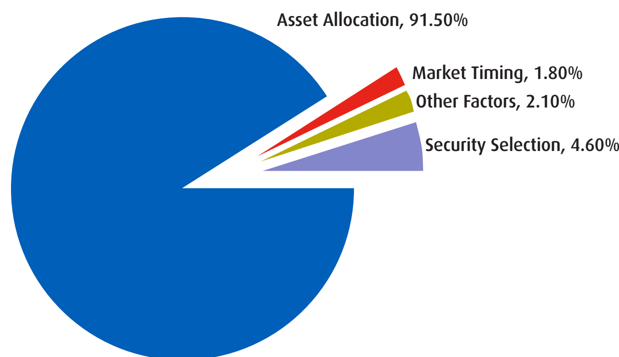
Consider ETFs as an investment option

Balancing risk and return is a fundamental aspect of investing. Taking steps to mitigate the risk is the best way to avoid a misstep when implementing a financial plan. ETFs can help overcome some common challenges when investing, including

- focusing on security selection and not asset allocation
- chasing past performance
- not rebalancing an investment plan
- implementing a portfolio with too much single-security risk
- not factoring in the impact of taxes when reviewing and/or updating the financial plan

Challenge #1: Focusing too much on security selection

Fads in investing come and go. This includes chasing "hot" stocks and trying to time the market. The key issue with investing fads is that they distract investors from the more important aspects of asset allocation. Several studies show the greater importance of asset allocation in comparison with market timing or security selection. The Brinson, Hood and Beebower study, "Determinants of Portfolio Performance," shows that asset allocation is the most important aspect in variation of portfolio returns. According to the study, 91% of the variation is an outcome of the asset allocation, while security selection and market timing have only a minor impact.[5]



– Asset allocation explained over 90 per cent of the variation in a portfolio's quarterly returns

15% of portfolio managers outperformed the index on a three-year basis ending December 2012.

Another way to look at the role of security selection is to compare it to a benchmark index over time. This is the approach that Standard and Poor's takes in its publication of the annual S&P Dow Jones Indices Versus Active (SPIVA), a report that measures the performance of actively managed funds against their relevant S&P index benchmarks. The report confirms that security selection over the long term is less of a factor, since managers who use security selection often underperform an index.[6]

Given that security selection is a minor aspect of variations in portfolio returns, one can use a low-cost index approach to obtain exposure to the desired asset classes, and then place an emphasis on determining the appropriate asset allocation. ETFs provide this low-cost access to indices. ETFs are rules-based and often restrict their managers from deviating from the index to make security selections or attempt market timing.

Challenge #2: Chasing past performance

It is often tempting to invest in an area of the market that has recently done well. The challenge is that the markets are always shifting, and an area that is performing well now may not continue to be a top performer next year. Below is a chart that shows the performance of various asset class categories of the market year by year for the last ten years.

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Highest Return	EMERGING MKT EQUITIES 27.8%	EMERGING MKT EQUITIES 16.8%	EMERGING MKT EQUITIES 31.2%	EUROPEAN EQUITIES 33.8%	EMERGING MKT EQUITIES 18.5%	FOREIGN BONDS 38.7%	EMERGING MKT EQUITIES 52.0%	CANADIAN EQUITIES 17.6%	CANADIAN BONDS 9.7%	EUROPEAN EQUITIES 17.3%
	CANADIAN EQUITIES 26.7%	CANADIAN EQUITIES 14.5%	CANADIAN EQUITIES 24.1%	EMERGING MKT EQUITIES 32.1%	CANADIAN EQUITIES 9.8%	CANADIAN BONDS 6.4%	CANADIAN EQUITIES 35.1%	EMERGING MKT EQUITIES 13.0%	FOREIGN BONDS 9.0%	EMERGING MKT EQUITIES 16.0%
	INT'L EQUITIES 13.8%	EUROPEAN EQUITIES 12.5%	INT'L EQUITIES 11.2%	INT'L EQUITIES 26.4%	CASH 4.4%	CASH 3.3%	EUROPEAN EQUITIES 16.2%	U.S. EQUITIES 9.3%	U.S. EQUITIES 4.4%	INT'L EQUITIES 15.3%
	EUROPEAN EQUITIES 13.8%	INT'L EQUITIES 11.9%	EUROPEAN EQUITIES 7.2%	CANADIAN EQUITIES 17.3%	CANADIAN BONDS 3.7%	U.S. EQUITIES -21.9%	INT'L EQUITIES 12.5%	CANADIAN BONDS 6.7%	CASH 1.0%	U.S. EQUITIES 13.5%
	CANADIAN BONDS 6.7%	CANADIAN BONDS 7.1%	CANADIAN BONDS 6.5%	U.S. EQUITIES 15.7%	EUROPEAN EQUITIES -3.0%	INT'L EQUITIES -28.8%	U.S. EQUITIES 8.1%	INT'L EQUITIES 2.6%	EUROPEAN EQUITIES -8.3%	CANADIAN EQUITIES 7.2%
	U.S. EQUITIES 5.2%	U.S. EQUITIES 3.3%	CASH 2.6%	FOREIGN BONDS 5.7%	INT'L EQUITIES -5.3%	EUROPEAN EQUITIES -32.6%	CANADIAN BONDS 5.4%	CASH 0.5%	CANADIAN EQUITIES -8.7%	CANADIAN BONDS 3.6%
	CASH 2.9%	CASH 2.3%	U.S. EQUITIES 1.6%	CANADIAN BONDS 4.1%	FOREIGN BONDS -5.9%	CANADIAN EQUITIES -33.0%	CASH 0.6%	FOREIGN BONDS -0.3%	INT'L EQUITIES -9.5%	CASH 1.0%
Lowest Return	FOREIGN BONDS -6.0%	FOREIGN BONDS 2.3%	FOREIGN BONDS -9.2%	CASH 4.0%	U.S. EQUITIES -10.5%	EMERGING MKT EQUITIES -41.4%	FOREIGN BONDS -12.9%	EUROPEAN EQUITIES -1.0%	EMERGING MKT EQUITIES -16.1%	FOREIGN BONDS -0.6%

Source: Morningstar Direct. All returns in C$ and are calendar year returns.

- **International Equities** MSCI EAFE Index
- **Canadian Equities** S&P/TSX Composite Index
- **Cash** DEX Canadian T-Bill 91 Day
- **European Equities** MSCI Europe Total Return Index
- **U.S. Equities** S&P 500 Total Return Index
- **Canadian Bonds** DEX Universe Bond Index
- **Foreign Bonds** Citi World Government Bond
- **Emerging Market Equities** MSCI Emerging Markets Total Return Index

The chart shows that no one area of the market is always performing well. Given this, the best approach is to hold multiple asset classes at once to create a diversified portfolio. This will help neutralize downward market movements in poorly performing markets, while ensuring you also participate in market advances.

Hold multiple asset classes to create a diversified portfolio.

This is another area where ETFs can play a role. There are ETFs that represent every asset class, that cover each of the international markets and that provide exposure to every sector of the market. This makes attaining diversification easy for all investors. Given the broad choice offered in ETFs, a broadly diversified investment portfolio can be constructed with just a number of ETFs, at a low cost.

Challenge #3: Not rebalancing an investment plan

Once an investment plan is implemented, it needs to be rebalanced from time to time to ensure the risk and return attributes that were set for the investment plan are maintained. Rebalancing is a process in which you trim your holdings and then add to other holdings so as to return to the desired original asset mix. When you set up an investment plan, it will contain an initial asset mix that is a combination of equities, bonds and, potentially, commodities. Once established, the asset mix will change over time given the movements of the markets, so it is important to rebalance to maintain this mix. Otherwise the investor may take on undesired additional risks, and perhaps forsake additional returns.

> *For example, take an investor who established a $200,000 portfolio comprising 60% stocks, 30% bonds and 10% commodities from January 1, 1992, to August 31, 2013.[7] If never rebalanced, the portfolio's annualized return would be 7.56%, and the value of the portfolio would be worth close to $975,000. But if the same portfolio were rebalanced on a quarterly basis, the annualized return would be be 7.84%, and the portfolio would grow to $1,034,000—overall, a 6% larger profit. Moreover, rebalancing would reduce portfolio volatility quite dramatically, lowering it from 10.64% to 9.26%. Simply put, rebalancing would result in a 19% improvement in the portfolio's reward/risk ratio.*

While the benefits of rebalancing have been known for some time, the process is cumbersome, as one needs to sell off a number of individual positions and purchase a number of others every time the process is initiated. An ETF can help simplify this process, as it is a basket of stocks, bonds or commodities, and one can make a transaction involving a collection of holdings all at one time. This is a key attribute, as it is often hard to trim individual positions—and trimming individual positions could also have extra transactional costs. The ability to deal with a group of holdings in a single transaction simplifies the rebalancing process, helping better capture the benefits of reducing risk and increasing returns.

It is important to rebalance to maintain the desired original asset mix.

Investment portfolios often have sector concentration limits to ensure diversification and prevent overexposure to a sector. A further benefit of ETFs for rebalancing purposes is that you can always look up the holdings in the ETF to see the exact composition of the basket. Knowing the holdings helps ensure concentration limits are also maintained as part of the rebalancing process.

Diversification can mitigate the risk associated with holding a single stock.

Challenge #4: Implementing a portfolio with too much single-security risk

One of the key benefits of an ETF is diversification, as it is essentially a basket of stocks, bonds or commodities. Advisors often point out that diversification can mitigate the risk associated with holding a single stock. Sometimes investors hold a single stock to represent the performance of a sector. This approach will increase the risk of a portfolio—and can cause a misstep in the path to retirement—as the outcome depends on the return of a single security. For example, holding just one stock, such as Apple, to represent the technology sector, rather than the diversified holdings represented by the Nasdaq 100 Index, would have a considerable impact on both volatility and performance. The benefit of diversification is that it helps smooth out the returns—while still participating in Apple's gains.

Note: The Nasdaq is an index, and to invest in it, you would purchase an ETF that tracks it, such as BMO's ZQQ.

Single-security risk is also a factor with fixed income. In recent years many investors have held corporate bonds to increase the yield in their portfolios. By buying individual bonds, the investor takes on the risk of a default by the corporation, but by buying a fixed-income ETF, the investor's

risk is diversified. For example, the BMO Mid Corporate ETF holds over 120 corporate bonds. Beyond the diversification benefits, it is important to highlight that ETF managers will have access to institutional pricing, which is often at better rates than retail offerings. This can help to improve yield in a portfolio while diversifying the risk.

Challenge #5: Not factoring in the impact of taxes when reviewing and/or updating the financial plan

A study conducted by BMO revealed that only 50% of Canadian investors have a financial plan. When asked if the plan had recently been updated, only a third of those with a financial plan said they had updated it in the last year.[8] Updating the financial plan is just as important as implementing one in the first place. Significant changes in one's personal and/or financial situation, or a major life event such as retiring, the death of a loved one, a divorce or disability, will often affect the implementation of the financial plan, and should prompt an immediate review. For example, if you were to come into an inheritance, this new source of funds might prompt a review of your investment approach and permit an adjustment of your asset mix.

When changing investments, you should consider taxes, and seek to mitigate taxes, typically by deferring them. The goal of deferring taxes until a later date is to let more of the portfolio have the benefit of compound growth. Deferring taxes is a core benefit of all registered plans. For funds held outside of a registered plan, it is also important to consider the impact of taxes when making changes to one's investment plan.

- ETFs are known as tax-efficient investment vehicles , but as with all investments, there is a capital gain or loss when the investment is sold outside of a registered plan. One innovation that is even more tax efficient is corporate class mutual funds that hold ETFs. These low-cost solutions are hybrids, as they are a portfolio of ETFs designed to satisfy different risk tolerances. Because they are sheltered under a corporate class, you can move from one portfolio to the next without triggering any tax until your money is finally withdrawn from the corporate class structure of funds. This allows investors to change their investments to match the changes in their financial plan, without triggering taxes.

50%
of Canadian investors have a financial plan, only a third of those with a financial plan said they had updated it in the last year.

ETFs are known as tax-efficient investment vehicles.

- Accumulation and decumulation of assets are different stages in one's life cycle: a period during which you are saving for retirement and one during which the funds are being withdrawn. During the accumulation phase, it is important to keep transactional costs down while saving on a regular basis. One way to lower those costs is to use a program of preauthorized contributions, typically found as a feature in most mutual funds, including BMO's ETF mutual fund portfolios. As you shift to the decumulation phase, this is also an area to look for tax efficiency. One way to mitigate tax is to focus on return-of-capital payment options. This is also a feature of BMO's ETF mutual fund portfolios. These products make regular payments, but they are tax efficient, because the payout is made from your initial principal. Investment gains are kept within the structure until they too are finally withdrawn. Normally, a minimum amount of taxes is paid, and in fact, in most cases, no taxes, on the return of capital, since the payout is one's principal investment; only the gains that are withdrawn later are taxed. This provides for further deferment of taxes outside of registered plans.

Conclusion

Having a financial plan and establishing an investment portfolio are key steps to meeting one's retirement goals. As the definition of retirement continues to change, investors who are 10 years or less away from retirement should update their financial plan regularly. This update process will help to ensure that the portfolio is aligned with changes in time horizon, liquidity needs and risk tolerance. Having a financial plan is essential, but there are still many challenges on the road to retirement that need to be considered to achieve a successful retirement.

The execution of a financial plan will require the use of a range of investments to develop a retirement portfolio. ETFs are investments that are growing in popularity, given their low cost and attractive features that help address some common challenges in implementing and managing an investment plan.

We believe proactive planning and professional advice go hand in hand. A BMO financial professional who understands your investment options can help you grow your savings and generate steady income to fund your retirement.

To learn more about BMO Exchange Traded Funds, click here etfs.bmo.com

[1] BMO Financial Group study conducted online by Pollara with a random survey sample of 1,000 Canadians 18 years of age and over, conducted from September 6 to September 10, 2012.
[2] BMO Nesbitt Burns survey conducted with a random sample of 1,000 Canadians 18 years of age and over, conducted from May 9 to May 13, 2013.
[3] BMO survey conducted online by Leger Marketing with a random sample of 1500 Canadians, 18 years of age or older, conducted from May 24 to May 26, 2011.
[4] "The Canadian National Retirement Risk Index: Employing Statistics Canada's LifePaths to Measure the Financial Security of Future Canadian Seniors," MacDonald, Moore, Chen, Brown, April 2011.
[5] "Determinants of Portfolio Performance." Brinson, Hood and Beebower, May 1991.
[6] S&P Down Jones Indices Versus Active Funds (SPIVA) Canadian Score Card, 2012.
[7] 60% S&P 500, 30% five-year Treasuries, 10% Dow Jones–UBS Commodity Index
[8] BMO Nesbitt Burns survey conducted with a random sample of 1,000 Canadians 18 years of age and over, conducted between May 9 and 13, 2013.

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