Due Diligence in Indexing

Index funds have long been favoured for their rules-based approach that offers some level of predictability. They are an investment route for those not looking to time markets or to seek active management expertise to outperform certain markets. They come with some level of certainty on movement of exposures over time through set rebalancing methodologies and are typically associated with low management fees.

But in times of significant volatility as we have seen recently, when ETFs become reliant price discovery vehicles, index investing too can require some level of active decision-making within the index ETF and the index it tracks. Some examples of this active decision-making can be seen in postponement of rebalancing schedules (this affected many equities and fixed income indices); proposed changes to index methodologies to better address liquidity and offer flexibility to those tracking that index (this affected many oil futures and fixed income indices); and ETF providers sampling securities within an ETF to better manage for short-term liquidity needs. Much of this type of active decision-making is already contemplated in ETF prospectuses and in index methodologies.

This begs a broader question on how different index ETFs within a category are constructed and what they may or may not be permitted to do. With close to 800 ETFs listed in Canada and over 2,000 listed in the US, how do you select which index ETF to use? Will all index ETFs within an asset category always act and perform the same way? Inception date, assets under management, management fees and ETF provider familiarity are all common criteria used by investors to choose index ETFs, but even index ETFs can vary from one to another.

Advisors and investors should consider a due diligence framework for selecting index ETFs, which include four key components – assessing index exposure, product structure, total cost of ownership and the ETF provider.

Index Exposure

The first component is centered on exposure at the index level. There are some key methodology differences that can exist between one index and another. Does the ETF represent the exposure being sought? This should be a seemingly simple question to answer but not every index is built the same. Weighting methodology, free-float calculation, timing of foreign exchange (FX) rates, tax schedule

used, rebalancing frequency and schedule vary by index provider and can result in meaningful differences in performance outcomes.

Historically, indexes were built for active managers to benchmark performance against –not for index funds to track. Many fixed income indexes have constituents that have minimal liquidity. ETF providers tracking these indexes are often unable to fully replicate the index, and in managing for a balance of tracking error versus trading costs, they may sample or optimize. In this method, an ETF provider holds a representative sample of securities that reflects the characteristics of the index. Although this method is a common occurrence in some types of ETFs in Canada, it is important to note that there is a certain level of active management involved in sampling an index. A portfolio manager must decide daily which securities to include or exclude from the ETF as cash flows in or out of the ETF and also at the time of rebalancing. However, more recently, some index providers have built investable indices that are more efficient to track by index ETFs.

Another factor that impacts relative performance of an index ETF compared to the index it tracks is withholding tax that is deducted at source from dividends or interest income paid to shareholders not resident in the same country as the remitting company. Withholding tax may be reclaimed in part or in full if a double-taxation treaty exists. Most index providers calculate indexes using two tax schedules, "net-of-tax" (previously known as "lux tax") and "US RIC" – neither of which reflect a Canadian tax schedule, which impacts Canadian-listed ETFs tracking the index. A small number of index providers, such as Solactive, customize indexes to account for Canadian withholding tax rates.

Product Structure

The second component of the framework is product structure. Advisors and investors should consider implications of an ETF's structure and country of listing.

An ETF can provide exposure by using derivatives, wrapping other ETFs, or directly investing in securities. Each of these methods can result in varying impacts on the performance of an ETF relative to its associated index. The structure also impacts how an ETF trades as well as how a portfolio manager oversees the ETF on an ongoing basis.

Canadian investors have looked to US-listed ETFs, which come with low expense ratios and high levels of secondary market liquidity. However, there are meaningful tax and currency considerations for many

types of investors. When purchasing US-listed ETFs, consider withholding tax implications on distributions made by the US ETF to the Canadian taxpayer as well as at the underlying level within the US-listed ETF. Another important consideration is FX impact and hedged offerings. Investors purchasing US-listed ETFs do not have an option to purchase CAD-hedged equivalents. Buying an ETF on a Canadian exchange often provides investors and asset managers access to CAD-hedged ETFs as needed.

Total Cost of Ownership

The third component of the due diligence framework is total cost of ownership. It's not enough to compare management fees or management expense ratio (MER) alone. ETF investors need to consider total cost of ownership, which includes costs associated with trading an ETF and those which are embedded in net asset value (NAV) and ETF performance. Costs that arise from trading an ETF include spread, commissions and any premiums/discounts. Costs that are embedded in NAV and ETF performance include MER, taxes and total expense ratio (TER).

ETF investors should also consider tracking error, the standard deviation of the difference between the returns of the portfolio and the returns of the index. There are various factors that contribute to an index ETF achieving minimal tracking error, including controlling trading expenses, cashflow management, rebalancing frequency or timing, optimization techniques, index construction, and hedging costs, if applicable.

ETF Provider

The last component of the due diligence framework is focused on getting to know the ETF provider. Understanding the ETF exposure itself is important but having some sense of how the ETF provider will manage the ETF through challenging times, provide investment insights and product support is another. Consider the ETF provider's experience and commitment to the ETF industry, how well they understand Canadian investors' needs and how strong their relationships are in supporting advisors, institutions and working with market makers.

Index ETFs vary in how they are managed and at the index level, which can impact performance outcomes in challenging markets. The decision on which ETF to buy cannot be based exclusively on size, history or volume. Ultimately, it is the responsibility of advisors and investors to conduct due diligence on ETFs being considered. This four-component framework of considering exposure, product structure,

total cost and fund provider can help advisors and investors in the due diligence process. Much of the necessary information is available in ETF prospectuses and index methodology documents that are publicly available, however, reach out to ETF providers to help guide you to the right information.

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