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Why you should always look under the hood of your ETFs

JONATHAN CHEVREAU | April 14, 2015 | Last Updated: Apr 14 1:56 PM ET
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If you're considering a robo-adviser, you have in effect also decided to use exchange-traded funds, because most of the new online wealth management services use ETFs as their building blocks.

As in the glory days of mutual funds in the 1990s, when one role of financial advisers was to help confused consumers pick from among the thousands of funds, so do 21st century robo-advisers relieve investors of the burden of choosing from the growing number of ETFs — more than 400 trading in Canada alone.

But just as it was always prudent for mutual fund investors to check the actual stock holdings of equity funds, it can also pay to look under the hood of the ETFs being chosen on your behalf by a robo-adviser.

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Recently, Sage Investors' portfolio manager Aman Raina signed up for a particular service he called ROBO. He committed a token amount, completed the questionnaire to assess his risk tolerance, and ended up in a suitably aggressive portfolio. His three-part series ran on his site and the Findependence Hub.

Many robo firms keep costs down by sticking to low-cost "plain-vanilla" ETFs from firms such as BlackRock Inc. or Vanguard Investments Canada Inc. If the robo firm charges the typical annual 0.5% fee for its services, an extra fee of 0.1% or so for the underlying ETFs would still keep all-in costs well under 1% a year.

That's less than half the average 2.42% MER of equity mutual funds in Canada (in 2014, according to Boomer & Echo's Robb Engen).

But when Mr. Raina put ROBO to the test, he was "surprised to see more specialized, tactical ETFs instead of more generic plain-vanilla ETFs that invest in broad indexes. It's a flag for me that these tactical types of funds skew toward active investing that churns stocks."

Some were quasi-active ETFs from Purpose Investments Inc., most with fees of about 0.6%.

Mr. Raina's blogs did not identify ROBO, but it's clear he was using Wealthsimple. Purpose Investments chief executive Som Seif said the fees in Raina's blogs were substantially lower than the 0.6% cited because Wealthsimple negotiated institutional discounts with Purpose. (He wouldn't say how much, but institutional rates in general tend to be at least 50% lower than what retail investors pay.)

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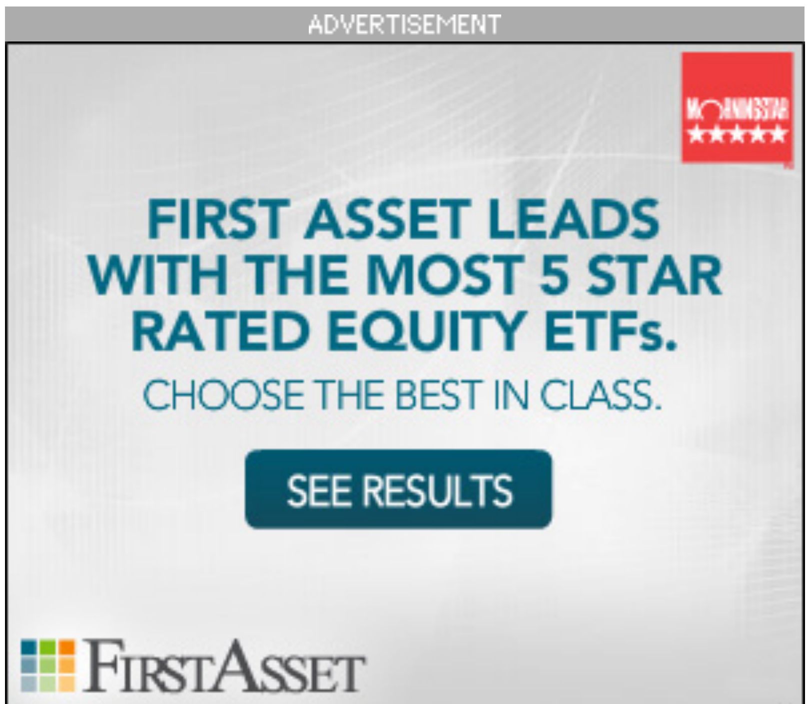
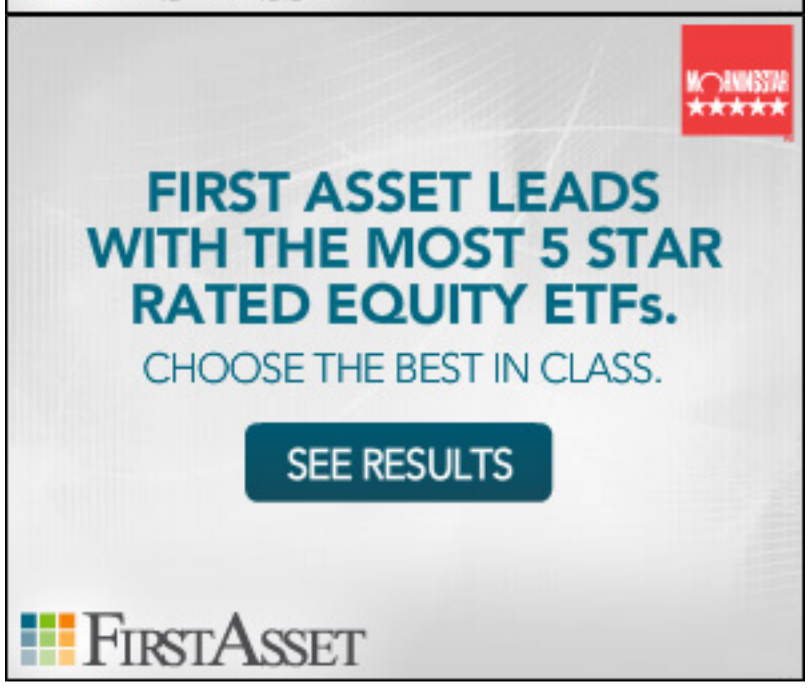




Wealthsimple "came to us," Mr. Seif said, "They loved what we're doing. One thing I admire about them when building their portfolios is they don't just use low-cost beta products."

He doesn't like the term "robo adviser," but says the "light advice" model used by robo advisers in general is "hugely valuable."

Based on his track record with Claymore Investments, ultimately sold to BlackRock's iShares unit, I have no doubt that Seif is able to add value through his ETFs and, therefore, to the robo-advisers that use them.

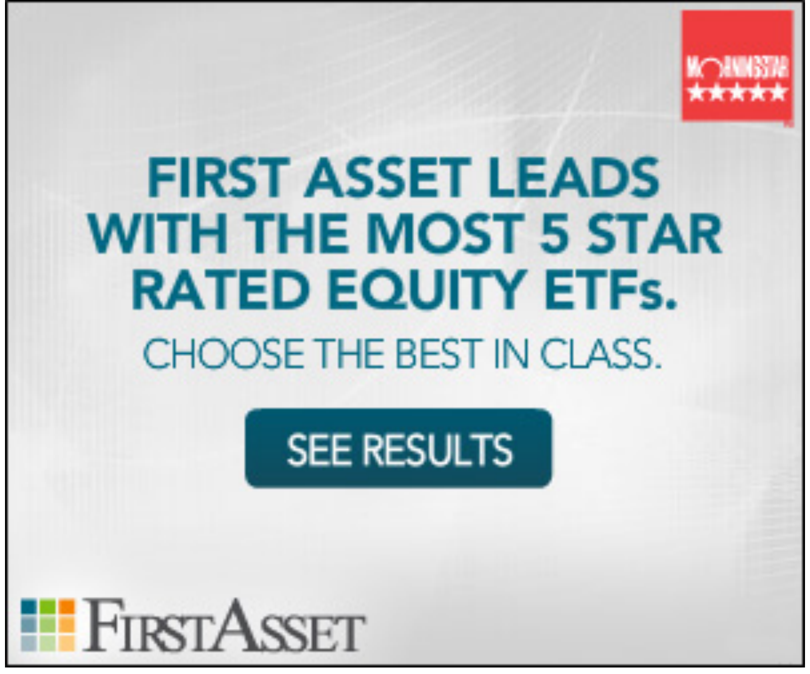
Even so, it's worth being aware that product selection can depend on business relationships. "I surmise alliances are being built between ETF advisers and robo-advisers to get preferred shelf space," said John De Goey, vice president of Toronto-based Burgeonvest-Bick Securities Ltd.

None of this is unethical, he hastens to add. In fact, it's fairly typical of the Canadian investment landscape. Still, it doesn't hurt for investors to ask how their robo firm chooses its ETFs.

Mr. De Goey thinks ETFs are becoming "the ultimate commoditized investment product."

Fees on core ETFs from the majors that track similar indexes may vary by just a few basis points and most consumers are well served by any of them, but he said it gets more complicated once you dip into the "secret sauce" of more complex products.

He cites some that use tax-loss harvesting or corporate-class structures to minimize tax



when switching in taxable portfolios. For those capabilities, consumers may need to ask themselves whether an extra 15 or 25 basis points in fees is worth it, he said.

Then there's the case of independent discount brokerage Questrade Financial Group Inc., which unveiled a robo-like service called Portfolio IQ in November. Its slogan is "Wealth Management isn't just for the Wealthy anymore."

Portfolio IQ is described as "an online wealth management service delivering professionally and actively managed portfolios at an ultra-low cost." It promises customized portfolios for those with as little as $2,000. Management fees range from 0.29% to 0.7%, depending on the amount invested and risk profile.

The second shoe dropped late in March, when a unit of Questrade launched its own family of smart ETFs, billed as the "building blocks of an intelligent portfolio."

In general parlance, the initials IQ refer to intelligence quotient, so you might have expected the new in-house ETFs to be included in Portfolio IQ.

Thus far, however, the six new funds — four equal-weighted U.S. sector ETFs and two broadly based U.S. mid-cap funds, all based on Russell indexes — trading on the TSX are not included in Portfolio IQ.

If they were eventually included in Portfolio IQ, it might be hard for Questrade to pull off the promised "ultra-low" cost, since fees on the ETFs range from 0.70 to 0.75%. A robo-adviser using only those ETFs would come in at an all-in fee north of 1.2%.

Reasonable, but not my idea of "ultra" low cost.

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