

# Dispel ETF myths with ETF realities

## Myth 1

### Low ETF trading volumes and assets under management (AUM) translate into low liquidity

#### Reality:

An ETF can have low trading volume and low AUM yet still have high liquidity. Similar to a mutual fund, an ETF's liquidity is not established by its trading volume but by its underlying holdings. On the minimum, an ETF or mutual fund will be as liquid as its underlying holdings.

It is also important to remember that ETFs are fundamentally different than individual stocks that trade on an exchange. This difference can have a meaningful impact on liquidity. Unlike stocks, which typically have a fixed amount of shares outstanding, ETFs are open-ended investment vehicles (similar to open-ended mutual funds). ETFs are able to issue new shares or withdraw existing shares in the market to meet investor supply and demand. This helps explain why metrics like AUM or trading volume are not helpful in estimating liquidity of an ETF.

An ETF that invests in large companies will have relatively higher liquidity as these stocks trade millions of shares daily. On the other hand, ETFs that invest in less liquid stocks or in securities that trade over the counter (OTC) may experience relatively lower liquidity, which may increase price swings. This would be no different within a mutual fund structure.

An advisor should evaluate an ETF's underlying holdings to determine liquidity, not its trading volume or AUM. If there is no liquidity concern with a mutual fund that invests in similar securities as an ETF, there should be no concern with regards to liquidity in an ETF.

Volume is not indicative of liquidity – regardless of the fund structure.

Advisors sometimes also attempt to evaluate an ETF's liquidity by reviewing exchange order books, which reflect price and number of shares available. However, market makers only reflect a fraction of the volume they are willing to trade in an ETF. They do so to better manage risks associated with significant market movements through the day.

## Myth 2

### Secondary market ETF liquidity is entirely reflected on screen

#### Reality:

Market makers only display a fraction of the volume they are willing to trade. Investors access ETF shares through the secondary market (e.g., stock exchanges) so it is understandable that investors assume that what they see is the total volume available to trade. However, ETFs are unique from stocks and mutual funds in that market makers can add new ETF shares into circulation or take shares out of circulation via the primary market. They do so by working with the ETF provider (i.e. Mackenzie Investments). This process helps keep the price of the ETF close to the ETF's underlying net asset value (NAV).

## Myth 3

### Mackenzie ETFs have wide spreads

#### Reality:

The spread of an ETF represents the spread in the underlying asset class, plus the costs, risks and Profit & Loss for the market maker. The spread seen on screen is two-way. The ETF is typically trading with the NAV at mid-point of the bid and offer prices. This means that the spread actually being experienced to buy in or sell out of ETF shares is half that of the total spread reflected on screen.

The transparency offered by ETFs allows investors to see these costs in real time. In comparison, within a mutual fund, the portfolio spread would look in line with a similar ETF, but the mutual fund structure does not provide this level of intraday transparency.

ETFs that invest in more liquid asset classes tend to have tighter spreads than ETFs that invest in less liquid segments of the market. Geography can also have an impact. Trading stocks or bonds in North America may come at a tighter spread as opposed to trading outside of North America. Higher levels of secondary market trading may have further impact to the tightness of spreads.

Bid/ask spreads should be of less concern to long-term investors as spreads are only incurred when purchasing or selling ETF shares.



#### Myth 4

### ETFs are more risky investments than mutual funds

#### Reality:

There is no notable research that demonstrates that ETFs are riskier than mutual funds. The risk or volatility associated with any fund structure, whether ETF or mutual fund, is influenced by various factors.

The following factors can impact the perceived risk or volatility of an ETF or mutual fund:

- Performance characteristics of the underlying securities
- Inherent risk and volatility in the markets within which the ETF or mutual funds invests
- The manager's investment style and strategy

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#### Myth 5

### Trading at a premium or discount to the NAV is a shortcoming of the ETF mechanism

#### Reality:

The fact that ETFs are designed to transact both in the primary market (creating and redeeming shares at net asset value, or NAV) and on an exchange at prices established by the secondary market is a benefit and allows investors to access realtime market prices when trading. The existence of both a primary and secondary market increases overall pricing efficiency and enhances liquidity.

#### Myth 6

### ETFs are only for day traders and short-term investors

#### Reality:

Like mutual funds, ETFs are effective tools for building portfolios for investors. While ETFs are often used by active investors as trading vehicles, they can be used effectively as buy-and-hold investments for long-term investors.

Whereas one investor may purchase a particular ETF to hedge, another may buy the same ETF for a completely different strategy, such as to grow capital. The product design of ETFs allows investors with similar or different investment objectives to own the same product and still accomplish their respective goals.

#### Myth 7

### All ETFs replicate their underlying indexes

#### Reality:

Most, but not all, ETFs are designed to provide investment results that generally track the performance of an underlying benchmark index by holding a portfolio of securities that mirror this performance. The majority of ETFs around the world use one of three techniques to achieve this goal: full replication, optimization-based tracking and synthetic replication. However, not all ETFs are replication-based and a growing number of actively-managed ETFs have been launched that leverage the expertise of portfolio managers to execute security selection and trading decisions.

#### Full Replication

In this approach, an ETF holds all of the securities in the same weightings as its associated index. Over time, the manager adjusts the portfolio to reflect changes in the index and manages cash flow from dividends or income generation. This strategy tends to provide very close tracking with the underlying index.

#### Optimization-Based Tracking

This strategy is designed to control trading costs and promote liquidity. It uses a sampling process to create a representative or optimized portfolio of securities that closely matches the characteristics of the underlying index. While this approach may be more cost-efficient, it tends to carry a higher potential for tracking error than ETFs that use full replication.



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Investments

### **Synthetic Replication**

These ETFs attempt to replicate index returns by purchasing derivatives such as swap agreements with one or more counterparties, such as a bank. Typically, the counterparty will agree to deliver the performance of the associated index (minus a small spread), including capital gains and dividends, in exchange for the value of the performance generated by a pool of physical securities held by the ETF. This allows the ETF to mirror the performance of an index without having to own the actual securities. This can be advantageous when it is difficult or expensive to trade in certain markets or sectors.

### **Actively Managed**

This category of ETFs, including Mackenzie Active ETFs, allows managers to apply their own expertise in overseeing portfolio construction and trading decisions, similar to actively-managed mutual funds. While the ETF will have a benchmark index, its managers will generally attempt to outperform that index's returns rather than simply match it.

The main difference between actively-managed ETFs and mutual funds is that actively-managed ETFs are priced and traded intraday, while active mutual funds can only be purchased or sold at their NAV after the market closes.

**Investors should work with an advisor to design an appropriate asset allocation and then choose the appropriate individual investments.**

### **Myth 8**

**ETFs are so simple, there's no need to seek professional advice**

#### **Reality:**

One core principle of investing is that asset allocation, more than individual stock selection, is a main driver of returns. Investors should work with an advisor to design an appropriate asset allocation and then choose the appropriate individual investments.

**For investors seeking new ways to target portfolio exposures and reduce risk through diversification, both ETFs and mutual funds are worth considering.**

**For information about Mackenzie ETFs, please talk to your financial advisor.**

**[mackenzieinvestments.com/ETFs](https://mackenzieinvestments.com/ETFs)**

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