

Exchange-Traded Funds (ETFs)

Advisor Education





Exchange-Traded Funds (ETFs)



What is an ETF?

Similar to a mutual fund, an ETF is a pooled investment vehicle where ETF shares represent an undivided interest in the underlying investment portfolio. ETFs are also subject to the same rules as mutual funds as set out in National Instrument 81-102 (Investment Funds), which specifies investment restrictions, reporting requirements and other limitations, and National Instrument 81-106 (Continuous Disclosure Requirements), which sets out requirements for reporting such as financial statements and management reports of fund performance (MRFP).

However, unlike mutual funds, which are bought and sold at the end of each day based on an end of day Net Asset Value (NAV) calculated by the fund's record-keeper, ETFs are similar to stocks, and trade on the exchange in real-time, throughout the day, at market-determined prices.



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Exchange-Traded Funds - General Information

1. How do I buy or sell an ETF?

Like a mutual fund, ETFs are open-ended, which means new shares can be issued to meet investor demand and existing shares can also be redeemed back to the fund. However, unlike a mutual fund, investors do not buy or sell directly with the fund; instead, shares are bought and sold on the stock exchange.

Investors buy and sell ETFs using the same robust and simple process as when trading single name equity stocks. Canadian ETFs typically have their primary listing on the Toronto Stock Exchange (TSX) and are generally available to trade on most other marketplaces in Canada.

ETF liquidity is generally supplied by market makers, who post continuous bids (prices at which the market maker will buy) and offers or “asks” (prices at which the market maker will sell) to the exchange. These market makers also have direct access to the fund in order to create or redeem shares. Trades that happen over the exchange are also known as the secondary market, while creates and redemptions directly with the fund are known as the primary market. Market makers are able to balance supply and demand for shares in the secondary market because they can create and redeem shares directly (the primary market).

Secondary market

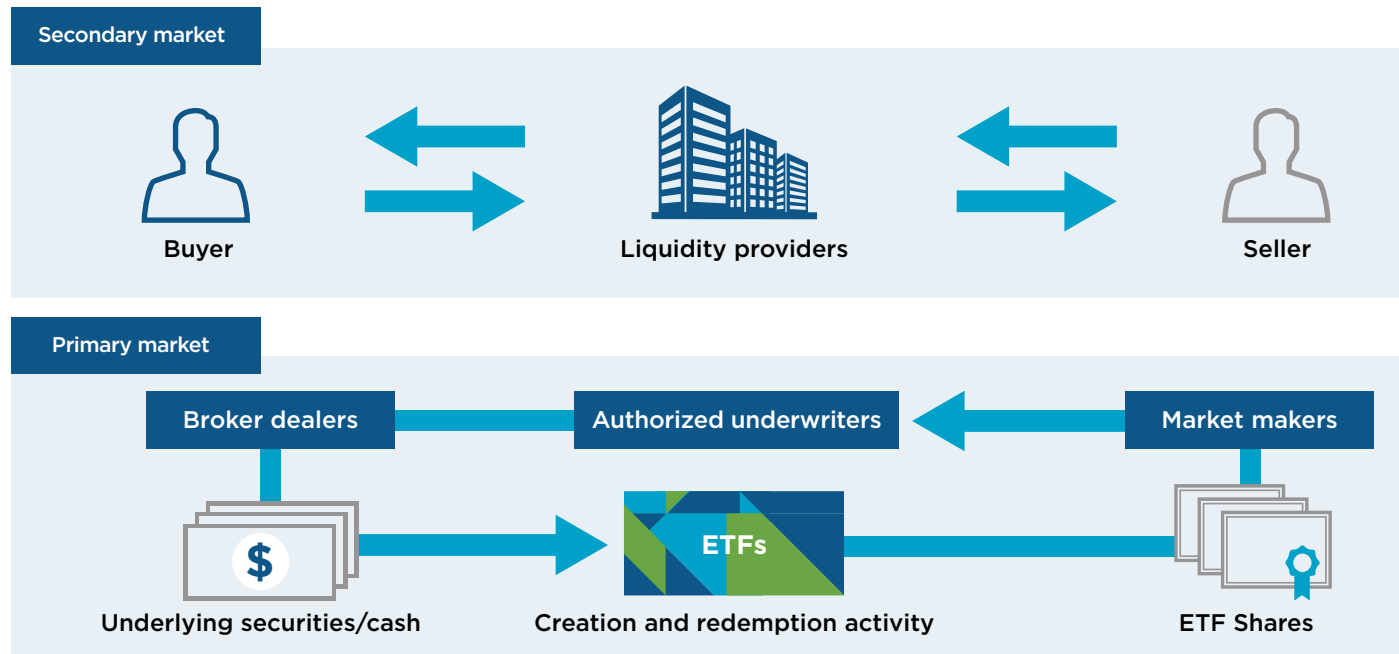
The primary visible source of liquidity for ETF investors is trading ETFs on an exchange through a brokerage firm. Trading takes place at the current market price during exchange opening hours. The exchange mechanism allows for all investor types to interact with each other in a transparent and robust market place. The ETF’s secondary market prices typically reflect the value of the underlying securities contained within the ETF at any given point in the day.

Primary market

In response to market demand in the secondary market, ETF shares can be created or redeemed in the primary market by authorized underwriters of the ETF. Primary market creations usually involve an exchange of a basket of securities, cash or both with the ETF manager in return for new ETF shares. Primary market transactions typically have a minimum size limit of 50,000 or 100,000 ETF shares or more.

Note: In an ETF context, market makers are sometimes called “Designated Brokers”, but “market maker” is the more accurate terminology, and will be used in this document.

Clients interact primarily on the secondary market, but the liquidity of an ETF extends beyond the secondary market.



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2. What pricing sources are there for ETFs? What price will I receive?

ETFs have both a market price (which is calculated in real time) and an end-of-day Net Asset Value (NAV). The market price can be further divided into a bid price (the price you receive as a seller) and an offer price (the price you pay as a buyer).

Investors will receive the offer (or bid) price when they buy (or sell) shares on the exchange. These prices can be viewed using a real-time price feed (such as through Thomson ONE or Bloomberg). The intraday bid and ask price of the ETF is typically a result of market forces, discussed in more detail below. Bid and offer prices are also size-specific (i.e. both a price and quantity of shares), so the exact price an investor receives will also depend on order size (see question #7 for additional information on handling larger orders).

The other valuation price typically observed by ETF investors is the ETF's Net Asset Value (NAV). NAV is an end-of-day valuation of the ETF typically based on closing prices of the securities held in the ETF's portfolio. NAV is usually calculated by the ETF's fund administrator after the market closes.

3. How are intraday bid and offer prices determined?

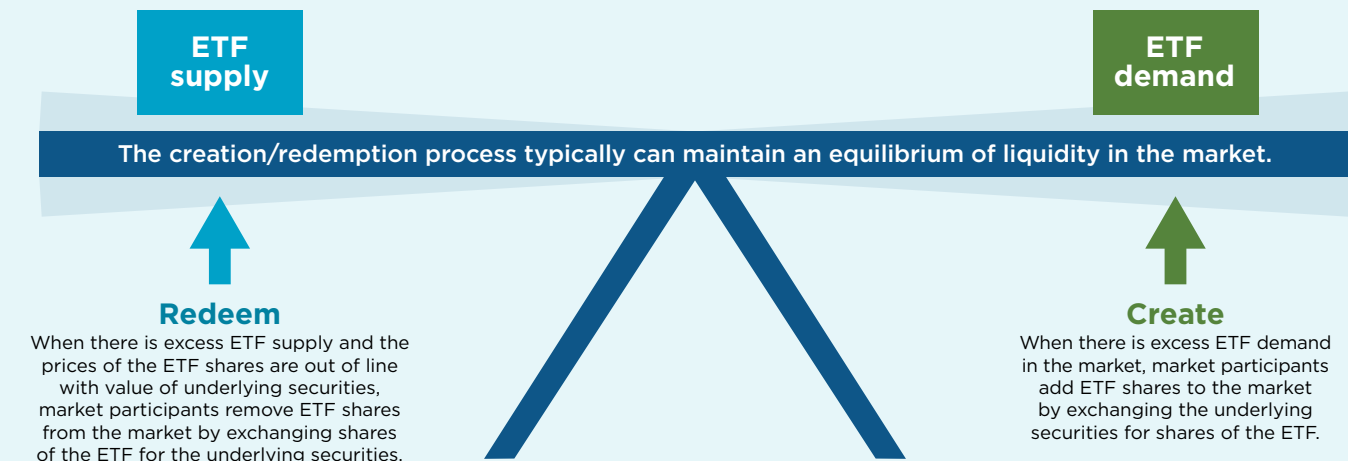
ETF liquidity is fundamentally a derivative of the liquidity of the securities contained within the ETF's portfolio. Market makers provide liquidity by posting bid and offer prices to the exchange (which facilitates trades in the secondary market). Market makers continuously adjust their intraday bid and offer prices to reflect the real-time value of the ETF's underlying portfolio, as well as the cost and difficulty of trading the portfolio.

As market makers see net demand to buy or to sell in the secondary market from investors, they may create or redeem the ETF shares in the primary market. The diagram below attempts to visually demonstrate this dynamic. For example if there is buying demand on the secondary market, market makers will typically create new ETFs using the primary market process.

The ability to trade an ETF on-exchange and create and redeem shares works to create an equilibrium of liquidity.

The supply and demand of an ETF is managed by market participants (e.g. market maker, designated brokers).

If a large order to buy or sell shares of an ETF exceeds on-exchange liquidity, market participants react accordingly to create or redeem shares of the ETF.



Shares of ETFs may be sold throughout the day on the exchange through any brokerage account. However, shares may only be redeemed directly from a Fund by market participants, in very large creation/redemption shares. There can be no assurance that an active trading market for shares of an ETF will develop or be maintained.

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4. Who are the ETF Market Makers?

ETF market makers typically fall into 3 groups:



ETF Designated Brokers (DB)

Designated Brokers are the lead market makers for the ETF. The Designated Broker is also the Registered Trader (RT) for the ETF on the TSX. As the RT, Designated Brokers have a formal obligation to the TSX to make markets in the ETF. A Designated Broker has the right to interact with the ETF in the primary market. ETF issuers will typically select a DB based on the ability of the DB to trade the underlying asset class that the ETF tracks. For practical purposes however, investors do not need to be concerned about whether a market maker is the official DB or not.



ETF Underwriters

Similar to DBs, ETF underwriters have the right to interact with the ETF in the primary market via a legal agreement with the ETF issuer but has no formal legal obligation to make markets in the ETF. As with DBs, underwriting firms are typically subject to risk and control checks by the ETF issuer.



ETF Liquidity Providers

ETF liquidity providers are firms who make markets in the ETF but may not have an underwriting agreement with the ETF issuer. Liquidity providers are usually specialist firms who trade in a particular segment or niche of the ETF market.

5. What's the typical bid and ask spread on ETFs?

The bid and ask spread of an ETF primarily reflects the cost to trade the underlying portfolio held by the Fund. As an ETF matures (in terms of assets under management and volume traded), ETF spreads can sometimes narrow to the point of trading inside the spread of the underlying securities. This is called price improvement and is most common in well-established fixed income ETFs.

6. Does an ETF's trading volume impact its liquidity?

The daily trading volume of an ETF is not an accurate reflection of the ETF's potential liquidity. Low historical ETF trading volume does not necessarily mean poor liquidity. Given the open-ended nature of the ETF, market makers can create new shares as needed. Therefore the ETF's true potential liquidity is directly a function of the liquidity of the underlying securities and not of historical trading volume.

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7. What should investors look for when buying or selling ETFs?

When dealing in any exchange-traded security that includes ETFs, we suggest investors follow some best practises as detailed below:

Limit orders

There is no assurance that ETF orders are able to be fully filled at the top-of-book quoted price. Investors are advised to use limit orders when buying or selling ETFs. A limit order provides some protection from unexpected price swings and also allows the market makers time to fill the order if the size of the trade is larger than their posted shares. Depth-of-book quotes are useful for investors in terms of indicating where larger size could be done on an ETF.

Timing of the trade

Timing of the trade is also important. Investors should try to avoid trading in the first 10 minutes after the market opens or the final 10 minutes before it closes. As the market opens, it may take a few minutes for some of the underlying securities to begin trading and have their value reflected in the price of the ETF. Towards the close, it can be more difficult for market makers to hedge any trades they make in the ETF, and prices may be wider and/or depth shallower as a result.

Large orders

For orders that are significantly larger than posted size or if the investor is unsure, it is advisable for financial advisors to contact their brokerage firm's trading desk or the ETF manager's capital markets desk before executing the trade. The ETF manager's capital markets desks are able to add colour on where larger size trades should be able to be executed through the use of analytical systems. The capital markets desk is also able to direct investors to well-placed or active market makers who can facilitate such trades in an efficient manner. Advisors placing larger orders can discuss options for NAV-benchmarked trades, which the advisor's ETF trading desk will generally be able to facilitate. (Note that there will still be a modest commission or spread associated with such trades). From a back office perspective, NAV-based trades will also sometimes be reported to the exchange (or "printed") the following morning once the official NAV is available (exact practice varies by dealer).

8. How is an ETF's performance reported?

ETFs are subject to National Instrument 81-102, Part 15, which stipulates the manner in which performance must be calculated and that performance should be based on the ETF's NAV. As a result, performance shown on ETF sponsor websites is generally calculated using the NAV; however, for client statements, dealers may report performance based on market price.

9. Do ETFs pay distributions?

Yes, ETFs collect the full dividend of all constituent stocks, and they pay out the dividend to the investor. Distributions

are typically paid out as a cash dividend, except at year-end when taxable capital gains are generally reinvested by the ETF.

Notional distributions are a common practice with ETFs and are necessary because ETFs cannot issue fractional shares. The notional distributions have the effect of increasing the investor's adjusted cost base (ACB), which is generally tracked by the dealer firm (as is the case with ordinary equities).

10. Can ETF distributions be reinvested?

Given the costs associated with trading, ETFs have not always been best suited for investors looking to continuously reinvest cash distributions received from their portfolio. To address this limitation, the ETF manager has established a Dividend Reinvestment Plan ("DRIP"). A DRIP allows investors to compound their investment through the convenient automatic purchase of additional shares, without incurring commissions. Investors may opt into the DRIP by contacting their brokerage; however, not all brokerages support an ETF manager's DRIP program.

11. Is there a minimum amount required to invest in an ETF?

There is no minimum investment. As with a typical stock transaction, brokerage firms may require investors to purchase a board lot, which is 100 shares.



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12. How is an active ETF different from other ETFs and mutual funds?

While there are now over 400 ETFs in Canada, the majority of assets are invested in traditional index-based ETFs. However, this is starting to change as the industry grows and more participants enter the market. ETFs can follow indices or rules-based methodologies, and although still in its infancy, increasingly some are offering active portfolio management.

A comparison of passive and active ETFs, and mutual funds:

	Passive ETFs	Active ETFs	Active Mutual Funds
What?	Seek to replicate returns of traditional (market cap) indices	The portfolio manager actively manages the assets to achieve a particular investment objective	
MER	Generally priced to reflect the passive nature of the strategy	Generally priced to reflect the portfolio manager's flexibility and active trading of stocks within the portfolio	
Trading	Intraday	Intraday	End of day
Price	Bid-ask-driven	Bid-ask-driven	Net-asset-value-driven
Performance	No expectation of achieving additional returns beyond the index less fees and any tracking error	Potential for higher risk-adjusted returns versus passive ETFs, depends on portfolio manager's skill	
Diversification	Hold most, or all of the securities in the target index	Hold a more concentrated portfolio of the portfolio manager's best ideas	

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Please contact your Dynamic Sales Representative for more information.

Head Office

40 Temperance Street, 16th Floor
Toronto, ON M5H 0B4
Toll free: 1-866-977-0477
Tel: 416-363-5621

Customer Relations Centre

Toll free: 1-800-268-8186
Tel: 514-908-3212 (English)
514-908-3217 (French)
Fax: 416-363-4179 or 1-800-361-4768
Email: service@dynamic.ca

advisor.dynamic.ca

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