

Canadian Financial Planner

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In the past few years, exchange traded funds (ETF's) have become a "hot" investment vehicle. Some financial commentators have gone so far as to suggest that a properly constructed portfolio of exchange traded funds have made mutual funds obsolete. This is an extreme position, but ETF's have a number of potential advantages over traditional mutual funds. In this edition of the Canadian Financial Planner, we shall compare the advantages and disadvantages of ETF's vs. mutual funds. The two main advantages of ETF's are tax flexibility and reduced fees. However, one interesting point in the debate between ETF's vs. mutual funds, both sides believe their product delivers a superior rate of return. Our review shall include:

- the basics of exchange traded funds
- the tax issues related to exchange traded funds and mutual funds
- advantages and disadvantages of ETF's
- structuring a portfolio with exchange traded funds

The Basics of Exchange Traded Funds

An exchange traded fund is similar to an indexed mutual fund. The ETF contains a basket of shares that will mirror the performance of a pre-determined index. There are numerous indexes available to investors. For example, an index can be by cap size, i.e., large, medium or small, by geographical area, by sector, or even style, such as value or growth.

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Exchange traded funds are not restricted to stocks, as bond funds are

also available. A key difference between Canadian mutual funds and exchange traded funds is their structure. Mutual funds are normally structured as a trust, whereas ETF's are publicly trade shares.

Tax Treatment of Mutual Funds

The potential tax advantage of ETF's over mutual funds result from mutual funds being structured as a trust. It is important to understand the following characteristics of mutual funds:

- tax rules applicable to trusts
- fund distributions
- adjusted cost base

Tax Rules Applicable to Mutual Fund Trusts - The investment income of a mutual fund trust flows through to the unit holders and investors pay tax on any capital gains and investment income, rather than the mutual fund trust. The tax rules related to mutual funds can be summarized as follows:

- mutual funds are often set up as a trust and the investment income is distributed annually to unit holders. Thus, the trust avoids paying tax on any dividends, interest or capital gains generated within the mutual fund
- most mutual funds make an annual distribution of investment income. Investors receive a T3 that outlines their share of investment income to be included on their personal tax return
- if the structure of the mutual fund is a corporation, rather than a trust, investors receive a T5, rather than a T3

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