Understanding the total cost of ETF ownership

When it comes to exchange-traded funds (ETFs), it’s tempting to focus on just one cost, whether that’s the management expense ratio (MER) or bid-ask spread.

But advisors and investors need to be aware of both the one-time and ongoing costs associated with ETFs and should compare ETFs based on their total costs of ownership. One-time costs are the bid-ask spread and commissions and trading fees. Ongoing costs include the MER, trading expense ratio and—for international ETFs—foreign withholding taxes.¹

A hypothetical example illustrates why it’s important to consider the total cost of ownership, particularly when investing in an international equity ETF. In the illustration at left, ETF A and ETF B wind up with total costs that are equal, but most of their major underlying costs carry different values.²

The reason? The replication structure, or how ETFs gain exposure to the underlying stocks in markets outside North America. In an indirect structure—represented by ETF A—a Canadian-listed ETF owns a U.S.-listed ETF. In a direct structure—ETF B—a Canadian-listed ETF holds the international stocks directly, avoiding a layer of foreign withholding taxes.

Generally, execution costs—quantified in the bid-ask spread and the trading expense ratio—are inversely related to foreign withholding taxes. That’s important to consider when one ETF is marketed as having low foreign withholding taxes compared with its peers.

If lower foreign withholding taxes are important, ETF B would fit the bill. Still, that choice comes with a trade-off: Both the bid-ask spread and trading expense ratio are higher than they are for ETF A.

Conversely, if a lower bid-ask spread is the priority, ETF A would be the pick. The trade-off in that case would involve accepting higher foreign withholding taxes.

So which is the best ETF? The only way to know is to analyze an investor’s personal, financial and tax situations. There’s no one right answer for everyone. That’s why a total cost of ownership evaluation can help investors and advisors from falling into the trap of fixating on one particular cost at the expense of others.

¹ This list of ETF costs encompasses the primary factors that affect a total cost of ownership analysis. Other costs may be less explicit but can affect performance.

² This hypothetical example assumes both the commissions and trading fees and management expense ratios are the same for both ETFs.
Glossary

**Bid-ask spread**—The difference between the price at which an investor can sell a security and the higher price required to buy the same security.

**Commissions and trading fees**—These may be either a flat fee or assessed as a percentage of the value of the transaction.

**Foreign withholding taxes**—The level of these taxes on the dividends paid to foreign investors depends in part on the replication structure of an ETF. There are three main structures encountered by Canadian investors: a Canada-domiciled ETF investing in the units of a U.S.-domiciled ETF, a Canada-domiciled ETF investing directly in foreign stocks, and a U.S.-domiciled ETF investing directly in foreign stocks. Canada-domiciled structures that promote low foreign withholding tax impact tend to result in higher execution costs in the form of the bid-ask spread and the trading expense ratio.

**Management expense ratio (MER)**—This expense ratio includes the management fee, or the expenses incurred by the ETF provider to manage the portfolio and oversee the fund; the harmonized sales tax; and may include other operating expenses not absorbed by the manager.

**Trading expense ratio (TER)**—This often-overlooked expense ratio provides an indication of the amount of trading commissions and other transaction costs incurred by the ETF from buying and selling investments in the underlying portfolio. ETFs that invest directly in international markets tend to have higher trading expense ratios.

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