Zero-fee ETFs can come with strings attached

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Exchange-traded funds have exploded in popularity, spurred by lower fees that improve returns. But these funds, which trade like stocks, can be an even better bargain if investors don't have to pay commissions to buy and sell.

Several Canadian discount brokers offer the allure of zero-fee ETFs. While these deals can be enticing, investors also need to be aware of limits to these freebies and potential pitfalls, some personal finance experts say.

"Read the fine print," says Justin Bender, a Toronto-based portfolio manager with PWL Capital Inc. "Look at all the fees for the different brokerages because they have better or worse set-ups, depending on what you are looking for."

Commission-free trading can vary. National Bank Discount Brokerage, for instance, doesn't charge fees to buy or sell North American-listed ETFs. Scotia iTrade, a unit of Bank of Nova Scotia, also has zero commissions, but only on 50 eligible Canadian-listed ETFs, and Qtrade Investor on only 100 eligible, North American-listed ETFs.

Both Questrade and Virtual Brokers, for what it calls its "classic" commission structure, don't charge a fee to buy North American-listed ETFs, but require a regular commission to sell. But Virtual Brokers, which was recently acquired by CI Financial Corp., will waive commissions for the purchase and sale of ETFs if investors subscribe to an online trading platform.

There can also be various strings attached to the no-cost transactions. National Bank Discount Brokerage stipulates that investors must buy or sell at least 100 units of an ETF. Qtrade Investor requires a minimum $1,000 order for trades. "For smaller investors, they might not be the best option," said Mr. Bender.

Investors without a lot of money to invest at once will need to make smaller trades to build up an investment in an ETF, said Mr. Bender, who also runs a blog for do-it-yourself investors at canadianportfoliomanagerblog.com.

Smaller investors, who are starting out and may have only $5,000 to $10,000, would typically go with Questrade or Virtual Brokers, he said. "Investors just can't sell an ETF for free, which is what people do when they rebalance a portfolio."

But there are other little fees that can apply, such as account maintenance or inactivity fees, he warned. Questrade and Virtual Brokers [classic commission structure] require a $5,000-minimum account to avoid a quarterly inactivity fee of $24.95. Questrade may charge an electronic communication networks [ECN] fee on some trades. For Canadian-listed ETFs, the cost is 0.0035 cents per unit.

For investors with less than $5,000 to invest, a viable option is the online bank Tangerine, suggested Mr. Bender. This unit of Scotiabank offers index mutual funds whose fees are higher than passively managed ETFs, but still reasonable at 1.07 per cent, he said. "You can save there until you have $5,000."

Some online brokers also charge annual fees for registered accounts. Questrade doesn't charge a fee for a registered retirement savings plan. However, Scotia iTrade will apply a $100-annual fee for an RRSP account if it holds less than $25,000, while National Bank Discount Brokerage will also charge the same for RRSP accounts with less than $20,000, he noted. "So, the fees start adding up."

The big bank brokerages – whether they offer zero-fee ETFs or not – are probably fine for investors with larger assets provided they don't trade too often, he said. "A $10-trading ticket isn't likely to create much of a drag on your portfolio."

Investors seeking commission-free ETFs, however, don't need an online broker offering a ton of funds because only a few are required for a diversified portfolio, said Tom Drake, an Airdrie, Alta.-based financial analyst, and personal finance blogger at maplemoney.com.

A Canadian, U.S., and international equity ETF, and perhaps a bond offering, would be sufficient for most people, Mr. Drake said. Qtrade Investors and Scotia iTrade limit the choice of zero-fee ETFs when buying and selling, but probably offer a sufficient number to get the job done, he suggested.

Commission-free ETFs also allow investors to pursue a dollar-cost averaging strategy whereby they can buy units of an ETF for a set-dollar amount on a regular basis – be it monthly or bi-weekly, he said. While investors get fewer units when prices are high, they also get more units when prices fall, he said.

The problem with selling ETFs without a commission, however, is the temptation to ditch a fund when markets head south because of fears of losing money, he said. "I would be worried about them getting out at the bottom of the market."

Steve Bridge, a fee-only financial planner with Money Coaches Canada in North Vancouver, is more concerned with zero-fee ETFs attracting some investors to dabble in sector or commodity ETFs that may be too risky for them.

For new investors, the inverse or leveraged ETFs, which use derivatives to amplify returns, "may seem exciting, but can be a dangerous choice and are not recommended," Mr. Bridge warned. For long-term investing, it's better to stick with plain-vanilla, broad index offerings, he said.

"There has been a great proliferation of ETFs," he noted. In Canada, it used to be easy with only a few names like BlackRock and Vanguard, but more firms, including banks and even mutual fund companies, have "jumped on the ETF bandwagon," he said. "How does one know which to buy?"

Investors who don't have time or the desire to research ETFs and rebalance portfolios may want to consider a robo-adviser firm, he suggested. The advantage of a robo-adviser, which offers low-fee ETF portfolios geared to risk tolerance, is that it's harder to "act on whims," Mr. Bridge said. Robo-advisers have sprung up across Canada in recent years, including Questrade's Portfolio IQ and VirtualWealth, a sister firm to Qtrade Investor.

While commission-free ETFs help to save money, that should not be the main driver in choosing an online broker, he stressed. In addition to trading, discount brokers can offer other services, ranging from research reports to news feeds.

"The more important factor for people should be going with a brokerage that they are comfortable with," Mr. Bridge said. "Does the platform work for you and offer services that fit you and your goals?"