Canadian ETF Association

How Many ETFs do you Really Need?

A question that comes up from time to time is the simple matter of diversification – how to achieve it and how to manage it. One simple test for this concern revolves around the number of ETFs required to build a properly structured and diversified portfolio. As with so many things in life, reasonable people might differ.

The consensus that most accept is that portfolio size is a key determinant and that the exact number of products also depends on a few other things – including client sophistication, the frequency of deposits, and whether the account is registered or not. Generally speaking, smaller accounts can justify having fewer holdings – if only to reduce the number of transaction charges (typically modest, but not nothing) involved in trading. Even if trading costs are set at a modest $15 / trade, that cost can add up if you're trying to maintain a balance on a TFSA with (say) $30,000 invested and $3,000 added semi-annually. Let's begin with some basic parameters and then flesh it out from there:

Account Size	Approximate Number of Products
< $100,000	1 to 4
$100,000 to $500,000	4 to 8
>$500,000	6 to 12

To begin, we need to come to terms with the other primary driver in this decision: how active you intend to be in monitoring your portfolio. The more involved you intend to be, the more granularity you can justify. Most people with small accounts want simplicity, ease of use and minimal commissions. For them, there are several providers (Blackrock, BMO and Vanguard are the leaders in Canada) that offer single-ticket solutions where one can purchase an ETF that offers instant diversification. If you want simplicity and ease of use, these products are tough to beat. You'll simply need to be sure you're buying an offering that matches your risk profile. Small investors who want to be a little more involved might want to have separate products for Canadian equity, International / Global equity and income.

Once we get into low six-digit territory, we often see people who become more interested in details. That's only natural, since they now have more skin in the game. For most people with over $100,000 to invest, there's a desire for expressing more discreet preferences. The usual suspects listed above are present, but there might be a desire to subdivide foreign stocks into U.S., developed non-North America and possibly Emerging Markets. Similarly, there might be a desire to further carve the income portion into domestic and foreign, government and corporate, investment grade and speculative and possibly even currency hedged and unhedged. The amount of fine tuning is up to the investor. How committed will you be to monitoring and re-balancing? Doing this needn't take much time, but it does require regular monitoring – even if no changes are usually made.

It is only once accounts get over a half million dollars that people should give serious consideration to expressing themselves fully in their investment decisions. Building on the holdings mentioned in the $100,000 to $500,000 section, this is the point where most people can finally justify being at least somewhat funky. There could be room for two or three positions (no more than 10% for any one and likely no more than 20% in total) for more esoteric pursuits. These include any number of potential alternative strategies, sector products and specialty products. Examples might include long/ short offerings, covered call products, thematic plays (e.g. health care) and micro-level calls (e.g. shorting cannabis). The thing about many specialty products is that, by themselves, they are often risky. Investors should be prepared to lose substantial portions of their allocations to these 'cherry on the sundae' expressions of preferences, hunches, flyers and macro-level trends that may or may not come to fruition.

As a rule, investors might want to be closer to the low number when at the low end of the account size range and only creep toward the higher number of products when they get to the high end of the range. For instance, having 8 products in a portfolio with $110,000 is likely overkill. It would almost certainly be better to simply aim for 4 and then, as the account grows, to judiciously add new products and themes along with that growth slowly over time.

Whether you build the portfolios yourself or work with an advisor, it is important that there's a resistance to the temptation to over-think and micro-manage things. Just because there are myriad options doesn't mean you need to try all of them. Have a strategic asset allocation. Monitor and maintain it. Manage turnover and taxes purposefully. Be reasonable in your expectations.

Portfolio construction is fairly easy to understand, but requires focus and discipline on an ongoing basis. Build a portfolio that suits your disposition and preferences and then stick to it.

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