Norbert's Gambit and US-Friendly RRSPs

A better way to buy US dollars in Scotia iTRADE accounts

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Toronto, Ontario
November 2013

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Justin Bender, *Portfolio Manager*, PWL Capital Inc. and Dan Bortolotti, *Financial Planning Consultant*, PWL Advisors Inc. *"Norbert's Gambit, A better way to buy US dollars in Scotia iTRADE accounts"*

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US-listed ETFs are the most tax-efficient way to invest in foreign equities within your RRSP account. The funds also tend to have lower annual fees than Canadian-listed ETFs. However, they must be bought and sold in US dollars, and if you have to exchange your Canadian dollars for greenbacks, it can be extremely costly. Many discount brokerages charge about 1.5%—or a whopping $150 on a $10,000 conversion. If you're going to use US-listed ETFs, you need to find a way to mitigate these high costs.

Understanding Foreign Exchange Quotes

Before we work through an example together, let's go over the basics of foreign exchange quotes. If you call up your discount brokerage and ask for a quote to convert your Canadian dollars to US dollars, they may respond with a number like 1.045. This means they will give you 1 US dollar for every 1.045 Canadian dollars you provide them with. A common way of writing this is:

USD/CAD = 1.045

The first currency in the pair is called the *base currency*, and it is equal to 1. The second is called the quoted currency: it tells you how many units you must pay to buy 1 unit of the base currency. For example, assuming you wanted to sell $25,650 Canadian dollars and buy US dollars, the calculation would go like this:

$$\text{US dollars received} = \frac{\$25{,}650 \text{ CAD}}{1.045}$$

$$= \mathbf{\$24{,}545 \text{ USD}}$$

In other words, when the brokerage quotes you 1.045 to convert your $25,650 Canadian dollars to US dollars, just divide $25,650 by 1.045 to determine how many US dollars they are offering.

Putting them on the spot

How do you know whether your brokerage is offering you a fair exchange rate? You could visit the OANDA or CanadianForex websites to lookup the spot exchange rate, which can be considered your benchmark. Suppose the spot exchange rate for USD/CAD conversion is 1.030 (look in the *ask* column). Using the same process as above, divide $25,650 by 1.030 to determine how many US dollars you would receive if you were able to get the best possible exchange rate:

$$\text{US dollars received} = \frac{\$25{,}650 \text{ USD}}{1.030}$$

$$= \mathbf{\$24{,}903 \text{ USD}}$$

The difference between these two outcomes is the approximate cost of converting currencies through your discount brokerage:

$$\text{Conversion cost} = \$24{,}903 \text{ USD} - \$24{,}545 \text{ USD}$$

$$= \mathbf{\$358 \text{ USD}}$$

This transaction would have resulted in a cost of about 1.44%:

$$= (\$24{,}545 / \$24{,}903) - 1$$

$$= -0.01437$$

$$= \mathbf{1.44\%}$$

Not only is that cost high, it's also hidden: most investors making this transaction would have had little idea they were being charged. Brokerages almost never post their currency exchange spreads, and customer service reps have been known to tell clients there is no fee for exchanging currency. This is only true in the most literal sense: a wide currency spread isn't a "fee" for the service. It's simply a high price.

The Scotia iTRADE US-Friendly RRSP Account Service

Scotia iTRADE launched its US-Friendly RRSP Account Service in January 2011. Instead of paying the egregious retail markup on foreign currency conversions, iTRADE investors can pay a quarterly fee of $30 per account (plus tax) in exchange for receiving what the brokerage calls "the single, benchmark, mid-market rate used by Scotia Capital Inc. to price its holdings of US/Canadian dollar currencies at the end of that trading day (SCI Rate)."

The trouble is, this rate is not published and clients won't know what it is in advance. In a Money Smarts Blog post, Mike Holman reports that a Scotia iTRADE representative told him the SCI Rate amounted to a spread of about 0.50%. In a comment on that blog post, a Scotia iTRADE representative explained that customers "will not be subject to a retail spread" and stated that on January 18, 2011, the SCI Rate for USD/CAD was 0.9924. That gives us something to work with. If we had converted $25,650 CAD on January 18, 2011 in a Scotia iTRADE US-Friendly RRSP account, we would have received $25,846 USD:

$$\text{US dollars received}_{\text{SCI Rate}} = \frac{\$25{,}650\ \text{CAD}}{\mathit{0.9924}} = \mathbf{\$25{,}846\ USD}$$

If we compare the SCI Rate to the benchmark rate of 0.98698 posted on the CanadianForex site for the same day, we would have received $25,988 USD.

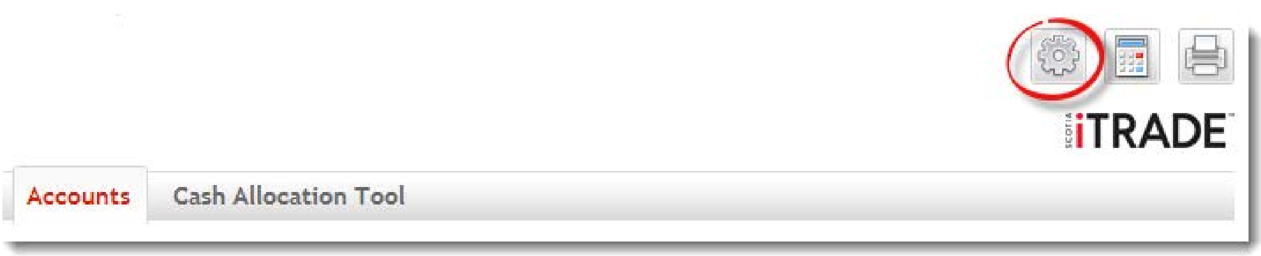
$$\text{US dollars received}_{\text{Benchmark Rate}} = \frac{\$25{,}650\ \text{CAD}}{\mathit{0.98698}} = \mathbf{\$25{,}988\ USD}$$

In this example, the SCI Rate cost about 0.55% relative to the benchmark rate ($25,846 USD / $25,988 USD – 1). This seems in line with the comments above. If the investor placed only a single trade this quarter (paying the $30 fee) this transaction would have cost about **0.66%** [($25,846 – $30) / $25,988 – 1].

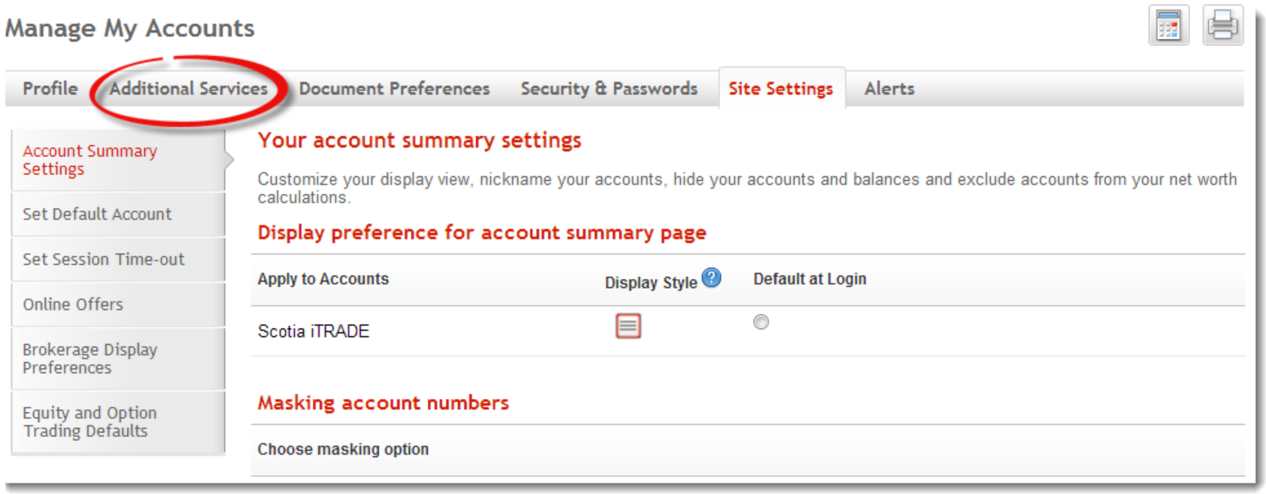
User-friendly instructions

Although enrolling in the US-Friendly RRSP Account Service can be done easily online, the process is not very intuitive. Here's how to do it:

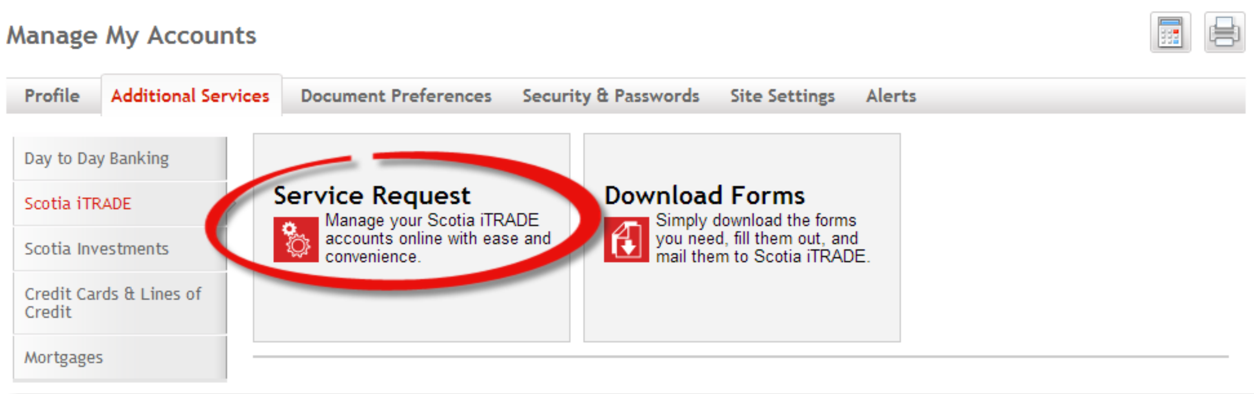
1. On the main account screen, click the gear icon:



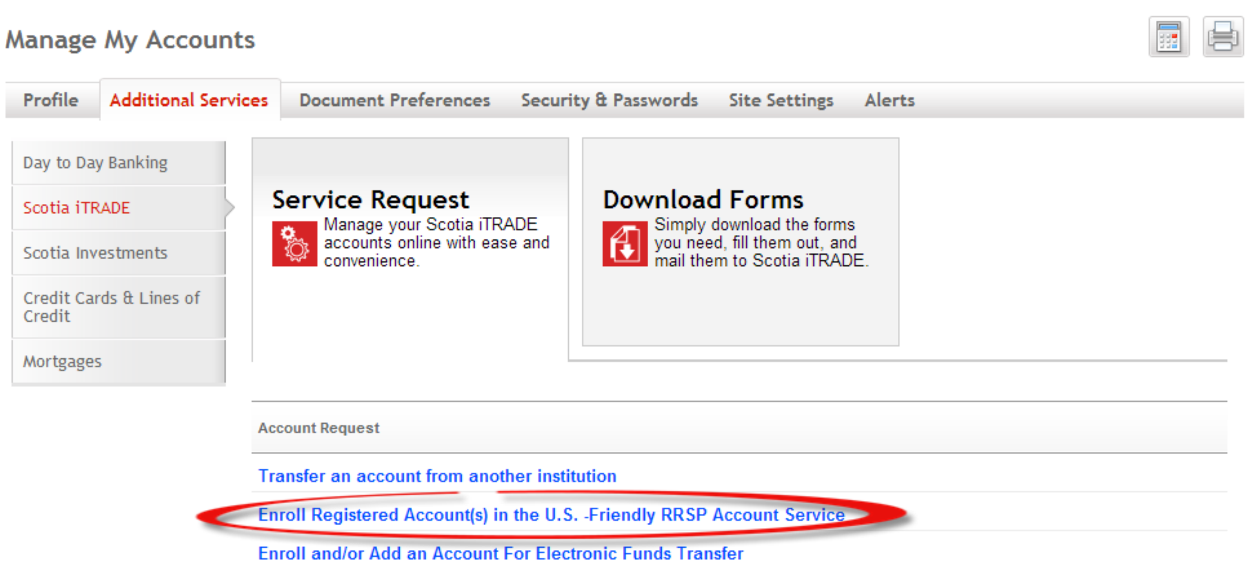
2. **On the "Manage My Accounts" screen, click the "Additional Services" tab.**



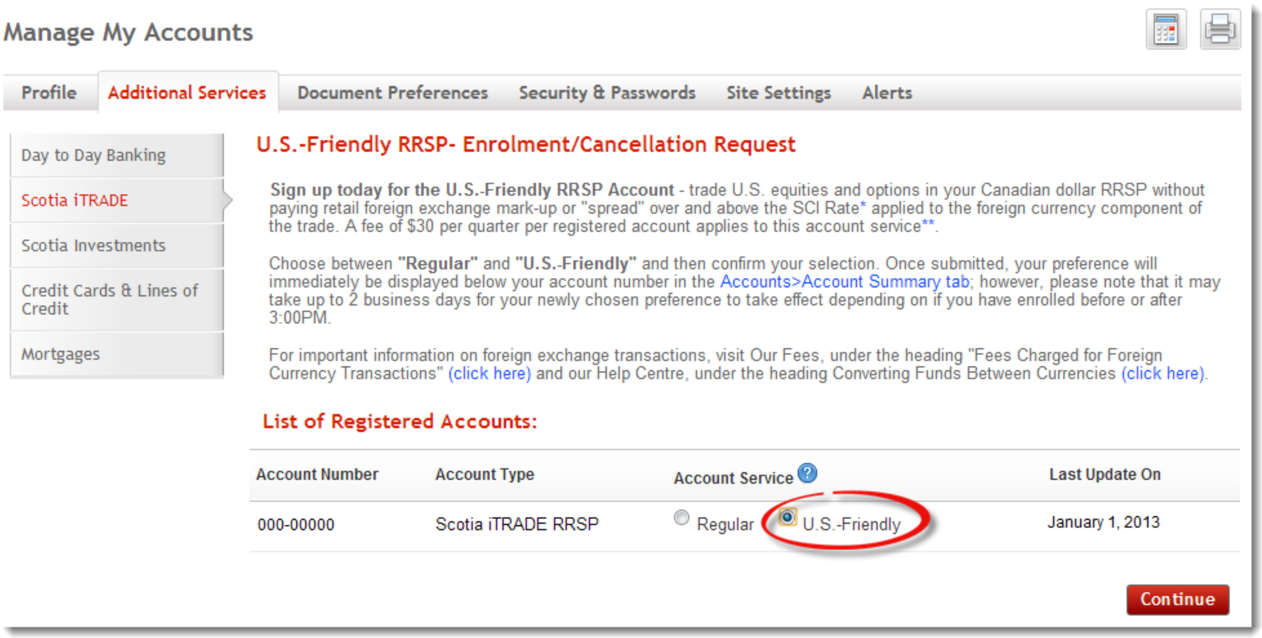
3. **Click on "Service Request."**



4. **Click on "Enroll Registered Account(s) in the US-Friendly RRSP Account Service"**



5. **Select the US-Friendly option for the relevant account(s) and click "Continue."**



Note that the fine print explains it may take up to two business days for this change to take effect, so don't start making your trades immediately. Moreover, the conditions also explain that the $30 fee "will be charged at the beginning of each quarter to each registered account that was enrolled in this service at any time during the previous quarter." If you add new cash or rebalance your portfolio annually, you can enroll in the service for one quarter and cancel it after your trades have settled.

Introducing Norbert's gambit

The US-Friendly service is your best option for an RRSP at Scotia iTRADE. However, if you need to convert loonies to US dollars in your *non-registered* accounts, we'll show you a technique that can save you hundreds of dollars per transaction.

Savvy DIY investors have long used a technique called "Norbert's gambit" to sidestep these steep currency conversion costs. The name comes from Norbert Schlenker, an investment advisor in B.C. who was the first to popularize it.

Here's an analogy that might help you understand the idea. Imagine you live in Windsor, Ontario, and you want to exchange $100 Canadian, which at today's spot rate is worth $95 US. But your local bank offers you only $93 US, because it will keep the other $2 as its profit. So you come up with a bright idea: you go to your local Walmart and buy an item for $100. Then you drive across the border into Detroit, where there is another Walmart that sells the same items for the equivalent amount of US dollars. You take your newly purchased item to the customer service desk and return it for a refund of $95 US. Now you've received a fair exchange on your money and sidestepped the bank's $2 fee.

OK, we know you can't do that at a real Walmart. But you can do something similar in your brokerage account. Some stocks and ETFs trade in both Canadian and US dollars, so you can simply buy them in one currency and then sell them in the other.

Norbert's gambit with DLR and DLR.U

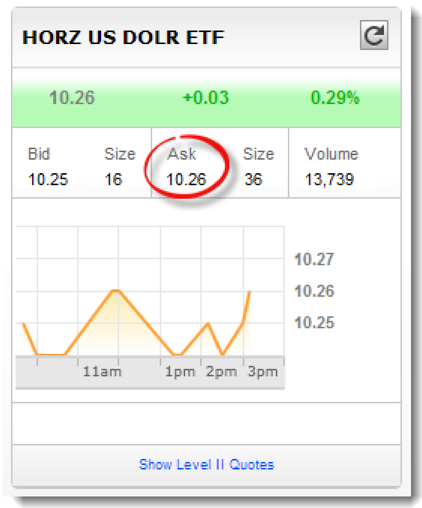
The simplest way to do Norbert's gambit is with the **Horizons US Dollar Currency ETF**. This ETF—which is equivalent to holding US cash—is available in two versions. Both trade on the TSX, but the first, with the ticker symbol DLR, is bought and sold in Canadian dollars, while the second, DLR.U, trades in US dollars. The two versions always trade close to $10 per share, and the difference in price between the two versions reflects the current exchange rate. At Scotia iTRADE, DLR trades commission-free, which is a nice bonus. (Note, however, that the $9.99 trade commission still applies when buying or selling DLR.U.)

You can use these ETFs to exchange Canadian dollars for US dollars and then use the proceeds to buy US-listed ETFs.

You can use Norbert's gambit to convert US dollars to Canadian dollars as well. Start by purchasing shares of DLR.U on the US-dollar side of your cash account (the shares will show up as "DLR" under your US Account Positions). Then submit an online request to transfer all shares of DLR.U from the US-dollar side of your cash account to the Canadian-dollar side of your cash account. (**See Step 3 below for instructions.**) Once you notice DLR has been moved to your Canadian Account Positions, sell the same number of shares of DLR on the Canadian-dollar side of your cash account.

Norbert's gambit can be confusing, so let's work through an example assuming you want to convert about $25,650 CAD in your Canadian-dollar cash account and use the proceeds to buy a US-listed ETF in your US-dollar cash account. We've used the Vanguard FTSE Developed Markets ETF (VEA) in our illustration, but you can use the same process when buying any other US-listed fund.

1. Get a quote for DLR and calculate how many shares you can buy for $25,650 CAD.



Number of Shares	=	(Purchase Amount) / Ask Price
	=	*($25,650) / $10.26*
	=	**2,500 shares**

Whenever you are purchasing an ETF, the ask price is what you are interested in. The ask price is what potential sellers are willing to accept for one share of the ETF. In other words, if you were interested in buying DLR, you should expect to pay $10.26 per share. The size indicates the number of "board lots" available at the current ask price (1 board lot is equal to 100 shares). In our example, you would be able to buy up to 3,600 shares of DLR at $10.26 per share. Since we are planning to purchase only 2,500 shares, we would expect to receive all of them for $10.26 per share.

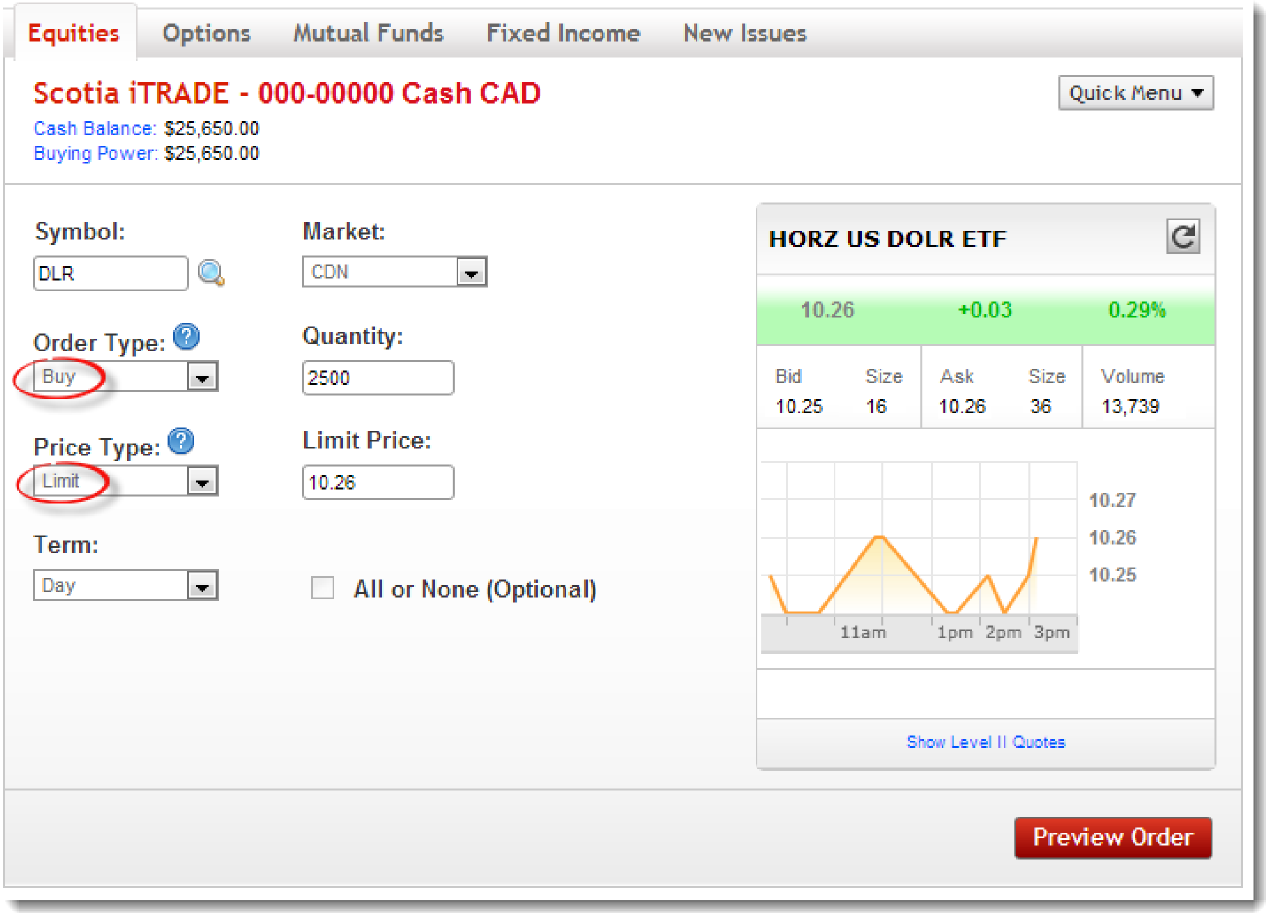
Push yourself to the limit

Whenever you buy or sell ETF shares, you can use a market order or a limit order. If you place a market order, it will be filled at the current price, whatever that happens to be. A limit order, on the other hand, allows you to specify the maximum price you will pay, or the minimum price you will accept.

We discourage investors from placing market orders at any time. A market order is like a blank cheque: you're saying to the stock exchange, "I trust you. Please write down whatever price you think is fair." Most of the time, a market order will be filled very close to the quoted bid or ask price, but sometimes you'll get a nasty surprise. So let's be clear: you should always use limit orders when buying or selling ETFs.

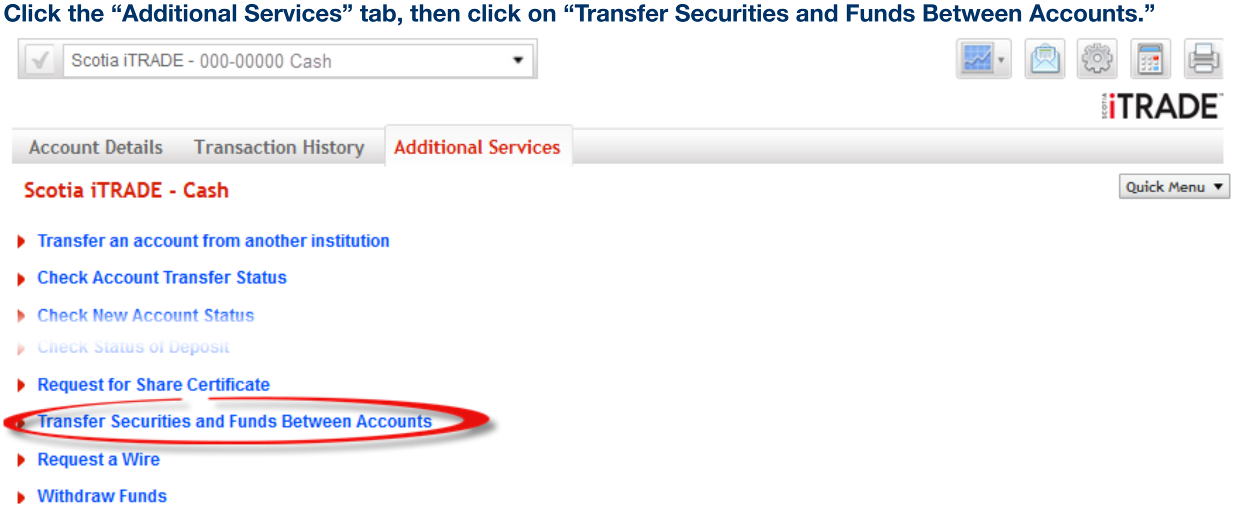
When purchasing DLR, we recommend placing a limit order at the ask price. If your trade is only partially filled at a limit price of $10.26, you can decide at that time whether to increase the limit price in order to fill the trade. (This happens frequently when making large transactions.)

2. Place a limit order to buy 2,500 shares of DLR at the current ask price on the Canadian-dollar side of your cash account.



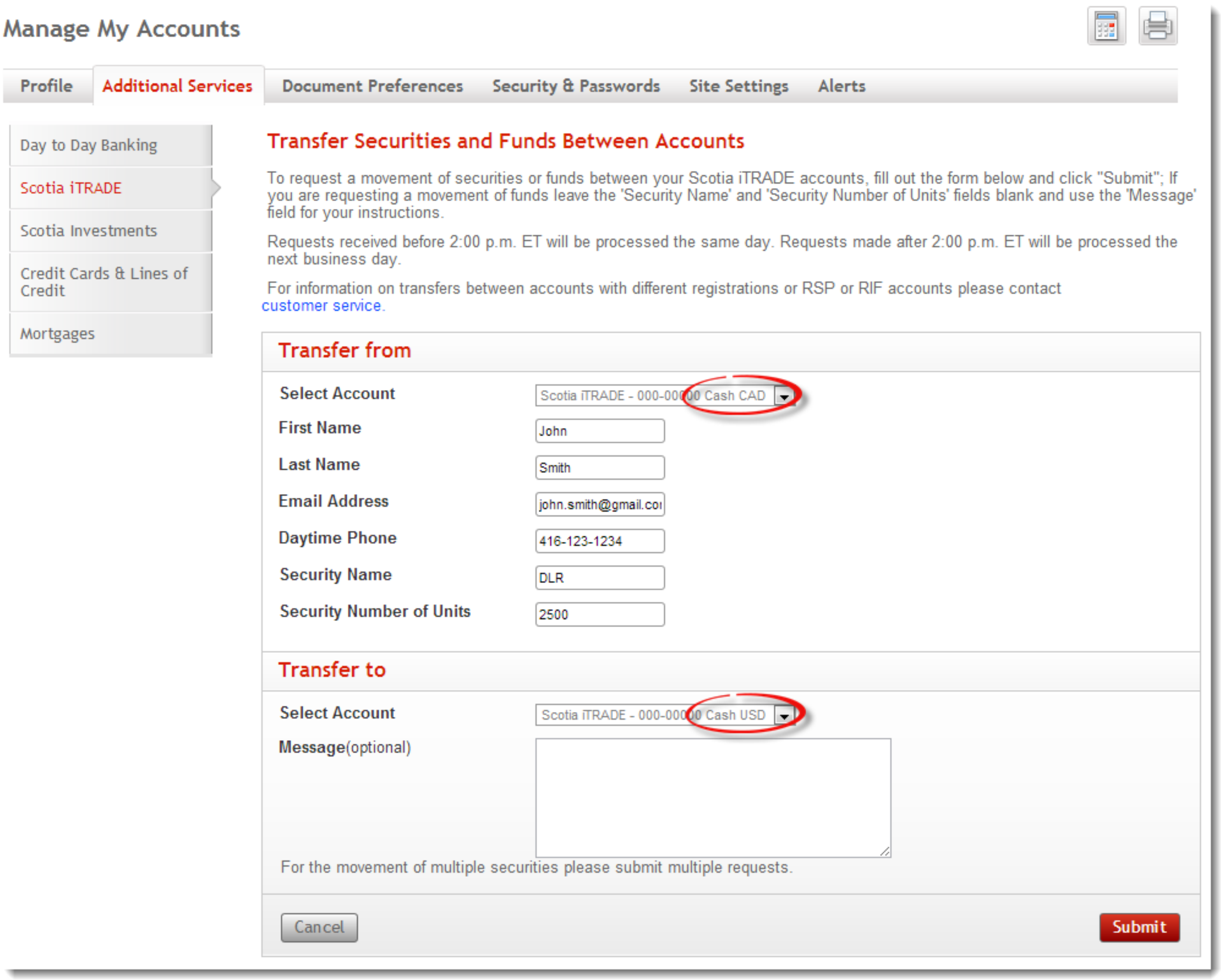
The trade should cost a total of $25,650 ($10.26 × 2,500 shares). Check in the View Orders screen (under the Quick Menu at the top right) to ensure all 2,500 shares have been filled at $10.26 per share.

3. Click the "Additional Services" tab, then click on "Transfer Securities and Funds Between Accounts."



4. Complete the *Transfer from* and *Transfer to* fields.

In our example, we are interested in transferring 2,500 shares of DLR from our cash account (CAD) to our cash account (USD):



5. **Once you notice DLR has been moved from a *Canadian Account Position* to a *US Account Position* (this normally takes about a day), call Scotia iTRADE at 1-888-872-3388 and ask to speak to a trader. Ask the trader to place a limit order to sell 2,500 shares of DLR.U at the current bid price in your USD Cash Account.**

Account Details | Transaction History | Additional Services

Scotia iTRADE - 000-00000 Cash — Quick Menu

Summary Balance

	Trade Date Cash	Settlement Date Cash	Market Value	Net Value	Withdrawal Limit	Buying Power
CAD	0.00	0.00	25,650.00	25,650.00	0.00	0.00
USD	0.00	0.00	0.00	0.00	0.00	0.00
Consolidated Total (CAD)	**0.00**	**0.00**	**25,650.00**	**25,650.00**		

Canadian Account Positions

Description	Symbol	Quantity	Average Cost	Market Price	Book Value	Market Value	Change $	Change %	Quick Menu
Equity and Equity Equivalents									
HORIZONS U S DLR CURRENCY ETF UNIT CL A	DLR	2,500	10.2600	10.26	25,650.00	25,650.00	0.00	0.00	
				Subtotal (CAD)	**25,650.00**	**25,650.00**	**0.00**	**0.00**	
				Total (CAD)	**25,650.00**	**25,650.00**	**0.00**	**0.00**	

Account Details | Transaction History | Additional Services

Scotia iTRADE - 000-00000 Cash — Quick Menu

Summary Balance

	Trade Date Cash	Settlement Date Cash	Market Value	Net Value	Withdrawal Limit	Buying Power
CAD	0.00	0.00	0.00	0.00	0.00	0.00
USD	0.00	0.00	24,902.92	24,902.92	0.00	0.00
Consolidated Total (CAD)	**0.00**	**0.00**	**25,650.00**	**25,650.00**		

U.S. Account Positions

Description	Symbol	Quantity	Average Cost	Market Price	Book Value	Market Value	Change $	Change %	Quick Menu
Equity and Equity Equivalents									
HORIZONS U S DLR CURRENCY ETF UNIT CL A	DLR	2,500	10.2600	10.26	25,650.00	25,650.00	0.00	0.00	
				Subtotal (CAD)	**25,650.00**	**25,650.00**	**0.00**	**0.00**	
				Total (CAD)	**25,650.00**	**25,650.00**	**0.00**	**0.00**	

Check in the *View Orders* screen to ensure all 2,500 shares have been sold at $9.95 USD per share.

You have now successfully converted about $25,650 CAD to $24,865 USD. This works out to a conversion rate of 1.0316.

Currency conversion rate = $25,650 CAD / ($24,875 USD – $9.99 USD)

= *1.0316*

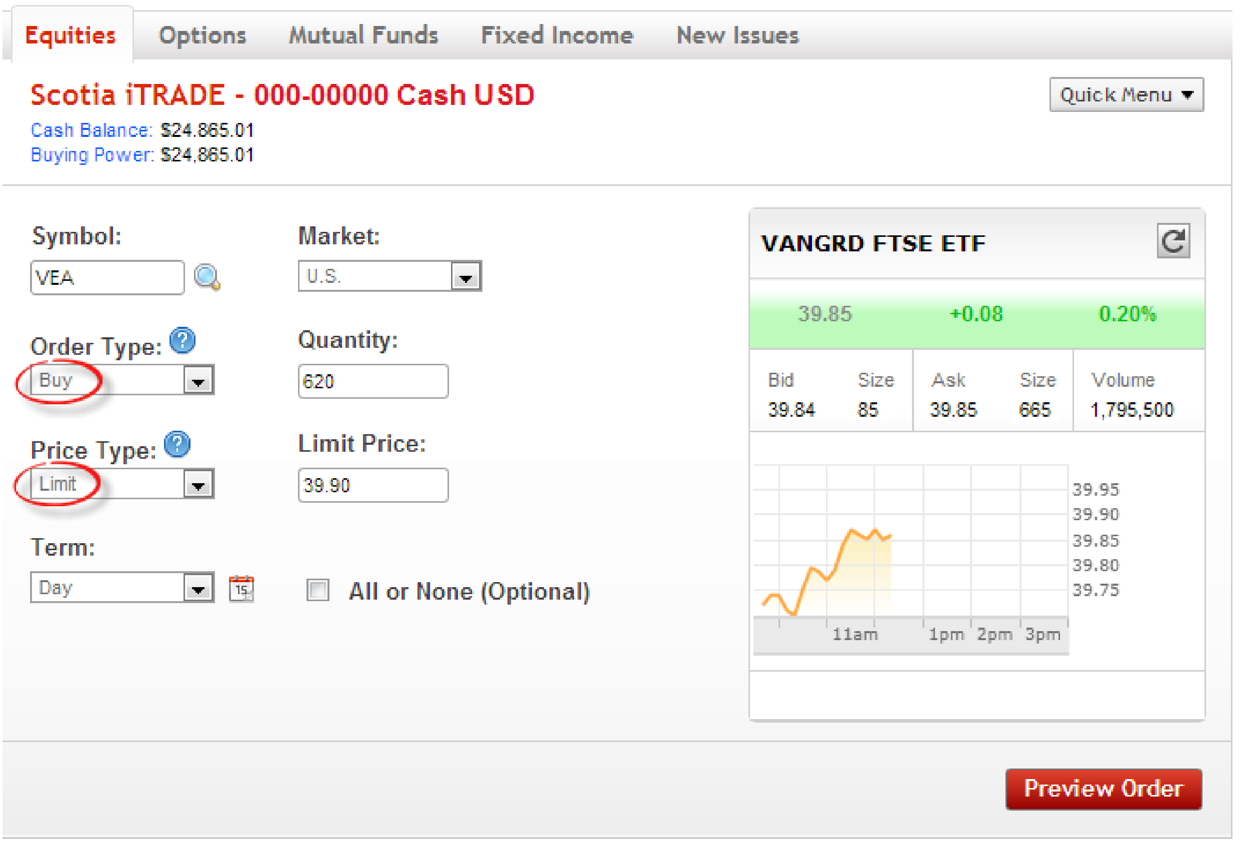
If we compare this rate to the spot rate of 1.030 from our previous example, this transaction cost us about $38 ($24,903 USD – $24,865 USD). The percentage cost of this transaction was therefore **0.15%** ($24,865 / $24,903 – 1). By using Norbert's gambit, you would have saved **$320 USD** on the conversion compared with the rate quoted by the brokerage ($24,865 USD – $24,545 USD).

6. Get a quote for VEA and calculate how many shares you can buy with the US-dollar proceeds from the sale of DLR.U.

Number of Shares	=	(Proceeds from sale of DLR.U – Commissions) / Ask Price
	=	[(2,500 shares × $9.95) – $9.99 – $9.99] / $39.85
	=	623.714 shares
	=	**620 shares**

You'll notice that we've rounded down the number of shares to leave a buffer in case the market fluctuates while we are placing the trade. VEA and DLR.U do not trade commission-free at Scotia iTRADE, so you will need to factor in the cost of the commissions when you are deciding on how many shares of VEA to buy.

7. **Place a limit order to buy 620 shares of VEA on the USD side of your cash account.**



In this example, we placed a limit order five cents above the current ask price. For more liquid (and volatile) securities, like equity ETFs, we recommend doing this in order to place a ceiling on how much you are willing to pay, while still allowing the trade to be filled quickly. It is important to understand that even though your limit order is five cents above the current ask price, you will still receive a better price if it is available at the time of the trade.

Beware of holidays! Since stock market holidays in Canada do not always coincide with stock market holidays in the US (think Thanksgiving), you have to be cautious when implementing Norbert's gambit, since the DLR.U sale may settle on a different day than the US-listed ETF purchase.

For example, suppose you placed the following trades on October 9, 2013:

1. Sell 2,500 shares of DLR.U on the Canadian stock market on the US-dollar side of your cash account
2. Buy 620 shares of VEA on the US stock market on the US dollar-side of your account

If this was a typical weekend, the trades would all settle on October 14 (T+3). Because it happens to be Thanksgiving Monday for Canadians on October 14 the sale of DLR.U would actually settle the next day, on October 15. The only trade that would settle on October 14 would be the purchase of VEA.

You would owe almost $25,000 USD on October 14, but you would not have the USD proceeds from the sale of DLR.U until the next day. Scotia might charge you interest on the debit balance in your US-dollar cash account.

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