

Making Cents of Your ETF's Loonie Currency Exposure

Simpsons: Would a U.S. dollar change your mind? American currency! What time would you like your breakfast, sir?!

Thanks for tuning in to another episode of the Canadian Portfolio Manager podcast, where we help you become a better ETF investor. I'm your host, Justin Bender, and in today's show, we'll be learning all about the currency exposure of your foreign equity ETFs. Joining me today to discuss this topic is Steven Leong, who leads product and capital markets for BlackRock's ETF business in Canada.

Now, I remember being thrown head first into the confusing world of currencies when I first started at PWL back in 2007. It was a different time back then. Currency-hedged foreign equity ETFs were the main options available for purchase on the TSX. So, if you wanted unhedged ETF exposure, you first needed to convert your Canadian dollars to U.S. dollars before purchasing U.S.-based ETFs on the NYSE or the NASDAQ.

Throughout 2007, the Canadian dollar was hovering around par relative to the U.S. dollar, which only made it more confusing. On any given day, I was never quite sure if 1 Canadian dollar was worth 98 U.S. cents, or the other way around.

Simpsons: I moved here from Canada and they think I'm slow, eh.

When BlackRock's Steven Leong shared his own past currency mix-ups with me, I was glad to hear I wasn't the only one.

Steven Leong: Currency is actually one of those subjects that it seems like our brains as humans, they're just not quite fully wired to handle. Even though the math itself isn't especially hard, I can certainly tell you that in my own career, I've done currency conversions backwards countless times when building a model. And, I've got more than

one memory of three or four CFA Charterholders kind of standing around a screen, looking at each other in disagreement over whether the currency has been properly handled. So, I hope I don't make any mistakes today, but for those of you who struggle with currency conversion, just know that you're not alone.

Many of our listeners have also been stumped when it comes to determining their ETF's currency exposure. Marc from Ottawa was kind enough to send in his question, which relates to the currency exposure of two U.S. equity ETFs, XUU and ITOT. Both of these funds happen to also be included in the Canadian Portfolio Manager model ETF portfolios.

Marc from Ottawa:

Hi Justin,

This is Marc from Ottawa. My question is, what is the currency exchange exposure when purchasing XUU and ITOT in Canadian and U.S. dollars, respectively. For example, if I buy \$30,000 CAD worth of XUU, and it gains 10% in one year, my investment is now worth \$33,000 CAD. If I had done the same investment in ITOT (but using the Norbert's gambit maneuver), to convert my Canadian dollars into U.S. dollars, I would have roughly \$21,600 U.S. dollars with today's exchange rate of \$0.72. If that also gained 10%, it is now roughly \$23,760 USD. Meanwhile, during the same year, the Canadian dollar got stronger, and the exchange rate is now \$0.80. If I convert this investment back into Canadian dollars, it translates to \$29,700, which is less than my original investment in Canadian dollars.

As a Canadian, would it not be best for me to hold most of my funds in Canadian dollars to avoid currency fluctuations? Finally, as a Canadian, are there any advantages to holding U.S. ETFs in U.S. dollars, as opposed to Canadian dollars?

Thanks.

Thank you, Marc, for providing this very relevant currency-related question. I also appreciate your detailed example, which we'll refer to as we work through your questions.

First, Steven will jump in with a quick response, and then I'll follow up with a few tips to fine-tune your currency return assumptions.

Steven Leong: The short answer here is that in this scenario, you're investing in an ETF that holds securities that are listed in the U.S., and which are priced in U.S. dollars. This means that you have exposure to whether the U.S. dollar goes up or down. Let's imagine that the U.S. dollar goes up against the Canadian dollar, but at the same time the prices of the stocks themselves don't change at all. In that case, the value of XUU has to go up, because its price is quoted in Canadian dollars, and the value of its assets has increased in Canadian dollar terms.

The reverse is true as well. So again, imagine that the stock prices, they don't change at all, but the U.S. dollar goes down against the Canadian dollar. In that scenario, the price of XUU also has to go down. As a Canadian investor, if you buy a U.S. stock market ETF, then you're exposed both to the price of the stocks and the U.S. dollar. And from a return standpoint, you want them both to go up.

Steven's last point is extremely important. With XUU, ITOT, or any other unhedged U.S. equity ETF, you actually have not one, but two investments. For example, for XUU, your first investment is the U.S. stock market, while your second investment is the U.S. dollar.

If you take away only one thing from today's episode, remember: **The currency in which your ETF transacts has no relationship to your ETF's currency exposure. This holds true whether the currency transaction is in Canadian dollars for XUU or U.S. dollars for ITOT.**

Let's apply this take-away to Marc's excellent XUU example. So far, Marc, you've only accounted for the U.S. stock market return of 10%. But XUU is priced in Canadian dollars. So, to determine your total return, you also need to factor in any appreciation or depreciation of the U.S. dollar relative to the Canadian dollar.

At the beginning of the period, 1 Canadian dollar is worth 0.72 U.S. dollars. In forex jargon, your Canadian dollar is your **base** currency, and your U.S. dollar is your **counter** currency. This tends to be how most Canadians think about their currency conversions. We want to know, if we have one Canadian dollar, how many U.S. dollars can we purchase with it?

Here's a quick tip:

When wrapping my head around currency fluctuations, I find it easier to make the foreign currency my **base** currency, and the Canadian dollar my **counter** currency. So, in Marc's example, the U.S. dollar becomes my base currency. So what I really want to know is, if I have a single U.S. dollar, how many Canadian dollars can I purchase with it?

If we were to adjust our currency figures in this manner, any **increase** in the relative exchange rate will now indicate an **appreciation** of the foreign currency. This is a good thing for an unhedged Canadian investor. Any **decrease** in the relative exchange rate is a **depreciation** of the foreign currency, which is a bad thing.

Put another way, if you hold a foreign currency that is going "up" or "appreciating", this is a good thing. If it is going "down" or "depreciating", it's a bad thing.

I find this framework much more intuitive when discussing investment returns.

Now that we've established the basics, here's a slightly technical example to help you become a currency transaction whiz.

In Marc's example, we already know that 1 Canadian dollar was worth 0.72 U.S. dollars at the outset. But suppose I want to know how much my base currency of 1 U.S. dollar is worth in my Canadian dollar counter currency? We simply divide 1 by 0.72, which tells us we've got **1.3889** Canadian dollars at the beginning of the measurement period. In other words, 1 U.S. dollar can initially buy 1.3889 Canadian dollars.

Now let's look at the end of the measurement period, when 1 Canadian dollar is worth 0.80 U.S. dollars. Making the same adjustment, we find 1 U.S. dollar is now only worth **1.25** Canadian dollars.

So, at the beginning of the period, 1 U.S. dollar can be exchanged for 1.3889 Canadian dollars, but at the end of the period, 1 U.S. dollar will only get you 1.25 Canadian dollars. This means the U.S. dollar has **depreciated** against the Canadian dollar. As

Steven mentioned earlier, from a return standpoint, you want the U.S. dollar to go **up** or **appreciate** against the Canadian dollar when holding an unhedged U.S. equity ETF, like XUU or ITOT. The fact that it's gone **down** or **depreciated** is a bad thing.

In Marc's example, the U.S. stock market increased by 10%, while the U.S. dollar depreciated against the Canadian dollar. So, where does that leave you as a Canadian investor?

First, we'll calculate the U.S. dollar currency depreciation as a simple holding period return. Take the ending exchange rate of 1.25, divide it by the beginning exchange rate of 1.3889, and subtract 1 from the result. This gives us -10% , or a 10% depreciation of the U.S. dollar relative to the Canadian dollar.

Next, we'll take Marc's first step of increasing XUU's value by the positive U.S. stock market return of 10%. That is, we multiply Marc's \$30,000 XUU investment by 1 plus the 10% U.S. stock market return to arrive at \$33,000. But then we need to **decrease** that result by the amount of the U.S. dollar's depreciation. So, we'll multiply this figure by $(1 - \text{the } 10\% \text{ depreciation of the U.S. dollar relative to the Canadian dollar, or } 0.9)$. So, \$33,000 times 0.9 gives us \$29,700 CAD.

If you followed all that in your head, you may also have noticed, this is the exact same figure Marc correctly calculated for the ending value of his ITOT investment in Canadian dollars.

In other words, the math brings us back to my earlier theme, which is: **The currency in which your ETF transacts has no relationship to your ETF's currency exposure.** Even though XUU trades in Canadian dollars, and ITOT trades in U.S. dollars, it made no difference to the overall investment returns in Marc's illustration. At least not after all U.S. dollars were converted back to Canadian dollars.

When you buy XUU with your Canadian dollars, BlackRock needs to convert your loonies to U.S. dollars to purchase XUU's underlying U.S.-based ETFs (like ITOT) on the NYSE. You don't actually see BlackRock's currency conversion taking place. But practically speaking, it's the same as if you converted your Canadian dollars to U.S. dollars yourself, and purchased ITOT directly on the NYSE.

If you're ready for another mind-bender, here's an even more technical dive into the inner workings of currency transaction.

If you were guesstimating at outcomes for Marc's illustration, you may have assumed a 10% U.S. stock market increase accompanied by a 10% U.S. dollar depreciation should be a wash. Ten up, ten down. Shouldn't they just offset one another?

But actually, Marc's example shows that his \$30,000 CAD investment decreased to \$29,700 CAD in this exact same situation. So, what's going on here?

It turns out, you can't simply net out your foreign stock market returns and currency returns. You need to chain-link them together. This is a complicated way of saying: "Add 1 to each return, multiply them together, and subtract 1 from the end result".

So, let's do that. We'll add 1 to our positive 10% stock market return, to give us 1.1. Then we'll add 1 to our negative 10% U.S. dollar currency return, to give us 0.9. We'll multiply 1.1 and 0.9 to come up with 0.99, and subtract 1 from this result. This equals a total return of negative 1%.

So, after a 10% U.S. stock market return and a negative 10% U.S. dollar return, you are not made whole. You have actually lost 1% of your portfolio value. This is why Marc's \$30,000 investment is now worth only \$29,700. He still lost 1% of the initial value of the fund, or \$300.

Let's wrap this section with one more demonstration of how XUU and ITOT have similar U.S. stock market and U.S. dollar exposure, even though they transact in different currencies. We'll leave Marc alone now, and consider two Canadian buddies, Bill and Ted. Each have \$10,000 CAD they would like to invest in either XUU or ITOT.

Bill and Ted's Bogus Journey: Ted? What? I have a feeling we're about to embark upon a most unprecedented expedition.

Bill, doesn't want to deal with currency conversions, so he decides to purchase XUU with his 10,000 Canadian dollars. Unfortunately, his timing couldn't be worse. Bill invests his cash at the top of the market on February 19, 2020.

Immediately following the purchase, his XUU holdings proceed to plummet, before finding a bottom of \$7,148 CAD on March 23, 2020. Bill has lost around 29%, at least on paper.

Bill and Ted's Bogus Journey: This is most non-non-heinous.

His pal, Ted, starts by converting his 10,000 Canadian dollars to 7,558 U.S. dollars, at a rate of 1.3231. He then purchases ITOT with his U.S. dollars on February 19th, and watches in horror as the fund loses 35% of its value in U.S. dollar terms. Ted bottoms out at \$4,913 U.S. on March 23rd, with his ITOT holdings dropping by an extra 6% relative to Bill's XUU holdings.

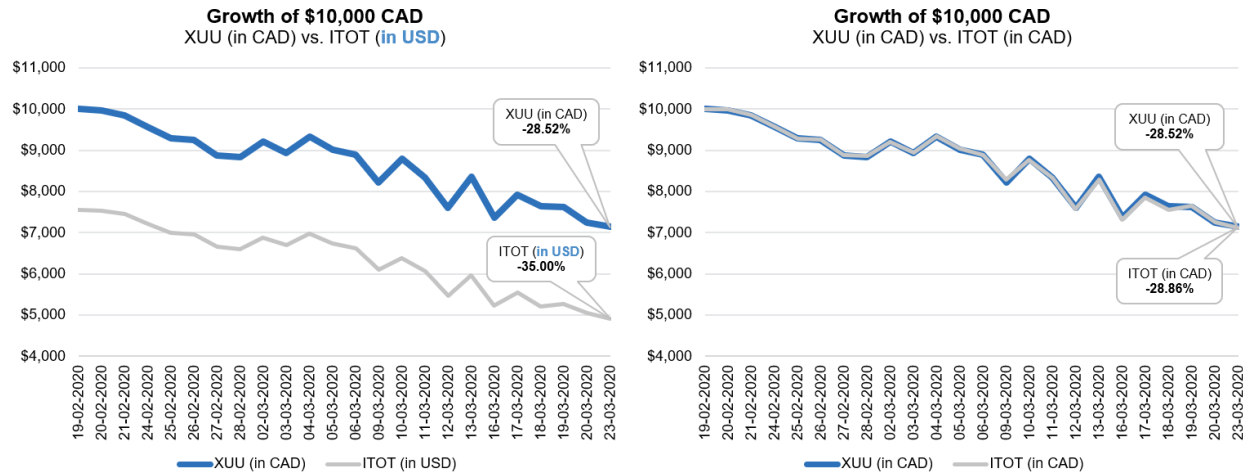
Bill and Ted's Bogus Journey: Bogus.

It gets worse for poor Ted. Since he has not yet come to terms with today's lesson on currency exposure, he instantly regrets his decision. On March 23rd, he sells his entire ITOT holding and converts his 4,913 U.S. dollars back to 7,114 Canadian dollars, at the current exchange rate of 1.4482. Maybe the lightbulb finally comes on for Ted when he is pleasantly surprised: After the conversion back, he realizes he actually has almost as many loonies as his buddy, Bill, and he has also lost only around 29% in Canadian dollar terms.

Bill and Ted's Bogus Journey: No way! Yes way, Ted!

In short, Bill and Ted both benefited about equally from their U.S. dollar exposure over this period. Because it appreciated by 9.5% against the Canadian dollar, it helped save their Canadian bacon to some extent. Due to similar U.S. stock market and currency exposure in both XUU and ITOT, both holdings fell in value by nearly 29% in Canadian dollar terms. This represented a 6% improvement over the overall U.S. stock market drop of 35%. Although Ted didn't realize the currency benefit on paper until he converted his U.S. dollars back to Canadian, it was there all along during his most excellent currency adventure.

Bill and Ted’s Excellent Adventure: Excellent! (electric guitar sound).



Sources: Bank of Canada, BlackRock, Inc.

So far, our examples have focused on a single foreign stock market with only one underlying currency. But the same currency concepts apply to ETFs that invest in multiple foreign stock markets. Steven will explain that now.

Steven Leong: Let’s take the example of XEF, which is the iShares Core MSCI EAFE IMI ETF. It invests outside Canada and the U.S. XEF holds stocks from several other countries, such as Japan, Switzerland, Germany, the U.K., and many others. And instead of one currency, there’s multiple, such as the yen, Swiss franc, euro, pound, etc. Some of those currencies might go up, and some of them might go down. Let’s assume again that the prices of the stocks that XEF owns don’t change. XEF’s price would still go up or down, depending on movements in those foreign currencies against the Canadian dollar, and how much of the portfolio each currency represents. If you own XEF, your preference would be for those currencies to go up, as that would increase the value of your investment.

One thing to keep in mind is that foreign currencies can move in different directions. The U.S. dollar for example could go up against the Canadian dollar at the same time that

the euro goes down against the Canadian dollar. The direction and the size of the move is specific to each currency. These relationships are also not just theoretical, they exist because XEF has to transact in foreign exchange. XEF handles all of its subscriptions and redemptions in Canadian dollars, but it has to buy and sell foreign stocks in local currencies. If there's a subscription, in order to invest in those foreign stocks, XEF has to sell Canadian dollars in order to buy yen or euro or franc etc., in order to settle local market transactions. If there's a redemption, the fund will be selling foreign stocks in order to pay for the redemption. It's going to receive yen, euros, etc., and then have to sell those currencies and buy Canadian dollars in order to pay out the redemption. So, one important advantage of using a Canadian ETF for these foreign investments is that currency conversion transactions are handled in the wholesale market by the manager, at very competitive and very small bid-ask spreads, especially compared to what the typical brokerage would charge you to convert Canadian dollars into another currency.

In other words, you can avoid getting hosed on your currency conversions by purchasing Canadian-based foreign equity ETFs like XUU, XEF or XEC. This should save you some conversion costs compared to U.S.-based foreign equity ETFs like ITOT, IEFA and IEMG.

For a U.S.-based international equity ETF that transacts in U.S. dollars, the overall currency concepts are very similar. Let's take the iShares Core MSCI EAFE ETF, or IEFA, as an example. That's XEF's U.S.-based counterpart. A Canadian investor would need to convert their Canadian dollars to U.S. dollars to purchase IEFA. But to purchase the underlying foreign stocks, BlackRock will then need to convert your U.S. dollars to the various underlying currencies, such as the Japanese yen, the euro and the Swiss franc.

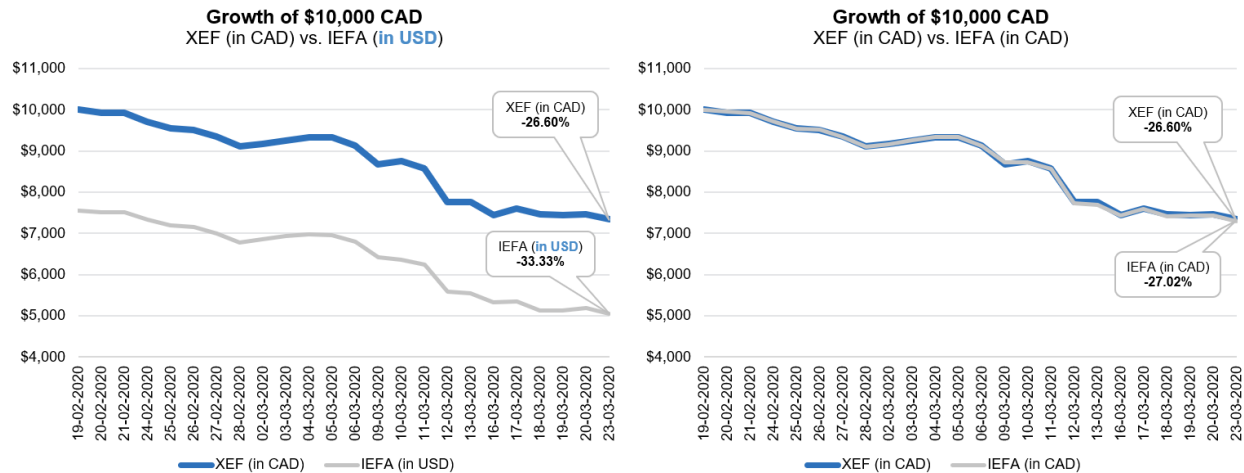
This makes IEFA's foreign currency exposure similar to that of XEF, even though one transacts in U.S. dollars and the other in Canadian dollars. At the risk of sounding like a broken record, it's the ETF's underlying foreign stock markets that determine the currency exposure of the fund – not the currency that your ETF transacts in.

For example, if XEF and IEFA invested 27% of their assets into Japanese companies, 30% into eurozone companies and 10% into Swiss companies, Canadian investors would have a 27% exposure to the Japanese yen, 30% exposure to the euro and 10% exposure to the Swiss franc. These currency exposures would be in addition to the stock market exposures of each region. XEF would have little to no exposure to the

Canadian dollar, and IEFA would have little to no exposure to the U.S. dollar (even though they transact in these two respective currencies).

Similar to Bill and Ted’s XUU and ITOT pairings, Canadian investors who held XEF or IEFA during the worst of the COVID-19 stock market crisis experienced similar performance, regardless of which fund they held. Between the market’s peak on February 19th and the market bottom on March 23rd, international stocks lost 31% of their value in their local currencies. Over the same period, the underlying international currencies appreciated against the Canadian dollar by around 6.1%. Again, this helped reduce the bleeding for Canadian investors.

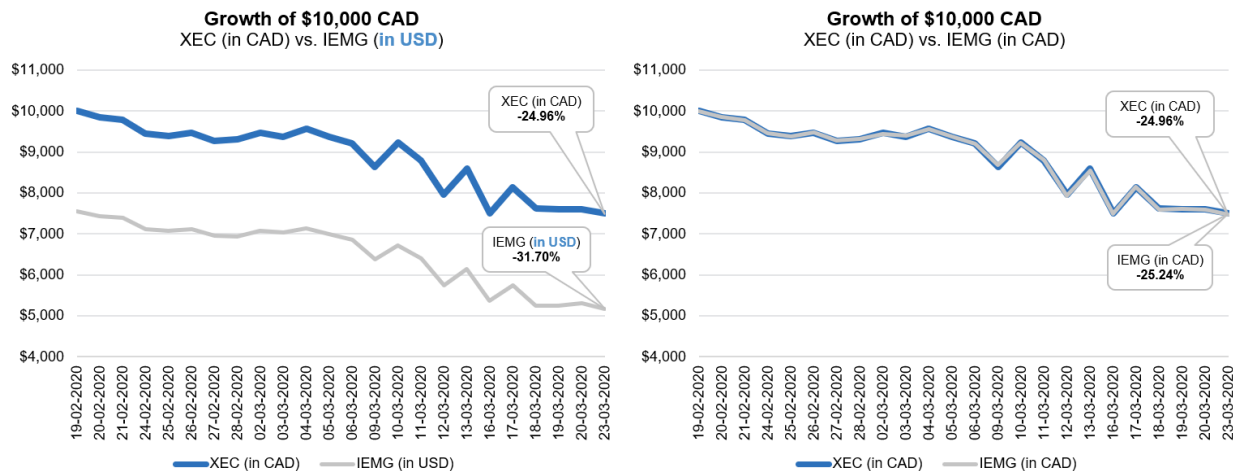
Specifically, after accounting for currency exposure, XEF fell in value by around 27% in Canadian dollar terms. IEFA (which trades in U.S. dollars) lost around 33% of its value in U.S. dollar terms. This was due to the 3.4% depreciation of the foreign currencies relative to the U.S. dollar. However, once the U.S. dollars are converted back to Canadian dollars, IEFA returned – you guessed it -- around 27% in Canadian dollar terms, which was similar to XEF.



Sources: Bank of Canada, BlackRock, Inc.

Emerging markets equity ETFs followed a similar pattern over the same period. Emerging markets companies lost around 28% of their value in local currencies. But due to the 4.3% average appreciation of the underlying emerging markets currencies relative to the Canadian dollar, XEC lost only around 25% of its value.

Across the border, XEC’s U.S.-based counterpart, IEMG, lost nearly 32% of its value, due to the 5.1% depreciation of the underlying emerging markets currencies relative to the U.S. dollar. However, once IEMG’s U.S. dollar returns are converted back to Canadian dollars, IEMG only lost around 25% of its value, tightly tracking XEC’s performance along the way.



Sources: Bank of Canada, BlackRock, Inc.

By now, I hope I’ve made it clear: The currency in which your ETF transacts does not determine your currency exposure. It could just as easily transact in the Japanese yen, the euro, or the Swiss franc, and still provide you with the same investment return in Canadian dollar terms. All this should help you remember: No matter what currency you use when you purchase BlackRock’s or Vanguard’s foreign ETFs, they may need to convert your currency to other currencies to transact in foreign stock markets. This means the currency you’ve provided does not provide any useful information for determining your ETF’s underlying currency exposure.

We’ve been hitting currencies from every which way but loose since the start of this episode. But there’s one more type of foreign equity ETF I’d like to touch on before we let go of the topic. That’s the “dot U” ETFs.

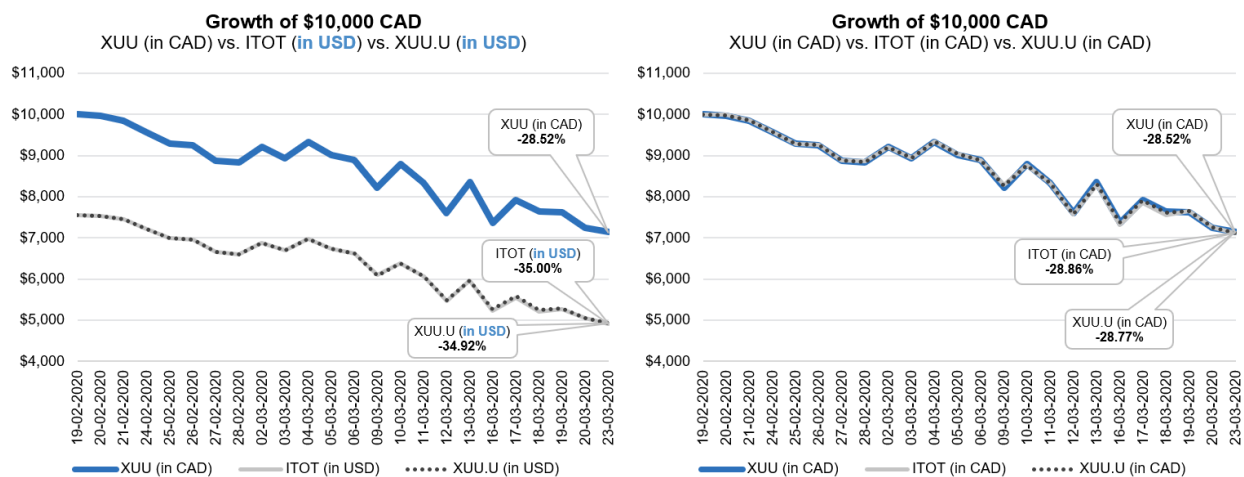
Simpsons: Okay, here we are. Alt dot nerd dot obsessive.

These “dot U” funds are just another version of many of the existing ETFs that trade in Canadian dollars, such as XUU, XEF, and XEC. The only difference is, they trade in U.S. dollars under the ticker symbols that include a “dot U” at the end. Examples include XUU.U, XEF.U, and XEC.U.

Don’t let the “dot U” in the ticker symbols fool you. Similar to U.S.-based ETFs, like ITOT, IEFA and IEMG, dot U ETFs transact in U.S. dollars, but once again their underlying stock markets determine their currency exposure.

For example, when comparing their returns in U.S. dollars, we would expect XUU.U to have nearly identical performance to ITOT. And, in fact, during the 2020 stock market crash, ITOT and XUU.U both lost around 35% of their value in U.S. dollar terms.

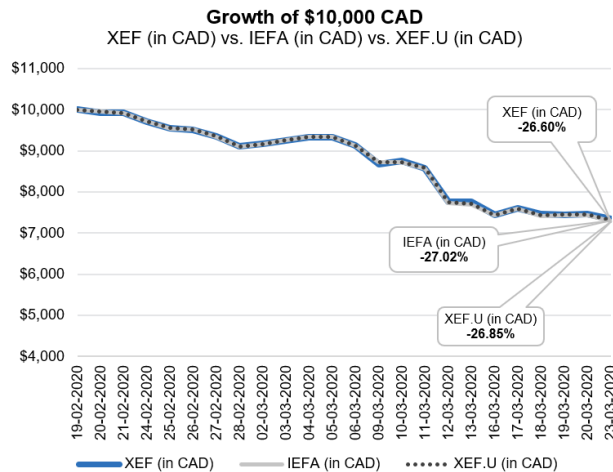
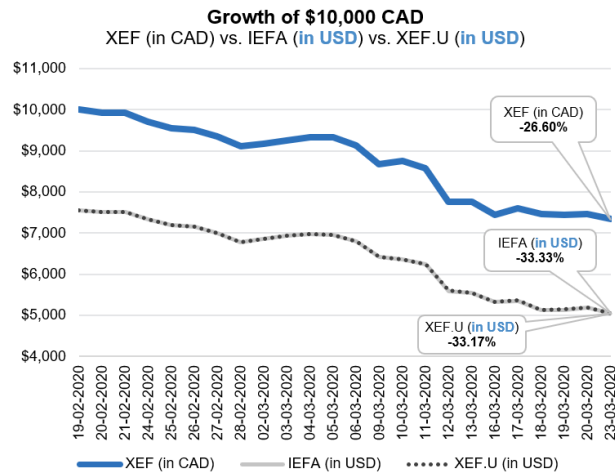
Also, once you convert both funds’ performance to Canadian dollar terms, XUU.U and ITOT provided similar returns to their Canadian-based counterpart, XUU. In fact, during the worst of the 2020 market downturn, all three ETFs dropped by essentially the same amount – just under 29% in Canadian dollar terms.



Sources: Bank of Canada, BlackRock, Inc.

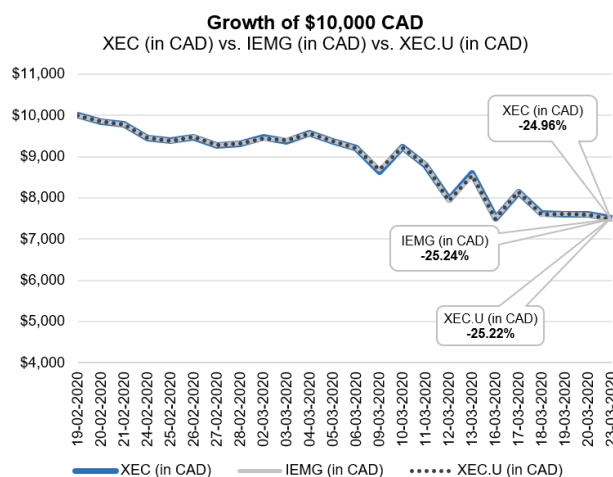
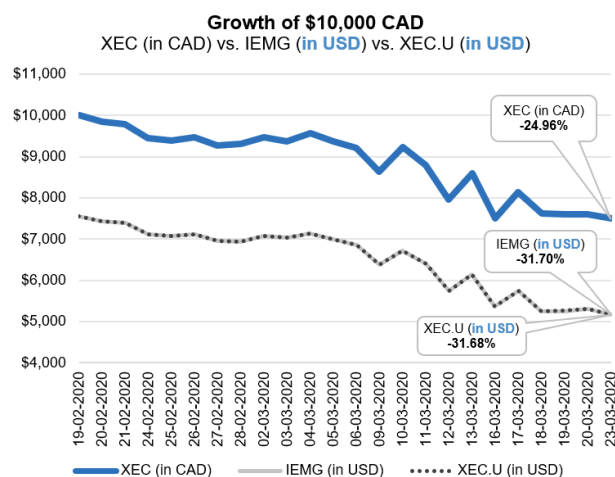
The same would apply for international equity ETFs that transact in U.S. dollars. Both XEF.U and IEFA dropped by around 33% during the worst of the 2020 downturn. But

once their performance was converted to Canadian dollar terms, both funds lost around 27%, which was nearly identical to XEF’s return over the same period.



Sources: Bank of Canada, BlackRock, Inc.

And on the emerging markets front, XEC.U and IEMG each fell by just under 32% in U.S. dollar terms. But when their performance was converted to Canadian dollar terms, XEC.U, IEMG and XEC all lost around 25% in Canadian dollar terms.



Sources: Bank of Canada, BlackRock, Inc.

This brings us back to my opening theme: It doesn't matter whether you buy your foreign equity ETFs with Canadian dollars, U.S. dollars, or any other currency. Even if BlackRock were to release a series of "dot Y," Japanese yen-traded ETFs; or "dot E" euro-traded ETFs ... the same rules would apply.

There is one more point you can take from all of this: Since investing in Canadian dollars is usually much more practical and straight-forward, doing so should be the default choice for most Canadian DIY investors, most of the time.

While we're on the topic of "dot U" funds, some of you may have noticed that the Horizons U.S. Dollar Currency ETFs also come in two currency flavours. DLR is the Canadian-dollar version, while DLR.U is the U.S. dollar version.

Both funds hold cash and cash equivalents denominated in the U.S. dollar. As we've learned, this provides investors with U.S. dollar exposure, whether they purchase DLR or DLR.U. So just like our other pairs of equity ETFs just discussed, both DLR and DLR.U provide Canadian investors with U.S. currency exposure, even if they purchase DLR with Canadian dollars.

Although either fund provides investors with a quick way to gain exposure to the U.S. dollar, most DIYers hold DLR and DLR.U over the short-term to perform the popular currency conversion strategy, Norbert's gambit. By purchasing DLR with your Canadian dollars on the Canadian-dollar side of your account, and selling the same number of shares of DLR.U on the U.S. dollar side of your account, you can convert your Canadian dollars to U.S. dollars very cheaply.

The reverse is also true – you can buy DLR.U with your U.S. dollars on the U.S. dollar side of your account, and sell DLR on the Canadian dollar side of your account to cheaply convert your U.S. dollars back to loonies.

Most brokerages require you to wait until your DLR purchase settles before allowing you to sell DLR.U. This creates a delay of around 2–3 business days. If you had planned to purchase U.S.-based equity ETFs with your U.S. dollars, this may cause you to miss out on potential stock market growth while you're waiting.

When BlackRock launched the dot U versions of XUU, XEF and XEC in October 2019, investors were very excited. They assumed – or at least hoped – they could now use the Canadian and U.S.-dollar versions of these funds to perform the Norbert's gambit

strategy, while maintaining their stock market exposure over the entire settlement period.

For example, let's say you ultimately wanted to purchase ITOT in your U.S. dollar RRSP to eliminate the 15% withholding tax on U.S. dividends. At your brokerage, you could use DLR and DLR.U to cheaply convert your Canadian dollars to U.S. But the transaction would take a few days to complete. And over those few days, you would only have exposure to the U.S. dollar – not to the U.S. stock market.

Instead, what if you could purchase XUU in the RRSP? This would give you instant U.S. dollar and U.S. stock market exposure, while you waited 2–3 business days before you could transfer the XUU shares to your RRSP's U.S. dollar side, sell XUU.U, and buy ITOT with the U.S. dollar proceeds.

Unfortunately, it wasn't meant to be. ... At least not yet. As a general warning, Norbert's gambit only works if the security pairs are identical, meaning they have the exact same CUSIP number. This is the number that identifies North American financial securities to facilitate trade clearing and settlement. DLR and DLR.U have the same CUSIP number. But the same cannot be said for XUU and XUU.U, XEF and XEF.U, or XEC and XEC.U. These three ETFs have different CUSIP numbers from their dot-U counterparts. So, unfortunately, they cannot be used to perform Norbert's gambit.

On a related note, I've been receiving many reader questions on whether there are advantages to buying one of these Canadian-based "dot U" equity ETFs with U.S. dollars, rather than buying a U.S.-based equity ETF. This sounds like a great opportunity for our next (Japanese gong sound) ...

ETF Kombat!

... where we pit two ETFs against one another to test their might.

In today's show-down, two U.S. equity ETFs will go head-to-head for your investment dollars. PWL's Director of Marketing, Martin Dallaire, will again be judging the match.

In one corner, we have the iShares Core S&P Total U.S. Stock Market ETF (with ticker symbol ITOT). ITOT will be facing off against its nearly identical rival, XUU.U. Both

funds transact in U.S. dollars, but ITOT trades on the NYSE, while XUU.U trades on the TSX. Although either ETF will provide investors with low-cost and diversified U.S. equity market exposure, there can be only one winner.

Round One... Fight!

If you have taxable investments, you'll likely be asked by your accountant every tax season whether you own "specified foreign property" with a total cost base of more than \$100,000 CAD. Even though XUU.U invests in the broad U.S. stock market, and trades in U.S. dollars, it is excluded from CRA's definition of "specified foreign property" for the purposes of their Foreign Income Verification Statement, or T1135 reporting. That's because it generally falls under the definition of a Canadian mutual fund trust.

The same cannot be said for ITOT. It trades on the NYSE, and is considered "specified foreign property" for T1135 reporting purposes. CRA desperately wants to get the lowdown on your ITOT holdings. If the cost base of your taxable ITOT holdings was more than \$100,000 in Canadian dollars at any time during the tax year, you'll need to provide these goons with the gross amount of foreign dividend income earned during the year, before withholding taxes (in Canadian dollar terms). Plus, you'll need to report the gain or loss on any shares of ITOT sold during the year (also in Canadian dollars). And if the cost base is more than \$250,000 CAD at any point during the year, you'll also need to throw in ITOT's maximum fair market value during the year, as well as its fair market value at year-end (both in Canadian dollar terms).

Collecting this information can be tedious for most investors, and easily avoided by opting for XUU.U over ITOT.

But wait, there's more. If you're uber wealthy, you may be subject to U.S. estate taxes if you hold any U.S. "situs property" – including U.S.-based ETFs like ITOT. This "gotcha" applies even if you have no direct ties to the U.S. In 2020, it would kick in if you passed away with an estate worth over \$11,580,000 in U.S. dollars, or currently around \$15,640,000 Canadian dollars.

Even though you can't take it with you, you don't want to hand it over to the IRS. Holding a Canadian-based ETF like XUU.U, gets you around this punitive tax.

X-U-U-dot-U wins.

Round Two... Fight!

As both ITOT and XUU.U transact in U.S. dollars, CRA requires investors to track both ETFs' cost bases in their taxable accounts in Canadian dollar terms. So, any time you make a new purchase, you'll need to adjust your transaction cost by the USD/CAD exchange rate on the settlement date of your trade, and add this to your cost base. This is relatively straight-forward once you get the hang of it. Or, you can use an online cost base tracking service, like adjustedcostbase.ca.

For tax-reporting purposes, you'll also need to convert any foreign dividend income received, or foreign tax paid to Canadian dollars. Most tax programs can easily handle these types of conversions. The Bank of Canada also provides an annual average exchange rate you can use.

XUU.U's cost base may also require return of capital or reinvested distribution adjustments. This is very common for a Canadian-based ETF. If the fund distributes return of capital in U.S. dollars, you'll need to reduce your cost base by this amount (while ensuring that you've converted the values to Canadian dollar terms). And if XUU.U distributes a reinvested distribution (also known as a "phantom distribution"), you'll need to increase your cost base by this amount (also converted to Canadian dollars).

You can probably already see how this could get confusing. ITOT's distributions, on the other hand, are expected to be 100% foreign income, so no adjustments to your cost base will be required. Based on the number of ACB tracking questions I receive on a regular basis, this should be music to most investors' ears.

If you're planning to hold U.S. equity ETFs in your RRSP, ITOT is also the superior choice, as U.S. dividends are exempt from the 15% withholding tax. Even though XUU.U trades in U.S. dollars, it is still a Canadian-based ETF. So, it does not receive the same withholding tax exemption as ITOT when held in an RRSP. XUU.U's tax disadvantage is estimated at around 0.3% per year.

I-TOT wins.

Round Three... Fight!

Similar to our past battles, U.S.-based ETFs tend to have lower product fees than their Canadian-based counterparts. ITOT charges a rock bottom fee of 0.03%, while XUU.U's cost is slightly higher, at 0.07%. Although the difference is a nothing burger for the average investor, fees do ma- ... hey ... Martin, what happened to the music?

Ahh ... XUU.U just left the match.

What do you mean, "he just left the match"?

He literally just walked out. I, I couldn't stop him.

Okay everyone, sorry about this. It looks like we've just had our first "[Quitality](#)". XUU.U was getting pummelled and I guess he didn't want to finish the match.

I-TOT wins - Quitality!

By now I hope you're more aware of your ETF's currency exposure than when you initially hit play on this podcast. In our next episode, we'll look at how to mitigate the

effects of currency fluctuations in your portfolio with currency-hedged ETFs. Until then, stay safe and stay the course.