A Twist: US ETFs

The US and Canada have a tax treaty: the impact for you is, briefly, that the US will withhold 15% of any dividends going to Canadian investors on US equities. However, the RRSP (but not the TFSA) is exempted from this withholding tax. That means there is a slight advantage to holding US equity ETFs in your RRSP, and buying those from American providers in US dollars[60].

Remember that there is value in simplicity. Taking the first steps in this book – getting started with investing, and investing in ETFs yourself to control costs – has a large impact on your results compared to a more typical actively managed mutual fund, which might have a MER 2 percentage points higher. Trying to perfectly optimize your holdings across your RRSP and other accounts, converting currencies, and holding US-domiciled ETFs to minimize the US withholding tax adds a rather large amount of complexity to shave a much more modest amount off your costs – a savings of about 0.3% on just one component of your portfolio[61], for just the portion in an RRSP. Keep this message of simplicity in mind as you read this chapter, and feel free to skip it if at any point it sounds overwhelming.

Vanguard is the leader south of the border, and the two main funds to look at are **VOO** and **VTI**, both trading on the NYSEARCA exchange (in TD just choose "US" for

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[60] The reason it has to be a US ETF is that a Canadian fund will pay the withholding tax on your behalf before it gets to the shelter of your RRSP.

[61] Calculated as a 15% withholding tax on a dividend yield of approximately 2%.

the market drop-down; in Questrade the symbols without any suffix will bring them up). As a small bonus, the MER is slightly lower on the American version of the ETFs (0.05% for VOO vs. 0.10% for XUS; 0.05% for VTI vs. 0.15% for VUN). Owning these US-listed funds in your RRSP will help you avoid the US withholding tax on the dividends.

However, these US-listed funds have to be purchased in US dollars (USD). There is a cost to convert your Canadian dollars: TD charges roughly 1.5% on top of the current exchange rate, and Questrade 2%, though this conversion will happen automatically once you purchase a USD-denominated fund. You will make this back in an RRSP through the tax savings in a couple of years so it's likely worthwhile even at that premium, but those high fees do take the shine off this strategy. There is a way to convert more cheaply by using the DLR and DRL.U ETFs, both of which trade on the TSX (even though one is denominated in US dollars), though this will involve paying fixed commission costs. The process is a little involved.

If you want to search online for more details, this process is known as “Norbert's gambit.” One way to think about Norbert's gambit is to visualize the physical case: if you were in Windsor, Ontario and wanted some American dollars, you could go to your local bank and they would charge you a 2% premium for them – though the exchange rate might be at par, the bank would charge you $1.02 Canadian for each American dollar you bought. To avoid that, you could buy something that's easy to sell for a universal value on either side of the border – a gold coin, or a share of stock – with your Canadian dollars, walk across the bridge to Detroit, and sell it to get American dollars at the fair exchange rate, avoiding the bank's fees. That is pretty much what you'll do in

Norbert's gambit, but with units of an ETF, and you never have to leave your desk.

Horizons has created an ETF pair that just tracks the relative values of the Canadian and US dollars. Listed on the TSX, DLR can be purchased in (or sold for) Canadian dollars, at a price that is very close to the current fair exchange rate. The paired fund, DLR.U, can be exchanged for US dollars even though it also trades on the TSX. In brief, you will buy DLR with your Canadian dollars, which can be converted into DLR.U, which you sell in US dollars. Once you have USD in your account, you buy your US-listed ETF without having to pay the brokerage's currency exchange fee.

The only trick then is following the steps to be able to buy one and sell the other within your brokerage accounts. The main reason to convert your currency and buy a US-listed fund is to save on that withholding tax in an RRSP, so that is where the discussion will focus. However, Norbert's gambit can also be used to exchange funds in a non-registered account if you ever need to[62].

Norbert's Gambit for TD: At TD, you will have separate sub-accounts for your US-denominated and Canadian-denominated investments (for your RRSP as well as TFSA and non-registered). First, determine how much money you have available to invest in your desired US-listed ETF. Then, in the order entry → stocks page, get a quote on DLR trading on the Canadian exchange, and make sure that you have your CAD sub-account selected in the account drop-down (typically the account suffix for CAD RRSPs is –S). The *ask* price is the price we will have to pay per share, and because this is in TD I will also have to set aside $10 for commissions before figuring out how

[62] There's no reason to in the plans laid out here, however there can be lots of reasons you may find yourself with the need to cheaply convert large amounts of Canadian or US currency.

many units I can afford. The trade should happen almost instantly, as there is an active market in the DLR ETF, but will take three business days in Canada for the trade to settle.

Then, you call TD Direct Investing and ask a representative to “journal” your DLR units to your USD account (typically the suffix for your USD RRSP is –U). This may take another day for the units to appear in the account. Then, you can sell the paired DLR.U, and you’ll have US dollars appear in your account. You’ll be entering your order to sell at the *bid* price.

With USD in hand, you can purchase ETFs listed on the American exchanges, such as Vanguard’s total stock market index (VTI).

At the end of the process, we’ll have USD ready to buy a cheaper (and more tax-efficient in an RRSP) US-listed ETF such as VTI.. To have converted cash to USD using the no-effort automatic conversion of the brokerage would have cost about 1.5–2% on top of the difference in value between the countries. By putting this effort in we paid about $0.02/unit in the “spread” (paying the ask, taking the bid in the transactions) plus $20 in extra commissions, which could represent hundreds of dollars in savings, depending on how much you have to convert. Though it was some work and effort[63], Norbert’s gambit is usually worthwhile for converting large amounts. Of course the main question is whether to get into the level of effort of buying US-listed ETFs to save a few tenths of a percent in taxes on a portion of your portfolio in the first place.

To convert from USD back to CAD, simply go in the opposite order: buy DLR.U with the USD first, call the

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[63] It took me about 25 minutes all told, though I was going slow, taking notes and screenshots.

broker to journal back to DLR in the CAD account, then sell the DLR units. In summary, at TD (and similar brokerages with a split CAD/USD sub-account structure):

1. Buy DLR in your CAD account. Wait 3 days.
2. Call the help line, ask an agent to “journal” DLR to DLR.U in your USD account.
3. Sell DLR.U, then buy VTI in your USD account.

Norbert's Gambit for Questrade: The first, one-time step in Questrade is to ensure that you have the correct option selected for how your trades settle – choose “trade currency” under “currency settlement”, found in the Account Management page of MyQuestrade (RRSP and TFSA accounts only). Otherwise you will end up going through the process only to end up with USD that automatically get converted back to CAD before you can buy anything – paying the commissions and premium exchange rate for nothing. Beyond that, the steps are similar, except that the purchases are commission-free (but not the DLR.U sale), and there’s only one sub-account for your RRSP. When you can call in (or use their online live support) to journal DLR to DLR.U, you don’t need to move it between accounts, just from the CAD version to the USD version.

At what point that effort becomes worth it depends on how you value your time to go through the process versus the brokerage's instant conversion convenience. To pay one or two commissions (at Questrade the purchase side is free) and the very minor spread of the DLR ETF pair represents a fairly small cost, with a portion of it fixed. The economic break-even point is at roughly $1,400, and it becomes more worthwhile for larger amounts. Personally, I don't bother for conversions under about $5,000 (i.e. savings of ~$45) as I find it a hassle and I only convert every year or two anyway.

A Caution on Holidays: Most days of the year this procedure goes off without a hitch, however sometimes the behind-the-scenes machinery is important to keep in mind: ETFs and stocks have a 3-day period to “settle” trades. Because you’re dealing with two countries, holidays don’t always line up and the 3 days to settle can happen at different times. For instance, if you place this trade on the Friday before Canadian Thanksgiving, then your sale of DLR.U to create USD will take the holiday Monday off, and so settle on the following Thursday (three business days). However, the US markets stay open that Monday, and your US ETF purchase will settle on Wednesday – a day before your USD are ready to cover it. You would be charged interest in that case for falling short, sometimes at credit-card like rates. Be sure to check for market holidays on both sides of the border before setting up the trade, or wait for each component to settle in turn.