ADVISER INVESTMENTS

SPECIAL REPORT

The ETF Advantage

UNDERSTANDING THE BENEFITS AND RISKS OF EXCHANGE-TRADED FUNDS

Exchange-Traded Funds (ETFs) are an increasingly popular investment that can be a worthy addition to your portfolio. Chances are you have already heard about ETFs, as institutions and individual investors have poured hundreds of billions of dollars into them in just the past few years. But if you're like many investors, ETFs remain a bit of a mystery; you aren't exactly sure what they are, how they work, and, most importantly, if you should invest in them.

In this special report you will learn: The mechanics of ETFs; the main differences between ETFs and mutual funds; how to choose the right ETFs from a rapidly expanding—and confusing—universe of choices; as well as when—and how—ETFs can make sense in your investment portfolio.

The growth of ETF assets is astounding. But, what exactly is an ETF?

An ETF is very similar to an index mutual fund. In fact, on the surface it looks just like an index mutual fund in that it holds a basket of stocks that track a target index, such as the Standard & Poor's 500 Index. As with index mutual funds, there are dozens of ETFs that follow narrow market segments as well as broad market baskets.

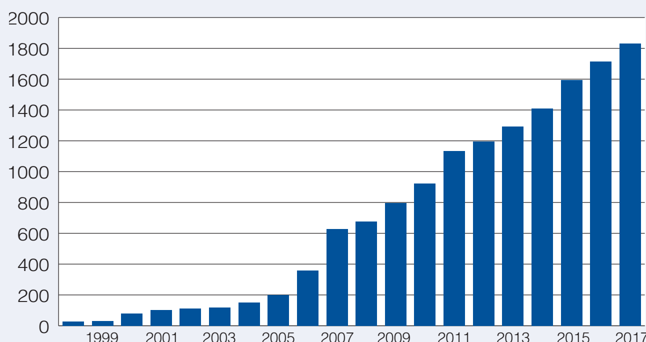
ETF ABCs

The main difference between ETFs and traditional mutual funds is how you buy and sell shares.

Traditional mutual funds are a unique investment in that each fund's share price is established only once a day at the close of the market. If you place an order to buy or sell mutual fund shares during the trading day your execution price isn't determined until the market closes for that day. For example, you can place an order to buy or sell fund shares at 11:15 a.m., but your trade will be based on the price of your mutual fund when the market closes for the day at 4:00 p.m.; that's when each mutual fund determines its share price—technically known as the Net Asset

The Number of Available ETFs Has Exploded

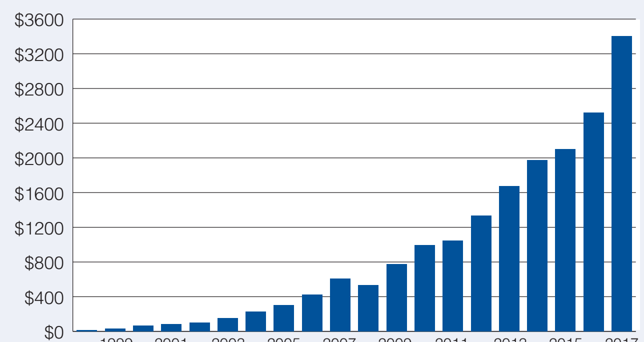
Total Number of Funds



Source: Investment Company Institute.

Investors Have Poured Money Into ETFs

Total Assets at Year-End (in $ billions)



Source: Investment Company Institute.

Value (NAV)—based on the closing price for every stock in its portfolio.

ETFs are priced throughout the trading day, just like a stock. If you place an order to buy or sell ETF shares at 11:15 a.m. your trade will be executed based on the market price at that time; you won't have to wait until the market closes at 4:00 p.m. for your trade to go through at the closing price.

Because the price is established by the market, the price one pays for ETF shares could be slightly higher or lower than the actual net asset value of the securities held in the ETF portfolio. This "spread" is usually quite small, but is a unique difference between traditional index mutual funds and ETFs.

The ability to buy and sell ETF shares at market prices during the trading day gives ETFs an edge over mutual funds. The technical term for this is called liquidity: With an ETF you have more liquidity than with a mutual fund. While that additional flexibility can be useful, it is not in itself a compelling reason for most investors to favor ETFs over mutual funds. At Adviser Investments, we believe a successful long-term investment strategy doesn't require the ability to aggressively trade intraday. In fact, studies have shown that very active trading tends to reduce performance for individual investors.

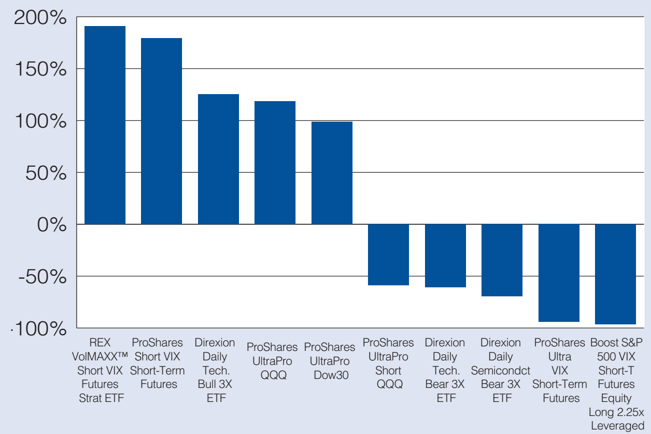
ETFs' Cost Advantage

Where ETFs truly shine is their cost structure. Minimizing your investment costs can have an impact on your net gains; the less you pay in fees, the more money that is left in your account to grow. The annual expense ratio charged by many ETFs is even lower than what you would pay to own many leading low-cost index mutual funds.

For example, the Vanguard Group offers both an index mutual fund and an ETF that track the CRSP US Total Market Index, an index of over 3,500 U.S. stocks.

Vanguard's Total Stock Market Index fund charges an annual expense ratio of 0.14%. That means that the fund deducts 0.14% from the fund's performance to pay operating fees every year. When you consider that the average expense ratio for an actively managed stock fund is in the vicinity of 1.25%, it's easy to understand the allure of index mutual funds.

But Vanguard's ETF that tracks the same index charges even less than the index fund. Vanguard Total Stock Market ETF has an annual expense ratio of 0.04%, 0.12% less than the mutual fund share's expenses.



Note: Returns are provided for information only, and should not be considered a recommendation to buy, sell or hold a particular fund. These top- and bottom-performing funds are highly leveraged, extremely risky and not suitable for the vast majority of investors. Source: Morningstar.

Granted, those are both very small percentages, but consider the savings you would have by using the ETF. If you invest $100,000 in the index mutual fund and it grows at an average annual rate of 8% for 20 years, your investment—net of the expenses—will be worth $454,159. The lower expense ratio charged for the ETF will leave you with $462,655, nearly $8,500 more on the initial $100,000 investment, or nearly 8.5%!

(Fidelity and Vanguard's battle over the last decade to slash expenses for investors has made ETFs' cost advantage over index funds less of a selling point, at least when investing in those fund giants' index funds. As we saw in 2018, when Fidelity launched the industry's first "zero-free" index funds, the competition continues to bring expenses down—and in Fidelity's case, make them disappear. Had the zero-fee funds been around for the 20 years in the example above, you would've earned $11,936 more on your initial investment than in an index fund charging 0.14%, a gain of 11.9% on your initial $100,000 buy-in.)

While annual expenses for ETFs can be lower than index mutual funds, it is important to understand that there is always a cost to buy and sell ETF shares. Remember, ETFs trade like a stock: You buy and sell shares that trade on a stock exchange, typically the American Stock Exchange or New York Stock Exchange. And just like any stock trade, there is a commission to pay. You can minimize that cost with an account at a discount stock brokerage; commission rates as low as $5 or so per trade keep your investment costs low. You

can also eliminate that cost completely—Fidelity, Vanguard and other mutual fund providers now offer access to a significant number of ETFs that trade commission-free for investors with brokerage accounts on their platforms.

ETFs' Tax Advantage

If you own mutual funds in a regular taxable account—rather than in a tax-deferred vehicle such as a 401(k) or Individual Retirement Account (IRA)—you know that each year you are liable for taxes on your investment even if you didn't buy or sell a share.

That's because mutual funds pass along any realized capital gains, dividends and interest income to shareholders. The idea is that the fund itself does not pay tax; it's the shareholders who bear the cost of those taxable distributions.

A fund generates taxable gains, whether an index fund or an actively managed fund, when it sells a holding above its original purchase price. Transactions may even occur in index funds despite their "manager-less" status. For example, if the stocks that comprise the underlying benchmark index change, the mutual fund will also need to adjust its holdings. If the fund has to sell a holding that is no longer included in the benchmark index, and the stock is sold at a gain, shareholders will get a tax bill.

There is also the possibility that an index fund would need to sell stocks to raise cash in the event shareholders wanted to redeem (sell) their shares at the same time, such as during highly volatile periods in the market. Index funds by definition typically don't keep a lot of cash on the sidelines, so if redemption requests greatly outstrip new money flowing into an index fund, the fund would need to sell some assets to meet those redemptions. If the stocks are sold at a gain, the remaining shareholders would face a tax bill.

Those potential tax headaches are greatly reduced with an ETF. The main advantage with exchange-traded funds is that there's no chance of being stuck with a tax bill if hordes of investors redeem their ETF shares. That's because the ETF trades directly through a stock exchange rather than through a mutual fund. You can be hit with tax, however, if the underlying benchmark index for an ETF changes necessitating a stock to be sold out of the portfolio. Also, just like a mutual fund, if you invest in an ETF that produces dividend income, you will pay tax on that distribution even if you reinvest the payout. And of course, you will indeed face a tax bill if you eventually sell your ETF shares at a higher price than what you originally paid. Unless the investment is in a tax-deferred account you owe tax on that gain.

Still, ETFs are more tax efficient and have greater advantages, when it comes to taxes, than traditional index mutual funds.

Other Benefits of ETFs

- **Greater flexibility** to pinpoint or target a certain industrial sector or geographical region.
- **Style and market cap purity.** No style "drift" as with many funds.
- **Eliminates "manager risk"** and the risk of a key manager leaving a fund.
- **Complete transparency**—know exactly what you own today, unlike funds, where holdings are disclosed four times a year and may be outdated by the time you see the report.

ETF Risks

Not all ETFs are created equal.

The growing popularity of ETFs has spawned a deluge of new ETF offerings. Two decades ago, there were just a handful of ETFs, and those few offerings focused on matching the performance of major broad market indexes such as the Standard & Poor's 500. Today there are over 2,100 ETFs and many of the newer offerings track very specific market segments, such as indexes tied to a single country, or a single market cap segment (large-cap, small-cap, etc.) or very specific sectors such as nanotechnology.

ETF marketing departments are so eager to roll out more investing options that quite often new indexes are formed specifically so an ETF can be launched to track that index. And how those indexes are constructed can create some potential problems for investors.

It is important to remember that the main argument for index investing is that with one investment you have exposure to a broad, well-diversified market segment; many of the leading index funds track hundreds if not thousands of stocks included in a benchmark index.

With a new ETF that focuses on a very specific—and small—market segment you can lose all that diversification advantage because the benchmark index might own just 20 or so stocks. It can also lead to tax problems if any stock is replaced in the index; chances are one or two stocks could represent a sizeable portion of the ETF's assets, thereby increasing the tax hit.

There are also a growing number of ETFs that seek to deliver returns that outperform a target benchmark index. Among them are highly leveraged products as well as so-

called “smart beta” or “factor” ETFs that use a variety of proprietary investment models and techniques designed to boost returns. But if the system doesn’t deliver, investors can face returns that actually lag the underlying benchmark index, sometimes by a big amount. (Take a look at the chart on the prior page to see how this can play out over a calendar year.) If that happens, you have squandered one of the most compelling reasons for investing in ETFs: The ability to closely track an index. (We’d also note that the Securities and Exchange Commission recently announced plans to increase scrutiny on “smart beta” ETFs that follow custom-built, non-transparent indexes.)

The newer ETFs may also lack important liquidity. Remember, you buy and sell shares of an ETF directly on a stock market. If you want to buy shares, your price is determined by what someone in the market is willing to sell those shares for. And vice-versa: When you want to sell, your price will be determined by what “the market” is willing to pay for your shares. If there aren’t a lot of potential buyers and sellers in the marketplace you could end up having to make your trade at a lower price (to sell) or a higher price (to buy). When you invest in the major broad market ETFs that are tied to established indexes there is typically plenty of liquidity when you want to trade.

Adding the ETF Advantage to your Portfolio

While it is easy to buy ETFs, figuring out how to incorporate them into your investment strategy is more challenging.

At Adviser Investments, we believe there is still a place for actively managed funds and traditional index mutual funds as well as ETFs in a diversified investment portfolio. We fully recognize that history shows that the majority of actively managed funds fail to consistently beat their benchmark index over the long-term. But that’s not to say all managed funds are underperformers. Since our founding, we have believed that actively managed funds from Fidelity, Vanguard and other fund providers with strong risk and return characteristics add value and should play a prominent role in many of our client portfolios.

And traditional index mutual funds that do not charge a sales commission—what are known as no-load funds remain a solid investment. A no-load index fund can be less expensive than an ETF if you make frequent investments of just a few hundred dollars; the sales commission on the ETF trades may eat up more of your money than the slightly higher expense ratio of the index mutual fund, but long-term investors will find ETFs more economical. All of this of course depends on how much money you have to invest and your plans for making additional investments.

THE ADVISER INVESTMENTS APPROACH IS TO USE ETFS AS A COMPLEMENT TO BOTH ACTIVELY MANAGED FUNDS AND INDEX MUTUAL FUNDS.

The Adviser Investments approach is to use ETFs as a complement to both actively managed funds and index mutual funds as well as in standalone portfolios. By mixing in ETFs with actively managed funds, we reduce the overall cost of an investment portfolio while still giving our clients the opportunity to capture index-beating returns.

If you have any questions about ETFs, or how Adviser Investments can help you, please call us at (800) 492-6868, or visit our website: www.adviserinvestments.com.

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