# The ETF Advantage

## UNDERSTANDING THE BENEFITS AND RISKS OF EXCHANGE-TRADED FUNDS

The popularity of Exchange-Traded Funds (ETFs) has skyrocketed in recent years, and for good reason. The combination of low costs and a reputation for tax-efficiency have made ETFs an attractive portfolio option for investors big and small.

But despite their popularity, ETFs remain a bit of a mystery. This special report cuts through the clutter to clarify what they are, why they are different from mutual funds, and how to select the right ETF from the rapidly expanding and often confusing fund universe.

## ETF ABCs

ETFs and index mutual funds share a core commonality: Both invest in a basket of securities that track a target index. And also like index mutual funds, some ETFs track broad stock-market-spanning indexes, including the S&P 500, while others follow narrow market sectors, niches or industries such as technology or health care.

The main difference between ETFs and traditional mutual funds is how shares are bought and sold. With a traditional mutual fund, regardless of when you place an order to buy or sell, the price of your mutual fund shares is set at the end of the trading day. That's because a mutual fund's share price is determined by net asset value (NAV) of the underlying securities held by the fund when the market closes each day.

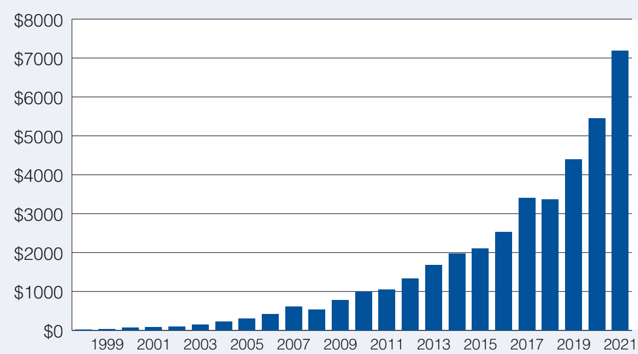
In contrast, ETFs shares are priced throughout the trading day like a stock. If you place an order to buy or sell ETF shares at 11:15 a.m., your trade will be executed based on the market price at that time.

Liquidity is another distinction. The easier it is to buy or sell a given security, the more *liquid* it is said to be. In this case, the ability to buy and sell ETF shares at market prices during the trading day makes ETFs more liquid than traditional mutual funds, which means ETF prices adjust quickly to market-moving news. And this comes with a bit of additional risk: Because pricing is set 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 difference in price, known as "spread," is usually quite small but is a key distinction between traditional index mutual funds and ETFs.

For professional traders, the greater liquidity provided by ETFs can make them more attractive than traditional mutual funds. But while that flexibility can prove useful, at Adviser Investments, we don't believe this is a particularly compelling reason for most investors to favor ETFs over mutual funds. Why? Because successful long-term investment strategies don't require the ability to aggressively trade intraday. In fact, studies have shown that very active trading tends to reduce performance for individual investors.

**Investors Have Poured Money Into ETFs**

Total Assets at Year-End (in $ billions)




Source: Investment Company Institute.

## ETFs' Cost Advantage

ETFs have an edge over most traditional index funds when it comes to costs—although that advantage has eroded in recent years. 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 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 4,000 U.S. stocks. Vanguard's Total Stock Market Index fund charges an annual expense ratio of 0.04%. That means that the fund deducts 0.04% 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 0.70%, 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 0.03%, 0.01% less than the mutual fund share's expenses.

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. (As recently as 2017, Vanguard charged 0.14% for its traditional index fund.) But since Fidelity launched the industry's first "zero-free" index funds in 2018, expense ratios for both traditional index funds and ETFs have moved lower, and have become less of a deciding factor for most investors.

## 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 when it sells a holding above its original purchase price. Such transactions may 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 pay a tax.

**FOR MANY INVESTORS, A DIVERSIFIED PORTFOLIO OF LOW-COST ETFS CAN HELP THEM ACCOMPLISH THEIR INVESTMENT GOALS.**

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 rush to 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 the gain.

Still, ETFs are more tax efficient than traditional index mutual funds, though that gap has narrowed significantly over the years.

## Other Benefits of ETFs

- **Greater flexibility.** As ETFs have become more popular, funds have been issued targeting ever-narrower niches, allowing investors to pinpoint a particular industrial sector or geographical region.
- **Style and market cap purity.** No style "drift" as with many funds.
- **Eliminates "manager risk."** Active fund performance often suffers if a key manager leaves—not a problem with ETFs.
- **Complete transparency.** ETFs report their exact holdings daily. Traditional funds disclose holdings four times a year, and these may be outdated by the time you see the report.

## ETF Risks

Not all ETFs are created equal.

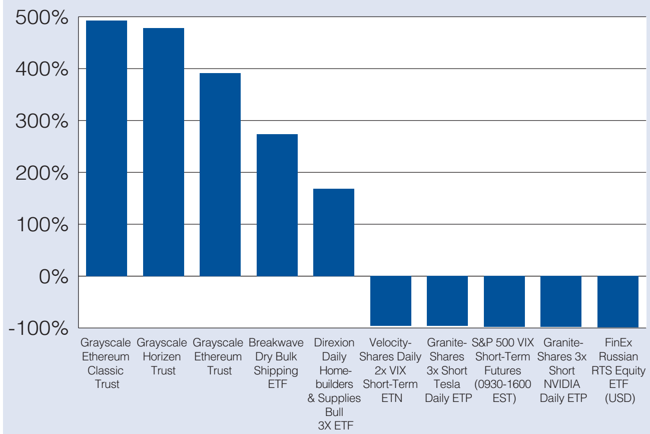
The growing popularity of ETFs has spawned a deluge of new offerings. Two decades ago, there was just a handful of ETFs, and those offerings focused on matching the performance of major broad market indexes such as the S&P 500. Today, there are over 2,500 ETFs and many of the newer offerings track very specific market segments, such as indexes tied to a single country, a specific industry or sector (biotech, self-driving vehicles), or even a theme (health and wellness, the internet of things).

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 it. And how those indexes are constructed can create some potential problems for investors.

It is important to remember that the main upside of index investing is that you have exposure to a broad, well-diversified market segment through just one investment. After all, many of the leading index funds track hundreds if not thousands of stocks included in a benchmark index. But with new ETFs focusing 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. This specificity can also increase tax liability: if one or two stocks represent a sizeable portion of the ETF's assets, the tax hit can be notable if they are sold.

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 strategy doesn't deliver, investors can face returns that actually lag the underlying benchmark index, sometimes by a large amount. (Take a look at the chart above 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.

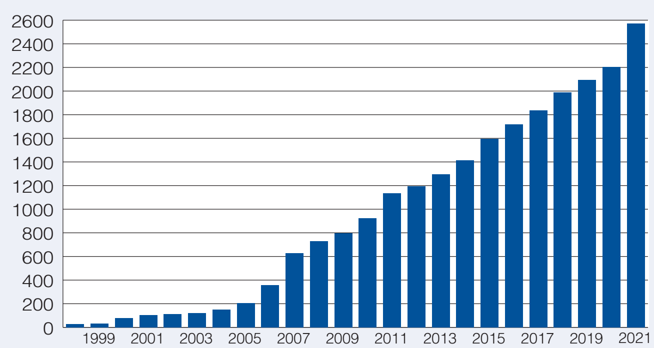
**Best and Worst Performing ETFs of 2021**




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.

**The Number of ETFs Keeps Growing**

Total Number of Funds




Source: Investment Company Institute.

Some 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 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 trade at a lower price to sell or a higher price to buy. Whereas, 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's easy to buy and trade ETFs, just like with mutual funds, building a portfolio that suits your specific needs can be more challenging.

At Adviser, we believe that an investment portfolio works best when it is tailored to fit within a client's overall financial plan. For many investors, a diversified portfolio of low-cost ETFs can go a long way, if not all the way, to helping them accomplish their investment goals.

But the flexibility of ETFs also means they are perfectly at home serving as a core of a more sophisticated investor's portfolio that also includes select actively managed funds, alternate asset classes or tactical strategies.

Whatever your investment philosophy or goal, ETFs have a role to play, which is why we recommend adding the ETF advantage to your portfolio. Our professional wealth managers would be happy to discuss how we can put it to work for you. Call us at (800) 492-6868 or email us at **info@adviserinvestments.com** to get started.