Why So Many ETFs?

SYNOPSIS

- An Exchange Traded Fund (ETF) is an investment vehicle that gives broad exposure to a sector, geography, or theme, and they have surged in popularity in recent years.
- ETFs are often confused with mutual funds but are very different in structure, taxation, and cost.
- ETFs offer investors several benefits when compared to owning single stocks and/or bonds, and the use of ETFs in DIAS portfolios has risen dramatically this year.

Q&A ON ETFS

Many investors have noticed some big changes to the composition of the DIAS portfolios this year, as several stocks have been sold and replaced with Exchange Traded Funds (ETFs).

This change in strategy has prompted several questions regarding the use of ETFs and the timing of the move. In an attempt to address investors' concerns, here are answers to some of the more common ETF questions:

What is an exchange traded fund?

An ETF is a marketable security that tracks an index or a basket of stocks, bonds, and/or commodities. The fund owns the underlying assets and then divides ownership of those assets into shares. These shares of the ETF are then traded on stock exchanges.

For example, if an ETF were created to track social media stocks, the fund would buy Facebook, Twitter, and other stocks in the sector, and then issue shares to investors that gave them a claim on a portion of the value of the fund. Over time, the value of the ETF shares would rise/fall as the portfolio value changed due to the movement of the stocks within.

How does an ETF differ from a mutual fund?

An ETF may sound similar to a mutual fund, but they are actually quite different for several reasons. Unlike mutual funds, ETFs:

- Trade throughout the day and experience price changes like regular stocks.
- Offer favorable taxation since capital gains from sales inside the ETF are not passed through to shareholders.
- Charge relatively small fees (typically below 0.005%) and are less actively managed.

Are ETFs new to the Global Financial investment strategy or have they been used in the past?

ETFs have been used extensively in DIAS portfolios for many years. In fact, the fixed income portion of the asset allocation can only be implemented using ETFs due to changes in the bond market after the financial crisis.

Since banks are now so fiercely regulated, they no longer hold inventories of bonds available to purchase, which has subsequently shifted all liquidity to the ETF world. This transition benefitted investors for three key reasons:

1. **Diversification**: An ETF can hold hundreds of bonds, so an investor can create a well-diversified bond allocation by owning just a handful of broad-based bond ETFs.
2. **Account Size:** Building a well-diversified bond

portfolio requires several million dollars in an account because an investor would need to own a large number of individual bonds. Using ETFs, an investor can create a bond allocation in almost any account size.

3. **Liquidity:** Selling a bond can take days/weeks with high commission charges whereas an ETF can be sold immediately for a very low fee.

Why am I paying a fee to an ETF manager when I can simply own single stocks and bonds with no fees?

The three most important rules in real estate are (1) Location, (2) Location, and (3) Location. When it comes to investment management, the three most important rules are (1) Asset Allocation, (2) Asset Allocation, and (3) Asset Allocation.

The table below confirms this truism by breaking down the determinants of portfolio performance over an average 20-year period:

Determinant	*Value*
Asset Allocation	93.3%
Security Selection	4.6%
Market Timing	2.1%

Source: Brinson, Hood and Beebower, "Determinants of Portfolio Performance" (1986, 1991)

Buy the worst house in the best neighborhood, and there's a good chance you will make money over the long run because location is the biggest determinant of gains in real estate.

The same applies to financial markets. Investors who pick the right geographies and sectors do best over time, so any opportunity for an investor to focus less time on a specific stock and more on getting the asset allocation correct is in a much better position to perform.

Stock selection only explains 4.6% of the long-term return on an investment but often takes up the overwhelming majority of an investor's time and resources. Hence, on a time-adjusted basis, stock picking is inefficient and rampant with risk.

Simply put, using ETFs allows investors to put more time and effort into the asset allocation, which more than makes up for the small cost embedded in the product.

Is Global Financial Private Capital simply indexing by using ETFs?

No. Using ETFs and indexing are two very different strategies. Although a select few of the ETFs added to DIAS do represent some index exposure, the portfolios will not and cannot be indexed.

Indexing does not protect the downside, and those who owned index funds in 2008 will attest to the inherent dangers of simply following an index.

Furthermore, indexing cannot generate consistency in returns year over year unless the index being tracked remains consistent, which is highly unlikely in any economic environment.

Why has Global Financial Private Capital now made the move to using more ETFs?

The decision to add more ETF exposure in 2015 was predicated upon three key reasons:

1. **Market Evolution:** The movements in equity markets over the past year have opened opportunities to move from single stocks to more broad-based investment themes, which experience lower volatility. For example, the Conservative Income portfolio's volatility has been reduced by close to 40% over the past three months.
2. **Liquidity:** Many of the ETFs added are finally

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liquid enough to meet the strict quality control administered in DIAS. Until recently, these products were too illiquid, but the surge in popularity from large money managers has now made these products big enough to include in the DIAS conservative portfolios.

3. **Turnover:** ETF strategies allow for fewer securities in a portfolio, which also lowers portfolio turnover and expected trading costs.

What are some examples of how ETFs are being used in the DIAS portfolios?

Three very different examples highlight the versatility and usefulness of ETFs within DIAS:

1. **European Hedged Equity (ticker: HEDJ):** As the Euro continues to weaken vs. most major currencies, companies in the Eurozone who sell the majority of their goods to customers outside the Eurozone should benefit greatly. A weaker currency makes Eurozone goods more attractive to buyers in other parts of the world (similar to how a stronger dollar may incentivize Americans to take a European vacation this year). This ETF tracks export-centric companies in the Eurozone but also hedges the Euro.
2. **Pipeline MLPs (ticker: AMLP):** This ETF tracks several large Master Limited Partnerships (MLPs) in the pipeline business. Although energy prices are down, pipelines are like toll roads and don't get impacted as much by the price of crude. These stocks usually pay very high dividends but frustrate investors in tax season due to the K1's issued by the firms. This ETF allows an investor to generate a consistent dividend yield but with no K1 at the end of the year since the ETF is not considered a partnership.
3. **Biotech Sector (ticker: IBB):** The biotech industry is one of the most exciting sectors in the U.S. economy. However, picking biotech stocks is risky unless an investor is well-versed in the science of drugs and medicine. This ETF allows an investor to gain access to the sector without having to understand the science of each individual company. Since over 93.3% of returns can be explained by picking the right sector, IBB offers a safer way to profit over the long run.

The benefits of each strategy come at a cost. However, the fees in these ETFs are tiny when one considers the benefits. For example, let's compare buying HEDJ to implementing the strategy without using an ETF.

An investor who purchases HEDJ is charged a single commission at the same rate as any large cap stock plus an annual fee of 0.0058%. The investor now owns shares of one ETF that currently holds 123 European stocks. This ETF trades at less than $70/share, so an investor can gain access to this investment theme with less than $80 in his account (assuming the commission was $10 or less).

If an investor wanted to replicate this strategy outside the ETF, he would need a lot more money in his account because he would need to purchase 123 stocks, which means 123 individual commission charges on a far more expensive foreign stock exchange. Then he would need to hedge out the effects of currencies, so he would need to contract with a currency dealer to sell his Euros and buy dollars at a future date. The dealer would charge a fee for this service.

Simply put, this strategy gives investors an excellent opportunity to increase diversification at a very low cost.

When does it make sense to own a single stock instead of an ETF?

Although the ETF industry has grown significantly over recent years, many sectors and investment themes do not require ETFs. For example, if an investor wanted to invest in the U.S. Telecom industry, there's no reason to use an ETF because AT&T and Verizon together represent the overwhelming majority of the market. Buying these two stocks will give the investor the exposure desired and at a cheaper cost than an ETF.

Is Global Financial Private Capital going to stop investing in single stocks?

No. Individual stocks will continue to be critical to the investment process, and ETFs are only used when the cost/benefit is in favor of the investor. Markets evolve over time, so there will be periods where ETFs are used more heavily than others, but there is no expectation that ETFs will ever replace single stocks entirely.

IMPLICATIONS FOR INVESTORS

The easiest way to lose money as an investor is to never change a strategy. Markets evolve over time, and those who are not willing to move with these markets will ultimately lose.

The increased use of equity ETFs is a direct result of a change in strategy to adapt to the evolution of the financial markets, and we will continue to assess new products that make the investment process more efficient.

The bottom line is that ETFs have and will likely continue to be an integral component to the investment process, and their benefits to investors far outweigh their negligible fees.

Sincerely,

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