ETFs … They Aren't Your Father's Oldsmobile

April 21, 2016

by Vern Sumnicht

of iSectors

For 12 years, we used active asset management, that is, professional money managers and/or actively managed mutual funds. After the dot.com bear market in 2000, we became more and more dissatisfied with the cost and performance of professional money managers. After much research, we opted for a passive index approach to investing as opposed to the active approach we had previously been using. The passive approach is unmanaged. In this approach, investments mirror a market index like the Dow Jones Index, NASDAQ Index, S&P 500 Index, or any of hundreds of other indexes.

The early work of Nobel Prize winners Markowitz, Miller and Sharpe in the 1950s developed the theory of "efficient markets". The hypothesis was that, on average, over time, professional money managers underperform unmanaged indexes equal to their management fees. All studies since then show that portfolios allocated among unmanaged indexes (passive approach) will outperform about 75% of all managed portfolios, *Active vs. Passive Management by Rex A. Sinqufield, October 1995*.

Work from Morgan Stanley's research head, Paul Mazzilli showed that for the 10-year period ending December 31, 2007, the asset managers of the following asset classes failed to outperform their benchmarks:

- 59% of large-cap blended funds in the United States
- 71% of large-cap value funds
- 34% of large-cap growth vehicles
- 73% of small-cap blended funds
- 64% of growth managers
- 75% of short-term high yield vehicles
- 100% of actively traded bond portfolios, focused on medium-term corporate paper and long-term government debt

After deciding to use a passive approach for investing our client's assets and focusing our time and energy on asset allocation rather than due diligence on money managers, stock selection, or market timing, we decided to use ETFs to implement our passive asset allocation strategies. We decided to use ETFs for the following reasons:

- Because ETFs are historically unmanaged, they avoid management expenses. ETFs will only incur a 0.01% to 0.70% (10-70 bps) annual administration expense as opposed to the 1% to 2% management fee typically charged by managed mutual funds.

- ETFs can be held in a margin account or even sold short. Buyers can enter limit orders, stop loss orders, good ‘til canceled, etc. In addition, many ETFs allow for put and call options to be bought and/or sold (written) against them.
- ETF funds are created when large institutions exchange baskets of securities (stocks, bonds, etc.) for shares of the ETF. These shares are then sold on the market and are subsequently bought and sold among investors through major exchanges just like shares of stocks. Therefore, ETFs do not pay commissions. Mutual funds, on the other hand, pay brokerage commissions to purchase securities when they receive money from investors, they pay brokerage commissions to sell securities when investors redeem their shares for cash and they pay brokerage commissions whenever the mutual fund manager decides to purchase stocks (bonds) he likes or sells stocks (bonds) he no longer wants to hold in the portfolio. In a managed equity mutual fund, these commissions amount to 1% to 1.5% on average annually.
- **Tax Advantages.** Because index-based ETFs don’t typically buy and sell securities, they don’t incur capital gains and therefore, they don’t need to distribute net capital gains to shareholders annually. So investors avoid the capital gains tax they would have to pay if they were holding mutual funds.
- **Transparency**. When you buy an index-based ETF, you know exactly what you are buying because ETFs typically mirror the securities held in the index. Mutual funds, on the other hand, are not as transparent. Portfolio managers generally do not like to disclose their holdings for many reasons. Many of the holdings they do disclose quarterly weren’t actually held in the portfolio during the quarter.

In summary, the structure of ETFs allows them to be more liquid, more flexible, and more transparent than mutual funds. In addition, ETFs have reduced management fees, commissions and taxes. The estimated annual savings of investing in index-based ETFs rather than managed mutual funds can easily exceed 2% to 3%.