
The Ins and Outs of Investing With ETFs



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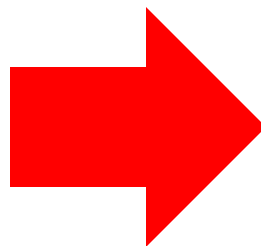
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Agenda

- ▶ What is an ETF?
- ▶ ETFs are not...
- ▶ Why use ETFs?
- ▶ A Few of Our Favorites
- ▶ Q & A

What is an ETF?

A 21st Century Investing Technology



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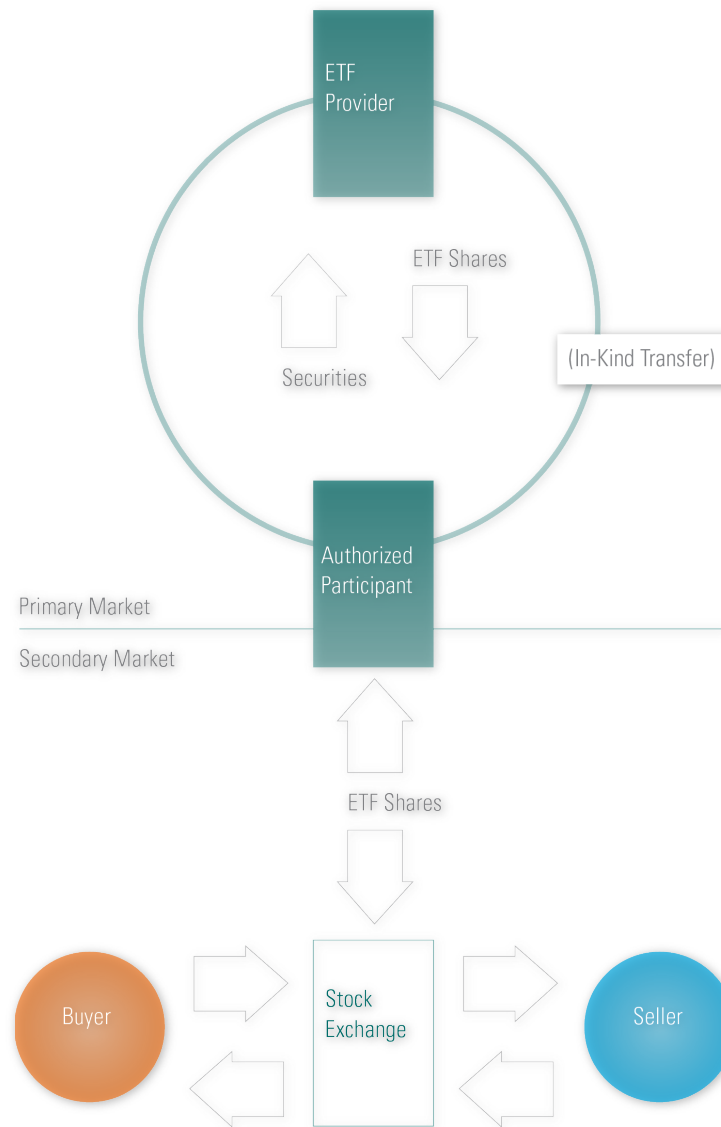
- ▶ ETFs are a product of and a poster child for the Information Age
 - ▷ The computing power needed to support the “ETF Ecosystem” simply didn’t exist a few decades ago
 - ▷ Their success is in many ways reflective of global trends towards greater transparency, lower costs, and disintermediation

Mutual Fund Creation and Redemption



Source: Morningstar

ETF Creation and Redemption



Source: Morningstar

ETFs Externalize Costs



ETFs vs. Mutual Funds

Feature	ETFs	Funds
Diversified	✓	✓
Index Tracking	✓	✓
Actively Managed	✓	✓
Frequent Portfolio Disclosure	✓	✗
Intraday Trading	✓	✗
Daily Creation/Redemption	✓	✓
NAV-based Trading	✓	✓
Ability to Short Sell	✓	✗
Futures or Options Available	✓	✗

- ▶ The ETF wrapper is more flexible and more transparent than a traditional fund
- ▶ Differences in distribution are also an important consideration
- ▶ Choosing between the two is increasingly a matter of preference and circumstances

Source: Morningstar

ETFs are not...

Bloomberg

Business

ETFs Are 'Weapons of Mass Destruction,' FPA Capital Managers Say

By [Charles Stein](#)

April 27, 2017, 10:16 AM CDT *Updated on April 27, 2017, 11:38 AM CDT*

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- ▶ The rise of passive investing distorts stock prices, they say
 - ▶ They question how ETFs will hold up in major market selloff
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ETFs are not...

was immeasurably greater. Indeed, many Wall Street professionals now say that at the height of the May excitement the mere thought of the mutual-fund situation was enough to make them shudder. As is well known to the millions of Americans who have bought shares in mutual funds over the past two decades or so, they provide a way for small investors to pool their resources under expert management; the small investor buys shares in a fund, and the fund uses the money to buy stocks and stands ready to redeem the investor's shares at their current asset value whenever he chooses. In a serious stock-market decline, the reasoning went, small investors would want to get their money out of the stock market and would therefore ask for redemption of their shares; in order to raise the cash necessary to meet the redemption demands, the mutual funds would have to sell some of their stocks; these sales would lead to a further stock-market decline, causing more holders of fund shares to demand redemption—and so on down into a more up-to-date version of the bottomless pit. The investment community's collective shudder at this possibility was intensified by the fact that the mutual funds' power to magnify a market decline had never been seriously tested; practically nonexistent in 1929, the funds had built up the staggering total of twenty-three billion dollars in assets by the spring of 1962, and never in the interim had the market declined with anything like its present force. Clearly, if twenty-three billion dollars in assets, or any substantial fraction of that figure, were to be tossed onto the market now, it could generate a crash that would make 1929 seem like a stumble. A thoughtful broker named Charles J. Rolo, who was a book reviewer for the *Atlantic* until he joined Wall Street's literary coterie in 1960, has recalled that the threat of a fund-induced downward spiral, combined with general ignorance as to whether or not one was already in progress, was "so terrifying that you didn't even mention the subject."

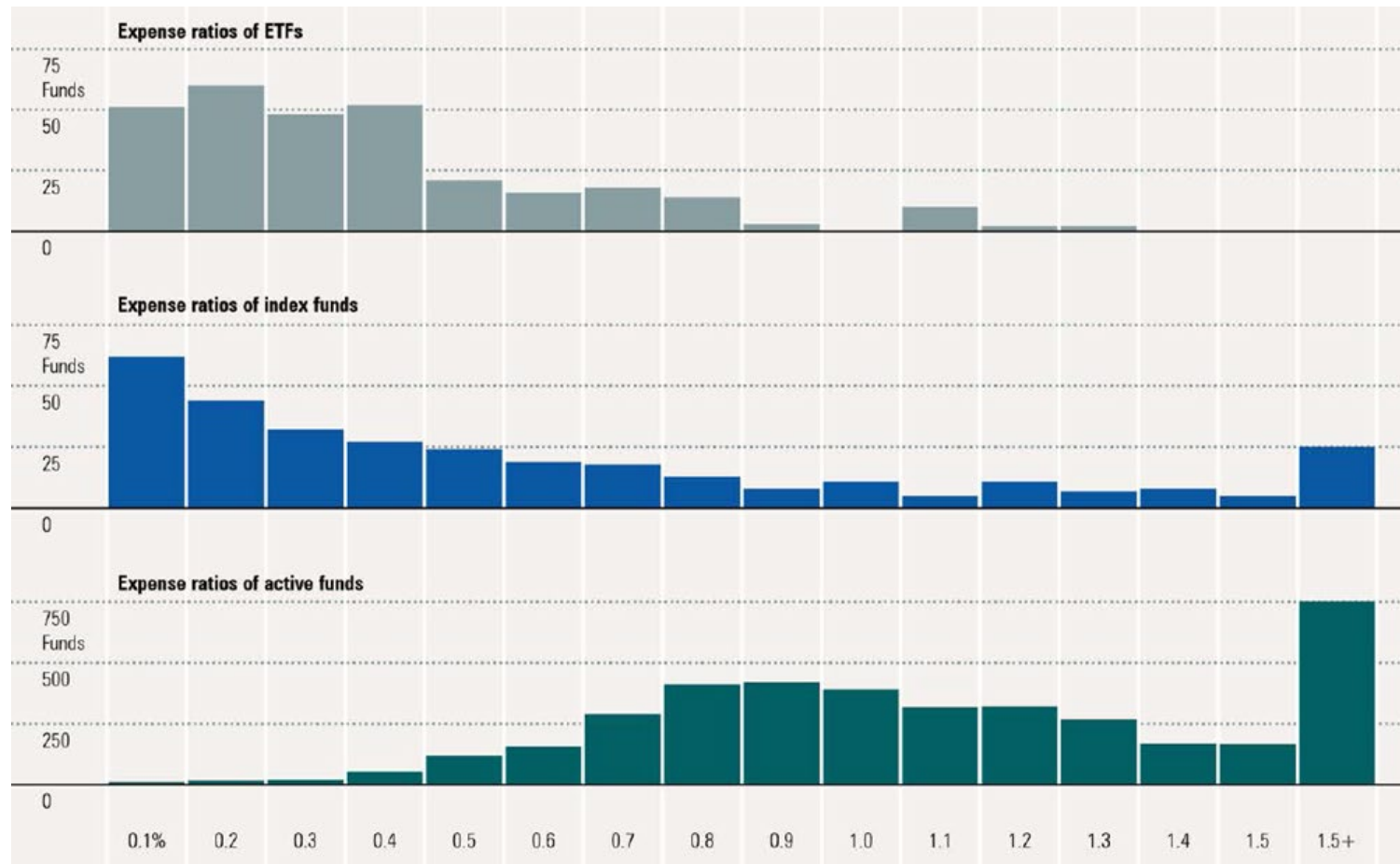
Source: "Business Adventures" by John Brooks

Why ETFs?

The Elements of ETFs' Appeal

- ▶ Low Costs
- ▶ Tax-Efficiency
- ▶ Relative predictability
- ▶ Access/Flexibility

Cost Matters



There is no more reliable predictor of fund performance

Source: Morningstar Direct. Data for U.S. large cap funds only. Data as of Dec. 31, 2017.

Picking Good Managers is Hard

Exhibit 1 Active Funds' Success Rate by Category (%)

Category	1-Year	3-Year	5-Year	10-Year	15-Year	20-Year	10-Year (Lowest Cost) *	10-Year (Highest Cost)
U.S. Large Blend	31.1	30.0	16.5	8.4	11.2	12.8	17.2	4.1
U.S. Large Value	52.1	35.6	20.3	14.0	15.4	16.8	26.2	9.2
U.S. Large Growth	34.4	37.0	20.6	9.3	10.9	11.3	17.6	6.6
U.S. Mid Blend	21.6	23.8	13.4	11.9	6.3	8.7	29.6	7.4
U.S. Mid Value	76.8	49.6	44.2	12.5	30.8	—	16.7	8.3
U.S. Mid Growth	42.6	59.5	54.6	40.7	30.5	—	47.8	33.3
U.S. Small Blend	29.4	19.5	16.8	12.7	10.0	29.6	27.0	11.1
U.S. Small Value	46.2	27.4	23.1	29.3	31.3	—	35.0	15.0
U.S. Small Growth	60.1	55.2	54.0	41.2	28.4	—	46.7	36.4
Foreign Large Blend	56.0	41.5	26.7	20.0	14.0	14.6	35.9	17.9
Foreign Large Value	80.2	41.3	24.2	31.7	—	—	42.9	23.8
Foreign Small-Mid Blend	25.0	11.8	11.5	22.2	—	—	25.0	0.0
World Large Stock	53.3	42.0	30.8	30.4	32.0	—	34.8	21.7
Diversified Emerging Markets	69.6	59.6	48.1	45.4	35.7	—	58.3	33.3
Europe Stock	73.7	48.1	37.5	32.4	30.6	—	42.9	0.0
U.S. Real Estate	71.1	67.5	53.2	45.0	27.5	28.6	62.5	25.0
Global Real Estate	75.0	60.3	38.5	48.1	—	—	45.5	45.5
Intermediate Core Bond	53.7	38.5	34.5	27.9	15.9	9.7	47.4	11.1
Corporate Bond	48.4	35.5	49.1	40.5	—	—	37.5	25.0
High-Yield Bond	54.8	46.2	59.0	42.3	—	—	59.5	40.5

Source: Morningstar. Data and calculations as of Dec. 31, 2020. *Green/red shading indicates that active funds in this fee quintile had above/below average success rates .

Tax Efficiency

Exhibit 13 Difference Between Average Capital Gains Distribution/NAV (%)

	Active OE— Passive ETF	Active OE— Passive OE	Active ETF— Passive ETF	Passive OE— Passive ETF	Active OE— Active ETF
Large Blend	3.44	1.93	0.24	1.51	3.26
Large Growth	4.15	2.14	1.50	2.01	3.55
Large Value	3.14	1.28	0.83	1.86	3.83
Mid Blend	4.03	0.52	-0.34	3.52	6.53
Mid Growth	4.68	2.51	-0.17	2.18	7.19
Mid Value	4.27	0.81	-0.20	3.46	5.44
Small Blend	5.02	0.81	—	4.21	—
Small Growth	5.47	4.26	—	1.21	—
Small Value	5.03	3.32	—	1.71	—
Foreign Large Blend	1.69	1.31	0.56	0.87	0.68
Diversified Emerging Markets	2.95	2.58	0.20	0.10	0.67
Intermediate-Term Bond	0.32	0.15	0.46	0.15	-0.11
High Yield Bond	0.34	-0.22	-0.06	0.30	0.42

Source: Morningstar, Analyst's calculations. Data as of Dec. 31, 2018.

Relative Predictability

- ▶ Investors' expectations are crystal clear
 - ▶ You will get your "fair share of the market's return"
- ▶ Relative predictability lends itself to better behavior

ETF Liquidity is Overrated

- ▶ Access - ETFs are widely available
- ▶ Flexibility – Investors can buy ETFs long, sell them short, use associated options, lend them out, etc.
- ▶ Handle with care
 - ▷ “I can't help likening the ETF to the renowned Purdey shotgun, supposedly the world's best. It's great for big-game hunting. But it's also excellent for suicide.” – Jack Bogle

Source: <http://www.bloomberg.com/bw/stories/2007-04-29/whats-wrong-with-etfs>

Trading Best Practices

- ▶ **Use limit orders**
- ▶ Look before you leap
 - ▷ Premiums and discounts
 - ▷ Bid-ask spread
 - ▷ Do not trade during periods of extreme volatility
- ▶ Avoid trading near the open and the close of the market
- ▶ Try to trade when the market for the securities underlying the ETF is open
- ▶ If you don't place any value on intraday liquidity — consider an index mutual fund instead




A Few of Our Favorites

Building Blocks For a Three-Fund Portfolio

- ▶ **Vanguard Total Stock Market ETF – VTI**
 - ▶ Morningstar Analyst Rating –  Gold
 - ▶ Expense Ratio – 0.03%
- ▶ **Vanguard Total International Stock ETF – VXUS**
 - ▶ Morningstar Analyst Rating –  Gold
 - ▶ Expense Ratio – 0.08%
- ▶ **Vanguard Total Bond Market ETF – BND**
 - ▶ Morningstar Analyst Rating –  Gold
 - ▶ Expense Ratio – 0.035%

Source: Morningstar Direct. Data as of Apr. 7, 2021.

A Trio of Dividend ETFs

- ▶ **Schwab US Dividend Equity ETF – SCHD**
 - ▶ Morningstar Analyst Rating –  **Silver**
 - ▶ Expense Ratio – 0.06%
- ▶ **Vanguard Dividend Appreciation ETF – VIG**
 - ▶ Morningstar Analyst Rating –  **Silver**
 - ▶ Expense Ratio – 0.06%
- ▶ **Vanguard High Dividend Yield ETF – VYM**
 - ▶ Morningstar Analyst Rating –  **Gold**
 - ▶ Expense Ratio – 0.06%

Source: Morningstar Direct. Data as of Apr. 7, 2021.

Further Afield

- ▶ **PIMCO Enhanced Short Maturity Active ETF – MINT**
 - ▶ Morningstar Analyst Rating –  **Gold**
 - ▶ Expense Ratio – 0.35%
- ▶ **iShares Edge MSCI Minimum Volatility Emerging Markets ETF – EEMV**
 - ▶ Morningstar Analyst Rating –  **Silver**
 - ▶ Expense Ratio – 0.25%
- ▶ **Vanguard Small-Cap Value ETF – VBR**
 - ▶ Morningstar Analyst Rating –  **Gold**
 - ▶ Expense Ratio – 0.07%

Source: Morningstar Direct. Data as of Apr. 7, 2021.

Questions?

