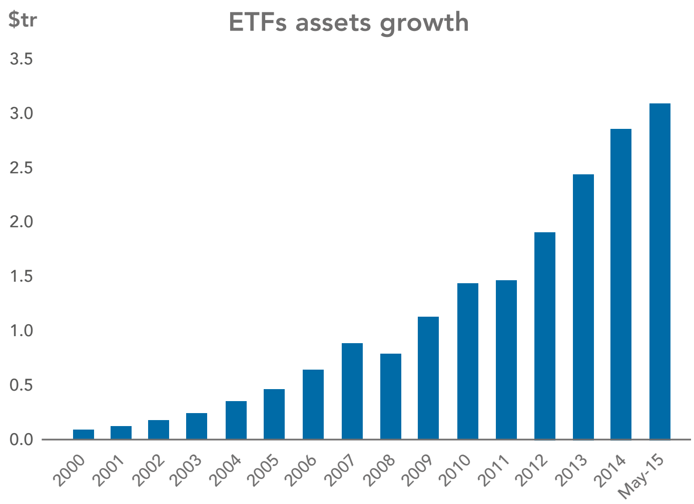
Exchange Traded Funds:
An important tool for building diversified portfolios

Exchange Traded Funds (ETFs) were launched in the early nineties and have since been growing from strength to strength. Their success as an investment vehicle is unquestionable but as all investment vehicles their pros and cons need to be understood in order to avoid pitfalls and ensure that investment goals are met.



Advantages

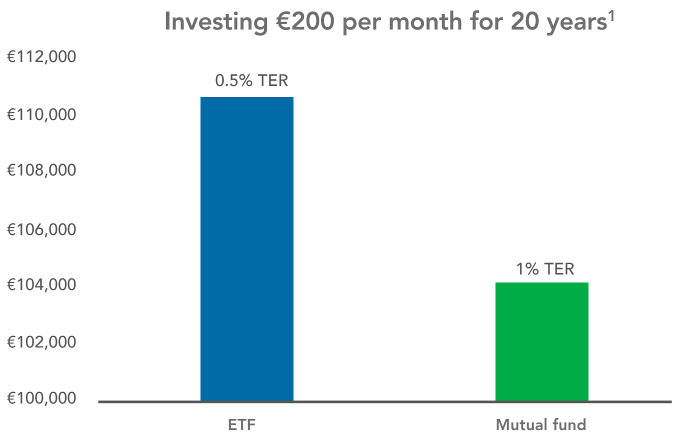
Liquidity

The easiest way to understand ETFs is to think of them as mutual funds that trade like stocks. That is, an investment pot where a number of investors place their cash that is invested in a predefined way into a predefined investment thesis. Investors can place and withdraw money in and out of the 'pot' as often as they like within a day. In contrast, mutual funds are priced once a day at best and can be traded on the following day at that price. Often this liquidity can be weekly and in the event of some funds with illiquid strategies or underlying investments (for example real estate, or hedge funds) the tradability can be quarterly or more.

This stock-like pricing and trading characteristic of ETFs is particularly attractive for investors looking to take intraday positions or to cover a position as an event occurs. Obviously, this is not a characteristic that makes a massive difference to long-term investors but it can be very useful to more active strategies.

Costs

In its annual review of investment returns, Bloomberg has been concluding year after year that one of the main differentiators of returns are management fees.



Although such conclusions can be myopic and too broad to condemn all active managers, it is nonetheless clearly obvious that you need to keep fees low in order to reap higher returns—other things being equal. In this sense, ETFs remain one of the cheapest ways to invest.

Particularly, when your target is replicating the risk and return of an index, only futures contracts can do a cheaper job, albeit at higher exposure. ETF total expense ratios (TERs) are significantly lower to traditional funds that may in certain cases also carry extra subscription or redemption fees.

Smaller investments

Being traded as equities, ETFs can be bought at very small denominations—one share at a time, allowing small investors the freedom to invest small amounts as and when they see fit. As mentioned above, it is not practical for a small investor to replicate the risk-return of a given index through buying its components directly and for many it is not within their means to do so using futures contracts. Using ETFs however, you can buy one share at a time. This allows not only for construction of small portfolios but can facilitate an effective dollar-cost-averaging strategy whereby an investor deploys a fixed dollar amount to their chosen investments on a regular basis in order to achieve a fair average cost.

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Diversification

By investing in an ETF that tracks a broad index such as the S&P 500 or the Russell 2000, an investor can quickly and cheaply gain exposure to a large number of stocks (500 or 2000 in the mentioned examples) depending on the index. They thereby provide an effective means to diversify a portfolio across stocks, but also across asset classes and geographies allowing for a simply constructed well diversified portfolio.

[1] The information presented in this graph is provided for informational purposes only, without regard to any particular user's investment objectives and/or financial situation and does not take into account any specific investment goals, needs or demands of individual users. The TERs for the ETF and the mutual fund are for informational purposes only. Furthermore, the before-expense returns for both products are assumed to be 8%, however this is an arbitrary number. These assumptions are only used to show how small differences in the TER may cause significant differences in net returns.

The benefits described above paint a very positive picture of what is indeed a very useful instrument in carrying out an effective investment strategy. However, as always, one needs to be careful using financial instruments as quite often there are less obvious aspects to their effects on a portfolio.

Disadvantages

Suitability

Although the universe of markets covered by ETFs is increasing rapidly and is now entering active management as well as some more exotic underlyings, it is however still smaller than that covered by the broader mutual fund industry. It is important to be sure that you can find one that covers what you are really looking to invest in, often a proxy is not what it seems and the drivers of risk and returns can differ substantially, even if they seem to be investing in a similar area. An obvious example would be the breadth of an index, e.g. the Dow Jones Industrial Average vs the S&P 500 cover similar areas but also have significant differences. These become less apparent when looking at fixed income (bond) indices and even more confusing when entering the realm of alternative assets. So it is useful to know that there is probably an ETF out there that covers what you want to be investing in, but it is far more important to know exactly what you want to be investing in.

Broad can be crude

A downside of indexing is that you are condemned to assured mediocrity—to paraphrase Seth Klarman one of the industry's most respected professionals. An index will always contain lesser quality investments and most indices are weighted by market cap inadvertently weighting one's portfolio to more expensive investments. This is in essence the same point as above, one needs to select the correct focused area of investment that fits their overall portfolio's risk-return requirements. The cheapness in fees and ease of investment in ETFs often lures investors in accepting to follow the market through good times and bad.

Liquidity

Once you have defined the index you wish to track and found an ETF that does so effectively and with low costs, you need to be sure that you can get in and out. Not all ETFs are traded equally. In some, millions of shares change hands on a given day and in other extreme cases, days can go by without a single trade. Although most ETFs have a market maker—a broker that is always willing to buy and sell the ETF, the very liquid ETFs will have a much tighter bid-ask spread (difference between the price at which you can buy or sell) and so will effectively be cheaper to invest in.

Self-propelling

Another repercussion of the meteoric rise of the ETF industry is their possible feedback into the investment loop, particularly as concerns those that are physically backed by scarce commodities. Such an example is the StateStreet's Gold Trust that receives money from investors and buys gold bars with it, it is physically backed by Gold. I mention this one as it is the largest Gold tracking ETF and had at one point reached a market cap of US$70bn and amassed over 40 million troy ounces of Gold! This is exactly what you want your ETF to be doing; taking your money and investing directly where it says it will. But, there is an indirect side effect; the ETF itself is becoming a major demand in Gold rather than a tracker of its price. It is inadvertently overexpressing the demand. This also works on the way down. The effect however is small and usually not a major driver of the underlyings price, it is simply another factor to keep in mind.

Physical vs synthetic

The most important issue with ETFs is the difference between what are known as synthetic and physically backed ETFs. A synthetic ETF uses financial engineering to replicate the performance of the targeted index and has the advantage of keeping costs extremely low.

To understand how this works lets look as an example two ETFs tracking the S&P 500, one physical and one synthetic. When you buy shares in the physical ETF it will take that money and buy the 500 shares that make up the S&P 500 index, simple enough.

The synthetic will take your cash and make an agreement with another financial institution to exchange on a daily basis the difference in value on your cash, as if it had been invested in the S&P 500, what is known in the industry jargon as a total return swap. So if the investment was $100 and the S&P 500 lost 3% yesterday, the ETF provider needs to pay its counterparty on the swap $3.

As part of this agreement the ETF provider gives over the cash at the beginning and receives 'assets' of an equal value in return. Confused and worried? You should be. You do not now carry only the risk of the S&P 500, but also of the ability of the counterparty to pay the difference and of the quality of the 'assets' swapped for your cash. When selecting ETFs you need to be aware of such a characteristic and gauge whether the added risk is being mitigated by lower fees, higher liquidity, or another characteristic.

Conclusions

In summary, the ETF universe is vast and growing. The choices that an investor faces are increasing but so are the issues that need to be taken into consideration. The important point here is that the advent of ETFs offers an excellent vehicle to achieve certain investment needs, but each ETF needs to be screened for its own merits and above all, investors need to know where they want to be putting their money and in what proportion. The asset allocation decision remains the main and foremost driver of returns of any portfolio.

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Christos Spanos

Mr. Spanos is a portfolio manager at Byron Capital Partners where he manages institutional multi asset class portfolios and systematic strategies. Prior to this, he was a founder and Executive Director of 7Q Financial Services Ltd. Previous experience includes founding and managing XS Capital Securities and Financial Services Ltd, heading the Asset Management department at Egnatia Financial Services (Cyprus) Ltd. He also served as a Financial Analyst and Portfolio Manager at Severis and Athienitis Financial Services Ltd. He is a CFA charterholder. He holds an MBA, an M.Sc in Medical Radiation Physics and a B.Sc (Honours) in Physics.

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