ADVISER FUND UPDATE

ADVISER INVESTMENTS

Market Summary and Commentary for Individual Investors from Adviser Investments

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Vanguard's ETF Reverse

In the realm of index funds and ETFs, it's been a race to the bottom as Vanguard and its competitors have done their best to attract investors with the lowest achievable fees. This week, Vanguard announced its most recent gambit to cut costs by conducting a one-for-two reverse share split for its S&P 500 ETF (VOO) on October 24, which the firm says will lower overall transaction expenses.

The traditional stock split results in shareholders having twice as many shares of a company at half the price. So if you owned 100 shares of XYZ Corp. priced at $100, after a split you'd own 200 shares at $50 apiece. A one-for-two reverse split of the sort Vanguard is planning takes those 100 shares and turns them into 50, doubling the share price at the same time.

Is this a bit of financial legerdemain, or can doubling the price of the ETF really cut down on costs? It's all a matter of the "bid-ask spread" on the share price. With any security that trades throughout the day, the price an investor pays fluctuates between what they are willing to pay, and what the seller is willing to take. The "bid" part of bid-ask is the price proposed by the buyer, the "ask" is the price desired by the seller, and the bid-ask spread is the difference between the two. The higher the spread, the greater the premium an investor ends up paying on a desired stock, ETF or bond.

Vanguard's S&P 500 ETF already trades very efficiently, and the average bid-ask spread is a tiny 0.01% of the share price. By halving the number of shares that need to be traded to for a given dollar amount, Vanguard will effectively halve trading costs, and also put its S&P 500 ETF more in line with competitors, which have similarly low bid-ask spreads, but higher share prices and operating expenses. (As of September 12, VOO was priced at about $77 a share, while S&P 500 ETFs from iShares and State Street Global Advisors were priced around $170 and $168, respectively.)

For the individual investor making a few trades a year, the savings in transaction costs will not likely amount to much, but on the institutional side, where millions of dollars of trades can take place a day, they add up fast. With expenses of just 0.05%,

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Vanguard's S&P 500 ETF will regain an advantage over higher-priced competitors, and may attract more institutional investors once the reverse split takes place.

The one wrinkle for investors to look out for is the fact that a reverse split could result in some taxable gains. If you own an odd number of shares, you'll end up with a fraction of a share after the split, which Vanguard will redeem for its cash value. Depending on your cost basis, you'll either be paying taxes on it or be able deduct it as a loss. But taxes on a fractional share, which could present an accounting problem, are not going to be a large sum of money by any means.

While the reverse split may seem like an unconventional move on the surface, it follows perfectly with Vanguard's close attention to the costs it passes on to its shareholders and its never-ending quest to reduce them as much as possible. Every little bit counts.

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