ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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20 Years of ETFs

January 2013 marks the 20-year anniversary of the launch of the nation's first publicly traded exchange-traded fund (ETF), State Street's SPDR S&P 500. Over the ensuing two decades, individual investors have embraced ETFs as a low-cost way to get targeted exposure to different asset classes or the stock market as a whole.

With ETFs grabbing market share and headlines in the financial media, you may be wondering if you should abandon your mutual funds in favor of ETFs. While we believe ETFs can play an important role in a diversified portfolio, the short answer to this question, in our opinion, is no. But before we get into our reasoning, let's first review how ETFs operate and what makes them different from mutual funds.

Just What Is an ETF?

An ETF is quite similar to a passively managed index mutual fund. It holds a basket of stocks or bonds that tracks a benchmark index, such as the S&P 500 index or the Barclays U.S. Aggregate Bond index. The goal of each ETF is to replicate the performance of its benchmark index as closely as possible.

The primary difference between ETFs and mutual funds is in the way they are priced and traded. Mutual fund prices (what's known as the net asset value) are determined at the end of each trading day. Therefore, if you place an order to buy or sell a mutual fund, you won't know what price you are going to get until after the market closes for the day. ETFs, on the other hand, trade just like stocks. This means you can place a trade and get a near-instantaneous execution.

It's important to note that the ETF's price is established by the market, so the price you receive when buying or selling could be slightly higher or lower than the net asset value of the securities held in the ETF portfolio. While the spread is usually quite small, these price differences can add up over time, especially for active traders.

ETFs vs. Index Funds

One area where ETFs can have a distinct advantage over mutual funds is how much they charge in expenses. You would expect an actively managed fund to be higher priced, and hold the manager of that fund accountable to earning that higher price by outperforming his or market benchmark. But when it comes to index funds, most broad market index ETFs offer expense ratios that are lower than those of their index fund counterparts. For example, Vanguard's Total Stock Market ETF (VTI) now charges just 0.06%. The investor share class of Vanguard's mutual fund equivalent charges 0.18%. With the largest ETFs providers (BlackRock, State Street and Vanguard) engaged in an ongoing price war, these fees may go even lower in the future.

While ETFs' lower expense ratios may not seem to be much of a big deal, when compounded over longer periods, lower expenses will translate into higher returns. For example, if you invest $100,000 in an index mutual fund with a 0.18% expense ratio that grows at an average annual rate of 8% for 20 years, your investment will eventually grow to $449,600. But if you had invested that same amount in an ETF tracking the same benchmark, earning the same rate of return but with a 0.06% expense ratio, your investment would have grown to $460,534, a difference of nearly $11,000.

Keep in mind that in many cases you will pay a commission each time you trade an ETF. Therefore, investors who plan to buy ETF shares on a regular basis, such as by dollar-cost-averaging, may be better off in an index fund. Over the past few years, some brokerage firms have started to offer the ability to trade certain ETFs with no commission charges. Therefore, you may want to explore that option if you plan to invest in or trade a particular ETF on a regular basis.

ETFs Offer Tax Efficiency and Transparency
ETFs can be more tax efficient than mutual funds, because, unlike mutual funds, they will never need to sell holdings to raise cash to meet a surge in redemptions. Of course, if you actively trade ETFs, you will create taxable events that could render the ETF's tax efficiency meaningless.

There are situations when an ETF can also trigger an unexpected capital gain. This occurs when an ETF is forced to sell certain securities due to changes in the makeup of its underlying index or when the sponsor decides to close it. If the ETF's securities are sold at a profit, shareholders will incur a capital gains distribution.

In addition to lower expense ratios and greater tax efficiency, ETFs offer greater transparency. You can find out exactly what securities an ETF holds on a daily basis. With active mutual funds, this information is provided only on a quarterly basis. Most ETFs also do not suffer from "style drift," which is the tendency of some active fund managers to stray beyond their fund's stated objective. However, there are now multiple ETFs in each investment category, and many use different underlying indexes and/or different methodologies to track their chosen index. There can be a wide range of risk and performance issues in a single group of, for example, large-cap growth ETFs or aggregate bond ETFs. You can't just buy a label like "Large-cap Growth" and know exactly what kind of investment you are going to get. You should always check under the hood to make sure you know what you are buying and confirm that it is in line with your desired objective.

ETFs and Actively Managed Funds

When sizing up an ETF, it's important to note that the vast majority are "passive" investments. Rather than trying to outperform a benchmark index as actively managed mutual funds do, ETFs, like index funds, simply try to match their benchmark index's performance. So when considering ETFs, you also have to consider how they differ from the actively managed funds you're considering. And to do this correctly, Adviser Investments believes that you need to compare the track record of the manager (not just the performance history of the fund) with the track record of the ETF.

While history shows that the majority of actively managed funds fail to consistently beat their benchmark index over the long term, it does not mean all managed funds are underperformers. Given our position as the leading experts on Vanguard and Fidelity funds, and our extensive research on funds from dozens of other fund groups, we have achieved a strong record of identifying actively managed funds that deliver index-beating returns for our clients.

Our Approach to ETF Investing

At Adviser Investments, we believe both actively managed funds and ETFs can fill specific roles within a diversified investment portfolio. As the ETF market has grown more robust and options have become overwhelmingly plentiful, figuring out how to incorporate them into an investment strategy can be challenging. But we have a long history of doing so--dating back to 1998, when most advisors had never even heard of an ETF. Moreover, our firm's Chief Investment Officer, Jim Lowell, and our CEO, Dan Wiener, are both nationally recognized authorities on actively managed mutual fund and ETF investing.

Our approach is to use ETFs as a complement to both actively managed funds and index mutual funds. This allows us to reduce the overall cost of a portfolio while still giving our clients the opportunity to meet their investment goals.

About Adviser Investments

Adviser Investments and its subsidiaries operate as an independent, professional money management firm with particular expertise in Fidelity and Vanguard mutual funds. With 2,400 clients and over $2 billion under management, Adviser Investments is one of the nation's largest mutual fund research and money management firms. Our investment professionals focus on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is $350,000.

For more information, please visit www.adviserinvestments.com or call 800-492-6868.