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ETFs: Celebrating 25 Years

This January marks the 25th anniversary of the first ever Exchange Trade Fund (ETF) - the SPDRs S&P 500 - bearing the ticker symbol SPY. While index funds in the mutual fund wrapper have been around since 1975, the ETF is relatively new, though not as new as some might think. Much has changed since the first ETF began trading, and there is no question that the investment vehicle has become very popular with both institutions and individual investors.

To celebrate this innovative and widely used investment vehicle's 25th - anniversary, I thought it appropriate to revisit a piece I wrote back in 2013 on the "Facts & Fantasies of Exchange Traded Funds." For those interested in some deeper education on ETFs you can read the whole report on our website at www.baystatewealth.com. As for the here and now, I will use this space to highlight some more recent views and concerns around ETFs. I must point out, however, that the "facts" around ETFs have not changed since 2013, so this report will focus on some of the more popular "fantasies," or misunderstandings, around ETF investing.

Fantasy 1: An ETF is an Exotic Investment Vehicle

The basic definition of an ETF is as follows (emphasis added):

> A fund or pool of investments grouped together *based on a known and disclosed set of rules*, making it effectively an index fund. This pool is given a notional value at initial offering and then the market (i.e. investors or traders) determine the value of that pool in the aggregate as it trades on an exchange throughout the day.

On its face, the above definition may not appear to be clear or simple, but it certainly does not describe something that is exotic. The critical distinction of an ETF is in the italicized language; an ETF is governed by a disclosed set of rules. In simple terms, an ETF is a defined pool of securities whose value in the aggregate is determined by the weighted value of each underlying security.

Fantasy 2: ETFs are Complicated

Dispelling this fantasy is probably best done through looking at an example. State Street brought the first ETF to market in 1993. This particular ETF tracks the price movement of the S&P 500 US Stock Index and is identified by the ticker symbol "SPY". The price of a single share of SPY is equal to roughly 10% of the value of the actual index. Therefore, if the S&P 500 market index is trading at a level of 2600, then one share of SPY will be priced at roughly $260. Theoretically, should the value of the index rise in value by 5% to 2,730, the SPY ETF will be priced at $273. However, the price of the ETF and the value of the index rarely trade in lockstep, this is primarily due to the expenses incurred by the fund and other factors. Most often, any difference in price relative to the index is small and should be viewed as the cost of investing.

It should be noted that not all ETFs are this simple. In fact, the concept of an "active" ETF has emerged recently. Instead of passively following an index like the S&P 500 or Dow Jones Industrial Average, these "active" ETFs have an underlying management team making active decisions within a set of rules. This segment of the ETF market remains small, with only about 200 actively managed ETFs available for investing, and their assets account for a very small percentage of the total ETF universe. Further, according to ETF.com, 60 of the listed 200 actively managed ETFs were launched this year through the end of October. This space of actively managed ETFs is still in its infancy and may be a story about firms looking to enter the space, with the hope that active management could be a differentiator, or further, it could be an evolution of the mutual fund industry. At this point, it seems best to take a wait-and-see approach to this new and somewhat unique offering.

Fantasy 3: Most ETFs are the Same

It is simply untrue that most ETFs are the same. In a space that approximates roughly 1,800 ETFs traded in United States, it stands to reason that each ETF is somehow different from the next. And, the space continues to grow with some 240 new ETFs brought to market this year through November 30th, according to ETF.com (a leading website on all things in the ETF industry). Presumably, these new ETFs offer something different than the existing ETFs. Considering the competitive landscape for ETFs, if a new ETF is not different in terms of strategy, it may struggle to gain traction with investors. While new ETFs appear to be coming to market in droves, it is important to note that not all ETFs succeed, or are traded indefinitely. So far in 2017, 122 ETFs have closed and are no longer trading, according to both ETF.com and FactSet.

Undeniably, most investors invest in broad ETFs (i.e. the vehicles that track the major market indices), but it should be noted that there are ETFs with exposures targeting unique and specific sectors. For example, if investors would like to express a political view, they may choose to invest in an ETF such as GOP or DEMS. Each of these funds are actively managed ETFs which aim to track an index of companies that support the respective political interests of either the Republicans (GOP) or the Democrats (DEMS). Or, maybe an investor believes that consumers will no longer shop in stores and would like to capitalize on that. That person could invest in Proshares Decline of Retail ETF, ticker symbol EMTY. Apparently, this ETF will track the inverse performance (i.e. short) of the traditional brick and mortar retail stock prices. These ETFs are not strategies endorsed by BWM for reasons beyond the scope of this piece, but are all great examples of how unique and specific the exposure can be in the world of ETFs.

It bears repeating that ETFs can come and go with little notice. As mentioned above, 122 ETFs have closed this year, roughly the same number of fund closures as seen in 2016, but 20 or so more than in 2015. Most funds that close do so because there is not enough interest from investors to warrant the cost to maintain it. After all, it is expensive to support, manage, and market an ETF. No one has ever given me a definitive size where an ETF will be successful and can be sustained, and presumably the answer to that would depend on the sponsoring company's size. Considering that fund closure is a real risk for ETF investors, it is important to consult an ETF Closure Watch List as part of one's full due diligence.

All in all, if there are roughly 1,800 ETFs traded daily in the United States, it is of great importance for one to conduct a thorough due diligence process before hitting the "buy" button. The due diligence process will educate the investor on many important facets of the investment vehicle, including what the fund owns, the rules that dictate the underlying holdings, as well as the fund's size, and its ability to thrive and not be shuttered.

Fantasy 4: No Need to Research ETFs, Just Pick it by Name

This fantasy is also false, and can be the most misleading and often confusing aspect for investors when it comes to ETF investing. For example, there are two very popular US Small Cap ETFs, one offered through Vanguard, with the ticker symbol VB, and the other offered by iShares, with the ticker symbol IWM. Both sponsoring companies use the title of "US Small Cap" in their description, though as can be seen below, the performance in a given period of time can be vastly different. For example, in 2016, IWM was up 21.6%, while VB was up just shy of 18.5%.

Chart 1: Performance of Vanguard Small Cap ETF and iShares Small Cap ETF 01/01/2016 – 12/31/2016

Source: FactSet, Baystate Wealth Management

Conversely, so far this year, through November 30th, both IWM and VB are up above 15%. The astute investor would have to question how two securities, both presumably following a similar index of US Small Cap Stocks would have such different performance experiences in a given year.

Chart 2: Performance of Vanguard Small Cap ETF and iShares Small Cap ETF 01/01/2017 – 11/30/2017

Source: FactSet, Baystate Wealth Management

Looking deeper into the methodology of each ETF is key to understanding how it has performed in a certain market environment, and why. It is this look under the hood that will inform an investor in terms of performance attribution, as well as an understanding of how it may perform in the future. For example, when comparing VB and IWM, per Morningstar, and as laid out below, VB has 1,416 underlying holdings, while IWM has 1,986 holdings. That in and of itself should not be a big performance driver, but it is important for an investor to be aware of, if only to understand that one investment has more holdings (stocks) than the other. Digging deeper into the data, the Vanguard ETF holds 44% of its stocks in what Morningstar would deem to be mid-cap stocks. Thus, the remaining 56% of the stocks would be categorized as small-cap stocks. In comparison, IWM holds roughly 92% in what would be categorized as small cap stocks. (For reference, when referring to small cap, the reference is to a company's market cap; defined as the number of shares outstanding for a company's stock multiplied by the stock's price. The typical range for small cap market cap size is $300M to $2B.)

Table 1: Defining Characteristics of IWM and VB

Name	Vanguard Small Cap	iShares Russell 2000 Small Cap
Ticker Symbol	VB	IWM
# of Holdings	1,416	1,986
Average Market Cap ($)	3,813,000,000	1,826,000,000
% in Small Cap Stocks	56%	92%

Source: Morningstar®

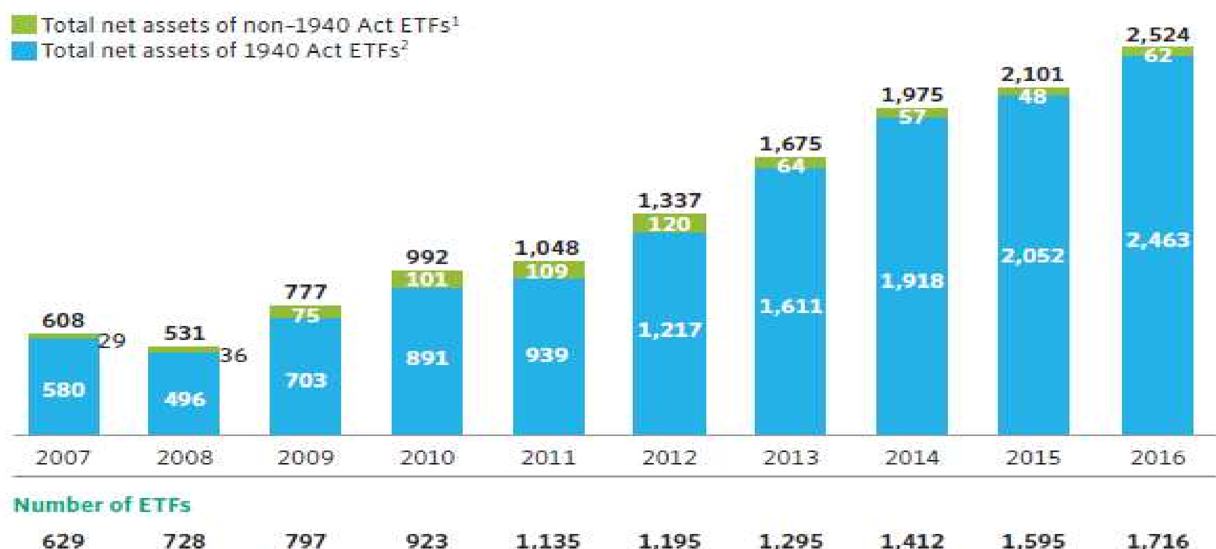
Because of Vanguard's large exposure to mid-cap stocks (almost half of the portfolio), the ETF will perform in a fashion that is more of a mix of both small- and mid- cap stocks (oftentimes referred to as "SMIDs"). In contrast, IWM has an average market cap of $1.8 billion, and holds 92% of its stock holdings in what would be deemed small cap stocks. Further, in 2016 mid-cap stocks, as benchmarked by the Russell Mid-Cap Index, returned 13.7% versus the pure small cap exposure found in IWM which was up 21.6% for the year. If you average those two together (equal weighting), one calculates a return of 17.65%, which is within 1% of the return on VB for the calendar 2016.

Another example of two ETFs with similar exposures, and the same title, is in the emerging market space. Blackrock's iShares emerging markets ETF benchmarks to the MSCI Emerging Markets as the underlying index, whereas the Vanguard version of the emerging markets ETF utilizes an underlying index provided by FTSE. Both ETFs are often quoted in the media as barometers for performance in emerging markets. Though, it must be noted that MSCI defines South Korea as an emerging market, giving the country a 16% weighting in the iShares ETF. On the other hand, FTSE defines South Korea as a developed country, and thus its ETF has 0% exposure to the country's stock market. Because of this ideological difference on the South Korean economy, in any given period, 2 investors, each invested in one of these emerging market ETFs, could have a very different experience. The gist of all of this is that, with ETFs, rules and definitions matter. When buying an ETF, looking under the hood to learn how a sponsoring company defines small cap stocks or emerging market stocks will determine an investor's true exposure and thus their investment experience. To be clear, it is not our belief that one ETF and/or Index is wrong and the other correct, but instead it is that one better fits our firm's definition of a market segment and thus becomes our desired investment vehicle.

Fantasy 5: Exchange Traded Funds are New Investment Vehicles

In January ETFs will be celebrating their 25th year of existence. As we celebrate this milestone, one must marvel at how the space has and continues to evolve. While it is true that the roughly $2.5 trillion in assets under management held in ETFs is dwarfed by the $16.3 trillion[i] in assets held in mutual funds, it is undeniable that ETFs are gaining traction. In fact, according to the Investment Company Institute, as shown below, ETF growth in both assets and the number of funds has only continued gain strength in recent years.

Chart 3: Total Net Assets and Number of ETFs ($Billions, year-end 2007 to 2016)



[1] The funds in this category are not registered under the Investment Company Act of 1940 and invest primarily in commodities, currencies, and futures.
[2] The funds in this category are registered under the Investment Company Act of 1940.
Note: Data for ETFs that invest primarily in other ETFs are excluded from the totals. Components may not add to the total because of rounding.

Source: Investment Company Institute

While it is true that the ETF is celebrating its Silver Anniversary, the need for due diligence and research on these ETFs has only become greater. As the above illustrates, even though the ETF structure is not exotic, the methodology for choosing the underlying stocks may be. And further, we have now learned that going by name alone may not give an investor the exposure they are looking for. As we cheer this investment disruptor on 25 years of growth, we also find ourselves humbled by the degree of research needed to fully understand the product itself.

As always, please call on us if we can be of service.

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[i] According to the Investment Company Institute 2017 Factbook