Manager's Report
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ETFs: Facts & Fantasies

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August Recap

In the face of ongoing concerns associated with rising interest rates, Fed intervention and the geopolitical risks surrounding the horrible events playing out in Syria, investors saw virtually all markets lose ground in August. As laid out below, only one sector of the major markets was positive last month, and that was commodities. Unfortunately, the strength in commodity prices was driven in large part by the uncertainty caused by the civil unrest and geopolitical concerns out of the Middle East, namely Syria.

Investment Index	August 2013 Return (%)	Year-To-Date Return (%)	Classification
Alerian MLP TR	-2.50	18.43	Master Limited Partnerships
Barclays Global Aggregate Hdg	-0.38	-1.15	Global Fixed Income
Barclays Global Aggregate	-0.52	-4.14	Global Fixed Income
Barclays US Agg Bond	-0.51	-2.81	Domestic Fixed Income
Barclays US Corporate High Yield	-0.61	2.71	Domestic High Yield Bonds
Barclays US Treasury 7-10 Yr	-1.11	-5.63	Domestic Fixed Income
Barclays US Treasury US TIPS	-1.45	-8.07	Domestic Fixed Income
DJ UBS Commodity	3.40	-6.16	Commodities
EURO STOXX 50	-2.35	5.86	European Equities
FTSE NAREIT All REITs	-6.23	-0.64	Real Estate Investment Trusts
MSCI ACWI Ex USA	-1.38	2.90	International Equities
MSCI ACWI	-2.08	8.81	Global Equities
NASDAQ Composite	-0.82	19.95	Domestic Large Cap Equities
Russell 2000	-3.18	20.03	Domestic Small Cap Equities
Russell Mid Cap	-2.66	18.89	Domestic Mid Cap Equities
S&P 500	-2.90	16.15	Domestic Large Cap Equities
STOXX Europe 600	-1.21	8.96	European Equities

Source:Morningstar Direct

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Facts & Fantasies around Exchange Traded Funds (ETFs)

In writing these monthly reports, we do our best to assist our readers in keeping up with the fast paced investment world. Recently our reports have focused on the fixed income markets and how interest rates were quickly adjusting to a world with more growth and potentially less Federal Reserve intervention. This month we are turning our focus to Exchange Traded Funds (ETFs), given that these investment vehicles are gaining more popularity by the day. Surprising to many investors, 2013 marks 20 years of ETFs and below we have laid out some of the facts and fantasies of the popular investment vehicle.

Fantasy 1: An ETF is an exotic investment vehicle

The basic definition of an ETF is as follows:

> A fund or pool of investments grouped together based on a rules based weighting scheme, 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 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. In simple terms, an ETF is a pool of similar securities whose value in aggregate is determined by the weighted value of each underlying security.

Fantasy 2: Index Funds are new relative to other investment vehicles

The "index fund", created by John Bogel, was initially launched at the end of 1975. The concept of an index fund is to own a basket of securities (the "index") as opposed to individual stocks. In the case of the first index fund, the basket was set up to replicate the makeup of the Standard & Poors 500 stock index. At the time investors could choose from many different investment options; however, the birth of the index fund gave investors the opportunity to capture the performance of "the market".

Advancements in technology allowed the ETF to be created in 1993, building on Mr. Bogel's idea of owning market exposure as opposed to attempting to beat the market. The advent of the ETF is an expansion on the concept of an index fund in that it is a pool of securities replicating an index. The primary difference between the two is that an ETF can be traded between investors throughout the day.

Fantasy 3: 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 carries the ticker symbol of "SPY". The price of one 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 1600, than one share of SPY will cost an investor roughly $160. Should the value of the index rise in value by 5% to 1,680, the SPY ETF will now be priced at $168. It should be made clear that the price of the ETF and the value of the index rarely trade in lockstep primarily due to the expenses of the funds and other factors. Though, most often any difference in price relative to the index is de minimis.

Fantasy 4: There are only a few ETFs available to investors

Most investors are familiar with indices such as the S&P 500 (SPY), the DJ Industrial Average (DIA), and the MSCI All Country World Index (ACWI), all of which can be traded as

ETFs. Though, it seems that most investors are not aware that there are several thousand indices globally, across all asset classes. According to the Investment Company Institute (ICI), there were roughly 1200 ETFs available to investors at the end of 2012. More recently, in doing a quick search on Morningstar, an investment fund watchdog, we found that there are over 1500 ETFs traded in the US and over 10,000 ETFs traded globally. Basically, there is an index for almost anything a rational investor would want. For example, there is an ETF that tracks the price of gold, and an index for utility companies, as well as multiple indices for Real Estate Investment Trusts (REITs). With the advent of new and more advanced technology, investors can now access parts of the market that were at one point available only to the super wealthy and connected investors. Through ETFs investors can participate in the performance of markets in China, Russia, Switzerland, Japan, and even in the currencies of those countries.

Fantasy 5: ETFs are not govern by regulators

Exchange Traded funds, as well as mutual funds, are governed by the Investment Act of 1940 and are registered with the Securities and Exchange Commission (SEC). In fact, it is often the case that the process of filing the ETF with the SEC for approval to trade on an exchange takes about one year. This is important in understanding how the actual investment is governed. With an ETF the investor truly owns a proportionate share of the underlying companies that make up the ETF. So in the prior example of SPY, which is priced at 1/10 of the value of the S&P 500 index, an investor holding that share of SPY lays claim to 1/10th of each company making up the ETF. This claim is backed by the firm producing and managing the ETF, which in the case of SPY is State Street Global.

Fact 1: ETFs are more liquid relative to Mutual Funds

One of the primary benefits of the ETF structure is its liquidity. Liquidity is often defined as one's ability to easily sell or buy something at a fair price. If something is liquid it is believed that there is a large market of potential buyers. Since ETFs trade throughout open market hours, they are presumed to be liquid. At any given time an ETF investor can find a counterparty willing to transact the investment, this is in contrast to how a mutual fund is traded. Although both vehicles are technically "funds", in that they hold more than one investment, mutual funds transact only once a day after the market closes at 4pm eastern standard time.

While it is true that historically there have been willing buyers and sellers in the market, making ETFs a liquid investment, it should be clear that these funds work in the same manner as a common stock. Market prices are determined by the forces of supply and demand, and should there be an instance when there is more supply than demand, an investment may sell for less than the desired price. The inverse is true if there are more buyers than sellers. These scenarios are commonly referred to as discounts and premiums. Most ETF providers work hard to reduce the effects of market imbalances, and for investors premiums and discounts are rarely an issue.

Furthermore, ETFs are traded exactly like ordinary stocks and therefore come with the same benefits. An investor can employ a "stop-loss" on an ETF just as one can with a stock. A stop-loss is simply the process of determining a price lower than the ETF's current price, and placing a trade to sell the ETF should that price be breached. Since mutual funds trade after market hours, there is no opportunity for an investor to know what price they would receive should they decide to sell (or buy) on any given day. This functionality of placing trades based on price and not simply on time, in part makes ETFs more liquid than mutual funds.

Fact 2: ETFs are low cost and transparent

ETFs, because of their structure, are cheaper than their mutual fund peers. In simplistic terms, a mutual fund must employ many analysts, pay for distribution, fund research and generally require larger expenses to remain competitive. An ETF eliminates the need for an active manager and thereby eliminates a high percentage of the expense. FINRA, the largest regulatory body of securities firms doing business with the public, commissioned Morningstar to compile the average expense ratios for mutual funds across different investment styles relative to their ETF counterpart. Their findings are listed below:

	Average Total Operating Expenses	
Fund Type	Mutual Funds	ETFs
US Large-Cap Stock	1.31%	0.47%
US Mid-Cap Stock	1.45%	0.56%
US Small-Cap Stock	1.53%	0.52%
International Stock	1.57%	0.56%
Taxable Bond	1.07%	0.30%
Municipal Bond	1.06%	0.23%

Source: FINRA

As for transparency, ETFs report their holdings each and every day and those holdings are made available on the firm's website. With this transparency an investor can monitor an ETF and determine the primary drivers of performance. This is contrary to mutual funds which report their holdings quarterly as mandated by regulation. Furthermore, mutual fund investors should care little about their holdings because when one invests in a mutual fund they are simply investing in that manager regardless of the underlying investments.

Fact 3: ETFs are tax efficient

Many investors tout the tax sensitive structure of ETFs. According to research done by ETF provider iShares, in 2012 43% of the largest mutual fund companies paid out capital gains in the tax year 2012. In contrast, during the same period, only 2% of ETFs managed by iShares paid out a capital gain. The composition and mechanics of ETFs, relative to their mutual fund counterpart, are the foundation of their inherent tax efficiency. Because mutual funds are actively managed, the underlying manager is often generating tax liabilities in the form of capital gains by selling the stocks that have appreciated. Sometimes these sales are driven by the ongoing research process and sometimes sales and tax liabilities are a byproduct of forced sales through investor redemptions. Either way, the tax liability is borne by the holders of the fund on a set date, regardless of when the investor purchased the fund.

An ETF by contrast is a basket of securities whose notional value is exchanged by investors through an open marketplace. In effect, the underlying companies of an ETF are not being sold but instead the basket is being exchanged, thus having zero or minimal tax liability exposure. (This is a simplified explanation of how ETFs are treated for tax purposes and should you have further inquiries please contact us directly.)

Fact 4: ETFs can be either passive or actively managed

While it is true that the majority of ETFs passively track a simple index such as the All Country World Index or the S&P 500, in recent years more actively managed ETFs have become available. For the most part, an actively managed ETF is simply tracking an index that changes its holdings or the weighting of its holdings based on specific guidelines or rules. Some rules underlying the management of an ETF are more complex than others. We often refer to the active management of ETFs as an ongoing "screening process".

In an actively managed ETF the management team will screen a pre-set group of investments, for example the 500 stocks of the S&P 500, against a set of factors. The index will then be weighted based on those factors, with the company with the highest factor getting the heaviest weighting and the company with the lowest factor getting the lowest weighting. A common actively managed strategy would be to weight stocks within an index based on fundamentals, such P/E ratios or price-to-book ratios, as opposed to the common weighting scheme of market cap (size).

Fact 5: ETFs are not an investment fad

The growth of the ETF industry has been well documented. Despite the fact that the industry as a whole remains smaller than the mutual fund industry, it continues to grab investors' attention and capital investment. According to the Investment Company Institute, as of the end of 2012 there were roughly 1200 ETFs available to US investors with roughly $1.3 Trillion in assets. This is up from a mere $83billion in assets spread across 102 ETFs back in 2001.

Are ETFs for Everyone and Every Asset Class?

Over the last 20 years the ETF has evolved, and this advancement in technology and evolution of an investment structure benefits the investor. ETFs provide investors with liquidity, transparency and a wider breadth of investment options and opportunities to gain market exposures. These are all great things and should be embraced. Though, it is imperative for each investor to understand what they own and how it works, above and beyond simply why they own it. Because there are many different ETFs, some of which track similar indices and others that are standalone, it is important to conduct the appropriate amount of research.

Finally, if an investor cannot find an ETF that tracks an index in a way that makes them feel comfortable, there is nothing wrong with going back to the old mutual fund model. ETFs may fit the majority of investors' needs, though there may be instances within certain asset classes where an investor may find added value in the type of active management that ETFs cannot offer. When this is the case, the most prudent decision may be to select a mutual fund for that exposure.

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

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