JUST A [TIKR]: THE SHORTFALLS OF ETF INVESTING

By: Round Table Wealth Management

Despite gaining widespread popularity, Exchange-Traded Funds (ETFs) are not an all-encompassing solution; they are just another "tool in the toolbox." For the do-it-yourself investor, ETF investing has a variety of shortcomings and presents unique challenges:

- ETFs cannot help an investor determine the proper asset allocation
- The sheer size of the ETF universe adds complexity to the investment process
- ETFs are not all highly liquid: trading small and midsize funds can be difficult
- ETFs can have misleading names relative to their underlying holdings

An Advisor can deliver great value and guide investors past these complications, providing comprehensive investment management which incorporates much more than just one "tool."

ETFS: A COMPASS WITHOUT A MAP

A compass is of little use if you don't know where you need to go. Investing is not very different: assets deployed without a proper plan are not nearly as impactful. When it comes to passive investing, ETFs have become everyone's favorite compass. They give a sense of direction, but don't reveal which path will get an investor to where he needs to be. While proponents of ETFs rightly cite the benefits of diversification and intra-day liquidity, the focus on the product itself seems to have overshadowed its *purpose* for investors, which is to provide exposure to an asset class as part of a portfolio. Financial innovation has increased the number of investment tools available to investors over the years, but the element that hasn't changed is the importance of **asset allocation** in achieving planning objectives. The questions of mutual fund vs. ETF, or even active vs. passive, are both completely secondary to the balance between equity and fixed income, for instance. Asset allocation is unequivocally the most impactful determinant of returns, and an ETF won't provide any answers there. On the contrary, an Advisor adds tremendous value in this regard through the careful development and monitoring of a portfolio as markets, regulations, and an investor's needs evolve.

THE COMPLICATIONS WITHIN TODAY'S ETF UNIVERSE FOR INDIVIDUAL INVESTORS

WHICH ONE IS THE RIGHT ONE?

As ETFs have become ever more popular, new fund sponsors have entered the market, while the top providers have continued to expand their offerings. As of December 2016, the U.S. ETF Universe has grown to over $2.5 trillion in assets across nearly 1,800 funds.[1] Of the roughly 1,600 passive U.S. ETFs, over 1,300 different benchmark indices are tracked! [2] Picking the right fund is a crucial task, as ETFs which seem alike on the surface may have meaningful differences in composition hidden beneath. Given the number and diversity of ETF offerings, the task for an investor trying to construct a diversified portfolio that will meet their goals can be rather daunting. However, an Advisor has the technical capabilities, resources, and expertise to sift through the sea of choices to identify the ideal investments, whether active or passive.

LIQUIDITY

Another aspect of ETF investing that individuals may find challenging or confusing at times is liquidity. ETFs have gained considerable notoriety as a highly-liquid asset, however that liquidity is mostly enjoyed by investors in the largest, most popular funds. Smaller, more specialized funds, or those simply with fewer assets, comprise the majority of ETFs available and have drastically lower liquidity. The less liquid the fund is, the more difficult and expensive it is to sell. For investors seeking to construct a more comprehensive allocation including alternative or international assets in less-liquid markets, relying exclusively on ETFs may not be the best way to invest. Owning an ETF with poor liquidity can really sting when markets sell off, leaving investors powerless as the losses pile up. ETFs unable to build enough assets or liquidity are also subject to being closed, which can force the realization of capital gains on investors as the fund is liquidated. This disastrous scenario is actually not as rare as one might think. **According to FactSet, over 120 ETFs shut down in 2016![3]** An Advisor can help accurately assess the liquidity risk of an ETF or access an investment strategy through a variety of other vehicles to successfully execute an investment idea.

WHAT'S IN YOUR ETF?

A less publicized risk ETF investors should be wary of is the representativeness of the ETF name itself. Often, it is easy to understand the purpose or underlying mandate of an ETF tracking a popular index such as the S&P 500. However, as previously mentioned, there are over 1,300 benchmarks tracked by ETFs, and not all of them are as familiar. Many ETFs are designed to track lesser-known indices which capture performance of illiquid spaces in the market or areas with few applicable companies. These ETFs can have allocations skewed towards a few stocks or sectors. Using the SPDR Emerging Middle East and Africa ETF (GAF) as an example, the name of the ETF gives the impression that a variety of countries across two continents are included in the product. However, due to the sizes of the underlying equity markets and liquidity considerations, roughly 75% of assets are invested in just one country, South Africa. (As it turned out, the fund was liquidated during the course of writing of this paper). Thus, the underlying holdings of an ETF may not be as diversified or representative of the investment objective as the name suggests.

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[1] Investment Company Institute, Bloomberg

[2] Estimated using data sourced from Bloomberg

[3] Kashner, Elisabeth. "Low Innovation, High Consolidation Mark ETFs in 2016." FactSet Insight, 19 Dec. 2016

THE BOTTOM LINE

ETFs have bridged the gap between index mutual funds and stocks, creating new pools of liquidity, while enhancing transparency for investors. Despite their benefits, it is important to remember that ETFs are a set of tools which still need a hand to guide them to their best use. The crux of the matter is that while there are passive investments, there is ultimately no such thing as passive investing.