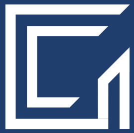

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VIEWS FROM THE BRICK

JUST BUY THE ETF

"Just buy the ETF and you'll be fine." This, or some derivative of it, has probably been said to each and every one of us in our investing experiences. You've even heard some of the most influential investors of all time take this stance (we're looking at you, Warren[1]). Even if you took that advice at face value, which one should you be buying? Never mind the fact that there's roughly 2,000 ETFs in the Morningstar database (that's not even all the ETFs available). ETFs aren't created equally and have come a long way in 25 years. Here's our response to someone who tells us to "just buy the ETF." Feel free to pass it along.

IT'S A WRAPPER, NOT A SOLUTION

Roughly 25 years ago, investors were introduced to the Standard & Poor's Depository Receipts (SPDR) first exchange traded fund (ETF) known as SPY. SPY is designed to track the performance, less of fees, of the S&P 500 equity index. This ETF was the first to reach the United States and today carries more than $279 billion in assets[2]. While SPY has grown into a staple in many investors' portfolios across the globe, this was simply the first taste of the investment vehicle that is the ETF.

Investors had long carried their exposures to the S&P 500 in one way or the other, but the construction of the ETF wrapper opened the flood gates to a technological revolution within investing. These exchange traded funds meant an intraday priced solution was made available that carried the diversification benefits of a fund. If you were familiar with buying and selling single stocks and liked the idea of diversification provided by a mutual fund, then you found your counterpart.

Rewind a quarter of a century and accessing the market wasn't nearly as easy (or cheap) as it is today. Broad index beta exposure might have been the first step in ETF investing, but as intelligent and innovative investors got their hands on the wrapper, it didn't take long for the real value of ETFs to be discovered. Soon enough, more niche and focused exposures were made available to investors within ETFs.

SOURCE: This presentation is solely for informational purposes and should not be taken as investment advice. For further information, please contact one of our investment adviser representatives. GFG does not maintain positions in any securities mentioned above. [1] State Street Global Advisors. [2] State Street Global Advisors.

A TECHNOLOGICAL BOOM

Like any other technological innovation in history, an introduction was followed by a boom. A big one. The ETF market went from zero to ~~100~~ 5,000 real quick. And more than 1,700 are based in the U.S. alone[3]. So let's go back to that recommendation to just buy the ETF. Which one did you mean? These products might have started as index funds with the intention of delivering broad market exposures to portfolios, but you don't come up with 5,000 ways to provide the same flavor. Ask Baskin Robbins, they know what's up. In fact, of the 2,000 ETFs in the Morningstar database roughly 12 (T-W-E-L-V-E) of them are broad U.S. market-based. Granted, these 12 account for one-fifth of the assets within the database[4], but that alone should end the perception that ETF is synonymous with index fund. Or even more importantly, "passive" investing. The rest of the universe is ETFs that focus on specific themes, criteria, sectors, industries, risk factors, countries and regions, etc.

VALUE IN OPTIONALITY

Now, the growth of the ETF industry does carry some risks, and we don't mean the idea of passive investing creating an investment bubble. That's a subject for a different post. The growth outlined above means plenty of subpar and reckless investment options have been presented to investors. But it also means anybody who is determined (or employed) to construct an efficient and purposeful asset allocation has a wide breadth of resources at their fingertips. In fact, while patient zero (SPY) was intended to satisfy institutional clients, the cost and accessibility of its descendants carry high appeal to retail investors. But if the true value in ETFs ended there, we wouldn't have an ETF market the size that we do ($4T[5]). We'd argue these investment products are most useful for the professional investor who is actively managing an investment portfolio.

These more niche exposure offerings find their way into actively managed mutual funds and hedge funds on a routine basis. Who's going to fault portfolio managers for acknowledging they can use some additional low-cost beta at a given time? Here's another scenario: You're an advisor who's done their macro homework and you've developed a thesis that a subsect of the market is poised to outperform. Maybe it's an industry, or a factor, or perhaps it's a region or even a country specifically. Do you amplify your market call by finding the *one* stock that is going to lead the way? If so, are you okay with that opportunity cost associated with delaying the deployment of your investment to find it? That single security risk? If you are, then I hope there's a glitch in Matrix and you picked the winner, Neo. Or do you develop your thesis and act on it before the rest of the market wipes out your alpha? Enter the ETF for said opportunity.

We won't dive too deeply into the struggles of actively managed strategies to outperform these lower cost solutions here; we've covered that on this site before. But our documented view of a smart combination of more "passively" managed strategies and pure active solutions is largely born from the concept of who would want to shrink the size of their tool box?

Just buying the ETF isn't what it used to be. Like the vehicle itself, its purpose has evolved in its short millennial lifetime. Maybe that's why it is so misunderstood.

SOURCE: Graph provided by Bloomberg. This presentation is solely for informational purposes and should not be taken as investment advice. For further information, please contact one of our investment adviser representatives. GFG Capital does not carry a position in any securities referenced. [3] Factset. [4] Financial Analyst Journal. [5] Factset.

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