
The Ins and Outs of Investing With ETFs



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Agenda

- ▶ What is an ETF?
- ▶ Why use ETFs?
- ▶ ETF Trading – Best Practices
- ▶ Core Building Blocks
- ▶ Tactical Tools
- ▶ Our Favorites
- ▶ Closing Thoughts and Q & A

What is an ETF?

What is an ETF?

- ▶ Like a mutual **Fund**
 - ▶ Regulated just like a mutual fund
 - ▶ Has a manager
 - ▶ Has a structured package of assets

What is an ETF?

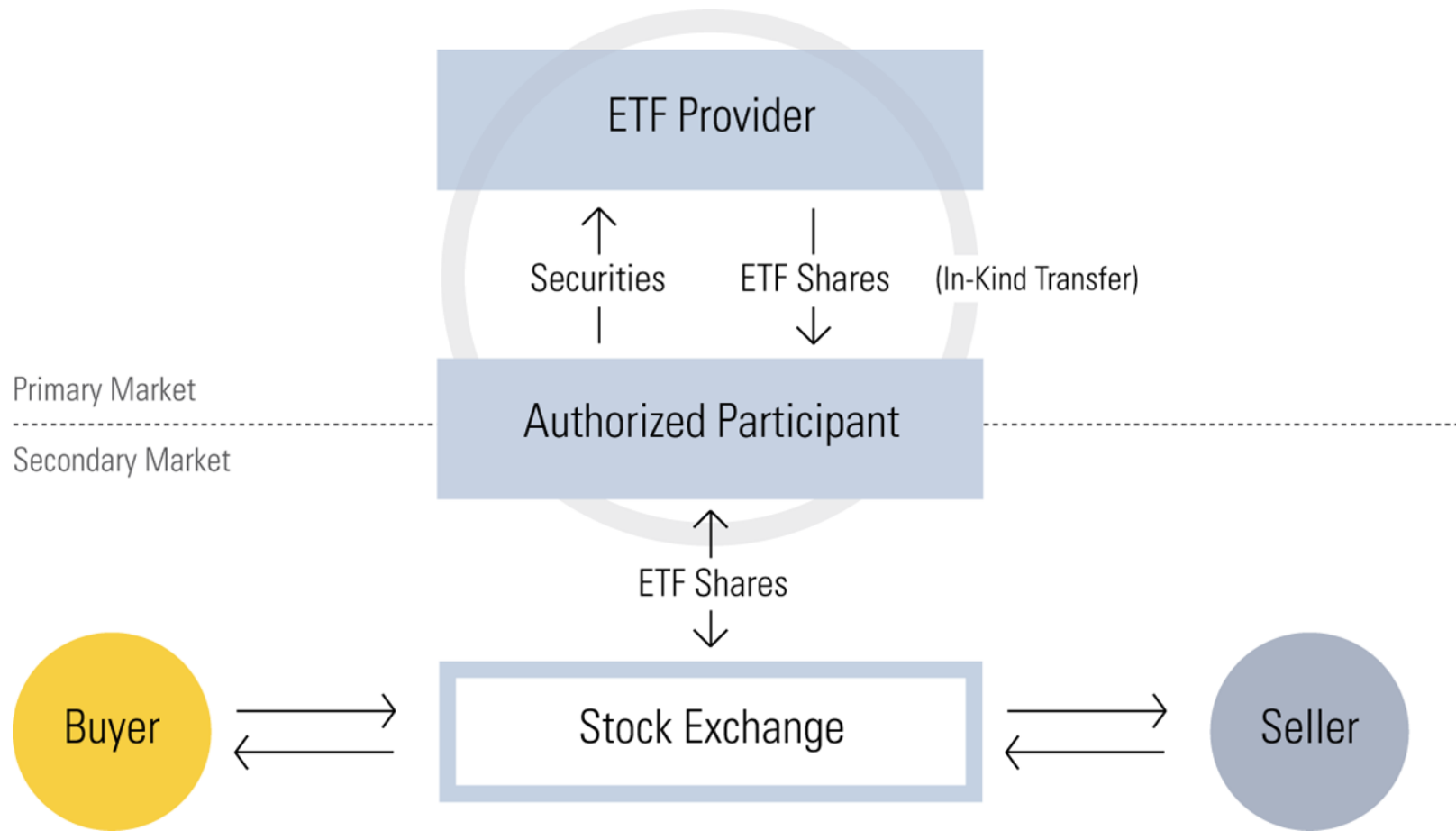
- ▶ But trades like a stock
 - ▶ Listed on an **Exchange** like a stock or closed-end fund
 - ▶ **Traded** intraday
 - ▶ Allows for stocklike strategies such as shorting and margin investing, but this flexibility entails complexity

Mutual Fund Creation and Redemption



Source: Morningstar

ETF Creation and Redemption



Source: Morningstar

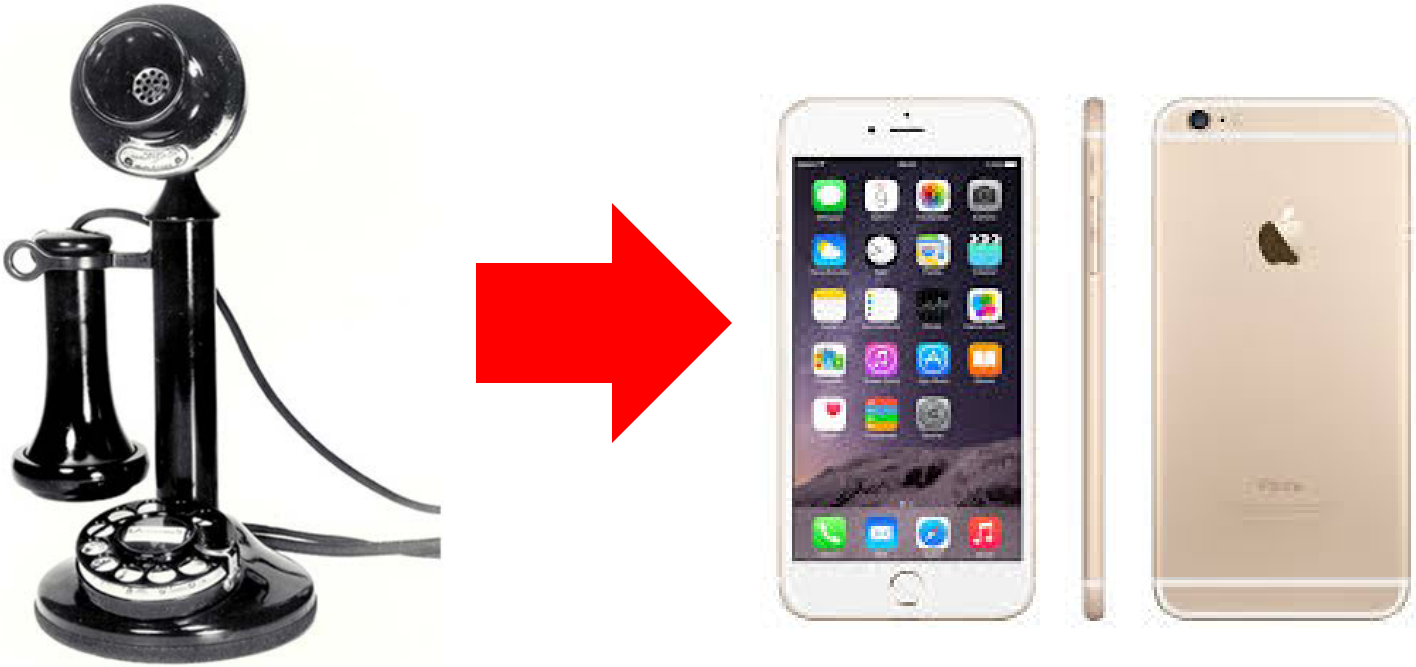
ETFs vs. Mutual Funds

Feature	ETFs	Funds
Diversified	✓	✓
Index Tracking	✓	✓
Actively Managed	✓	✓
Frequent Portfolio Disclosure	✓	✗
Intraday Trading	✓	✗
Daily Creation/Redemption	✓	✓
NAV-based Trading	✓	✓
Ability to Short Sell	✓	✗
Futures or Options Available	✓	✗

- ▶ The ETF wrapper is more flexible and more transparent than a traditional fund
- ▶ Differences in distribution are also an important consideration
- ▶ The most important factor remains costs

Source: Morningstar

A 21st Century Investing Technology



Source: Morningstar

A 21st Century Investing Technology

- ▶ ETFs are simultaneously a product of and a poster child for the Information Age
 - ▶ The computing power needed to support the “ETF Ecosystem” simply didn’t exist a few decades ago
 - ▶ Their success is in many ways reflective of global trends towards greater transparency, lower costs, and disintermediation

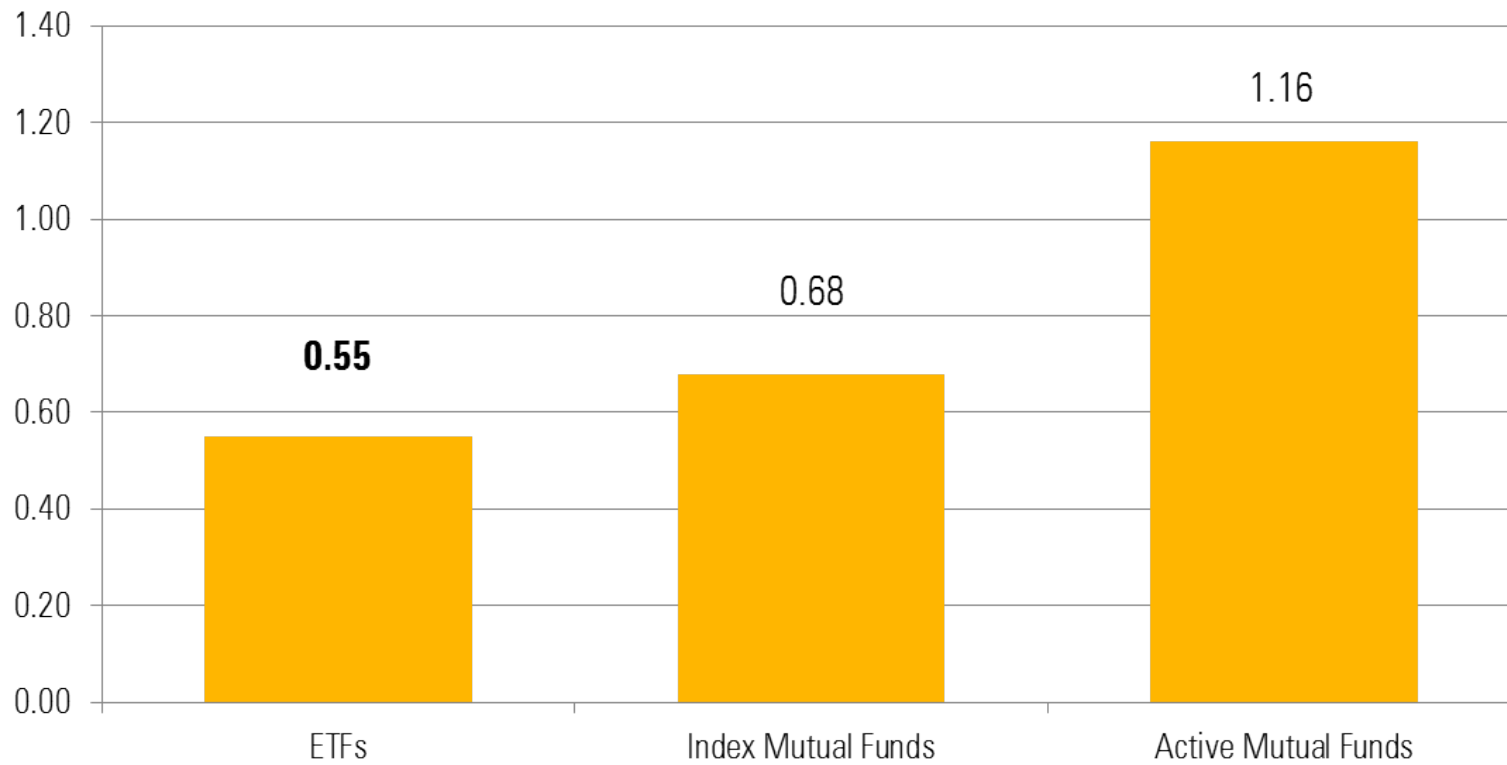
Why ETFs?

The Elements of ETFs' Appeal

- ▶ Low Cost
- ▶ Tax-Efficient
- ▶ Liquid
- ▶ Relative predictability

Cost Matters

Median Expense Ratio



Source: Morningstar

Cost Matters

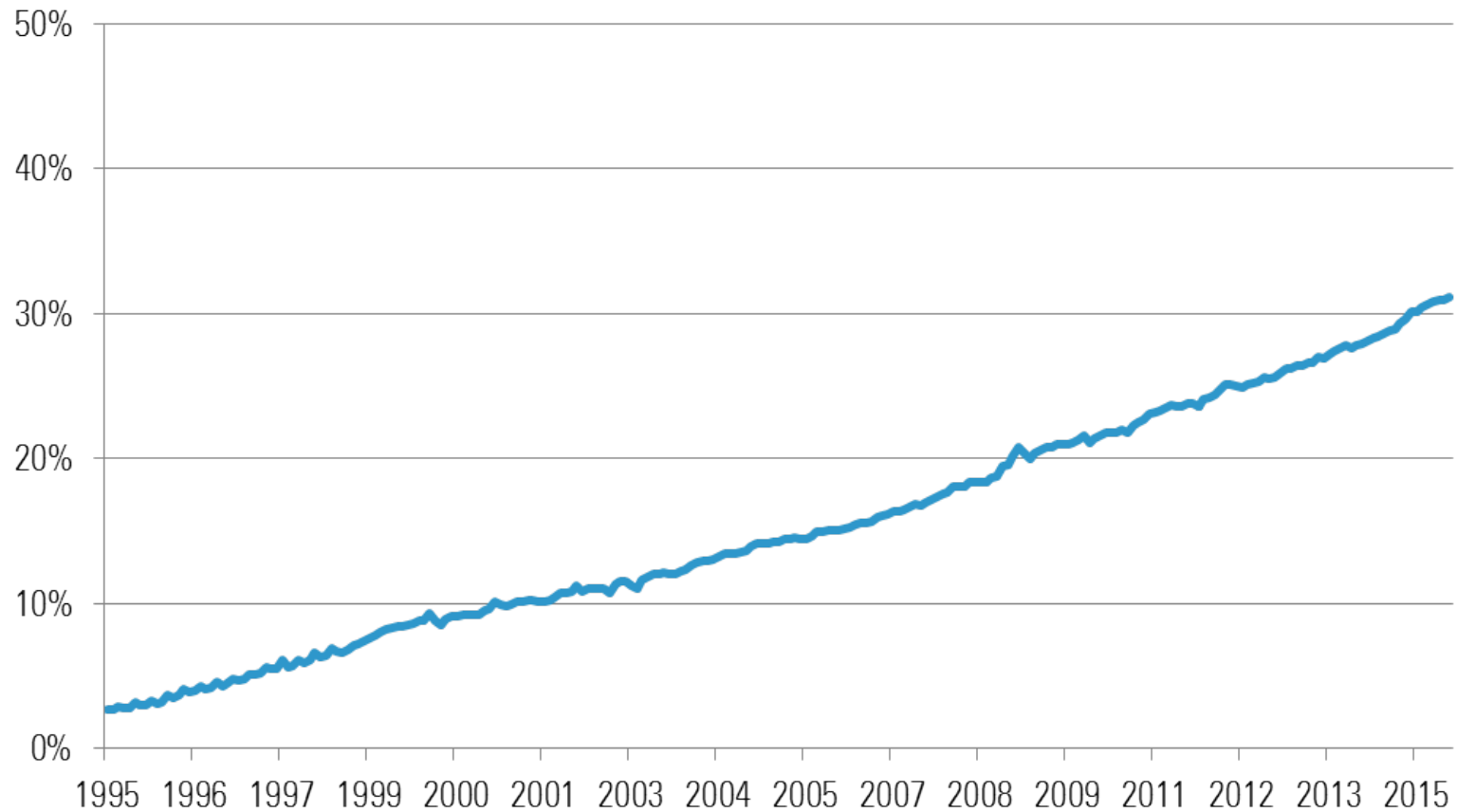
- ▶ "It must be the case that ... after costs, the return on the average actively managed dollar will be less than the return on the average passively managed dollar," William Sharpe, *The Arithmetic of Active Management*
- ▶ "I don't rely on the efficient-markets hypothesis. I go by the "cost matters" hypothesis," Jack Bogle, Vanguard
- ▶ "If there is anything in the whole world of mutual funds that you can take to the bank, it's that expense ratios help you make a better decision. In every single time period and data point tested, low-cost funds beat high-cost funds," Russ Kinnel, Morningstar

Active Funds' Success Rate by Category (%)

Category	1-Year	3-Year	5-Year	10-Year	10-Year (Lowest Cost)	10-Year (Highest Cost)
U.S. Large Blend	32.7	35.6	25.1	21.6	29.7	9.9
U.S. Large Value	21.3	49.0	25.4	38.2	66.3	18.6
U.S. Large Growth	42.3	26.0	12.2	16.9	28.9	14.2
U.S. Mid Blend	36.5	34.5	23.8	13.7	21.7	4.6
U.S. Mid Value	20.9	34.8	13.5	54.4	68.2	27.3
U.S. Mid Growth	48.0	37.0	31.1	26.8	47.1	13.4
U.S. Small Blend	40.7	35.5	37.1	38.9	35.7	34.2
U.S. Small Value	25.2	22.0	47.7	48.4	52.2	34.8
U.S. Small Growth	51.4	40.8	30.2	24.4	33.8	17.9
Foreign Large Blend	47.0	44.8	52.8	40.2	58.5	34.2
Diversified Emerging Markets	58.2	70.4	65.8	36.6	47.4	22.2
Intermediate Term Bond	47.9	73.0	69.7	42.4	54.9	30.5

Source: Morningstar data and calculations as of 12/31/14

“Passive Share”



- ▶ “Passive Share” – index fund and passive ETF assets as a % of US mutual fund and ETF assets

Source: Morningstar

Tax Efficiency

Median Tax-Cost Ratios (%) Across Large Blend Stock Funds

	1Y	3Y	5Y	10Y	15Y
Actively Managed Mutual Funds	1.70	1.18	0.83	0.77	0.70
ETFs	0.80	0.66	0.53	0.44	0.47
Difference	0.91	0.52	0.30	0.33	0.23

Source: Morningstar. Data as of 10/27/15.

Tax Efficiency

Capital Gains Distributions Across Large Blend Stock Funds

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Number of Mutual Funds	737	807	862	929	994	1053	1114	1199	1300	1385
Number Distributing Capital Gains	354	517	668	374	62	107	253	476	823	1088
% of Total Distributing Capital Gains	48%	64%	77%	40%	6%	10%	23%	40%	63%	79%
Number of ETFs	16	21	29	29	34	38	42	48	54	65
Number Distributing Capital Gains	0	0	1	0	1	1	1	3	4	5
% of Total Distributing Capital Gains	0%	0%	3%	0%	3%	3%	2%	6%	7%	8%

Source: Morningstar. Data as of 10/27/15.

Liquidity

- ▶ Handle with care
 - ▶ “I can't help likening the ETF to the renowned Purdey shotgun, supposedly the world's best. It's great for big-game hunting. But it's also excellent for suicide.” — Jack Bogle

Source: <http://www.bloomberg.com/bw/stories/2007-04-29/whats-wrong-with-etfs>

Relative Predictability

- ▶ Investors' expectations are crystal clear
 - ▶ You will get your "fair share of the market's return"
- ▶ Relative predictability lends itself to better behavior

Vanguard Total Stock Market Index Fund VTSMX				
	3Y	5Y	10Y	15Y
Total Return (% Annualized)	12.34	13.15	6.97	4.38
Investor Return (% Annualized)	12.68	13.59	7.77	6.45
Return "Gap" (% Annualized)	0.34	0.44	0.80	2.07

Source: Morningstar. Data as of 10/27/15.

ETF Trading Best Practices

Trading Best Practices

- ▶ **Use limit orders**
- ▶ Look before you leap
 - ▷ Premiums and discounts
 - ▷ Bid-ask spread
 - ▷ Do not trade during periods of extreme volatility
- ▶ Avoid trading near the open and the close of the market
- ▶ Try to trade when the market for the securities underlying the ETF is open and functioning
- ▶ If you don't place any value on intraday liquidity—consider an index fund instead

Core Building Blocks

ETFs are Ideal Portfolio Building Blocks

- ▶ Don't forget the KISS principle

	YTD	1Y	3Y	5Y
Bridgewater All Weather	-7.15	-7.14	-0.73	5.68
Bridgewater Pure Alpha	2.67	3.24	2.86	6.30
60/40 2 ETF Portfolio (VTI/BND)	-2.84	0.88	8.42	9.39

Source: Barron's, Morningstar. Data as of 9/30/15.

Tactical Tools

ETFs Can Also Be Used Opportunistically

Name	Ticker	Price/Fair Value	P/B	10-Year Average	P/E	10-Year Average	Price	12-Mo Simple Moving Avg
Materials Select Sector SPDR ETF	XLB	0.86	2.83	2.52	16.85	16.78	39.92	48.13
Energy Select Sector SPDR ETF	XLE	0.87	1.46	1.94	14.78	12.91	61.20	76.89
Financial Select Sector SPDR ETF	XLF	0.86	1.27	1.24	14.55	14.30	22.66	24.17
Industrial Select Sector SPDR ETF	XLI	0.91	3.38	2.71	17.26	16.79	49.89	54.98
Technology Select Sector SPDR ETF	XLK	0.91	3.76	3.03	18.67	18.43	39.50	41.51
Consumer Staples Select Sector SPDR ETF	XLP	0.96	4.36	3.38	22.29	18.09	47.19	48.44
Utilities Select Sector SPDR ETF	XLU	0.98	1.65	1.64	16.74	15.84	43.29	44.55
Health Care Select Sector SPDR ETF	XLV	0.90	3.49	2.87	21.18	18.84	66.23	71.32
Consumer Discret Sel Sect SPDR ETF	XLY	0.92	4.47	2.77	19.35	17.63	74.26	73.82

Source: Morningstar. Data as of Sep. 30, 2015.

Our Favorites

Our Favorite ETFs

- ▶ It shouldn't come as a surprise that our favorite ETFs are...
 - ▶ Low-cost
 - ▶ Liquid
 - ▶ Transparent
 - ▶ Tax-efficient
 - ▶ Tied to sensibly constructed benchmarks
 - ▶ Sponsored by strong stewards of shareholder capital

For Broad-Based Dirt-Cheap U.S. Equity Exposure

Vanguard Total Stock Market ETF ★★★★★		
VTI		
<i>Nuts and Bolts</i>	Expense Ratio (%)	0.05
	Estimated Holding Cost (%)	0.01
	Estimated Holding Cost - Expense Ratio (%)	-0.04
	Current Market Price \$	105.06
	Total Assets (\$Mil)	55,330
	Avg. Daily Volume (Trailing 3Mo, '000 Shares)	3,000
	Inception Date	5/24/2001
<i>Analysts' Take</i>	<p>Vanguard Total Stock Market ETF VTI covers the entire U.S. stock market for a razor-thin 0.05% expense ratio. It is the quintessential core stock holding, providing investors with an excellent choice for passive exposure to U.S. stocks. No other exchange-traded fund offers such a broad portfolio of U.S. stocks for such a low cost.</p>	

Source: Morningstar.

Best in Class Ballast

Vanguard Total Bond Market ETF ★★ ★		
BND		
<i>Nuts and Bolts</i>	Expense Ratio (%)	0.07
	Estimated Holding Cost (%)	0.04
	Estimated Holding Cost - Expense Ratio (%)	-0.03
	Current Market Price \$	82.13
	Total Assets (\$Mil)	27,090
	Avg. Daily Volume (Trailing 3Mo, '000 Shares)	2,400
	Inception Date	4/3/2007
<i>Analysts' Take</i>	Vanguard Total Bond Market ETF offers core fixed-income exposure at a very low cost. This broadly diversified fund of U.S. investment-grade bonds can serve as the anchor for the fixed-income slice of investors' portfolios.	

Source: Morningstar.

A Low-Cost Portfolio of High-Quality Dividend Payers

Schwab U.S. Dividend Equity ETF ★★ ★		
SCHD		
<i>Nuts and Bolts</i>	Expense Ratio (%)	0.07
	Estimated Holding Cost (%)	0.10
	Estimated Holding Cost - Expense Ratio (%)	0.03
	Current Market Price \$	39.02
	Total Assets (\$Mil)	2,730
	Avg. Daily Volume (Trailing 3Mo, '000 Shares)	594
	Inception Date	10/20/2011
<i>Analysts' Take</i>	Schwab U.S. Dividend Equity SCHD is a suitable core holding for investors who want a high dividend yield without tilting toward distressed and deep-value stocks.	

Source: Morningstar.

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