



What is an ETF?

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

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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

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Mutual Fund Creation and Redemption



Source: Morningstar

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**A 21<sup>st</sup> 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

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**Why ETFs?**

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**The Elements of ETFs' Appeal**

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

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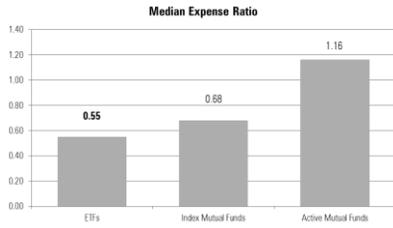
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Cost Matters



Source: Morningstar  
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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

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Active Funds' Success Rate by Category (%)

Category	1-Year	3-Year	5-Year	10-Year	10-Year	
					(Lowest Cost)	(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	39.2	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 10/23/14  
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Tactical Tools

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ETFs Can Also Be Used Opportunistically

Name	Ticker	Price/Fair Value	P/B	10-Year Average	P/E	10-Year Average	12-Mo Simple Price	12-Mo Simple Moving Avg
Materials Select Sector SPDR ETF	XLB	0.88	2.83	2.52	16.85	16.78	39.92	48.13
Energy Select Sector SPDR ETF	XLE	0.67	1.45	1.94	14.78	12.91	61.20	76.89
Financial Select Sector SPDR ETF	XLF	0.88	1.27	1.24	14.55	14.30	22.66	24.17
Industrial Select Sector SPDR ETF	XLI	0.91	3.38	2.71	17.28	16.79	48.89	54.98
Technology Select Sector SPDR ETF	XLK	0.91	3.76	3.03	18.67	18.43	36.50	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	18.74	15.84	43.28	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	19.25	17.63	74.16	73.82

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

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Our Favorites

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**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

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

<b>Vanguard Total Stock Market ETF ★★★★★</b>		
VTI		
<i>Mutual Funds</i>	Expense Ratio (%)	0.06
	Estimated Holding Cost (%)	0.01
	Estimated Holding Cost - Expense Ratio (%)	-0.04
	Current Market Price \$	106.06
	Total Assets (\$M)	65,330
	Avg. Daily Volume (Trailing 3Mo, '000 Shares)	3,000
	Inception Date	5/24/2001
<i>Analyst's Take</i>	Vanguard Total Stock Market ETF (VTI) covers the entire U.S. stock market for a razor-thin 0.06% 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.	

Source: Morningstar

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**Best in Class Ballast**

<b>Vanguard Total Bond Market ETF ★★★</b>		
BND		
<i>Mutual Funds</i>	Expense Ratio (%)	0.07
	Estimated Holding Cost (%)	0.04
	Estimated Holding Cost - Expense Ratio (%)	-0.03
	Current Market Price \$	82.13
	Total Assets (\$M)	27,090
	Avg. Daily Volume (Trailing 3Mo, '000 Shares)	2,400
	Inception Date	4/3/2007
<i>Analyst's 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

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A Low-Cost Portfolio of High-Quality Dividend Payers

Schwab U.S. Divident Equity ETF ***	
SCHD	
Expense Ratio (%)	0.07
Estimated Holding Cost (%)	0.10
Estimated Holding Cost - Expense Ratio (%)	0.03
Current Market Price \$	39.02
Total Assets (\$M)	2,730
Avg. Daily Volume (Trailing 3Mo, '000 Shares)	594
Inception Date	10/20/2011

Analyst Note
Schwab U.S. Divident 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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