How Exchange-Traded Funds Can Enhance a Portfolio

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An exchange-traded fund (ETF), as its name suggests, is a basket of securities that tracks a certain index or an active investment strategy and trades on a major stock exchange. Because they share some of the properties of mutual funds and have some characteristics of common stock, investing in ETFs can offer the best of both worlds — combining the flexibility of trading individual stocks with the built-in diversification and low costs of mutual funds.

At PFM, we believe that ETFs can play an integral role in helping our clients achieve their investment goals. In this InvestEd we will provide an overview of what they are, how they are used and note important considerations for investors.

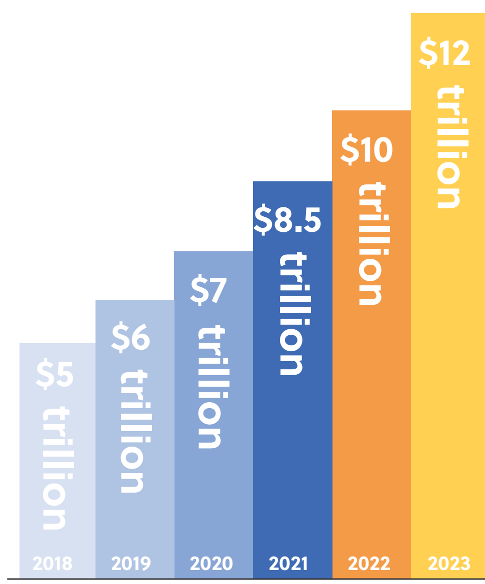
What Are ETFs?

ETFs share many characteristics with mutual funds, but with some key differences. Like mutual funds, ETFs offer the benefits of pooled investing, which include diversification, economies of scale, professional management and regulation. However, ETFs are unique in that they can be traded like common stock in designated exchanges. Trades can occur intraday, can be long or short, and options are often available for larger funds.

ETFs are offered in virtually all asset classes, ranging from traditional investments like stocks and bonds to alternative assets like commodities or currencies. While most ETFs are designed to replicate an index of securities (i.e., domestic and international equity, fixed income, commodities and foreign exchange), there is a growing list of ETFs that provide active management in similar fashion to mutual funds. There are also many ETFs that provide exposure to a specific sector, industry, factor or other strategy that is not typically found in a mutual fund vehicle.

Since the first ETF was introduced in the U.S. in 1993, the ETF universe has grown to roughly $5 trillion in assets under management. Experts expect global growth to reach $12 trillion by 2023.

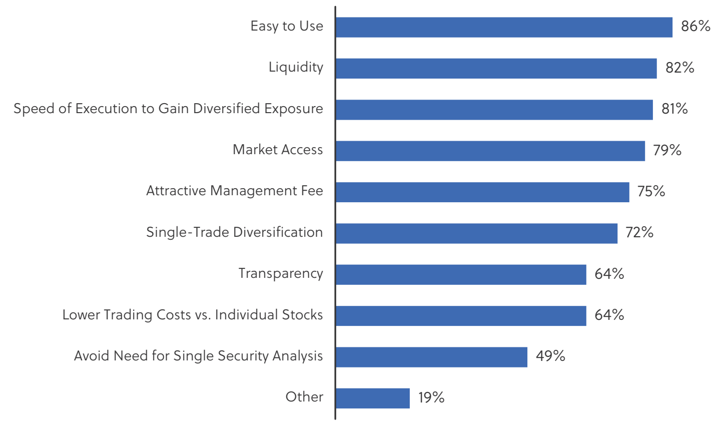
Chart 1: Potential Global ETF Asset Growth Trajectory



Source: BlackRock; Global Business Intelligence, as of April 2018.

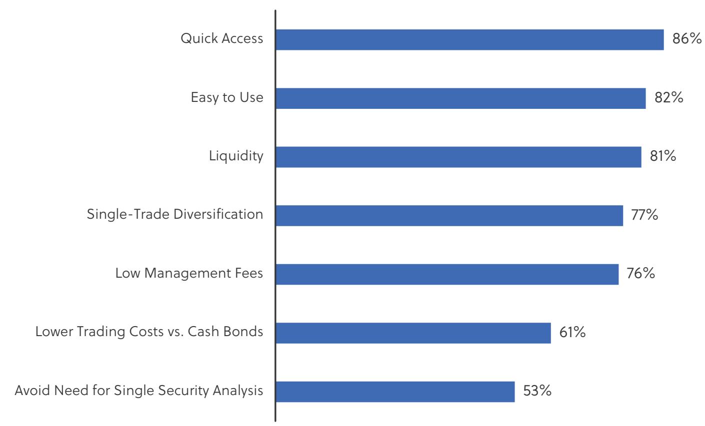
Much of the accelerated growth of this asset management tool is due to institutional investors increasingly using ETFs to gain quick, cost-effective market access to a variety of asset classes and exposures. PFM has used ETFs to gain passive exposure due to favorable fees when compared to similar mutual funds. We have also utilized ETFs to gain specific exposure to stocks that are expected to provide downside protection relative to the broad market. The following outlines some of the more common reasons institutional investors are using ETFs in client portfolios.

Chart 2: Top Reasons for Using Equity ETFs



Note: Based on 129 responses.
Source: Greenwich Associates 2017 U.S. Exchange-Traded Funds Study.

Chart 3: Top Reasons for Using Bond ETFs



Note: Based on 90 responses.
Source: Greenwich Associates 2017 U.S. Exchange-Traded Funds Study.

How Are ETFs Used?

- **Strategic Allocation** – Investors can achieve long-term market exposures at relatively low costs compared to mutual funds.
- **Tactical Adjustments** – Investors are able to increase or decrease allocations to almost any asset class and implement tactical ideas in an efficient manner.
- **Active Management** – Investors can use passive ETFs through dynamic allocations.
- **Portfolio Completion** – ETFs may help investors fill any gaps in underrepresented asset classes.
- **Transition** – ETFs can be used to help gain immediate market exposure to a desired asset class while a portfolio is still being constructed or rebalanced.
- **Liquidity Sleeve** – ETFs can be used to potentially meet upcoming liquidity needs in portfolios while reducing the drag on cash.

What Are Some of the Advantages of ETFs?

- **Low Cost** – In many cases, ETFs may be a lower-cost option when compared to traditional mutual funds.
- **Flexible Trading** – Unlike mutual funds that trade only at the end of the day, ETFs are traded throughout the day like stocks, which could provide greater flexibility in implementing an investment strategy. ETFs may also be an option for gaining temporary market exposure because they do not have any limits on redemptions or short-term trading fees like many mutual funds.

- **Transparency** – Unlike mutual funds, which show their holdings quarterly, ETFs provide daily holdings.
- **Wide Range of Options** – ETFs provide a significant range of options across all major asset classes, including many that are not typically found in mutual fund vehicles. This includes not only broad asset classes, but very specific strategies related to certain sectors, factors, etc.
- **No Minimums** – Most mutual funds may have minimum initial investment amounts, especially for their lower-cost share classes, while ETFs do not have any minimums.
- **Tax Efficient** – Although not an issue for most public and nonprofit investors, ETFs generally create fewer taxable events than most mutual funds. When mutual fund shares are sold, the fund needs to sell underlying securities, and any capital gains from those sales are passed on to investors. However, ETF shares are sold to other investors and therefore do not require any sales of the underlying investments to meet investor withdrawals.
- **Liquidity** – Although ETFs may have daily liquidity considerations (see below in Potential Disadvantages of ETFs - Liquidity Concerns), for institutional investors that is typically not an issue. The Authorized Participants, who create and sell ETF baskets to investors, can create large, institutionally significant-size baskets at low bid/ask spreads, which are not advertised nor indicated by publically displayed daily trading volume.

What Are Some of the Potential Disadvantages of ETFs?

- **Brokerage Fees** – Although the expense ratio for ETFs may be lower than the comparable mutual fund, the additional cost of brokerage fees should also be considered since it may offset the lower expense ratio.
- **Bid/Ask Spread Differences** – Unlike mutual funds that trade at the NAV of the underlying assets, ETFs trade based on the market price and often have a bid/ask spread that causes the purchase/sale price to differ from the NAV of the underlying assets. This may mean that you are paying a premium to buy the underlying assets or selling at a discount and may also cause some dispersion of returns versus the index it is tracking.
- **Liquidity Concerns** – Although most ETFs have sufficient daily trading volume and are highly liquid, the fact that selling shares of an ETF is dependent on having a buyer of those shares can be a concern for more thinly traded strategies. It is important to know the daily trading volume of the ETF and how it relates to the amount of shares the investor would like to purchase to help ensure there will be sufficient trading volume to sell those shares in the future.
- **Lack of Ownership of Underlying Securities** – While ETFs provide access to a wide variety of asset classes and securities, investors should remember that they do not directly own the underlying securities for a given strategy. Depending on an institution's investment policy, objectives and market conditions, this should be taken into consideration before purchasing an ETF.

PFM's Perspective

At PFM, we regard ETFs as tactical tools that can be useful adjuncts, and in certain instances, smart alternatives to mutual funds in response to specific portfolio challenges. Whether as a means of gaining quick exposure to a particular asset class or as a way to nimbly adjust a portfolio to its initial asset allocation target, to name a few examples, the judicious use of ETFs in portfolio construction can help us better serve our clients.