BLOG

The Pros and Cons of Exchange Traded Funds (ETFs)

Exchange traded funds (ETFs) have become a popular investment vehicle mainly because they are easy to buy, can be inexpensive, and can offer various levels of focus and diversification. However, as with any investment vehicle, ETFs have both benefits and disadvantages. In this post, I describe what ETFs are and outline some of the pros and cons. Additionally, I briefly describe the EQIS ETF Models. You can decide if ETFs, and in particular the EQIS ETF Models, are right for your clients.

What are ETFs?

ETFs are single securities that trade on market exchanges like a stock but consist of a portfolio of stocks and/or bonds. Typically, the primary goal of an ETF is to track an index, whether it is broadly followed or proprietary, by holding the same investments or market exposures of that index. For example, the SPDR ETF is supposed to adhere to the movements of the relatively broad S&P 500 Index. When the value of the S&P 500 goes up and down, the value of the SPDR ETF is designed to go up and down with the index. Another example is the XBI ETF, which is supposed to mimic the movements of the relatively narrow S&P Biotechnology Select Industry Index.

Pros of ETFs

1. ETFs offer diversification opportunity

ETFs are intended to provide for easy diversification. The ETF and its index can be either broad or narrow, leading either single or multiple ETFs to achieve various levels of diversification. For example, if an investor is interested in buying some biotech stocks but doesn't know which stocks to buy, a good option is an ETF that consists of a few dozen biotech stocks that are represented in the index or industry. If an investor is interested in a broadly diversified portfolio of stocks but doesn't know how to start or how to diversify, then an ETF that mimics a broad index that consists of a wide variety of stocks from different industries, sectors, or geographic regions may be a good choice. Buying an ETF is one of the easiest ways to invest in a diversified portfolio and add diversification to an existing portfolio of stocks.

2. ETFs are easy to buy and sell

Because ETFs are actively traded on an exchange, any time an investor wishes to buy or sell an ETF, it usually can be done quickly and at a fair price. In finance jargon, this means that ETFs are “liquid” investments. This liquidity effectively allows an investor to buy or sell many stock exposures in a single transaction rather than multiple individual trades. This is unlike investing in non-exchange traded investments like real estate, private firms, private equity, or other illiquid investments. With many real estate investments, for example, it may be difficult to find a buyer or a seller quickly at a fair price.

3. ETFs are typically not expensive

An ETF usually costs less than a mutual fund, which is another type of diversified portfolio.[1] This is primarily because ETFs tend not to be actively managed, nor are they subject to some of the expense of traditional mutual funds. Again, ETFs seek to passively track an index, so they are easy to create and do not require active, ongoing management, other than quarterly adjustments responding to any changes to the index. Also, ETFs are not subject to the same tax impact as active mutual funds, which must pass through the fund's cumulative realized gain and loss on a pro rata basis to investors periodically, whether the investor was an owner at the time or not.

Cons of ETFs

1. ETFs are not actively managed portfolios

Because ETFs are typically designed to track an index, they generally are not actively managed portfolios. However, in certain cases, active management may be beneficial, if the result is that the manager beats its benchmark. Additionally, some active managers incorporate defensive strategies seeking to add protection against losses and lock in gains. They try to make sure the portfolios do not fall in value when there is a market downturn by actively adjusting in response to economic and market indicators. This kind of active oversight and trading typically does not occur within an ETF.

2. ETFs are bundled investments

ETF investors cannot separate or exclude specific stocks and/or bonds in an ETF. For example, if an ETF contains a holding that an investor does not wish to own, that stock cannot be excluded from the ETF. This can give rise to two significant concerns:

A. ETFs may limit tax harvesting potential. If one of the stocks in the ETF loses value, investors cannot realize losses on that specific stock for tax purposes. However, in some cases, ETFs can be more tax efficient than mutual funds.

B. A bundled investment such as an ETF may limit an investor's ability to be an “impact”

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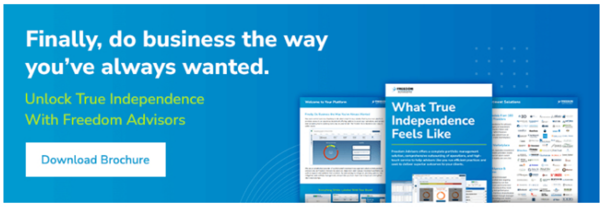
investor. For example, if they want to invest in a broadly diversified ETF, but do not want to own stock in firms that sell tobacco or alcohol, or use fossil fuels, you cannot request for those specific stocks to be excluded from an ETF that already contains those stocks.

EQIS ETF Models

We offer ETF models spanning a variety of investment philosophies, including strategic, tactical, and income, across five risk categories, from conservative to aggressive. Each model is built to address a unique investment goal, supported by a professional investment team and a sophisticated risk-management process.

Each model uses multiple ETFs and strategies tailored to investors seeking a straightforward solution for their investing goals while taking advantage of an ETF's tax-efficiency and lower cost. This design is intended to seek a reduction in risk and to provide potential for good performance in the long run. Additionally, our approach and limited holding by ticker in the portfolio sometimes makes it easier to examine the portfolio and its transactions.

Our ETF models are constructed and managed in line with the our market outlook and allocation process. Our allocations philosophy is founded on the four pillars of diversification: asset classes, equity styles, geographic regions, and investment philosophies. The ETFs used in our models are initially screened by the our investment team using a rigorous due diligence process, and ETFs chosen for our investment programs are additionally subject to ongoing due diligence reviews.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(1) https://www.investopedia.com/articles/investing/102915/why-are-etf-fees-lower-mutual-funds.asp

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