

## **Make it: ETFs and New Investing: Our Approach**

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The proliferation in Exchange Traded Funds (ETFs) over the past decade has vaulted them into the mainstream of the investment community. Since the introduction of the Standard and Poor's Deposit Receipt (SPDR) in 1993, ETFs have grown to \$534.5 billion in assets with 758 U.S.-listed ETFs as of the end of 2008. Despite the bear market in 2008, ETFs enjoyed \$178.4 billion in net inflows which made them the fastest-growing area of the fund industry. Trading volumes for ETFs also skyrocketed in 2008. Almost \$25 trillion worth of these fund vehicles were traded on U.S.-based exchanges in 2008, an increase of 70% over 2007. By comparison, the volume of U.S. equities (excluding ETFs) traded in 2008 increased only 10% year-over-year.

The volatility in the equity markets over the past 18+ months has brought the importance of the benefits of ETFs to the forefront of the market place. The liquidity, transparency and diversification inherent in the structure of these vehicles all became highly desirable investment attributes during the downturn. Clients holding equity positions during 2008 could have mitigated some of their losses by owning diversifying ETFs in fixed income, commodities, and currencies. The speed and low cost of trading ETFs made prudent asset allocation decisions, such as moving assets into cash-equivalents, less onerous for investors. The liquidity and transparency of ETFs also provided a balance for anyone struggling with lock ups in hedge funds or auction rate securities. Certainly lower trading costs, availability of diversifying asset classes, and easy access to funds are draws for the individual investor, but the same benefits appeal to the professional money manager.

Turning to performance, it may seem intuitive that stock pickers would outperform broadly diversified indices during the worst of the market declines. The data does not bear out this conclusion. Although active managers have the tools at their disposal to identify the relative outperformers, they fail to beat their passive benchmarks a majority of the time, especially after accounting for taxes and fees. Confronted with this evidence, clients are becoming wary of paying higher fees for active management with the hopes of beating the benchmark, the performance of which may be easily replicated by an ETF.

The facts are straightforward. According to Morningstar, 58% of all actively-managed funds underperformed their benchmark index in 2008. Large-cap U.S. equity funds lagged the S&P 500 index at a rate of 62%, as did 63% of all U.S. diversified equity funds. Though conventional wisdom holds that funds which invest in "less efficient" areas of the market, where company information is more scarce such as small caps, have a better chance of beating their benchmark. This did not bear out in 2008 either. In fact, 72% of small-cap managers underperformed their benchmarks.

History does not bode well for active management even in a market recovery. After the last recession ended in late 2001, the U.S. equity market began to rebound in October 2002. In the

following 12 months, 78% of U.S. managed equity funds underperformed their benchmarks. Once tax implications are considered, even fewer actively managed funds reach the hurdle of outperforming their benchmarks. Since ETFs have lower portfolio turnover, they tend to generate fewer capital gains than active management. Due to their exchange-traded structure, investors are not exposed to forced securities sales to meet redemptions.

ETFs also provide an easy avenue to take advantage of tax loss harvesting for clients without changing their desired asset class exposure. The proliferation of ETFs means that there are multiple choices of investment vehicles within the same asset class. While selling Coke and buying Pepsi may not provide equivalent investment performance and risk, swapping two ETFs within a particular asset class may offer a more comparable investment profile.

A broadly diversified portfolio of liquid, transparent, and cost-effective ETF investments is the best way to meet investors' goals through both bull and bear markets. ETFs provide a pure asset class return, which lets the asset allocation work over time. They eliminate the problem of fund manager turnover, and provide liquidity and diversification to investors with illiquid investments such as real estate and private equity. With these uncertain markets, investors want easy access to their money and a clear investment strategy. No investment tool available today provides better liquidity, transparency and diversification than ETFs.