

ETF Investor

Investing & trading with exchange-traded funds (ETFs) and closed-end funds (CEFs). Strategies & analysis but no buy or sell recommendations.

Approaching Paradigm Shift For Wealth Management?

Tyler Mordy, a Research Analyst with [Hahn Investment Stewards](#), wrote an excellent overview of wealth managers' 'revolutionary shift' to ETFs. ETFs' 'threat to the typical business model of asset management firms is enormous,' says Mordy. We reprint the essay here in its entirety, complete with charts:

It's always difficult to recognize the beginnings of a revolutionary shift when in its infancy. Often, only when accompanied by hindsight can we be certain that a fundamental change has in fact occurred. Fortunately, when discussing the impact of exchange-traded funds (ETFs) on the wealth management industry, both individual investors and institutional money managers have been given more than one reason to acknowledge the colossal shift underway.

While not heralding the end of active management, the arrival of ETFs argues enthusiastically for avoiding high-priced stock selection fees and embracing active strategies only where it counts most: asset allocation. If the wealth management industry has only one reason to fear ETFs, it is that they can supply the lowest cost pure exposure to most investment categories. Lower investing costs equate to lower revenues and profits for the typical financial services firm.

Further, ETF suppliers, highlighting the low costs associated with ETFs, tend to illuminate the fees other management approaches are charging for their services. Many fee schedules, not readily disclosing total costs, have been extracted for public examination. Wealth managers ideally are in the business of stewardship – safeguarding and growing client capital using the best available tools at acceptable risks. Higher fees can only frustrate this objective.

ETF Advantages over Mutual Funds

Using ETFs, astute investors and professional managers alike can achieve an active asset mix with widely-diversified investments that have transparent holdings, no specific equity or corporate fixed income risk, intra-day pricing and greater tax efficiency. Unlike pooled funds or mutual funds, ETFs can insulate portfolios against the activities of other unit holders. Since these listed securities are held directly by the client, capital-gain or loss events are usually only triggered when a position is sold, and not by outside unit holders, as may be the case with mutual funds. ETFs also eliminate some of the uncertainties inherent in mutual funds. While mutual funds usually release security holdings quarterly with a substantial delay, ETF holdings are revealed daily.

Moreover, instead of purchasing shares intraday at prices to be determined after market close, ETFs are continuously priced throughout the trading day.

The main drawback to ETFs is the costs incurred when buying and selling. Opponents point out these frictional charges render ETF investing inappropriate for active traders. While excessive trading with ETFs will significantly dampen returns, high turnover mutual funds share the same disadvantage. Investors using ETFs for a longer term investment program should strive for low turnover and only implement strategy shifts that stand to make a material impact upon long-term performance.

Having a disciplined framework for the implementation and rebalancing process will limit unnecessary rebalancing and ensure that low total expenses are maintained. Over time, these activities provide a sure way of improving returns. After all, costs can

be controlled much more easily than future returns.

Focus on Asset Mix

It is well documented that over the long-term and after fees, most equity fund managers do not consistently outperform their benchmarks. The facts speak for themselves. The table below shows the number of equity fund managers outperformed by the index. During the 20 year period surveyed by Dr. Burton Malkiel, the Chemical Bank Chairman's Professor of Economics at Princeton University, only 10% exceeded the comparable index return. A similar experience applies to bond mutual funds.

Percent of Large Capitalization Equity Funds Outperformed by Index

S&P 500 versus Large Cap Equity Funds

1 Yr	73.00%
3 Yrs	72.00%
5 Yrs	63.00%
10 Yrs	86.00%
20 Yrs	90.00%

Source: Dr. Burton G. Malkiel, "Asset Allocation and the Case for Indexing Canadian Annual Derivatives Conference of the Montreal Exchange"; Period ending December 31, 2003

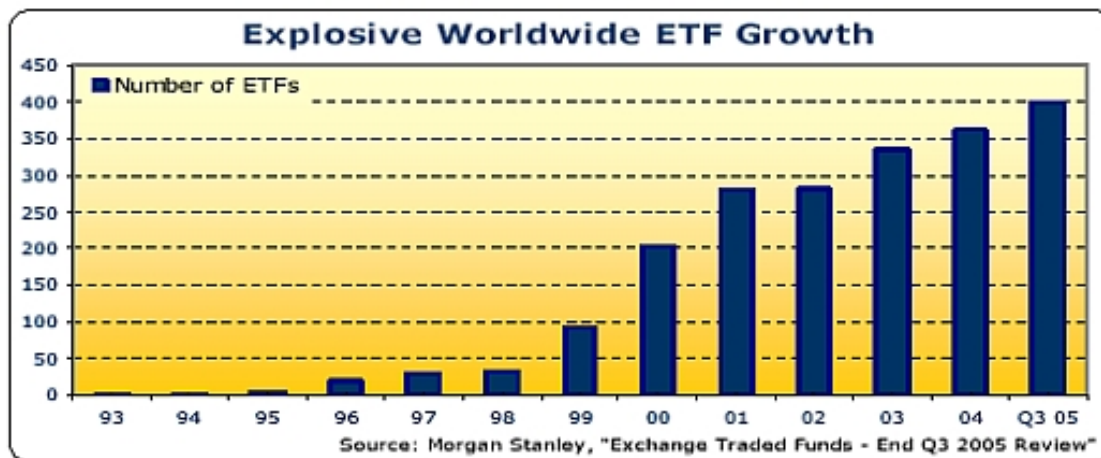
Asset mix management, the practice of dividing your investments among varying asset classes, has been shown to be a much more reliable approach for securing higher returns over the long-term.

The enlightening Brinson et al. studies have concluded that over 90% of performance variation can be attributed to asset allocation decisions. Therefore, investment programs should focus on ensuring an appropriate asset mix and keeping costs low.

Tools for Navigating All Market Conditions

ETFs equip investors with a comprehensive range of low-cost alternatives to accessing different asset categories including overseas markets, government and corporate bond markets and alternative assets ranging from precious metals to industrial commodities. Both the US and Canadian mutual fund industries are flooded with domestic-focused funds. Although Canada's equity market, as measured by market capitalization, accounts for just 3.2% of developed market capitalization, the mutual fund industry is dominated by Canadian-centric funds.

In contrast, ETFs offer investors wide-ranging exposure to almost any international sector, style and capitalization play at a fraction of the cost of mutual funds. According to Morgan Stanley's latest quarterly global ETF report, 66 new ETFs have been launched year-to-date bringing the total to 400 ETFs available worldwide (not including cross-listings). Correspondingly, average trading volumes of ETFs have increased a whopping 39.9% year-to-date. With the increasing number of internationally indexed ETFs cross-listed on domestic exchanges investors have the benefit of avoiding costly currency translations and other foreign related brokerage fees.



ETFs also supply exposure to emerging markets – both at the national and regional level. In many developing countries, favourable demographics, healthy country balance sheets, bulging foreign exchange reserves and attractive relative valuations all bode well for future returns. However, accessing these markets, let alone picking stocks in them, can be a difficult undertaking. Markets are often less liquid, there are higher transaction costs and dealing in foreign currency discourages most investors. In the mutual fund world, exposure to emerging markets is usually tied in with a hefty management expense ratio (MER) while ETFs tracking broad emerging markets indexes start at only 30 basis points.

Fixed Income ETFs carry even lower MERs, some charging as low as 15 basis points. Trading on exchanges similar to their equity brethren, pricing transparency, historically only available at the institutional level, has been a breakthrough for individual investors. The other key advantage is maintenance of a constant maturity. Without directly purchasing bonds and rolling them over at maturity each time, preserving durations in the fixed income component of their active strategies becomes much more convenient.

Although total ETF assets under management are up 16.1% ytd at just over 359 billion US dollars, this still pales in comparison to the monstrous mutual fund market. Recent ETF product innovations, however, are outshining their pooled rivals. Perhaps the most exciting development for investors has been the industry's forays into alternative investment classes – that is, investment categories that have a low or even negative correlation to core equity and bond markets such as precious metals, commodities or hedge-like vehicles. Traditionally, most investors have avoided these categories due to the costs and difficulty accessing specific markets, regulatory constraints or merely a lack of coverage in the mainstream media.

Last year's landmark introduction of a gold bullion-backed ETF (NYSE: GLD) initiated fierce competition among ETF providers. Since then, filings to release alternative style ETFs include indexes following foreign currency (paying interest), criteria-based, oil, silver, leveraged equity and the much anticipated broad-based commodity ETF from industry giant Barclays Global Investors.

The benefits of these types of investments are numerous — avoidance of unfamiliar futures markets, no transportation and storage fees, and effortless tracking to name a few. With the advent of inversely-indexed ETFs (several already available in Europe, many in registration with the SEC), investors - even in registered accounts - can now implement sophisticated, transparent strategies, effectively incorporating both long and short positions without voyaging into the murkier and much pricier world of hedge funds.

Conclusion – The Future of Investing

With money market vehicles offering low real returns and developed equity markets clinging to expensive valuations, securing long term healthy returns will be more challenging than ever. ETFs have granted investors the opportunity to divert holdings

from conventional investments into asset classes with more attractive valuations and greater growth prospects.

Combined with prudent asset allocation strategies, ETFs are bringing sophisticated investment options, traditionally reserved for high net-worth or institutional sized portfolios, to the individual investor at far lesser cost. Wealth managers can now assemble quality global portfolios exclusively using ETFs, allowing them to lower their fees and pass the savings onto clients. The threat to the typical business model of asset management firms is enormous.

.....

Tyler Mordy is a Research Analyst with Hahn Investment Stewards & Company Inc., an investment counselor providing sophisticated portfolio management services using exchange-traded funds. He can be reached at tmordy@hahninvest.com or visit the firm's website at www.hahninvest.com.

