EXCHANGE TRADED FUNDS

This is one of a series of Research Briefs created by Brinton Eaton to keep our clients informed about key developments — in financial planning, tax strategy, and investment management — that we research and implement as appropriate on your behalf.

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At Brinton Eaton, we regularly make use of “exchange traded funds” (ETFs) in client investment portfolios. What are ETFs? How do they differ from mutual funds, and what are their relative advantages and disadvantages? How are we using them to manage your portfolio? This Research Brief attempts to answer these questions at a high level. Please do not hesitate to contact us for a more detailed discussion.

ETFs Described

ETFs were introduced in the U.S. in 1993 and have become very popular, in fact, more popular than mutual funds at a similar age. ETFs are investment vehicles that are a lot like mutual funds but trade like stocks.

Both ETFs and mutual funds provide instant diversification by owning a large number of individual securities. Like a passively-managed mutual fund, ETFs are generally designed to replicate the performance of specific underlying indexes, such as the S&P 500 Stock Index or the Barclay’s Capital Aggregate Bond Index.

Like stocks, ETFs can be traded throughout the day, be bought on margin, and sold short (though, as you know, Brinton Eaton generally does not employ margin buying or short selling of any security in any of our client accounts). An ETF share’s net asset value (NAV) is derived from the aggregate value of the underlying securities held by the ETF in essentially the same manner as NAV is determined for a mutual fund. The share’s actual market value is based on supply and demand of the shares themselves, and can thus theoretically trade at greater or less than its NAV at any point during the trading day (though, by virtue of ETF design, departures from NAV are typically very minor).

ETF Advantages

With respect to tax efficiency, ETFs have a clear advantage over mutual funds. Conventional mutual funds must distribute the capital gains from their underlying portfolio of securities directly to fund shareholders, who are tax-liable in the year of such distribution. Often these gains are generated by other shareholders redeeming their fund shares; but it is the remaining shareholders that are saddled with the taxable gains even though they have made no transactions. The legal design of ETFs allows certain capital gains on the underlying securities to not be distributed to investors at all, but instead serve to increase the share price of the ETF itself. Investors realize such capital gains only when they

sell their ETF shares, and they can thus beneficially time the tax impact, or defer it indefinitely.

Another advantage of ETFs over mutual funds is their cost. Their expense ratios are often less than those for corresponding open-end mutual funds. Unlike conventional mutual funds, however, buying and selling of ETF shares are subject to bid/ask spreads and brokerage commissions — but the spreads are normally very narrow, and the brokerage commission for our clients is at the same favorable rate that Brinton Eaton has negotiated with our custodian for other security trades. However, these trading costs are an issue only if the ETF shares are traded often.

It should be noted that, while ETFs have important advantages over conventional mutual funds in certain situations, individual client circumstances (e.g., tax status, anticipated trading frequency) will dictate which type instrument we will use in any given situation.

ETFs in Portfolio Management

The ever-growing supply of ETFs — in particular, the availability of virtually identical ETFs from competing sources — permits us to employ another tax-advantageous tactic while monitoring and managing your portfolio. To take a very specific example, there exist several ETFs that track healthcare industry equity indexes. One is the iShares Dow Jones US Healthcare ETF issued by BlackRock, and another is the SPDR Healthcare Select Sector ETF issued by State Street Global Advisors. Let's assume that your portfolio contains the SPDR. On occasion, as market values fluctuate, the SPDR may fall below its cost basis. That presents an opportunity to sell the SPDR, harvest the tax loss, buy the equivalent iShares, and not change your sector exposure at all — all without infringing on the IRS's "wash sale" rules.

More fundamentally, ETFs can provide an efficient way to achieve proper diversification in portfolios of any size, including those portfolios too small to accomplish sufficient diversification through individual stocks and bonds. In addition, ETFs are useful in enabling rebalancing trades to maintain a portfolio at its desired asset allocation, even for the largest portfolios. For these reasons, we establish a "working layer" of ETFs across various asset classes/sectors in virtually every client portfolio. Additional context for this is provided in our other Research Briefs on asset allocation, rebalancing, and other aspects of portfolio construction and management.

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