Examining ETFs
by Eric D. Nelson, CFA

It always comes as a surprise to investors and financial market commentators, but Vanguard founder John Bogle is not a raving fan of exchange-traded funds (ETFs). Everyone assumes that the indexing maven would champion ETFs as a way for non-Vanguard account holders to achieve access to indexed investments. Instead, he approaches the ETF topic with trepidation. We share his skepticism and have a few other issues with ETFs as well.

ETFs: Easy To Use and Misuse

Speaking about ETFs in general, Bogle warns that “individual sector and country funds are too narrow for most.” Further, he says leveraged and inverse ETFs are the territory for “fruitsakes, nut cases and (the) lunatic fringe.” Finally, when you consider that 75% of ETF assets are held by institutions and are heavily traded (Bogle figures the annual turnover on the SPDR S&P 500 ETF is about 8,000% annually), he says “that’s no way to invest.”

Bogle is right here. Indexing, whether you are using mutual funds or exchange-traded versions, works best when implemented broadly across asset classes and markets, and their low cost, tax-efficient nature is allowed to compound over many years or decades.

It is well documented that frequent trading by investors results in a “buy high, sell low” approach and exacts a significant performance penalty. Even among no-load index funds, a Morningstar study found investors trailed their investments by almost 2% annually over the 10-year period ending in 2005. Any investment structure or vehicle that enables or promotes rapid-fire trading or frequent portfolio adjustments is not going to benefit long-term investors.

The Issue With Traditional Indexes

The biggest issue with exchange-traded funds is one that Bogle ignores. ETFs are simply baskets of individual securities that trade on market exchanges like stocks and are tasked with tracking their underlying index of investments as closely as possible. The iShares Russell 2000 ETF (IWM) is no better or worse, save for a small expense ratio, than the Russell 2000 Index itself. The ETF simply seeks to replicate the index’s holdings on a minute-by-minute basis throughout the trading day.

An ETF manager’s job is not to deliver absolute performance; their goal is to track their underlying index as closely as possible on a relative basis. These index holdings and changes are maintained and submitted to the ETF managers by third-party companies such as Standard & Poor’s, Russell and Morgan Stanley Capital International (MSCI). Tracking “error”—differences between index returns and ETF results—even if it results in ETF outperformance, is not a favorable thing. ETF investors want the return of the index minus a small expense ratio as reliably and consistently as possible, absolute returns be damned.

Slavishly tracking an index has its drawbacks. Indexes typically update (“reconstitute”) their holdings only once or twice annually, and usually telegraph their changes in advance. That allows savvy traders to front-run the changes, temporarily distorting prices that can lead to higher total (but hidden) trading costs. What’s more, for an index seeking to target a particular subset of the market, once or twice-a-year updates can lead to stale holdings that are not representative of the most current target universe. Finally, some of the smallest and most illiquid holdings can be tough to buy and sell with immediacy and on set schedules, with a more patient approach required to avoid large price impacts.

Broad-market ETFs seek to hold the entire stock or bond market and don’t face these issues, but unfortunately result in a heavy concentration of larger “growth” companies (in the case of stock indexes) or government bonds (in the case of fixed income indexes). And, to be fair, asset-class ETFs are coming around to these issues and their underlying indexes are starting to address some of their shortcomings. But as the historical record shows, outlined in Table 1 on the following page, they have a long way to go.
The results are clear—targeting a purer and more consistent portfolio of the desired securities, while implementing this approach patiently (as DFA’s “asset class” mutual funds do) has lead to noticeable differences in long-term returns.

**Investment “Costs” Aren’t Just Expense Ratios**

A few observations—the results are diluted a bit by the fact that the indexes in Table 1 do not have expenses but indexed ETFs do, which would add another 0.2% to 0.4% annually to the return differences (the DFA funds are net of costs).

Further, the spread between DFA mutual fund and index results grows as the asset classes become more illiquid and difficult to maintain. The difference in US large value stocks is only 0.6% annually, but almost triple in US small cap and small value stocks. International differences are all more than 1%, and in the most illiquid and costly region to invest (emerging markets), 2% to almost 4% differences result.

Finally, part of the significant return differences are attributable to the greater small cap and value exposure of the DFA funds vs. ETFs, but that is far from the whole story.

DFA’s US Large Value fund has outperformed the Russell 2000 Value (small cap) index despite a sizable historical small cap return premium. The DFA International Small Cap fund, with no value orientation, has matched the MSCI EAFE Small Cap Value Index. And the DFA Emerging Markets fund (DFEMX, +10.4%) almost matched the MSCI Emerging Markets Value Index and beat the MSCI Emerging Markets Small Cap Index despite robust small cap and value return premiums over this period.

**When Only The Best Will Do**

Bogle and other critics are partly right on ETFs. The concentrated and speculative nature of many of them promotes poor investment behavior, and the ability to trade them immediately is of no use to long-term investors and has historically hurt their returns. But the 1% to 2% or more in missed-out-on returns from poor index design and fund implementation is just as costly, and probably the main reason why ETFs have a long way to go to reach investment-product supremacy.

As advisors with a fiduciary responsibility to clients, our effort and value goes beyond just understanding your unique financial situation and developing an asset allocation with an acceptably high probability of achieving your goals. We research the thousands of index funds, ETFs, and “structured” mutual funds available and attempt to use only those that deliver the highest return in the asset classes we want to own.

Squeezing a bit more out of your portfolio can help you retire sooner, generate a larger stream of cash flow in retirement, and leave a larger legacy to those you will one day leave behind. Said differently, it is a pursuit well worth our efforts.

**Table 1: DFA Fund Returns vs. Indexes**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>DFA Mutual Fund Return</th>
<th>Russell/MSCI Index Return</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Stocks (1994-2014)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Large Value</td>
<td>+10.4%</td>
<td>+9.9%</td>
<td>0.6%</td>
</tr>
<tr>
<td>Small Cap</td>
<td>+10.8%</td>
<td>+9.1%</td>
<td>1.8%</td>
</tr>
<tr>
<td>Small Value</td>
<td>+12.3%</td>
<td>+10.3%</td>
<td>2.0%</td>
</tr>
<tr>
<td>International Stocks (1999-2014)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Large Value</td>
<td>+6.5%</td>
<td>+5.0%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Small Cap</td>
<td>+9.3%</td>
<td>+7.9%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Small Value</td>
<td>+10.8%</td>
<td>+9.3%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Emerging Markets (1999-2014)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Value</td>
<td>+12.7%</td>
<td>+10.6%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Small Cap</td>
<td>+13.5%</td>
<td>+9.9%</td>
<td>3.6%</td>
</tr>
</tbody>
</table>

The results are the same for Emerging Markets funds as well, with the DFA Emerging Markets Value fund (DFEMX) delivering superior returns compared to its MSCI Emerging Markets Value Index counterpart.

**Source of data:** DFA Returns 2.0.

1994 is the first full year of data for DFA US asset class funds
1999 is the first full year of data for MSCI (net divs.) indexes

**DFA funds used in Table 1:** US Large Value = DFLVX, US Small Cap = DFSTX, US Small Value = DFSVX, Int’l Large Value = DFIVX, Int’l Small Cap = DFIIX, Int’l Small Value = DISVX, Emerging Markets Value = DFEVX, Emerging Markets Small Cap = DEMSX.


Past performance is not a guarantee of future results. Indexes and index portfolios are not available for investment, and do not include the costs or market impact that comes with managing actual investments. This information is provided solely for educational purposes and is not a promise of results or a solicitation of services.

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*edited by Kathy Walker*