Are ETFs Better Investments?

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So much has been written lately about exchange-traded funds (ETFs) and all their so-called flaws. Some complaints and warnings about ETFs include:

1. ETFs do not always sell at the price that reflects the underlying value of the holdings.
2. ETF investing faces bubble-like conditions. ETFs as a class may come crashing down.
3. Sometimes ETF fees are just as high as those of actively managed mutual funds.
4. ETFs generally automatically invest in an index of equities or other instruments and so there is no one at the helm to strategically manage the fund's portfolio if the market runs into bad times.

As someone who has studied the market for more than 20 years, the only explanation that I can come up with regarding this public bashing of ETFs is that either the writer is uneducated about the industry or is hungry for a headline that will attract attention.

Setting the ETF Record Straight
Exchange traded funds are one of the best new developments to come our way for individual and even larger institutional investors.

The price of an ETF and its real value are sometimes different. This disparity is called the spread between the net asset value (NAV) and the selling price or the premium discount. In other words, the ETF sells above or below its true underlying value.

In reality this is true, but if you stick to the top 100 ETFs by size, the difference becomes negligible. For example, as of this writing, the iShares S&P 500 index ETF through State Street Global (ticker: IVV) is selling at a discount of -0.0227 percent. If you were to invest $50,000 today in the IVV ETF you would end up paying approximately $113 less than the real value of the fund. If you were to invest in a basket of ETFs today, my bet is that you will end up paying some premiums and some discounts where you would end up pretty much even.

I suppose you could try to time your trades so that you always buy at a discount, but at these levels of disparity between prices, you are more likely to incur a greater opportunity cost by waiting than you will gain in savings from the discount or even at par.

The 'Bubble' Fallacy
This makes no sense to me at all. In my mind, a bubble occurs when money flows into an area of the market beyond the value based on the underlying fundamentals. The result is that the investment vehicle becomes so overvalued that at some time the bubble pops as investors sell in droves.

The ETF approach will not result in a bubble, as, depending on the ETF, one can invest in a variety of strategies, sectors, and countries. However, if one invested in an ETF that represented an overvalued investment category and fellow investors sold off that category, not only would the ETF decline in value, but so would any corresponding mutual fund and stock investment, and they should go down by about the same amount.

Fees
ETFs carry an average annual management fee of 0.19 percent versus mutual funds with 0.92 percent. Some ETFs carry a higher fee because of the high cost of accessing a certain market or hard-to-trade foreign stocks.

For example, if you wanted to access the Turkish stock market, setting up an account on the Turkish exchange, wiring funds, paying transaction fees and so forth would cost you considerable time and money. However, by investing in the Turkish ETF (ticker:TUR) the cost becomes very attractive at 0.61 percent. In my opinion, paying a minor fee to have access to such an obscure market is one heck of a bargain.

Keeping in mind the overall average ETF fee of 0.19 percent, essentially your fund costs have been lowered fourfold as compared with the average mutual fund. If you have an advisor overseeing your account, you will be paying his or her fees as well, but as a whole, you are way ahead in the total fees associated with your investment as opposed to 5 to 10 years ago.

ETFs and Passive Management
ETFs generally invest in indexes and so no active managers oversee the funds. Yes, most ETFs do invest in indexes.

However, remember when the market plummeted in 2008? My homework showed that 80 percent of the time the indexes outperformed actively managed mutual funds during that horrible selloff. Sad but true. In addition, if you would rather have a manager overseeing your investment and making buy and sell decisions at the fund level, then you can invest in a mutual fund or invest in a growing number of ETFs that are actively managed.

One recent announcement: Pimco's flagship Total Return Fund, managed by Bill Gross, is about to become available through an ETF structure at the same cost to the individual investor as Pimco charges large institutional clients.

Despite the concerns cited by critics, ETFs are an efficient, low-cost way for an investor or advisor to access many diverse aspects of the stock, bond and futures markets in an inexpensive manner.

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Tags: financial advice, investments, making the most of your money

About Susan Carr-Templeton

Susan Templeton is the founder of Stafford Wells Advisors, a wealth management firm serving individuals, families and businesses and advising workplace retirement plans. Stafford Wells was founded in 2008 with the mission of delivering independent, complete, unbiased investment and planning advice, free of any conflicts of interest. Susan Templeton has more than 20 years experience in investment management. She received her B.S.B.A. degree in marketing from the University of Denver and her M.B.A. from the University of Chicago. Susan is a trustee for the Advocate Foundation where she chair's the Planned Giving Committee and is a member of the Investment Committee. Susan serves on the investment committee for the Visiting Nurse Association (Chicago) and is a former trustee of the Village of Oak Brook Police Pension Plan.