PWL CAPITAL INC.

The Economic Pulse

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Are exchange-traded funds dangerous? (Part 4 of 4)

After a modest start during the 1990s, ETFs have grown into a major phenomenon in the financial markets, with assets now reaching US$1.3 trillion worldwide. This exceptional growth has attracted a number of criticisms from investors, journalists and regulators. In the first three parts of this series, we discussed the merits and feared flaws of physical, synthetic and exotic ETFs. In this last part, we will review our own experience with ETFs. PWL has incorporated these investment vehicles into portfolios for over a decade with positive results. What have we learned? What works and what doesn't?

Big mistakes and best practice

We favor simple investment vehicles that are easy to understand. Therefore, we tend to avoid exotic ETFs such as inverse, leveraged and commodity ETFs, which can exhibit unpredictable behaviour. Complexity is also sometimes used by the financial industry to mask high fees. Simplicity is generally an investor's ally.

Another huge pitfall for investors is making bets on sectors or countries. For example, when the popularity of the tech-heavy NASDAQ index was at its summit, the temptation to invest massively into the corresponding ETFs was probably great. Now, twelve years later, the index is still 40% below its March 2000 high. In general, **PWL builds broad-based portfolios**, holding thousands of securities from all sectors and in all major global markets and in companies of all sizes (not only large ones). We don't believe anyone can reliably predict which sector or country is going to outperform, and therefore, we avoid concentrations in country- or sector-based ETFs.

A third (rather common) mistake is to trade ETFs actively. This increases the portfolio's trading and tax costs and provides no benefit in return. **We prefer the "buy and rebalance" strategy.** We invest in accordance with the investor's strategic asset allocation, and when the market carries asset-class weights away from their targets, we sell part of the overweighted ones (typically the ones that have appreciated) and we reinvest the proceeds into the underweighted asset classes (typically those that have depreciated) in order to bring the portfolio back to its strategic asset allocation. In doing so, we tend to systematically buy low and sell high without generating too many transactions.

Last but not least, we've started to receive inquiries about active ETFs, or ETFs that represent shares of an actively managed portfolio. Once again, we don't believe active managers can predict the markets. In fact, actively managed mutual funds have a very poor track record in general. We're uncomfortable with active funds, whether they're packaged into ETFs, mutual funds or any other format. Active decisions introduce the so-called manager drift: if the manager holds the wrong stocks or a large cash position at the wrong time, investors can miss positive market returns. **Our best practice is to hold ETFs that track the market in general.**

Conclusion

In this series, we have attempted to address the potential dangers of ETFs—real or imagined. We believe that most ETFs are not dangerous in of themselves, but that using them the wrong way can be harmful. Investors' worst mistakes are often caused by a false belief that they can predict or "outsmart" the market. But finance, unlike astrophysics, is not a hard science. Market movements are a reflection of human behaviour, which is largely unpredictable. Consequently, a portfolio of broadly diversified stock-and-bond ETFs will likely deliver a satisfactory investment experience and avoid the "dangers" of losing money permanently.

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