



Why Exchange Traded Funds?

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INTRODUCTION

When it comes to *efficient* investing, is it better to use mutual funds or exchange traded funds (ETF)?

At Efficient Advisors, we believe that as long as the mutual fund or ETF is low cost, is part of an overall diversification strategy and is not actively managed, you can use either investment vehicle to build a prudent portfolio designed to deliver market returns.

While mutual funds and ETFs offer similar benefits inside tax qualified retirement accounts (401(k), IRAs, etc.), ETFs may be the better solution for investors looking for a tax efficient investing solution.

What is an Exchange Traded Fund?

Believe it or not, ETFs have now been around for over 15 years. The first ETF in the U.S. was the SPY. Known as SPDRs or 'spiders' the Fund has grown to become the largest ETF in the world. As of June 2009, the size of the U.S. ETF industry was over \$590 billion dollars, including net inflows of \$176 billion last year. Since many ETFs invest in targeted asset classes, they are ideal for investors seeking a passive, structured strategy.

Other key characteristics of ETFs:

- ETFs cover all major asset classes such as equities, bonds, currencies and commodities.
- Equity ETFs are baskets of investments that represent a diversified group of companies (similar to mutual funds).

- Unlike mutual funds, however, ETFs trade like ordinary stocks on a stock exchange and can be bought or sold throughout the day.

Some equity ETFs mirror well-known indexes like the S&P 500 or the Dow Jones Industrial Average, and some track securities specific to a particular industry or country.

Tax Efficiency of ETFs

Whether an investor is looking to *buy and hold* or an immediate income stream ETFs offer distinct tax advantages.

■ Using ETFs reduces investor's taxable capital gains distributions.

- As explained by DFA academic advisors Kenneth French and Eugene Fama, Sr.: "The big advantage of ETFs is that the sale of securities inside the fund does not typically generate taxable capital gains for ETF shareholders. Investors in traditional open-end (mutual) funds must pay taxes each year on any net capital gains generated by trades inside the fund. As recent recipients of 1099s well know, these capital gain taxes are due regardless of whether the investor has sold any fund shares. ETFs avoid irksome capital gain distributions through the clever use of exchanges in kind—trades of fund shares for securities in the fund—with arbitrageurs. Because these trades are

not taxable events, ETFs are typically able to rebalance their portfolios without realizing capital gains.”

■ **Morningstar study offers empirical data to support the reduction in capital gains distributions from ETFs**

- A 5-year study of capital gains distributions conducted by Morningstar, found that only two ETFs made capital gains distributions over the period.
- The results were drastically different for the open end mutual funds. Of the 27 groups of funds reviewed, 25 made capital gains distributions over the 5 years period, with several in small-cap categories making distributions larger than 5% of total asset value.

■ **As you might expect, this advantage is especially pronounced when ETFs are compared to actively managed mutual funds.**

■ **ETFs also offer greater opportunities for investors to harvest losses when buying, selling or exchanging investments.**

■ **Background:**

- Individuals can claim a \$3,000 deduction from their current (ordinary) income for net capital losses. In other words, if you lose \$3,000 on an investment, and you realize that capital loss by selling the fund that incurred the loss without realizing any capital gains in the same year, you can claim a \$3,000 deduction on your income tax return.
- If you realize a loss larger than \$3,000, it carries forward indefinitely. So, you can claim \$3,000 of losses in each subsequent year until the loss is “used up”. For many people this could be equivalent to an annual tax refund of \$1,500 or more.
- However, to claim a tax deduction you must not buy back exactly the same stock or fund within 30 days

■ **Impediments to tax loss harvesting with mutual funds**

- Most mutual funds report average share price and do not allow you to identify and trade individual tax lots.

- Even if you could identify and trade individual tax lots, moving to similar but not identical index funds may mean moving assets between fund companies, which is a time consuming burden.

■ **Use of ETFs also limits “phantom gains” or fund earnings on which you may owe tax but which were accrued before you purchased your shares.**

■ **With ETFs tax-loss selling is easy and fast.**

- Tax lots of each block of ETFs are usually tracked when you purchase them, and show you summaries of unrealized losses so you know what to sell at the end of each tax year. And moving between “fund families” is easy with ETFs, since they are all traded like stocks. Also, the number of ETFs has exploded in the last two years, and that means that you can easily find very similar (but not identical) ETFs to transfer into.

Getting Started: Investing with Exchange Traded Funds

Efficient Advisors recommends that investors work with a trusted Advisor to implement a prudent allocation strategy. A trusted Advisor ensures that you will remain prudent, unemotional and disciplined (market volatility coupled with imprudent investment behavior can potentially hurt your portfolio's performance and rob you of the needed return to sustain your financial needs). A prudent investment strategy focuses on capturing the returns of the market without the need to pick stocks, pick sectors, and time the market or any other speculative investment techniques.

■ Embrace the Prudence of Passive ETF Investing.

- The goal of passive investing is to achieve the market rate of return rather than trying

to BEAT the market. By targeting specific asset classes (i.e., U.S. large companies, U.S. small companies, U.S. large value companies, U.S. small value companies, International companies, etc.), a prudent ETF asset class allocation strategy allows you to forgo the need to forecast or predict the direction of the market. The only action you will need to take is to rebalance the portfolio when the allocation targets are 'out of balance'.

■ **Determining the Asset Allocation.**

- The asset allocation decision is one of the most critical decisions that you must make since the majority of investment return in your portfolio comes from the portfolio structure. Since stocks and bonds behave differently, the goal of asset allocation is to maximize the portfolio's expected return in relation to its risk.

■ **Rebalance the Portfolio.**

- Since asset classes do not move in the same direction all the time, the asset allocation percentages will drift from the original allocation targets. It is imperative to maintain the allocation targets so you can

capture the asset class returns in the portfolio. Rebalancing adheres to the simple principle of buying low and selling high.

■ **Stay the Course but Adjust if Needed.**

- Life and all its circumstances bring unexpected events that might require us to make changes. A formalized plan can help us to determine if our plan needs course correction or adjustment.

■ **Ignore the Financial Pundits.**

- It can be unsettling to watch the hype spouted by financial gurus, talking heads, financial news shows, etc. It is best to implement your plan, turn off the noise and enjoy your life.

About Efficient Advisors & Wealth Management Partners

Efficient Advisors, LLC

(Efficient) is an independent registered investment advisory and technology firm located in Philadelphia, Pennsylvania focused on supporting and enhancing the practices of financial advisors. Efficient offers discretionary asset management, back office services, integrated marketing and branding strategies all aimed at assisting financial professionals to operate efficiently and in the best interests of their clients.

Wealth Management Partners, LLC

WMP was found in 2001 with the purpose of helping clients be prudently invested utilizing Nobel winning academic strategies without the need to use the traditional and failed approaches of investing. Since most investors fail to capture a market rate of return

utilizing speculative strategies, WMP offers clients the ability to invest their money in global capital markets using a structured methodology of investing.

For over 10 years Wealth Management Partners have helped many clients embrace the power of global free markets through prudent diversification. This investment approach relies on academic strategies developed by the top minds in investment finance. The Efficient Market Hypothesis, Modern Portfolio Theory and The Three Factor Model serve as the foundation of prudent investing without the need to employ speculative techniques such as technical analysis.

About Lawain 'Mac' McNeil & Jon Bucklin

Lawain 'Mac' McNeil

is Chief Executive Officer and founder of Efficient Advisors. He oversees advisor training and development. As former Executive Vice President of Sales & Marketing for one of the largest independent registered investment advisory firms in the United States, Lawain brings a vast amount of experience in advisor training, education and marketing. He has consulted and coached many financial advisors on how to shift from a commission based practice to a fee only fiduciary practice. Lawain has assisted advisors in capturing over \$1 billion dollars in assets under management.

A lover of technology, Lawain is the creator of the Blog, **AdvisorBlogger**, a social media site created for financial professionals. You can visit his blog at <http://www.advisorblogger.com>

Jon Bucklin, CFP® , RFC

Jon Bucklin has been working with clients since 1981. He uses education and academic investment policy to help investors achieve freedom and peace of mind.

As president and founder of Wealth Management Partners, LLC, Jon is a pioneer of The Investor Coach Approach™ to wealth management. He specializes in structuring market portfolios, planning for retirement, and helping clients understand the human side of investing.

For over 10 years Wealth Management Partners have helped many clients embrace the power of global free markets through prudent diversification. This investment approach relies on academic strategies developed by the top minds in investment finance. The Efficient Market Hypothesis, Modern Portfolio Theory and The Three Factor Model serve as the foundation of prudent investing without the need to employ speculative techniques such as technical analysis.

Contact Information

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