Investment Advisers Are in Love with ETFs

First introduced in the 1920s, the mutual fund undoubtedly revolutionized the investment industry. Being a pooled investment product invested in dozens of companies, the mutual fund gave individual investors the opportunity to invest relatively small amounts of money in a myriad of companies. Prior to the mutual fund it was virtually impossible to build a diversified portfolio with, say, only a thousand dollars.

One problem with mutual funds was that they charged high fees and they tended to underperform the market (as measured by an index, like the S&P 500). To solve that problem, a new mutual fund was born that only tried to mimic the market, while charging very low fees: the index fund. Vanguard was the pioneer in this field and it now manages more than $5 trillion.

The last decade or so has seen a new wrinkle in the fund industry. One feature about index funds is that they have to be bought or sold only at the end of the trading day based on its net asset value (NAV). To solve this minor inconvenience Wall Street created product that is very similar to an index fund, but it can be bought a sold like a stock: the exchange-traded fund or ETF. ETFs, like stocks, are traded on the stock exchanges and can be bought and sold whenever the market is open.

ETFs Have Exploded in Popularity

There are more than $4 trillion currently invested in ETFs and they are very popular with investment advisers. Let’s say you have $1 million to invest and want to hire an investment adviser. Many of these advisers will take your $1 million and allocate it between different ETFs that mimic a sector or an index, like the S&P 500. And for that, they’ll charge you a fee, typically around 1%. This is very lucrative for the adviser, as they don’t do any research on individual companies. The problem is that any individual can basically buy an index for virtually zero cost. The adviser doesn’t add much value for the fee they are charging. Let’s look at a real-world example on how an ETF-loving investment adviser might invest your well-earned assets.

We recently analyzed the portfolio of a potential client that had his assets at a well-known brokerage firm. The client had two taxable, individual accounts at the brokerage firm and the accounts were invested in ETFs as shown below.

Account 1

Symbol	Description	% of Portfolio
VOO	Vanguard S&P 500 ETF	38.7%
VTI	Vanguard Total Stock Market Index Fund ETF	36.6%
IJH	iShares Core S&P Mid-Cap ETF	9.9%
IJR	iShares Core S&P Small-Cap ETF	9.6%
MCHI	iShares MSCI China ETF*	5.2%

Account 2

Symbol	Description	% of Portfolio
VGK	Vanguard FTSE Europe Index Fund ETF*	14.0%
XLK	Technology Select Sector ETF	11.3%
IEMG	iShares Core MSCI Emerging Markets ETF*	9.8%
IJH	iShares Core S&P Mid-Cap ETF	9.0%
XLV	Health Care Select Sector ETF	7.2%
XLF	Financial Select Sector ETF	6.9%
EWJ	iShares MSCI Japan ETF*	6.5%
XLY	Consumer Discretionary Select Sector ETF	5.2%
XLC	Communication Services Select Sector ETF	5.1%
XLI	Industrial Select Sector ETF	4.8%
XLP	Consumer Staples Select Sector	4.5%
IJR	iShares Core S&P Small-Cap ETF	3.9%
EPP	iShares MSCI Pacific ex Japan ETF*	2.8%
XLE	Energy Select Sector ETF	2.6%
EWC	iShares MSCI Canada ETF*	2.3%
XLRE	Real Estate Select Sector ETF	1.5%
XLB	Materials Select Sector ETF	1.3%
XLU	Utilities Select Sector ETF	1.2%

** denotes an ETF investing in international companies*

It was very interesting to us that in one account (Account 2) the adviser decided to individually buy the 11 sectors that make up the S&P 500, while in the other account the adviser decided, to hell with it, I'll just buy the index! To which we say—and we can't stress this enough—why pay someone 1% to buy an index when you can buy it for virtually zero cost?! Paying a fee to an adviser for buying an index means that your account will underperform the index by the amount of the adviser's fee—there is no way around that.

It was curious to us that in Account 1, while the adviser decided to put the bulk of the assets (about 75%) in an index mimicking the market as a whole, he divided it into two different ETFs: the Vanguard S&P 500 ETF (VOO) and the Vanguard Total Stock Market Index Fund ETF (VTI). We found this a bit strange, as the two are very similar to each other.

Below are the sector weightings and the top 10 holdings for VOO and VTI.

Sector Weightings of VOO vs VTI (%)

	VOO	VTI
Basic Materials	2.30	2.48
Consumer Cyclical	9.85	10.06
Financial Services	15.93	15.80
Real Estate	3.15	4.60
Consumer Defensive	7.77	7.05
Healthcare	14.16	13.95
Utilities	3.49	3.39
Communication Services	10.41	9.55
Energy	4.33	4.02
Industrials	9.74	10.41
Technology	18.87	18.70

% of Portfolio for 10 Largest Holdings

	VOO	VTI
Microsoft	4.33	3.63
Apple	4.18	3.35
Amazon.com	2.92	2.47
Facebook	1.82	1.53
Berskhire Hathaway	1.60	1.34
JPMorgan Chase	1.58	1.26
Alphabet Inc Class C	1.51	1.24
Alphabet Inc Class A	1.49	1.24
Johnson & Johnson	1.38	1.15
Procter & Gamble	1.23	1.03

Given the similar composition of both ETFs, why wouldn't they just choose one and invest in that one?

Getting Specific

ETFs, especially those focused on a specific sector, are often concentrated in just a few companies, so it is important to examine the holdings of a particular ETF before buying. Additionally, sometimes an ETF contains holdings that are not obvious candidates to represent the sector that it is supposed to track. Let's look at an example from one of the ETFs we presented above.

Here are the top 5 holdings of the Technology Select Sector ETF (XLK):

Company	% of ETF
Microsoft	19.41
Apple	19.02
Visa	5.25
Intel	4.38
Mastercard	4.32

Only two companies—Microsoft and Apple—make up close to 40% of XLK. Thus, someone buying this ETF in order to gain exposure to the technology sector must recognize that the performance of this ETF will be hugely driven by the performance of just these two companies. Also, it is interesting to see that Visa and Mastercard—two companies that might not be readily associated with the technology sector—are among the five largest holdings of the Technology Sector ETF.

When we discussed the portfolio with the prospective client we asked, "Do you think your current adviser has analyzed the individual holdings of all these ETFs?" His response—"I doubt it"—did not surprise us.

Conclusion

ETFs may provide an efficient way for individual investors to invest in the stock market. Nevertheless, we feel that one should be wary of investment advisers that charge hefty fees and just buy ETFs that mirror an index. We may be biased, but we believe investment advisers should earn their fees by analyzing financial statements, investigating companies, and trying to beat the market.

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