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GEMS: Which ETF?

Introduction

GenTrust uses a primarily passive approach to investing. We use predominantly passive instruments such as ETFs, although we often will "tilt" client portfolios moderately based on our views of the relative performance of different asset classes. One question we often get from clients is "how do you decide which ETFs to buy?" In this GEMS we explore the answer to that question.

We manage client portfolios within a framework of allocating to various "sleeves" or "super asset classes" such as municipal bonds, taxable bonds, equities, real assets and alternatives. The weights to each of those sleeves is dependent on many factors including the client's overall risk tolerance, liquidity needs, taxation, inflation importance, and other factors. We benchmark each sleeve to an index that tracks the corresponding asset class. We also benchmark each overall client portfolio to the weighted average of those individual benchmarks. When we select which benchmark to consider for each asset class, we attempt to choose ones which span the greatest possible choices of that investment type. For example, we don't choose the S&P500 as our equity benchmark because it does not include equities outside the US which we believe are important considerations for portfolios.

Given that each sleeve has a benchmark, when we consider which ETFs to hold within that sleeve, we consider several factors:

- Fit within sleeve
- Index construction
- Cost
- Tax efficiency

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Fit within sleeve

How a particular ETF fits within a sleeve is very important. Are the assets the ETF holds part of the overall benchmark? For example, our benchmark for taxable bonds is the Barclays US Aggregate Bond Index, which does not contain non-US bonds, high yield, EM bonds or inflation linked bonds. If we want to have allocations to an ETF that holds those bonds which are outside of the benchmark, we need to understand how it moves in relation to the corresponding benchmark and what sort of tracking error, or correlation to the benchmark, it will have. High yield bonds trade very much like equities in down markets whereas bonds in the Barclays US Aggregate often do well in down markets so understanding how the ETF will behave in various scenarios and what tracking error is acceptable is an important part of selecting which ETFs.

Index construction

ETFs generally track indices that are created by the companies that manage the ETFs. Not all indices are created equal, so we spend a great deal of time trying to understand this. One example is the market for thematic ETFs that attempt to give investors exposure to Artificial Intelligence stocks. There are several such ETFs and at times their performance can vary dramatically. Often indices are flawed in the way they are constructed, and it is our job to identify when that's the case. For example, indices that track commodities often will have positions in very short-dated commodity futures which bleed value over time. Understanding this and avoiding these types of indices is important.

Cost

Most ETFs are low cost but there's still often substantial differences in both expense ratios and transaction costs. Another cost that is imperative to understand is the bid/offer spread, which is the difference between where you can buy and sell a certain security, and this cost represents the cost of illiquidity. While the largest S&P 500 ETFs can most times be purchased with less than 1bps of bid/offer, several smaller ETFs in less liquid markets can have bid/offer spreads that are easily 20-30bps. This cost is per transaction, so we need to be aware of that when entering, rebalancing, and exiting those ETFs and make sure the extra bid/offer is justified by value we believe exists and can't be accessed less expensively. Also, because we manage billions of dollars for clients, we often will need to trade tens of millions of an ETF in a particular day, therefore any ETF we allocate to needs to be liquid and not have trades of that size impact the execution.

Tax efficiency

ETFs are generally more tax efficient than their mutual fund counterparts because they benefit from a process known as "creation/redemption" which allows new units of the ETF to be created or redeemed often without creating tax consequences for the holders of that ETF. In essence, the number of shares of an ETF can be increased/decreased to meet demand without triggering realized gains. However, even with that advantage, there are still tax differences among ETFs depending on their index construction. For example, one area that we have been researching since the largest names in the S&P 500 have grown to be such a significant portion of the S&P 500's value, is the idea of diversifying away from the S&P 500 (which is market cap weighted) and to another weighting mechanism such as equal weighted. The market cap weighted version of the S&P 500 (SPY) has a 2% annual turnover as there are limited changes to which companies are the largest 500 per year. However, the equal weight ETF (RSP) has annual turnover of 21% which is needed to rebalance the portfolio back to equal weights periodically. Higher turnover inside the ETF means that more sales/purchases are being executed (usually selling things that have gone up more), creating tax consequences for the holder of that ETF.

Conclusion

GenTrust uses primarily passive instruments to manage our portfolios. The choice of which ETF to use is one we spend a tremendous amount of time on. We take into consideration several factors including how the ETF fits within the sleeve of investments it is in, how the index underlying the ETF is constructed, the cost of the ETF, and the tax efficiency of the ETF.

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