RIVERFRONT INVESTMENT GROUP

# Weekly View


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SUMMARY


- ETF investors should constantly be searching for biases within the Fund
- ETFs introduce complexity to a portfolio
- We believe fees should be a secondary consideration when picking an ETF


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# How to Pick ETFs and the Games We Play

## You can add value (or shoot your foot) with ETF selection, just like stock picking

Numerous studies have been conducted to suggest that when it comes to choice, sometimes less is more. Research shows that consumers become overwhelmed when presented with too many choices and that while optionality might seem appealing, it can easily generate confusion and sub-optimal selection decisions.

For investors, the proliferation of exchange traded funds (ETFs) has democratized access to new investment themes and strategies, but it has also presented a challenge for making the right portfolio decisions, especially for those that don't have professional help. Therefore, this week we'd like to highlight some of the criteria we use to pick ETFs. We'll also cover some of the shortcomings we see of screening for ETFs based on expense ratios and how a Financial Advisor can help simplify the selection process.

## 1. Index Construction Is the Most Important Determinant of Returns

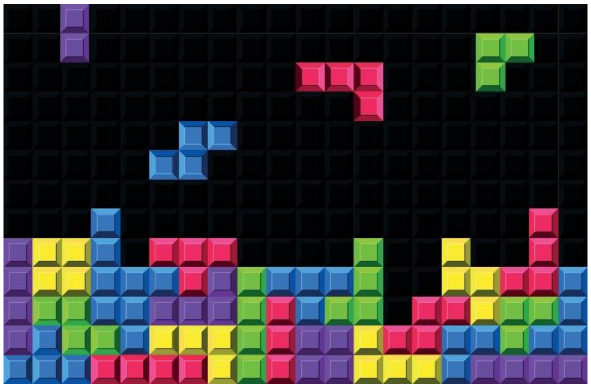
Every ETF has biases, many of which are not immediately obvious. Like the popular children's game of "Where's Waldo," ETF investors should similarly be searching for biases within these funds. We use the term 'biases' when referring to bets within an ETF, and these bets offer the buyer an opportunity to add (or detract) value. The term 'bias' can carry a negative connotation, but it shouldn't since we believe biases can often be desired. The key, in our view, is that biases are identified prior to an ETF's inclusion in a portfolio to minimize the potential for unintended consequences. The most common 'hiding places' are typically found in the following areas:

- **Concentration:** Is the ETF concentrated in a handful of securities? For example, many cap-weighted energy ETFs will have more than 40% of the Fund in the top two holdings. Therefore, if you buy a cap-weighted energy ETF, it will be important to have a view on those two companies since they are likely to drive a large portion of future returns. There are also energy ETFs that give equal weighting to the stocks in the sector and can therefore perform quite differently.

- **Country or Regional Exposure:** Not all international ETFs are created equal, and depending on the index the ETF tracks, you might not realize that some countries are excluded. For example, a country like South Korea is classified as an 'emerging market' by some index providers, but a 'developed' country by others.

- **Sector or Industry Exposure:** Many ETFs suggest they offer exposure to a factor or theme, but they might also be making an oversized bet on a certain sector or industry group. For example, products marketed as "low volatility" might really be a Utility and Staples fund in disguise.

## 2. Make sure the ETF fits into the existing portfolio structure



ETFs come in many different shapes and sizes. Therefore, it is important to properly assess the portfolio need and then identify the ETF that best fits that need without unnecessary 'excess baggage'. Like the classic game of Tetris, we should consider the following questions:

- What does our current portfolio structure look like?
- How do we find the right ETF to efficiently fill the holes in our investment strategy, without introducing "air pockets" like a poorly placed Tetris block?

At first glance, a portfolio of 10 ETFs can appear relatively straight-forward. However, since every ETF is comprised of dozens if not thousands of stocks or bonds, unintended exposures can easily arise. For this reason, ETF investors should make sure they have the analytical tools to understand their current positioning, and a robust screening process to understand the ETF they might purchase.

## 3. Don't Let Expense Ratios or Fund Asset Sizes Drive the Security Selection

Most of the asset growth in the ETF industry has gravitated towards the products that are the cheapest (meaning lowest expense ratio). However, we believe fees should be a secondary (or even later) consideration when picking an ETF. This is because the return differential that is attributable to index construction can easily dwarf the effects of expense ratios. For example, consider the following technology ETFs, all of which might sound relatively similar in title to the average investor:

| FUND NAME | VANGUARD INFORMATION TECHNOLOGY ETF | SPDR NYSE TECHNOLOGY ETF | INVESCO S&P 500 EQUAL WEIGHT TECHNOLOGY ETF |
|---|---|---|---|
| **Ticker** | **VGT** | **XNTK** | **RYT** |
| Expense Ratio | 0.10% | 0.35% | 0.40% |
| Assets | $39.6B | $0.6B | $2.2B |

*Securities shown for illustrative purposes and not intended as investment recommendations. RiverFront currently owns VGT in some of its portfolios. Past performance is no indication of future results.*

Based on this information alone, one might conclude that VGT is the best option, considering it has the lowest expense ratio and it is the largest option of the three for gaining exposure to the technology sector. However, none of the information above considers what we believe to be the most important part of ETF selection, which is the index construction.

As you can see in the table below, these three technology ETFs are not all created equal. In fact, there are some stark differences in terms of concentration risks:

| FUND NAME | VANGUARD INFORMATION TECHNOLOGY ETF | SPDR NYSE TECHNOLOGY ETF | INVESCO S&P 500 EQUAL WEIGHT TECHNOLOGY ETF |
|---|---|---|---|
| **Ticker** | **VGT** | **XNTK** | **RYT** |
| % in Top 3 Holdings | 42% | 23% | 5.57% |
| Largest Holding | Apple Inc (21.6%) | Tesla Inc (13.9%) | Lam Research Corp (1.9%) |

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They are also very different regarding their various industry exposures within the technology sector:

| FUND NAME | VANGUARD INFORMATION TECHNOLOGY ETF | SPDR NYSE TECHNOLOGY ETF | INVESCO S&P 500 EQUAL WEIGHT TECHNOLOGY ETF |
|---|---|---|---|
| **Ticker** | **VGT** | **XNTK** | **RYT** |
| Software | 36% | 21% | 24% |
| Computers | 27% | 5% | 16% |
| Semiconductors | 18% | 34% | 27% |
| Internet | 2% | 25% | 5% |

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With such differences, it should not be surprising that the performance for these three funds has been materially different in 2020. For example, there is a 40% return spread between XNTK and RYT, the best and worst performer this year, even though the difference in expense ratios was only 0.05% between those two ETFs, as shown below:

| FUND NAME | VANGUARD INFORMATION TECHNOLOGY ETF | SPDR NYSE TECHNOLOGY ETF | INVESCO S&P 500 EQUAL WEIGHT TECHNOLOGY ETF |
|---|---|---|---|
| **Ticker** | **VGT** | **XNTK** | **RYT** |
| Total Return (YTD) | 40.74% | 67.34% | 27.43% |
| Expense Ratio | 0.10% | 0.35% | 0.40% |

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As you can see, these 3 ETFs have various biases, shapes, and sizes and, depending on the prevailing investment environment, it's likely they will perform differently within a portfolio, despite sharing a title that merely mentions the technology sector. Importantly, this does not suggest any of these ETFs are superior or inferior products; they simply provide different exposures. In other words, they should all be viewed as distinct tools to be used for distinct investment purposes.

For perspective, there are 84 different technology ETFs from which we picked 3 for this example, highlighting the plethora of choices investors face. This phenomenon is not limited to the technology sector either. From thematic ETFs, to dividend-oriented products, all the way to Environmental, Social, and Corporate Governance (ESG) focused strategies, there are major index construction differences that create wide return dispersions.

## Conclusion:

With thousands of ETFs available in the marketplace, it can be overwhelming for the average investor to make the right selection decision. While it can be tempting to pick an ETF based on the lowest expense ratio or by choosing the Fund in the category with the most assets, our work suggests that index construction should be the primary factor when searching for an ETF. Unfortunately, this part of the ETF screening process is not always obvious to the part-time investor. It is why we believe so strongly in the value that financial advisors can bring to an individual's investment journey. These professionals will have the tools to help navigate the available options, and to make sure the products selected will fit within a tailored financial plan.

*When referring to being "overweight" or "underweight" relative to a market or asset class, RiverFront is referring to our current portfolios' weightings compared to the composite benchmarks for each portfolio. Asset class weighting discussion refers to our Advantage portfolios. For more information on our other portfolios, please visit www.riverfrontig.com or contact your Financial Advisor.*

*Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.*

*Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.*

*Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.*

*Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.*

*Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.*

***Exchange-traded funds (ETFs) are sold by prospectus. Please consider the investment objectives, risk, charges and expenses carefully before investing. The prospectus and summary prospectus, which contains this and other information, can be obtained by calling your financial advisor. Read it carefully before you invest. As a portfolio manager and a fiduciary for our clients, RiverFront will consider the investment objectives, risks, charges and expenses of a fund carefully before investing our clients' assets.***

*ETFs are subject to substantially the same risks as those associated with the direct ownership of the underlying securities owned by the ETF. Additionally, the value of the investment will fluctuate in response to the performance of the underlying index or securities. ETFs typically charge and/or incur fees in addition to those fees charged by RiverFront. Therefore, investments in ETFs will result in the layering of expenses.*

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