



## PLIMSOLL MARK CAPITAL

*We at Plimsoll Mark Capital provide these position papers in response to certain questions and inquiries we receive during our most recent client meetings. As you know, our intention is to make our process as interactive and transparent as possible to our clients, so we remain partners in achieving your long-term objectives.*

### ETFs – What they are? And how Plimsoll uses them in your asset allocation framework!

An *exchange-traded fund* (ETF) is an investment fund that is traded on a stock exchange, much as stocks are. ETFs hold assets such as stocks or bonds, and trade at approximately the same price as the value of their underlying assets. Nearly all ETFs mirror the performance of a particular index, such as the S&P 500.

Initially, ETF's were introduced to offer investors a low cost alternative to mutual funds. The first ETF's came to the market in 1992 as a way to duplicate the performance of major equity indices (such as the S&P 500) and are commonly referred to as "index funds." Because "index funds" simply mirror major indices and there are no imbedded active management fees, the fees are low.

ETFs generally provide the easy diversification, low expense ratios, and tax efficiency of index mutual funds, while still maintaining all the features of ordinary stock, such as limit orders, short selling, and options. Because ETFs can be economically acquired, held, and disposed of, some investors invest in ETF shares as a long-term investment for asset allocation purposes.

### ETFs offer the following advantages:

- *No minimum investment size.* You may purchase as little as one share.
- *Low costs.* Most ETFs are passively managed, allowing them to charge low management fees. What's more, ETFs are insulated from the costs of having to buy and sell securities to accommodate shareholder purchases and redemptions. ETFs typically have lower marketing, distribution and accounting expenses as well.
- *Trading flexibility.* ETFs can be bought and sold at current market prices at any time during the trading day. (Mutual funds can be traded only at the end of the day.) ETF shares can be purchased on margin and sold short, (enabling the use of hedging strategies) and allow stop orders and limit orders, which allow investors to specify the price points at which they are willing to trade.
- *Tax efficiency.* Like other index funds, ETFs typically have low turnover of the securities in their portfolios, so they tend to generate low capital gains. ETFs also have additional advantages that let them avoid realizing gains. In particular, they do not have to sell securities to meet investor redemptions. Investors generally receive capital gains tax liabilities from an ETF only when they sell its shares, whereas mutual fund investors may receive capital gains distributions at any time.
- *Market exposure and diversification.* ETFs provide an economical way to rebalance portfolio allocations and to invest cash quickly. An index ETF inherently provides diversification across an entire index. The funds offer exposure to a diverse variety of markets, including broad swaths of the U.S. and global markets as well as country-specific indexes, industry sector-specific indexes, bond indexes, and commodities.

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- *Transparency* - ETFs, whether index funds or actively managed, have transparent portfolios and are priced at frequent intervals throughout the trading day.

As of April, 2010, there were 839 ETFs containing \$805 billion of assets, according to the Investment Company Institute. Meanwhile, some 7,638 mutual funds contained \$11.2 *trillion* in assets. Considering ETFs' advantages, why after 18 years do they hold less than 10% of the assets of mutual funds?

We believe there are two reasons for this. First, if there is the desire to diversify beyond the S&P 500 Index, an investor must in effect become a portfolio manager, actively choosing the desired ETF mix of countries and industries. This is a formidable task. Second, there is always the opportunity to outperform an index with an actively managed mutual fund or separate account. While it is true that the average mutual fund does not outperform after fees, it is also true that a select group of managers have demonstrated the ability to outperform over the longer term.

In a few instances an ETF is clearly the investment vehicle of choice—in particular, when the underlying asset does not lend itself to active management. The best example is the gold index fund, GLD, that tracks the price of gold by actually holding gold bullion.

Previously we have talked about passively managed ETF's. Now we would like to introduce the actively managed ETF. This is an actively managed fund that is traded on an exchange. As the concept is new, there is little performance history for individual funds. Actively managed ETFs also negate the tax benefit of the passive ETF. As trading volume is very light, actively managed ETFs have larger bid/ask spreads. Finally, management fees generally range from 45 to 75 basis points, bringing them closer to the mutual fund fee range. While we would not necessarily call these bad ideas, their disadvantages seem to outweigh the ability to trade fund shares on an exchange.

Moving away from equities, there are a number of fixed-income ETFs—110 as of March 31, according to the Investment Company Institute. These are constructed to track various domestic and international bond indices, covering a multitude of maturities, qualities, and sectors. While a considerable amount of research is necessary to identify the ETF that meets the investor's specific needs, with particular attention to the maturity and quality of the index, they can be a good way to provide fixed income diversification. Except for Treasury bonds, the underlying liquidity of the positions in a fixed income ETF may be a problem in fast moving markets, and the exchange price may vary from the value of the underlying investments. Fixed income ETFs should not be viewed as trading vehicles and should only be bought or sold during periods of bond market stability.

At Plimsoll Mark Capital, we believe ETFs can play a useful role in a diversified portfolio. We will often choose an ETF when we seek low-cost exposure to a specific type of investment opportunity in which active management does not add significant value, either in the form of increased returns or reduced risk. Our job is to identify the ETFs that meet your investment objectives, and to perform the necessary due diligence on them.

Currently, we are using ETFs in the inflation hedge category of Plimsoll client portfolios, to make investments in the following assets class: commodities (GSG), gold (GLD) and treasury inflation protected securities (TIP). We will continue to evaluate the suitability of these vehicles on an ongoing basis, as we do with every investment in our portfolios.

Please feel free to contact either of us with any questions regarding your account.

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