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Our Menu Options Have Not Changed

It's annoying to learn that "in order to serve you better" an organization has installed a computerized phone answering system. Certainly some companies benefit from such systems, but we do look askance when a mechanized voice claims that the new scheme was introduced to benefit customers when, more than likely, any value accrues to the company. In this newsletter we expose one of Wall Street's fairly recent innovations – the Exchange Traded Fund (ETF) – and question whether these were invented to serve investors better, as promoters claim, or for reasons that enrich Wall Street while exposing buyers to unnecessary risk.

A Cure Without A Disease

In their simplest form, ETFs were created to be like index funds except that they were engineered to trade throughout the day instead of at the market's close. This defining feature of intraday trading encourages trading and market timing—something that is good for brokerage firms, but research suggests is bad for most investors[1]. It naturally begs the question, what problem were marketers of ETFs trying to solve when they created and expanded these products?

Moreover, for this "privilege" of being able to trade frequently, market prices for ETFs "may deviate significantly from NAV" or net asset value[2]. This compares to index mutual funds which ensure that investors trade at NAV. If you wonder whether it is the investor or Wall Street who benefits, see the footnote below for actual disclosure language where the ETF Prospectus concludes, "frequent trading may detract significantly from investment results[3]."

Unintelligent Design

In addition to the downside of more trading as just discussed, we are skeptical of the ETF product for a host of other reasons, including the confusing process that takes place when Wall Street forms an ETF. We begin with a description of ETFs from the Securities and Exchange Commission.

> *"ETFs do not sell individual shares directly to investors and only issue their shares in large blocks…known as 'Creation Units'…Institutions buy Creation Units with a basket of securities that generally mirrors the ETF's portfolio. After purchasing a Creation Unit…[they] often split it up and sell the individual shares [of the ETF] on a secondary market...Because of the limited redeemability of ETF shares, ETFs are not considered to be – and may not call themselves – mutual funds[4]."*

Clear on that? This kind of financial legalese smacks of other Wall Street brokered "hot products" we have seen before, and, we emphasize, the above language

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1) Barber, Brad and Terrance Odean. "Trading is Hazardous to your Wealth." *Journal of Finance.* April 2000.
2) iShares by Blackrock. 2014 Prospectus for iShares Core S&P500 ETF. July 31, 2014.
3) From iShares Core S&P500 ETF 2014 Prospectus: "When buying or selling shares of the Fund through a broker, you will likely incur a brokerage commission or other charges imposed by brokers as determined by that broker. In addition, you may incur the cost of the "spread," that is, the difference between what investors are willing to pay for Fund shares (the "bid" price) and the price at which they are willing to sell Fund shares (the "ask" price). Because of the costs inherent in buying or selling Fund shares, frequent trading may detract significantly from investment results…"
4) http://www.sec.gov/answers/etf.htm. November 8, 2013.

applies to a "plain vanilla" ETF. Initially, ETFs followed broad-based, highly liquid indexes, in large developed markets such as the S&P 500, Russell 3000 or MSCI Japan, to name a few. In true Wall Street form though, when simple things can be made more complex, they are—if it will spur growth and higher fees.

As a result, over the last 10 years the industry has quintupled the number of funds (300 to 1,455) and grown assets in ETFs over 10 times ($204 billion to $2.1 trillion)[5]. ETFs now cover markets that are not particularly liquid (e.g. junk bonds), can be narrow in focus (e.g. single country currencies), use leverage to amplify returns (e.g. "ultra" short/long ETFs), or may not even be intended to track an index at all. Let's look at the disclosure language from one of the world's largest investment firms (hint: sounds like rack block) when recently advertising their latest Germany currency fund in the Economist Magazine.

> "*The Fund's use of derivatives may reduce returns and or increase volatility and subject the Fund to counterparty risk, which is the risk that the other party in the transaction will not fulfill its contractual obligation. The Fund could suffer losses related to its derivative positions because of a lack of liquidity in the secondary market as a result of unanticipated market movements. Such losses are potentially unlimited.*"

We Told You So

Yikes stripes…the ETF sponsor's lawyers suggested disclosure that losses could be "unlimited" right in the advertisement. The counterparty, liquidity, volatility and other risks that the funds themselves disclose—in small print—are real and worth some large print here. Be reminded that fancy Wall Street products generally have no trouble *taking in* lots of money while assuring investors that liquidity exists on "most days" or "under normal circumstances." It is when investors clamor to get out that problems are exposed and money is lost (think roach motels). A good example from the recent past is the "auction rate bond" which was all the rage as a higher interest-earning cash/money market alternative from 1988 -2008, but failed miserably in the financial crisis due to liquidity mismatches. Banks were later castigated for not disclosing those risks to investors which is probably why such dire, and appropriate, language is now needed with ETFs.

The broader point is that some investors may eventually rue the day that they owned what they thought was a high-quality investment but was actually an ETF backed by illiquid securities, enhanced by derivatives with unknown risks, or backed by the same "too-big-to-fail organizations" that have wreaked havoc in the past. All of this is for an "innovation" we believe has little apparent benefit to the client.

At Hamilton Point, we prefer individually purchased core bonds and stocks and selected mutual funds that, like us, believe in fundamental research. The result for our clients is that they know what they own and why—actual shares (not Creation Units), in quality companies and funds, researched by Hamilton Point. By substantially avoiding most ETFs[6], our clients are shunning some of the potential risks, not appreciated by many, that we believe exist in portfolios dominated by ETFs. That is how we hope "to serve our clients better"…and by the way, humans still answer our phones during business hours.

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Hamilton Point Investment Advisors, LLC is an independent and independent-minded wealth advisory firm. Please contact us for a complimentary review of your portfolio. In addition, visitors to the firm's website, www.HamiltonPoint.com, can read past investment newsletters.

5) "*Exchange Traded Funds.*" Investment Company Institute, April 2015.
6) As of June 22, 2015, 1.2% of Hamilton Point Assets Under Management were held in ETFs. Some clients own custom ETF positions (0.25% of AUM) or positions in gold ETFs (0.95% of AUM), as there is not another publicly-traded security that provides direct exposure to gold.