

## *Thank Goodness for ETFs!*

*"If you buy the same thing they buy you will get the same performance they get"*  
-Sir John Templeton

Considerable dispute exists between passive and active management of equity portfolios. This paper seeks to discuss the idea that active investment strategies focusing on individual stock selection can benefit from the market inefficiencies that have been produced by the widespread adoption of Exchange Traded Funds (ETFs).

### *The Obvious Benefits of ETFs*

The introduction of many different types of ETFs offer investors various benefits, some of which are less obvious than others. First, we will discuss the obvious benefits to investors using these popular investment instruments.

ETFs offer investors many unique features that may help facilitate certain top-down investing strategies. Such features include quick diversification across a market or sector. Since ETFs hold a basket of stocks or bonds that are often tied to an index like the *Standard & Poors 500 Index®*, investors can systematically gain exposure to certain segments of the market by purchasing a single issue. Such passive strategies may be especially beneficial in gaining exposure to international securities, where the lack of available information may make individual security analysis impractical or ineffective.

Unlike closed-end funds, ETFs offer market pricing that is closely tied to their

net asset value. Since market makers use their ability to exchange creation units with their underlying securities, ETFs trade on stock exchanges and generally provide individuals with a high degree of liquidity.

ETFs also offer tax advantages and, in most cases, low transactions costs. Generally, ETFs are tax-efficient because of the way they are created and redeemed, which allow the investor to pay most of his capital gains on the final sale. Transaction costs are typically low for most ETFs due to the costs associated with passive management and the absence of front-end charges or redemption penalties.

### *The Hidden Benefits of ETFs*

Second, we will discuss the less obvious benefits created by the widespread adoption of ETFs in today's financial markets.

While investors can use ETFs to execute top-down strategies in sectors such as oil, gold, financials, or semiconductors, these investing actions often do not give much consideration to stock specific fundamentals. Usually, when large groups of investors engage in broad investing decisions without giving much consideration to the unique fundamentals of each individual stock, we believe inefficiencies develop and opportunities are created for active managers.

Because ETF transactions generally involve baskets of stocks, we believe this type of investing can create a herd-like mentality that often translates into naïve buying or selling pressure on a group of stocks. Furthermore, any market activity that ignores the individual fundamentals underlying each company can result in temporary mispricing in the market. Individual equities represent different investment merits based upon future earnings prospects, various unique business risks, financial profiles, management talent, and long-term growth prospects. Such competitive advantages may allow one enterprise to thrive at the expense of a weaker competitor in the same sector or industry group. Therefore the wholesale buying and selling of stocks in a given sector can result in a disconnect between the underlying fundamentals, which represent reality, and the market's perception of the fundamentals of an individual security. We believe mispricing in individual stocks can be summed up into a simple equation; *Reality - Perception = Profit or Loss*. If an investor perceives an ETF to be a good bargain and chooses to invest, the reality is that not every stock represented in that ETF's basket of securities may be an attractive value. Therefore certain stocks in a group may become overvalued due to naïve buying pressure in a given ETF. Such a circumstance can provide an opportunity for a prudent investor that has insights into the specific fundamentals to capitalize on selling an overpriced security. The inverse of this action can also occur. When widespread selling exists in an ETF, an unwarranted price decline may occur regardless of positive underlying fundamentals in a given security. We would also point out that a market or sector can be fairly valued even when

some of the underlying stocks are temporarily mispriced.

***“.....Reality - Perception = Profit or Loss.”***

While there is little dispute that markets are efficient over the long-term, we believe inefficiencies do exist in the short-term. We view the short-term trading volatility that individual stocks exhibit on a daily basis as ample evidence that such inefficiencies exist. Furthermore, we believe the trading and pricing mechanics of ETFs may amplify short-term market pricing inefficiencies and increase volatility in individual stocks. The common use of leverage and complex derivative instruments in ETFs may further exaggerate short-term swings in individual stocks. A prudent investor that obtains specific knowledge about the underlying fundamentals of an individual stock can often see through the trading noise created by such market volatility and identify opportunity. While we do not advocate short-term trading or speculation based on these circumstances, these conditions may present attractive entry or exit points for active investors.

It is well-documented<sup>†</sup> that abnormal pricing activity occurs when a stock is added or removed from a stock Index, such as the *S&P 500®*. As ETFs make it more convenient for investors to passively invest in almost every indexed equity class, short-term pricing inefficiencies may result from the simple fact that such funds are forced to buy or sell a stock to minimize tracking error against the performance of an index. Furthermore, we believe the effects of ETF investing on short-term pricing discrepancies may be inversely correlated to the size in terms of

<sup>†</sup>See Graham and Pirie's journal article in the endnote.

market capitalization and trading volume of the sector or group represented. Returns in small cap stocks are also more sensitive to asymmetric information that active managers may exploit. Such participation is limited among ETFs.

**Contact Information:**  
2905 Maple Avenue  
Dallas, Texas 75201  
888-878-4426 Toll Free  
214-231-5000 Fax

### **Conclusion**

While ETFs may represent a logical investment vehicle for passive investors pursuing top-down investment strategies, we view the widespread adoption of ETFs as an opportunity for active investment managers to capture excess returns in individual stocks. The methodology required to capture these excess returns, relative to their risks, requires nothing more than research, research, and more research. It is our opinion that nothing can take the place of good, old-fashioned due diligence. In most cases, this means going straight to the sources of information in an effort to truly understand what's going on in the underlying, unique businesses. These efforts require the in-depth analysis of financial statements, the interviewing of management teams, visits with customers and suppliers, as well as the studying of competitors. Such activities are difficult to replicate in academic formulas or computer models.

Wherever free market capitalism reigns, investors will always find new and innovative ways to invest in equity markets. We acknowledge that there are many ways to achieve excess returns in the stock market, some more creative or complex than others. However, we would argue that strategies pursuant to bottom-up analysis of company fundamentals are a sound approach for most long-term investors. ■

## Endnotes

Arnerich, Tony, Sheree Demers-Arntson, Jillian Perkins, Travis J. Pruitt, Ximena Spicer, and Lynn Spruill. Active versus Passive Investment Management: Putting the Debate into Perspective. Rep. Arnerich Massena & Associates, 2007. Print.

Graham, Steven, and Wendy Pirie. "Index Fund Rebalancing and Market Efficiency." *Journal of Economics and Finance* 18.2 (1994): 219-29. Print.

Madura, Jeff, and Thanh Ngo. "Pricing Behavior of Exchange Traded Funds." *Journal of Economics and Finance* 32 (2008): 1-23. Print.

Sullivan, Rodney N. *Global Perspectives on Investment Management: Learning from the Leaders*. Charlottesville, VA: CFA Institute, 2006. Print.

The above discussion is based on the opinions of Eric Marshall and is subject to change. It is not intended to be a forecast of future events, a guarantee of future results and should not be considered a recommendation to buy or sell any security.

The S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. You cannot invest directly in an index.