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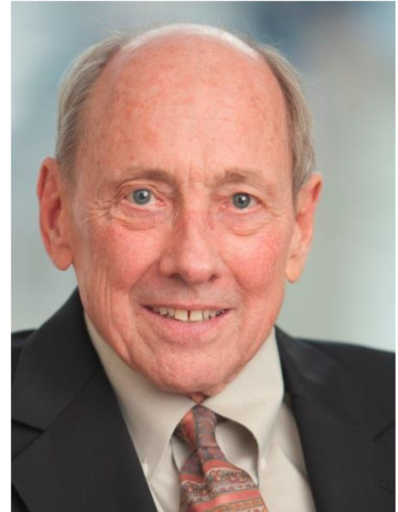

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ETFs vs No-Load Mutual Funds

Marshall E. Blume, Ph.D.

mblume@prudentmanagement.com

We are frequently asked about Exchange Traded Funds (ETFs). Indeed, ETFs are hot. In the past ten years, they have more than doubled their holdings of publicly traded stocks from 3.1 to 7.9 percent, but mutual funds still dominate.

PMA continues to evaluate ETFs, but so far has chosen not to use them. Rather, we have used no-load mutual funds – funds without a sales commission – for reasons detailed below. But at the macro level, you – like all of our clients – have trusted PMA to balance return with the risk required to achieve it. This has and will always drive our investment decisions.

We have chosen to pass on ETFs for two primary reasons. First, trading ETFs incur trading costs. Second, trading ETFs involves basis risk - the possibility, and indeed likelihood, that the price at which an ETF investor buys or sells differs from the underlying value of the ETF. In contrast, trading in no-load mutual funds incurs neither trading costs nor basis risk.

ETFs are certainly not without merit. The main advantage of ETFs is that they can be traded during the market day, whereas mutual funds trade only once a day at the close of trading at four o'clock. That said, trading during the day is not critical to investors who invest for the long run, as PMA clients do.

So let's return to our reasons for passing on ETFs, beginning with trading costs: Trading ETFs involves three type of costs, costs similar to those in trading common stocks: brokerage commissions, spreads, and market impact.

Brokerage Commissions typically represent a small fee for trading ETFs, and many brokers will waive these fees on a select set of these funds in which they have a special interest. The **spread** is the compensation to a market maker who stands ready to buy and sell an ETF and is measured by the difference in the price that a market maker is willing to buy, the bid, and the price that it is willing to sell, the offer. For actively traded ETFs, this spread is often minimal. For less-actively traded ETFs, however, the spread can be substantial. **Market impact** is the effect that a trade has on the prices at which it is executed. Large trades – like many of those made by PMA - often move the market, meaning that an investor could get an initial block of shares at the initial bid price, but would have to pay a premium for the remainder due to the market impact of the large trade. The buyer obviously bears this cost.

With the exception of brokerage commissions, these costs do not apply to the trading of no-load mutual funds. And for PMA there are no brokerage commissions as it has negotiated with its custodian to waive them on all mutual fund transactions. At the end of the day, a mutual fund determines the fair price of a share and executes all buys and sells orders at that price – eliminating any spreads – and executes the buy and sells orders at that price, regardless of size – eliminating market impact.[1]

The second reason we have chosen to pass on ETFs so far is **Basis Risk**. To understand Basis Risk, let's look at ETFs in relation to their close cousin, closed-end funds. A closed-end fund is an investment company that starts with an initial public offering and then invests the proceeds in a portfolio of financial assets.

Closed-end funds go back a long way, but never gained significant traction, representing only 0.4 percent of publicly traded stock. As it turns out, closed-end funds frequently trade at a discount from fair value or net asset value, varying from day to day and can sometimes be as large as 30 percent or more. Occasionally, they will also sell at a small premium. These varying discounts and premiums ultimately create Basis Risk, thereby introducing substantial additional volatility to returns. This may explain why closed-end funds never took off.

ETFs are like closed-end funds but with a mechanism that helps to mitigate, but not altogether eliminate the Basis Risk. The mechanism tends to work well when the underlying assets are highly liquid, but less well when the assets are less liquid.[2] What is certain is that the process is not terribly transparent, allowing certain participants with process know-how to profit while others hug the sideline. We view this as an unnecessary risk.

[1] Many mutual funds have the option of executing a sale redemption by transferring ownership of underlying assets to the investor instead of cash. The fund might exercise this option for an extremely large redemption, but as a matter of practice it virtually never happens.

[2] Due to a combination of law and regulation, this mechanism allows ETFs to reduce or eliminate capital gain distributions—a well-touted tax advantage. In fact, this tax advantage may be more theoretical than real: The large Vanguard 500 Stock Index, which has the same objective as the widely held SPRD S&P 500 ETF, has not paid a capital gain distribution in the last 25 years.

At the end of the day, PMA – for reasons of trading costs and basis risk – has opted against ETFs in favor of no-load mutual funds. This simply fits with our long-term investment horizon and with the premise that has anchored our firm since inception – we will always balance returns with the risk required to achieve it. We will invest every client dollar as we do our very own, with a desire for solid returns without putting principal balances at undue risk.

Will we continue to monitor the ETF market? You bet. Until we see a reduction in costs or risk, however, we'll stick with no-load mutual funds as we focus on the return of client portfolios relative to their risk. It's a strategy that has served us well for over 35 years.