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INVESTMENT THOUGHTS

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HOW WE BUILD BETTER PORTFOLIOS WITH EXCHANGE TRADED FUNDS

Over the past 25 years, Exchange Traded Funds or “ETFs” have flourished and now hold $4 trillion in assets in the United States. They are popular with both individual and institutional investors because they have unique characteristics and features which provide many advantages. We use ETFs as one of several types of investments to construct portfolios to help you meet your investment goals.

Exchange-traded funds hold a basket of securities that trade on an exchange throughout the day. They generally track an index of stocks, bonds or other assets. Many provide broad, efficient exposure to the markets. Others allow us to invest in specific segments of the market that we believe will perform well. They also help us meet specific objectives such as boosting your portfolio’s income or reducing its volatility. We put a lot of time and effort into selecting the right ETFs for you. Our goal is to invest in those that are well designed, low-cost and tax-efficient.

The cost of investing in ETFs has dropped in recent years, making them more attractive. Since 2012, the average ETF fee has declined 40% and now has an expense ratio of 20 basis points or 0.2%. That comes to just $20 in fees per $10,000 investment. The average ETF we invest in for our clients has an even lower expense ratio.

There are many other factors to consider when purchasing ETFs. We look at the design of each ETF and we find that some are poorly constructed. They do not provide the exposures they say they do or do not track their underlying indexes well. The price of some ETFs may deviate from the value of their underlying assets. This means that an investor, if not careful, may pay more for an ETF than its assets are worth. We also avoid investing in ETFs that hold assets that can become illiquid during periods of market stress. For example, we avoid ETFs that hold low quality stocks or bonds.

We strive to manage portfolios to minimize the taxes our clients will pay. Exchange Traded Funds tend to be very tax efficient. Unlike mutual funds, most ETFs do not pay capital gains distributions. Tax laws require fund companies to pass realized gains on to their clients who then pay capital gains tax. ETFs usually do not pay capital gains distributions for two reasons. First, they usually have low turnover because they track an index. This means they do not have to sell as many assets that would incur a gain. Second, unlike a mutual fund, they often do not have to sell securities to meet investor redemptions. Instead, they can deliver shares in-kind to institutions that do not have to pay capital gains tax. This allows them to remove low cost holdings from their fund without tax consequences to their investors. Investors will only pay capital gains tax when we sell an ETF that has appreciated.

We invest in several different types of ETFs for our clients. The mix of ETFs in a portfolio may vary depending on their objectives. Here are some categories of ETFs that we use in portfolios:

Core: Many of our largest ETF holdings provide diversified low-cost exposure to market indexes. For example, we own several ETFs that track US and international stock markets. Because we do not need to trade in and out of these ETFs, they tend to be very tax efficient.

Income: We invest in several ETFs that pay above average dividend income to investors. In some cases, they hold stock in companies that have higher dividend yields than the market. In other instances, they hold companies that have average dividend yields but increase their dividends at a faster pace. Companies that pay dividends are often more mature and higher quality. They have a history of holding up better when the market sells off.

Factors: Factor ETFs allow us to hold groups of stocks that research shows can be beneficial to you. They also sometimes allow us to reduce risk and address some of the shortcomings of investing in broad market index funds. For example, they help us tilt portfolios toward stocks with the following characteristics:

- High quality: Hold stock in companies that have strong balance sheets and are highly profitable.
- Value: Hold inexpensive stocks. Value investing works over time because it “forces” people to do what is unnatural: buy low and sell high.
- Low volatility: Hold stocks that fluctuate less than the market.

Size: We invest in ETFs to gain exposure to stocks in small and medium sized companies. These companies often grow their sales and earnings faster than larger companies do and produce higher returns.

Sector: These ETFs provide exposure to different economic sectors of the market. For example, we may invest in a sector ETF to gain exposure to consumer, financial or industrial stocks. We do this when it makes sense for our clients to have broad exposure to a sector.

Niche: We also invest in ETFs to provide exposure to companies that focus on certain businesses. For instance, we hold several ETFs that invest in alternative energy companies in our Socially Responsible Strategy. They hold stock in companies that produce solar and wind power.

ETFs report their holdings every day making them more transparent than many other types of investment vehicles. This is very helpful for monitoring our portfolios. We analyze a portfolio's holdings, including individual stocks and bonds and the underlying holdings in each ETF. This "look-through" analysis provides us with an accurate picture of all the portfolio's exposures. This allows us to avoid unintended concentrations in any one segment of the markets and helps us make informed decisions and adjustments as our investment strategy evolves.

After a period of strong growth, there are now over 2,000 ETFs available in the United States. The marketing departments of many ETF issuers have pushed hard to get a piece of the action by introducing new ETFs as fast as possible. This has resulted in the introduction of many second-rate ETFs. We will continue to work hard to sort through the wide array of choices and select those that we believe are best for our clients. If selected wisely, ETFs have many advantages that help us construct better portfolios for you.

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