Rinehart Wealth Management
Greater Trust

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The Emergence of ETFs and the Role They Have in Your Portfolio

Clients often ask us "*What are Exchange-Traded Funds (ETFs)?*" and "*Why do you use them in portfolio construction?*" The purpose of this newsletter is to answer these questions and provide perspective on advancements in the dynamic wealth management landscape.

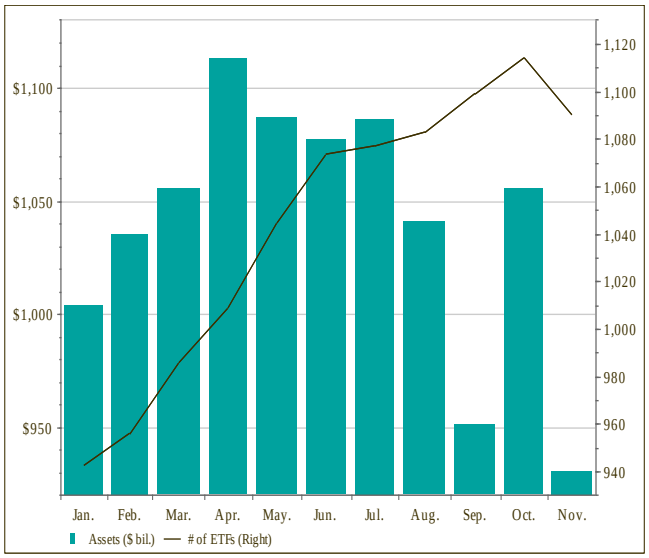
What are Exchange-Traded Funds (ETFs)?

Exchange-Traded Funds (ETFs) are open-ended funds that track a basket of investments (or an index) and trade like a stock. ETFs are rapidly growing investment vehicles which offer investors access to inexpensive beta (i.e., systematic risk or return attributable to market movement) as well as certain trends, sectors or asset classes. They can offer significant cost, tax and trading advantages relative to mutual funds. We often use ETFs for clients to reduce costs, diversify risk and access particular sectors or trends. We feel ETFs are a complementary tool that, when used correctly, can accentuate risk-adjusted performance and lower portfolio management expenses.

Growth of ETF Industry

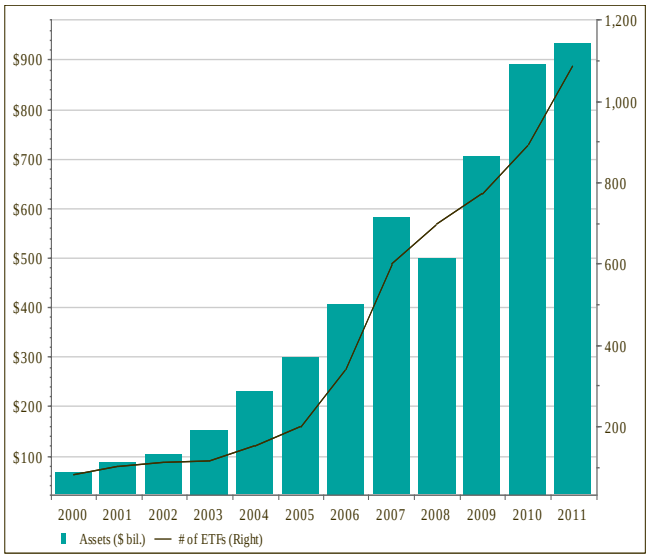
The ETF industry has grown rapidly and undergone significant change since the SPDR S&P 500 ETF (SPY) was first introduced in 1993. Charts I and II show the rapid growth of the ETF industry. At the end of November, there were 1,090 ETFs available within the United States, with an additional 1,892 ETFs available throughout the rest of the world.[i] Obviously, the task of analyzing the composition and quality of ETFs is becoming increasingly difficult, which is why we have a process to compare ETFs and find high-quality products.

Chart I – YTD Growth in the Number of ETFs and ETF Assets



Source: ICI Monthly ETF Data & iShares ETF Landscape Nov. 2011

Chart II – Growth in the ETF Industry since 2000

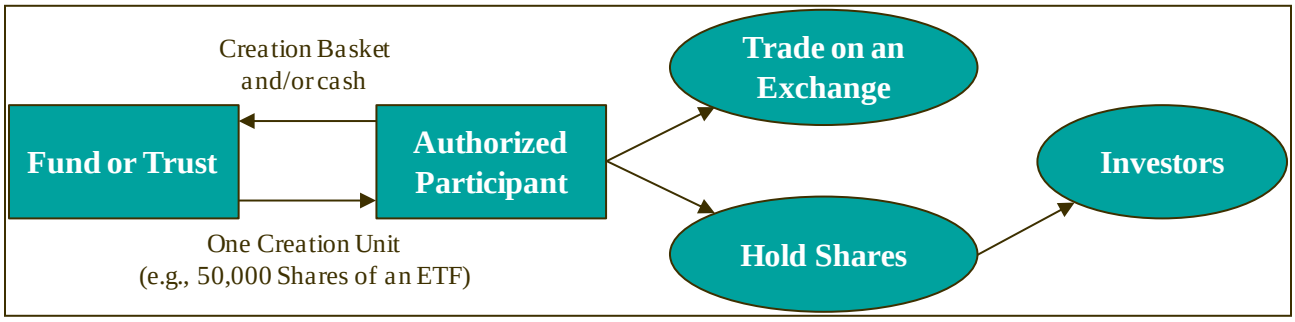


Source: iShares ETF Landscape Nov. 2011

Construction and Liquidity

The concept of the ETF is straightforward, however, the construction and liquidity (trading volume) of the ETF often creates confusion. The process for creating an ETF is known as an "In-Kind" transfer mechanism involving an Authorized Participant (AP) and the fund or ETF sponsor. An Authorized Participant (AP) delivers the holdings, normally equities, comprising the ETF to the fund and the fund receives shares of an ETF. Diagram III depicts this process:

Diagram III – "In-Kind Transfer Mechanism"



Source: ICI 2011 Investment Company Fact Book

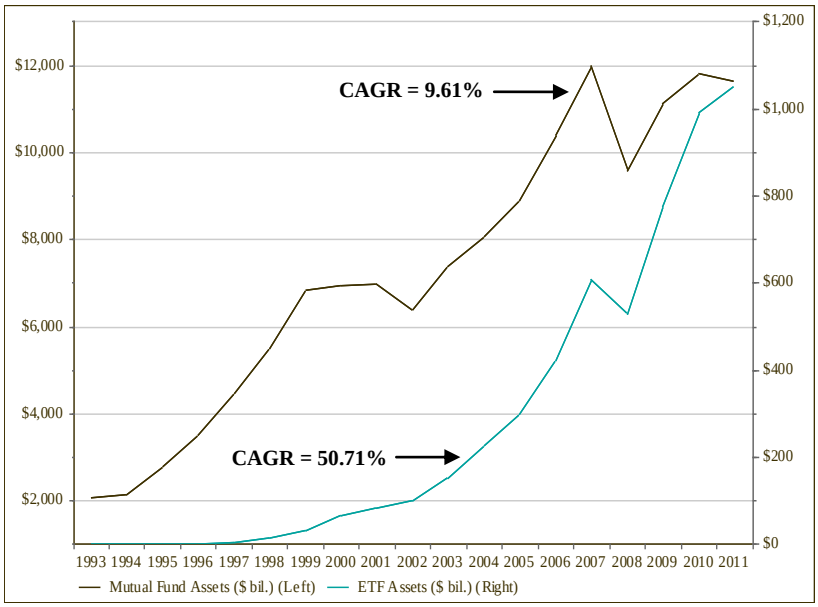
Inherent in the ETF creation process is a liquidity mechanism. When there is market demand for additional shares, they can be immediately created. This is in contrast to shares of stock which are finite until a structured liquidity event occurs (e.g., a capital market issuance of new shares, the block sale of secondary shares, etc.). However, it is important not to oversimplify the liquidity equation as the underlying securities in the ETF are the main driver of fundamental liquidity. For this reason we analyze the composition of each ETF and primarily use ETFs in large, efficient markets where liquidity is less of a concern.

Comparing ETFs to Mutual Funds

Prior to the launch of the first ETF, mutual funds served as the primary way for investors to buy baskets of stocks in one trade. Since then there has been a migration away from mutual funds toward ETFs, and we expect this trend will continue due to the advantages of the ETF structure in portfolio construction. Chart IV shows how asset growth in ETFs has significantly outpaced that of mutual funds.

Chart IV – Growth of US Mutual Funds vs. ETFs

CAGR = Compound Annual Growth Rates for Net Assets of US Mutual Funds & ETFs from 1993 – 2011 (using only 10 months for 2011)



Source: ICI Research – Funds & Market Statistics

Below is a chart comparing some of the main differences between owning an ETF and owning a mutual fund:

Chart V – ETFs vs. Mutual Funds

	Exchange-Traded Funds (ETFs)	Mutual Funds
Expense Ratio	0.06% - 0.85%	0.10% - 2.75%
Fixed Income*	0.27%	0.96%
U.S. Large Cap*	0.33%	1.22%
Int'l Large Cap*	0.51%	1.42%
Trading Fees	Brokerage Fees	Both (No Load & Fee Funds)
Sales/Marketing Fees	None	12b-1 and/or Load Fees (A,B,C)
Management Style	Passive	Active
Trading	Intraday	After-Market Only
Transparency	Daily	Quarterly
Tax Efficiency	Low Turnover	Higher Turnover

**Average Net Expense Ratio . Source: Morningstar ®*

Tax Efficiency

For the most part, ETFs are more tax efficient than mutual funds as a result of their low turnover and dissimilar construction. Mutual funds tend to generate more capital gains distributions due to shareholder redemptions and portfolio rebalancing. Often one shareholder's trading activity can trigger gains for other shareholders. This can be inconvenient, especially when investors are hit with capital gains distributions despite experiencing considerable unrealized losses in the market. ETFs minimize this scenario by paying redemptions with shares of stock. The investor's tax liability is based on the purchase price paid for the ETF shares, not the fund's cost basis.

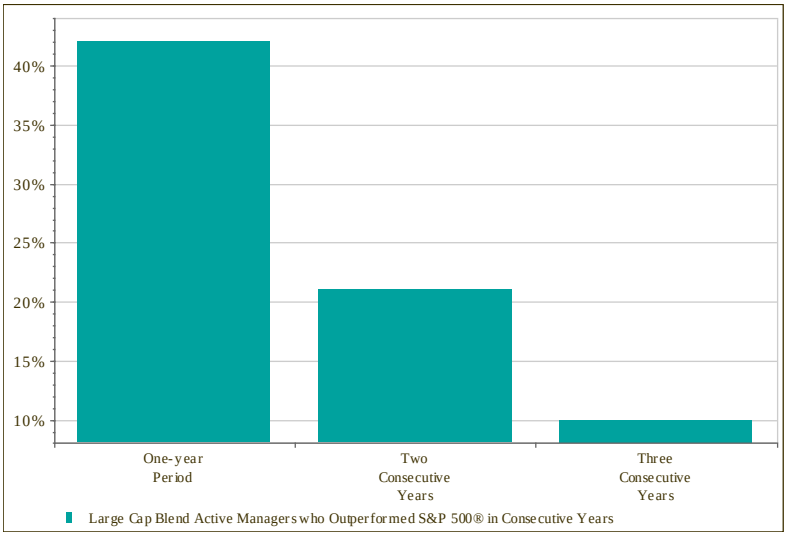
The long-term average cost of mutual fund capital gain distributions can be considerable. Over the last ten years, taxable mutual fund investors gave up an estimated 1-2% in return due to taxes.[ii] The management fee combined with inefficient tax management can put the cost of investing in mutual funds north of 3.5%. Often we find the level of outperformance by mutual funds to be disappointing relative to these costs.

Why use ETFs in Portfolio Construction?

We use ETFs to cost-effectively replicate beta, quickly access trends and diversify illiquid assets. ETFs track indexes (e.g. the SPY tracks the S&P 500 Index), whereas most mutual funds are actively managed by a fund manager relative to a benchmark. Because the manager attempts to exceed the benchmark performance, he or she receives compensation. This "active" management results in a higher cost structure.

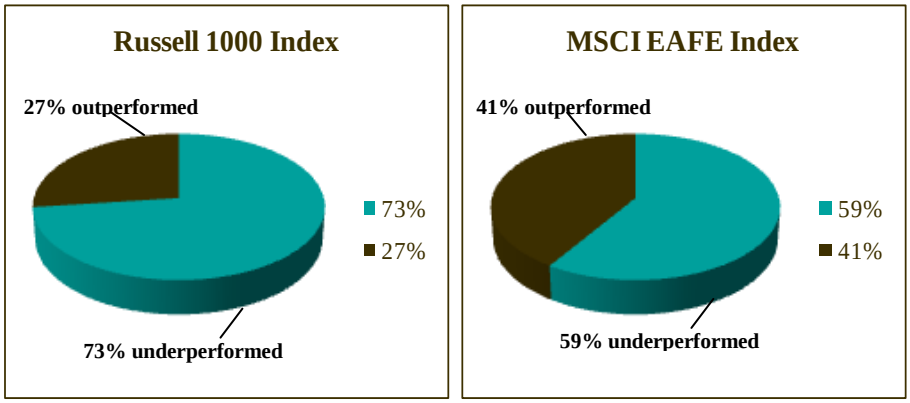
We accept the extra cost if the manager is capable of producing alpha, which is performance in excess of the benchmark. However, persistence is hard to find in mutual fund management. Often funds that beat the passive index one year do not beat it the subsequent year. This increasing lack of consistent outperformance argues for using an ETF for general market exposure. Chart VI illustrates the results of a study done by BlackRock, revealing that only 10% of Large Cap Blend managers beat the S&P 500 for three consecutive years. Chart VII shows the percentage of managers who underperformed the index over five years ending in 2010.

Chart VI -- Mutual Fund Performance Persistence



Source: iShares, "Discover the Benefits: An Introduction to iShares ETFs"

Chart VII – Active Managers performance relative to Index



Source: iShares, "Discover the Benefits: An Introduction to iShares ETFs"

Because ETFs are passively managed, they offer a cost-effective way to access beta (i.e., market risk). Given beta occurs naturally in financial markets, we try to minimize paying for beta and use ETFs in more efficient areas of the market. An area where we have increasingly shifted from mutual funds to ETFs is large cap domestic equity.

We use broad ETFs to fulfill the client's need for beta while we accentuate the portfolio with core holdings based on proprietary research to add alpha. This is one way we drive down management costs in portfolios. We see value in actively managed products in less efficient markets where managers generate considerable alpha due to information scarcity and illiquidity. For this reason, we generally prefer actively managed funds for small cap, emerging markets, and certain hybrids.

Another way we utilize ETFs is to quickly access large macro, sector or factor trends without taking unwanted unsystematic (company-specific) risk. For example, if we believed that the price of oil was attractive and we wanted isolated exposure to oil, we would use an oil-ETF, such as the Vanguard Energy ETF (VDE). In this way we get exposure to a broad basket of companies with exposure to oil prices, while diversifying away much of the company-specific risk. Additionally, if we felt a particular factor was set to outperform, such as quality or dividend yield, we could use an ETF to quickly access a basket

of companies with the desired factor. An example of this would be using the Vanguard Dividend Appreciation ETF (VIG) to quickly introduce dividend yield exposure to portfolios.

As we mentioned earlier, ETF creation in itself naturally reduces certain liquidity risks, so we can use ETFs to diversify illiquid assets. For example, fixed income ETFs have advanced the fixed income investment landscape, bringing liquidity, transparency and diversification to bond investors. By purchasing a fixed income ETF, we can obtain exposure to a certain segment of the fixed income market in one trade, reducing the need to research, price, purchase, and manage a large number of individual bonds. Trading individual bonds is still very costly for the individual investor and using ETFs can contribute to a lower portfolio cost structure.

It is important to utilize innovative investment vehicles, while adhering to our core philosophy of creating high-quality portfolios through disciplined research and diversification. ETFs have revolutionized portfolio construction and trading. We are constantly researching new investment products such as ETFs in an attempt to improve the risk-adjusted performance and expense structure of client portfolios.

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[i] iShares BlackRock®, *ETF Landscape: Industry Highlights*, November 2011

[ii] Tom Roseen, *Taxes in the Mutual Fund Industry – 2010: Assessing the Impact of Taxes on Shareholders' Returns*. Lipper, A Thomas Reuters Company, April 2010