"If you don't study any companies, you have the same success buying stocks as you do in a poker game if you bet without looking at your cards"   Peter Lynch

Exchange Traded Funds – aka ETFs

Mindless Investing in ETFs – The Greater Fool Theory

By way of background, exchange traded funds are investment vehicles that are designed to provide convenient (and easy) access to an investible market including stocks, bonds, commodities and currencies. Although there are many different approaches, most ETFs are *passive* strategies intended to generate returns closely aligned to a specific index such as the S & P 500 Index. ETFs are similar to stocks in that the price of an ETF changes throughout the trading day and usually are priced to closely reflect the value of the underlying holdings (NAV, net asset value). For purposes of this brief discussion, the focus of this article is on ETFs that follow one of the popular stock averages.

Before plunging into some of the pitfalls of ETFs, it is important to look at the recent history of ETFs. Following the financial crisis of 2008-09, investors were disenchanted with the ability of investment managers to outperform the popular indices while also having to pay relatively high fees that detracted from an investor's returns. In 2009, the assets allocated to ETFs were approximately $1 trillion. However, over the last several years, assets devoted to ETFs have exploded to more than $5 trillion, an increase of 400% in only eight years. Along with the huge expansion in this category, the number of ETF offerings grew to more than 6,000. By way of comparison, there are only about 2,400 stocks listed on the New York Stock Exchange.

The advantages of ETFs are well known and include low fees, ease of buying and selling, tax efficiency, lower minimum required investment, greater transparency and the ability to gain exposure to a specific asset class, industry, economic sector, country or geographic region. As such, a well-conceived and thoughtful analysis of an ETF can provide targeted exposure to a desired part of the global marketplace and help create a well-diversified investment portfolio. These advantages are just some of the factors that have created the wave of assets moving from actively managed accounts and mutual funds to the ETF category. However, it must be pointed out that while low fees are always a consideration, the low fees will be meaningless if the underlying assets are not appropriate to the individual investor. In this regard, some newer ETFs formed in recent years that focus on fundamentals or specific themes (such as sports ETFs) have underlying expenses as high as long-established mutual funds but have no stated goals to deliver performance greater than their benchmarks. In the rush to embrace this new method of investment management, many of the disadvantages of ETFs are overlooked or simply not analyzed with great care. In their haste, many investors take on other risks that have not been fully explained.

Among the many risks are market risk, trading risk, liquidity risk, composition risk, tracking error risk, counterparty risk, tax risk, closure risk and hype risk. Market risk is simply the fact that an ETF cannot avoid the fate of the market they are intended to track. Trading risk refers to the total cost of owning an ETF. ETFs incur costs such as commissions, sales charges, market impact cost such as the bid-ask spread and management expense ratio. Liquidity risk is associated with the liquidity of the underlying asset. Composition risk refers to the fact that two ETFs tracking the same index may not hold the same holdings and could differ from the underlying index. Tracking error risk refers to the fact that an ETF may not exactly follow the index due to management fees, tax treatment and the timing of dividends. Counterparty risk comes into focus when dealing with securities trading and specifically when holdings are loaned to another investor for a short time. Tax risk doesn't apply to all ETFs but is especially important if the ETF is exposed to commodity and currency markets. Recently, about 100 ETFs close each year when managers are forced to liquidate the fund and pay out to the investors. In a closure, managers incur capital gains, transaction expenses and legal expenses that effect the investor. Lastly, there is hype risk as investors tend to flock to the next big thing.

From this brief enumeration of the various risks associated with ETFs, it should be easy to conclude that ETFs are not the panacea that investors thought they represented when they first came into focus two decades ago. Nevertheless, investors who have struggled to match the returns of widely followed indices such as the S & P 500 Index have embraced SPY, the ETF designed to replicate the S & P 500 Index. SPY is now the ETF with the most assets and continues to see a steady flow of new money to the fund. Due to its popularity, it may be instructive to closely examine this fund to understand its nature and how it may perform during the next downturn in the economy and the markets.

In attempting to understand SPY, let's look at the construction of the underlying asset, the S & P 500 Index. The Index is a capitalization weighted index meaning that each stock has a weighting determined by its capitalization as a percentage of the total combined capitalization of the entire 500 stocks in the index. Needless to say, the largest stocks therefore have the largest weighting in the index. Keeping this in mind, everyone even slightly interested in the equity markets during the last several years have been mesmerized by the dominance of growth stocks and, in particular, the FAANG stocks. The FAANG stocks are Facebook, Apple, Amazon, Netflix and Alphabet (formerly Google). These stocks have been market leaders for the last couple of years and are currently selling at price/earnings multiples that are excessive. Amazon is currently selling for 253 times the latest 12-month earnings per share and Netflix is selling for 197 times the latest 12-month earnings per share. In general, the FAANG stocks are priced for perfection when there are many reasons to be skeptical about their continued outperformance.

As already mentioned, these five stocks have performed admirably during the last couple of years and now comprise approximately 11% of the S & P 500 Index. Specifically, Apple has a weight of 4% of the Index, Google has an almost 3% weight and Amazon and Facebook combine for another 4%. In addition, the Index is heavily weighted in the technology sector with five of the top ten stocks in the index being tech names. And, in the top 25 names in the Index are Microsoft, Intel and Cisco Systems. In total, the technology sector accounts for almost 25% of the Index, up from 18% just four years ago. Keep in mind that at the peak of the dot-com bubble in early 2000, the tech sector weighting was almost 35% but fell to 13% in the crash.

So, when investors seeking a well-diversified investment choose the S & P 500 Index ETF, they unknowingly are placing a significant portion their money in the highest priced and most overvalued sector of the market. This is true because there is no individual manager deciding which stocks look the most attractive after careful analysis. Instead, the new money into the ETF is allocated in strict accordance with the current weighting of each stock in the Index. Of course, this is the exact opposite of what every novice investor is always told…..***buy low and sell high***. Managers of Index funds have no choice but to ignore valuation metrics and fundamentals. Just like any investment, it's always important to ***"know what you own."*** Unfortunately, in the present composition of the index, investors have the highest exposure to a sector that offers minimal upside from current levels. Thus, when the market turns down and investors want to reduce their exposure to the popular averages, they will all be selling the same basket of stocks. Lastly, be aware that ETFs are a relatively new investment vehicle and their liquidity has not been tested in a real-time bear market. Frankly, it a recipe for disaster that will shock investors who thought they were in a diversified index with well-defined risks. It could get ugly and become the fodder for many horror stories.

Before turning to our perspectives on the market and how best to prepare for a slowing economy and a possible bear market, one other aspect of the current market needs to be discussed. Historically, in low volatility markets such as seen in 2016, 2017 and very early 2018, liquidity was sufficient to meet the needs of most large and small investors. However, it is a fact that as volatility rises, liquidity falls, often dramatically. Since late January 2018, volatility has returned with a vengeance and liquidity has dried up in the process. Reduced liquidity means that at any given time, it is more difficult to buy or sell securities without noticeably affecting the price of the security in question. In this new environment, the trading of ETFs can be impacted by the reduced level of liquidity. Within the ETF marketplace, there is a methodology for keeping the price of an ETF reasonably close to the underlying value of the targeted index. High speed trading platforms use algorithms to assist in this important function. However, if the market is rapidly declining, there can be a disconnect between the price of the ETF and the value of the underlying index. Thus, in a volatile and declining market, liquidity dies up and the disparity between the price of the ETF and the underlying index widens. This often results in investors selling at significantly lower prices than the actual net asset value of the fund.

Within this uncertain environment when valuations and fundamentals appear to have little significance, there are some other considerations to ponder as the market gyrates in a trading range. The market has a long history, and history has lessons for those who wish to take note. Over the long term, twenty years or more, value stocks and growth stocks perform similarly. Over shorter periods of time, three to five years, growth will outperform value for a while and will then be followed by a period when value stocks outperform growth stocks. This is nothing more than the ebb and flow of assets to the most attractive sector based upon a three- to five-year time horizon.

As we move through the second quarter of 2018, growth stocks have put on an incredible performance and have largely outperformed value stocks since the economic recovery began in 2009. This lengthy period of outperformance of growth stocks is unprecedented in modern market history and suggests that it may be time to stop, take notice and reassess the outlook for the coming years. In doing so, it is difficult to ignore the absolutely compelling values that exist today in high quality companies with strong balance sheets and a solid business plan for growing earnings and dividends. Having been in the investment management business for almost five decades, the opportunities for value investing have seldom been better. We at Metis Value Partners, LLC are excited about the values currently available in the equity markets and are looking forward to participating fully in the resurgence of value stocks in the years to come. As always, keep in mind that ***price is what you pay and value is what you get.***

We appreciate your confidence in us and our time-tested methodology and look forward to working with your as we grow our respective businesses by serving the needs of our valued clients.

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