
How to Build a Strong Portfolio with ETFs



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Agenda

- g What is an ETF?
- g Advantages
- g Investment Strategies
- g Questions

What is an ETF?

A 21st Century Investing Technology



What is an ETF?

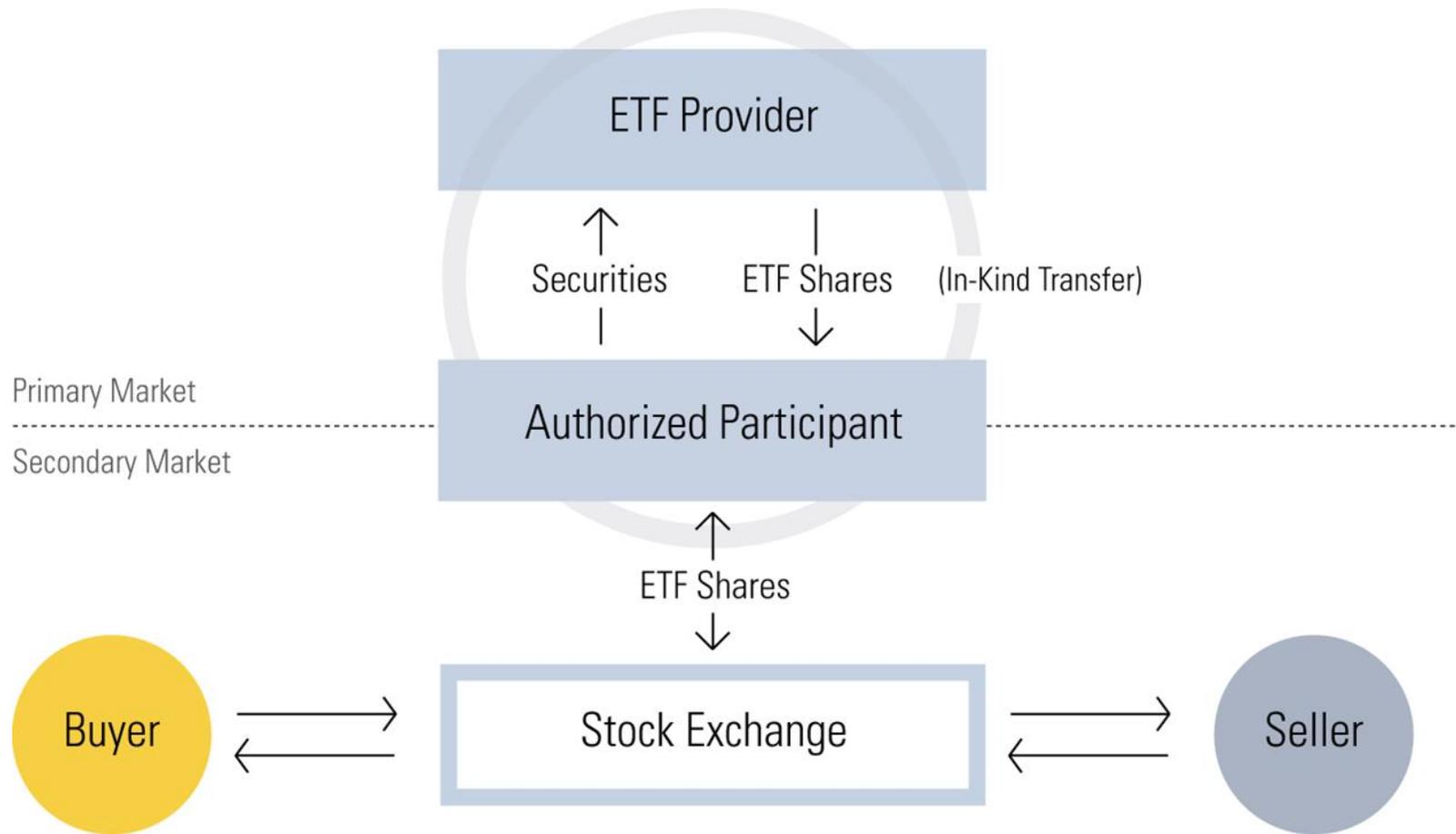
- g Like a stock, these trade on an exchange
- g Like a mutual fund, they own a portfolio of many securities

How a Mutual Fund Works



Source: Morningstar

How an ETF Works



Source: Morningstar

ETFs Externalize Costs



Why ETFs?

g Tax-Efficiency

g Transparency

/ This is a deterrent for many traditional active managers

/ Most ETFs are index funds

g Cost-Efficient

/ Externalize trading costs

/ Low Fees

	Median Fee (%)
Index Mutual Fund	0.49
Active Mutual Fund	1.00
Index ETF	0.47
Active ETF	0.60

What Types of ETF Strategies are Available?

g Passive ETFs that own “the market”

/ These track broad market-cap-weighted indexes

g Smart-beta ETFs

/ These are index-based strategies that make active bets

g Active ETFs

/ Not many; these don’t track an index

g ETFs span multiple asset classes, including stocks, bonds, and commodities

ETF Investment Strategies Worth Considering

The Market Portfolio

g When in doubt, own the market

/ Vanguard Total Stock Market ETF VTI

/ Owns most U.S. stocks and weights them by market capitalization

g Benefits

/ Low fees

/ Harnesses the market's collective wisdom

/ No key manager risk

/ Tax efficient

/ Well-diversified portfolio

Most Active Managers Underperform Over the Long-Term

Exhibit 1 Active Funds' Success Rates by Category (%)

Category	1-Year	3-Year	5-Year	10-Year	15-Year	20-Year	10-Year (Lowest Cost)	10-Year (Highest Cost)
U.S. Large Blend	31.1	15.5	16.4	10.9	13.9	19.7	17.3	2.1
U.S. Large Value	30.1	12.6	13.5	8.3	16.0	8.4	16.0	5.3
U.S. Large Growth	48.9	29.7	21.0	8.3	10.7	—	14.4	3.1
U.S. Mid Blend	31.4	19.3	17.9	11.9	7.8	10.6	21.9	12.5
U.S. Mid Value	22.0	12.5	7.5	9.4	20.2	—	7.7	0.0
U.S. Mid Growth	75.8	58.9	48.6	30.3	26.9	—	35.7	25.0
U.S. Small Blend	21.3	21.2	19.0	24.9	17.1	32.4	41.0	25.6
U.S. Small Value	15.9	16.8	23.6	33.3	17.1	—	38.5	34.6
U.S. Small Growth	52.1	51.4	35.1	24.3	9.1	—	20.4	24.4
Foreign Large Blend	18.5	25.4	32.8	24.5	28.4	38.1	31.6	13.2
Foreign Large Value	14.5	20.0	27.2	26.3	—	—	42.1	21.1
Foreign Small-Mid Blend	21.2	19.2	16.0	70.6	—	—	75.0	75.0
World Large Stock	41.3	26.8	30.1	26.3	24.5	—	37.1	11.8
Diversified Emerging Markets	20.8	33.0	51.8	54.5	—	—	71.4	25.0
Europe Stock	24.0	21.7	12.5	43.3	31.0	—	100.0	33.3
U.S. Real Estate	23.9	7.2	33.3	34.2	35.5	29.8	60.0	26.7
Global Real Estate	72.4	9.8	51.9	14.9	—	—	20.0	0.0
Intermediate Term Bond	38.1	66.9	51.3	55.6	34.0	24.6	70.2	47.4
Corporate Bond	28.6	59.2	53.8	66.7	—	—	80.0	80.0
High Yield Bond	28.8	37.8	40.2	56.3	—	—	64.5	48.3

Source: Morningstar. Data and Calculations as of 12/31/2018.

Criticisms

g Own all the bad stocks

/ Yes, but...this portfolio never misses the market's big winners

g Market-cap-weighting might assign bigger weightings to more expensive areas of the market

/ True, but stocks that are expensive are usually priced that way for good reason

International Stock Market Portfolio

g Vanguard Total International Stock Market ETF VXUS

/ Includes both foreign developed and emerging market stocks

/ Currency Risk

g It's still good to have some exposure to foreign stocks

/ Where stocks are listed isn't necessarily representative of where they do business

/ Most large companies are global

/ Restricting holdings to the U.S. artificially limits diversification

Fixed Income Market Portfolio

g Vanguard Total Bond Market ETF BND

/ Broad market-value-weighted exposure to the U.S. investment-grade bond market

/ Conservative portfolio, tilts toward treasuries and agency MBS

g This won't be the highest returning bond fund around, but it provides a defensive counterweight to stocks

g Many active managers take more credit risk than this fund to boost returns

/ Beware

Strategy 2 – Defensive Investing

Defensive Investing

- g Option 1: Tilt more heavily toward bonds and away from stocks
- g Option 2: Take a more conservative approach within each asset-class

Defensive Stock Strategy

giShares Edge MSCI USA Minimum Volatility ETF USMV

- / Attempts to construct the least volatile portfolio possible, using stocks from the MSCI USA Index
- / Considers past stock volatility and correlations
- / Constrains sector weightings and turnover

Defensive Stock Strategy

g Benefits

- / Should exhibit lower volatility than the market
- / Better downside protection
- / Lower sensitivity to market fluctuations

g Trade-offs

- / Will likely lag during market rallies
- / This will still lose money during market downturns

Defensive Stock Strategy

- g Expectation: Competitive to slightly lower returns than the market over the long-term, with lower risk
- g Why should it work?
 - / Behavioral biases
 - / It's easier to forecast risk than returns
- g iShares Edge MSCI EAFE Minimum Volatility ETF EFAV applies a similar strategy in foreign developed markets

Defensive Bond Strategy

- g Tilt toward short-term investment-grade bonds
- g Vanguard Short-Term Bond ETF BSV

Strategy 3 – Factor Investing

What is a Factor?

g A factor is a common characteristic that can explain and predict security returns

g Examples:

/ For Bonds:

/ Credit risk

/ Interest rate risk

/ For Stocks:

/ Valuations

/ Size

/ Momentum

/ Quality

Multifactor Stock Investing

- g While all these factors have good long term records, they can each underperform for a long time
- g Diversifying across these factors can reduce (but not eliminate) the risk of underperformance
- g iShares Edge MSCI USA Multifactor ETF LRGF
 - / Targets large- and mid-cap U.S. stocks with attractive:
 - / Value
 - / (Small) Size
 - / Momentum
 - / Quality

International Multifactor Strategy

giShares Edge MSCI Multifactor International ETF INTF

Strategy 4 – Income Investing

Don't Aggressively Chase Yield

- g The highest-yielding areas of the market are often riskier than average
- g Two ways to stay out of trouble:
 - / Broad diversification
 - / Screen for quality

Stock Income Investing

g Vanguard High Dividend Yield ETF VYM

/ Targets the higher yielding half of all U.S. dividend payers

/ Weights them by market capitalization

g Schwab U.S. Dividend Equity ETF SCHD

/ Screens for high yielding stocks with attractive:

/ Dividend growth, ROE, Cash Flow/Debt

Bond Income Investing

g High yield bonds don't diversify stocks as well as investment grade bonds

/ To increase income without taking a lot of credit risk, consider investment grade corporate bonds

g iShares Broad USD Investment Grade Corporate Bond ETF USIG

/ Offers broad exposure to investment grade U.S. corporate bonds with at least one year until maturity

/ Market-value weighted

Recap

g ETFs are an efficient 21st century investment vehicle

/ Tax efficient

/ Transparent

/ Externalize trading costs

g Investment strategies

/ Own the market (VTI/BND)

/ Take less risk than the market (USMV/BSV)

/ Try to beat the market (LRGF)

/ Target high yielding securities (VYM/UISG)

Questions?