



## **The fundamentals of ETF selection** *How we choose investments at OCM*

When I formed Osbon Capital Management (OCM), my goal was to develop and manage portfolios that were highly diversified, kept expenses low, limited tax liabilities, promoted transparency, and, to the extent possible, avoided unpleasant surprises. With these goals in mind, I adopted indexing as the core of the OCM investment strategy and chose exchange traded funds (ETFs) as the investment building blocks that would facilitate my vision for the business. OCM client portfolios are now composed exclusively of index ETFs. Here's why, and how we select ETFs.

I have always been drawn to index investing for its elegant simplicity. By owning a large basket of securities representative of the entire market, an investor can literally "be the market." This investor need not make bets on any particular security; owning everything means reaping all of the benefits of the general upward movement of markets over the long-term, while minimizing exposure to any single catastrophe.

Princeton professor Burton Malkiel describes the beauty of index investing far more eloquently than I can. See our [article](#) "Random Walk Redux" for an overview of his groundbreaking research. In a nutshell, he describes how passively managed index portfolios often outperform actively managed funds, especially when measured on an after-tax basis, which is the only meaningful measurement for most individual investors.

### **Building the house**

Building a portfolio is in many ways similar to building a home. The selection of construction materials is just as important as the architectural design. Stronger materials yield a sturdier, safer, more comfortable structure. Researching and selecting ETFs are critical functions to which we devote significant time and energy.

The first step in selecting desirable index ETFs is recognizing that not all ETFs are indexes. Some are actively managed funds susceptible to the pitfalls of high expenses and market-timing. Others are merely sponsor-selected collections of stocks meant to look like indexes. OCM chooses only ETFs that represent specific published indexes, avoiding all that are too specific or narrow in scope to meet our diversification standards. We also avoid actively managed ETFs and "short ETFs" as they fall outside of our pure indexing strategy.

We are also careful to avoid exchange traded notes (ETNs) which sound and trade like ETFs, but are secured only by an IOU of the sponsor, not by the value of the indexed securities. For instance, Lehman's commodity ETNs – RAW and EOH – collapsed when Lehman went bankrupt, even though the indexes the ETNs were meant to track were healthy.



### **What we look for**

As the universe of available ETFs now numbers more than 700 (with total assets of more than \$600 billion), we see a significant range in the quality and desirability of ETFs. Due diligence is essential in choosing all investments, ETFs included. OCM conducts its ETF research through proprietary information providers, such as Bloomberg, and through company sources. We regularly and systematically review ETFs, always seeking to identify and utilize those investments that best suit the needs of our clients.

We have vetted and approved 65 ETFs for inclusion in our client portfolios. We rigorously evaluate the following:

- **Fund description** – What exactly is being indexed? Is it a true index?
- **Sponsor** – Is the sponsor experienced in, and committed to, index ETFs?
- **Expense ratio** – Are return-eroding expenses kept to a minimum?
- **Tax efficiency** – Is the fund managed in a way that minimizes taxable gains, especially short term?
- **Tracking error** – How closely does the ETF match the index it tracks?
- **Date started** – Is there sufficient track record to evaluate elements listed above?
- **Assets** – Is the ETF large enough to be liquid and tradable at any time at a price that reflects its real net asset value?

Of the criteria listed above the first one is most important. It is critical to understand what is being tracked, as not all indexes operate identically. For instance, an index with rigid entry and exit rules may result in more turnover, higher expenses and higher tracking error than a similar index with less rigid in and out rules. We generally favor ETFs based on MSCI (Morgan Stanley Capital International) and Russell indexes as we find them to be logically constructed and efficiently managed.

### **Committed to cost control**

Once the composition of an index ETF is established, the ETF is reviewed and ranked for historical expense levels and tax efficiency. ETF costs have been falling consistently. Vanguard has been the most aggressive firm in cutting costs, offering some ETFs with operating expense ratios as low as 7 basis points. Any expense ratio up to 25 basis points meets our standard. Anything over that must justify its expense. International equity funds, for example, are simply more expensive to operate, so their expense ratios may approach 50 basis points.

**The OCM advantage:**  
Osbon Capital Management's goal is to keep and grow capital for individuals using index ETF investments. In selecting ETFs we emphasize quality, long term thinking, low to no leverage, tax efficiency, and liquidity.



Cost control is an ongoing priority at OCM. We recently reviewed our universe of 65 ETFs and in many cases were able to reduce expenses by 25 basis points by moving to similar but more efficient offerings.

Similarly, we favor ETFs that do not pass on any capital gains until shares are sold, allowing investments to grow in value without the dilution of current taxes.

### **ETFs versus mutual funds**

ETFs are not the only index vehicles available. In fact, index mutual funds significantly pre-date ETFs. Often lumped together as interchangeable, index ETFs and mutual funds are far from identical. While both offer the basic advantages of indexing – the ability to own dozens or hundreds of securities through a single transaction, low expenses, and transparency – we see important inherent advantages in ETFs:

- ***Investors own their basis.*** Unlike a mutual fund where the newest incremental buyer owns the collective basis of the fund, investors who own ETFs own their own basis (cost). When the ETF is sold, any capital gain is based on that investor's own specific basis.
- ***Gains are realized at sale.*** By their very design, ETFs minimize capital gains tax exposure. Unlike mutual funds that distribute taxable gains periodically, ETFs accumulate gains until investors therefore allow investors sell. By deferring the tax liability, returns compound more quickly.
- ***Prices update continuously.*** Mutual funds are priced once daily based on the net asset value at the end of the day. ETFs, by contrast, fluctuate in value throughout the day, allowing investors to make decisions on immediately available prices. With indexes surging and falling in value by 5-10% on many recent trading days, continuous pricing is an important plus for ETFs.

No investment vehicle is perfect. But for investors seeking to earn the total market return, we see ETFs as exceptionally powerful tools, facilitating construction of globally diverse portfolios that continuously seek to provide low cost and tax efficiency. Index ETFs are also desirable for what they prevent – large, precarious positions in any single stock. Amid the current financial crisis, for instance, our investors in ETFs were exposed to the deterioration of AIG, but only as a barely noticeable part of large, diverse indexes.

In short, index ETFs are solid building materials with which investors can build a comfortable, sturdy, cost-efficient investment house.



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