An introduction to Exchange-Traded Funds (ETF)
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Evolving from Mutual Funds…

Three big deterrents from investing are cost, volatility and risk of enduring loss. Any ways of reducing them are welcome. Until 1931 the only way to buy and maintain a diversified portfolio was via a stockbroker charging a percentage commission; beyond the means of most people.

Out of crisis arose an opportunity. In response to the 1929 Crash, Municipal&General (M&G) invented the Unit Trust 'pooled' fund; a basket of assembled stocks, enabling people of ordinary means - and regular savers - to invest more affordably in world markets.

These days, each pooled fund is an investment *company* with its own legal identity; run by directors who select the contents of the basket and occasionally alter it; measuring its performance against an adjacent index (eg FTSE100, S&P500); intending always to beat it.

…via Index Trackers…

In 1975, American investor Jack Bogle bravely expressed a judgment that fund managers were too often failing to beat their benchmark; partly owing to management charges.

To make his point, he dared found an investment company (Vanguard) mutually owned only by its clients. He launched an index-tracking fund; explicitly not trying to beat the index, but faithfully and perpetually to match it as close as he could.

At first Bogle's approach suffered ridicule from the investment community. "*Who wants to be operated on by an average surgeon, be advised by an average lawyer, or be an average registered representative, or do anything no better or worse than average?*"

For a fraction of active managers' fees, Bogle demonstrated '*after charges, the average active-investor must underperform the average passive-investor.*' Forty-six years later, Vanguard has more than 20 million investors, who between them still own the company.

…to Exchange-Traded Funds

Although mutual funds fulfil many retail investors' needs, they don't attract institutions, because mutuals trade only once a day (usually at noon). Vulnerable to competition, institutional investors seek strategies offering an edge of speed and versatility. They want tactical advantage; instant, measurable response, and cheaply.

In 1990, the Toronto Stock *Exchange* offered an index-tracking option of its own; matching the Toronto 30 Index, *tradable* all day, it was an 'exchange-traded fund' now known as ETF.

Its value soon became evident, and not for long could institutions keep secret from retail investors their adept device: State Street, Invesco, Vanguard, iShares all saw the value of offering ETF in the retail market. They've proliferated ever since, and worldwide in September 2020 there were 6,970 Exchange-Traded Products, with a total value of $7 trillion.

Of some UK investment managers, the disparaging attitude to ETF reminds me of a quip attributed to Mahatma Gandhi: '*First they ignore you, then they laugh at you, then they fight you, then you win.*'

In my opinion; for the core portfolio of most retail investors, ETF are the most suitable investment vehicle. I believe ETF are now fully-established, and will advance to a state of balance with actively-managed funds.

Comparing ETF to other kinds of pooled fund

ETF serve the same purposes as mutual funds; access to world markets at low cost; lower risk with diversification; increased buying-power thanks to economies of scale.
Yet ETF offer several extra merits:

a. Needing no discretionary input, ETF are cheaper by half - or even more. The annual charge for an all-round diverse portfolio - *UK, USA, Europe, Asia, Emerging Markets, UK corporate bonds, UK gilts, World aggregate-bond, World real estate and World commodities* - could be as little as 0.14%. I doubt such a portfolio of active funds would cost less than ten times as much.
b. Because ETF match their index, their composition is explicit, and their boundaries are clear. That's valuable on two counts: we know exactly what we own, and we can avoid overlap between funds.
c. ETF trade instantly, all through the day. Usually not important when buying, but once we've decided to sell, celerity is often a high priority.
d. The UK regulator (FCA) is in support of the low-cost and simplicity which ETF embody. Having a statutory objective to promote competition in the interests of customers, FCA has written, '*where there is something lower-cost or simpler which will fully meet a client's need, FCA expects advisers to recommend it. Any additional cost would have to have an explicit benefit for the client.*'
e. Even the UK Treasury supports ETF. Most transactions on LSE are subject to 0.5% stamp duty, but ETF are exempt.
f. To dismiss every single actively-managed fund, I judge would be complacent. A few I support avidly: those into which the managers have invested much of their own resources: Baillie Gifford, Smith, Anderson, Lindsell & Train, Rothschild.

Other factors supporting ETF as my first choice of investment vehicle:

a. Modern stockbrokers charge not a percentage commission, but a fixed price irrespective of trade-size. That well suits investors of larger sums.
b. For investors of smaller sums (eg less than £1,000 and regular-savings) I recommend Vanguard's own ETF, because it trades all 25 free-of-charge.
c. Thanks to modern IT, we can all easily keep track of our own portfolio; even on a smartphone. I'm accustomed to teaching clients how to make their own transactions via their laptop. For clients preferring not to transact, Dexterity will happily make the trades; either after we've conferred and agreed, or upon '*execution-only*' instruction.
d. No kind of payment do I receive from any ETF provider or stockbroker. To clients I charge a fee for my time and know-how. I have professional indemnity insurance to the level FCA requires.
e. For safety - to support investor confidence - ETF obey rules to limit borrowing and short-sales; rules about independent boards and segregated custody of assets.
f. For tax-convenience, most ETF issuers domicile in Ireland or Luxembourg. Both nations run an investor compensation scheme lest an ETF provider go bust.

Disclosure

Of my own savings, almost 100% I've invested equally between 12 Global thematic ETF including: water, clean energy, health care, electric vehicle technology, cyber security and others. A small amount of cash I hold to cover unavoidable charges.
The broker I use is AJ Bell, because I deem its efficiency consistent, and its charges modest; 0.2% annually for custody and administration and £3.95 per transaction.
There is an option cheaper-still; provided clients be willing to take care of their own transactions. In that case for Dexterity's on-request support, I charge £200 per hour.