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ARCATAUR CAPITAL

Arcataur Capital Management LLC
A Registered Investment Advisor

High Quality Investment Management
For Individuals and Institutions

Exchange Traded Funds - ETFs

Exchange traded funds (ETFs) were first created in 1993 and are an increasingly popular class of funds that trade like stocks. They can be bought and sold throughout the market day and offer portfolio exposure to many of the world's leading indexes. In recent years, they have gained popularity among individual investors, but have been a tool for institutional investors and active traders over the last two decades.

When you invest in an ETF, you are investing in a basket of securities that provides exposure to a particular segment of the market, such as a broad market, sector or geographic area. Generally, ETFs track indexes. ETFs are popular among investors because they are an easy and low-cost way to quickly build a well-diversified portfolio.

At times ETFs are compared to mutual funds which are purchased or redeemed directly with the fund one time each market day, at the close of the market. While you can place an order to buy or sell a mutual fund earlier in the day, your order will be processed only at the end of the day. The price you pay for your mutual fund is based on the Net Asset Value of the fund, determined by the day's closing prices of all the securities within that fund (plus any applicable sales charges, or loads).

An ETF trades much more like a stock. It's traded on a stock exchange, and you can buy or sell shares at any time during the day. The price is determined by supply and demand for the ETF in the market. Just as with stocks, you typically pay a commission for each trade. Many custodians provide discounted or even free commissions on certain ETFs. This reduces the cost of investing in such instruments. In general ETFs offer diversification with the trading flexibility of a stock.

Benefits of investing in ETFs

- **Costs are often low.** ETF expense ratios are generally low (although there are exceptions). **The index based ETFs Arcataur uses have embedded fees below 0.4%, with many below 0.1% annually**.

- **They are more diversified than individual stocks.** Because ETFs represent a basket of securities rather than a single stock, they provide more diversification, and investment risk is not concentrated in a single holding.

- **They represent almost every asset class.** That's good news if you're looking to broadly diversify across asset classes or if you're looking to fill a niche in your portfolio. ETF asset classes include large-cap, mid-cap, and small-cap stocks; growth stocks and value stocks; domestic, international, and emerging market stocks; sectors; long-term, mid-term, and short-term bonds; real estate; currencies; commodities and more.

- **They can be traded any time during the market day.** ETFs allow you to take advantage of opportunities that occur during the day. Unlike traditional mutual funds, you don't have to wait until the markets close for your trade to be completed.

- **They offer potential tax benefits.** Unlike mutual funds, ETFs don't sell their holdings to satisfy shareholder redemptions. This can keep capital gains low. And since most ETFs track indexes, their holdings tend to have less turnover, which further reduces distributions.

- **Their holdings are transparent.** ETFs make their holdings publicly available on a daily basis. This can help investors understand exactly what they hold.

Exchange Traded Funds - ETFs

What are the risks and drawbacks of ETFs?

- **Market risk is always a consideration.** Just like any other investment, you can lose money in ETFs if the market that they track experiences a downturn. Though you can't eliminate this risk, you can help mitigate it by investing in a mix of ETFs in different asset classes, such as domestic stocks, international stocks, and bonds.
- **Some ETFs are high risk.** Leveraged ETFs and ETFs that are narrowly focused may be more volatile than traditional ETFs. **Arcataur Capital does not utilize leveraged nor narrowly focused ETFs.**
- **Investors generally pay a commission for every trade.** Unlike no-load mutual funds, ETFs have a trade commission. However, many custodians provide certain ETFs with a discounted or with no trade commission.
- **Not all ETFs are low cost.** Although many ETFs have low expense ratios, some do not. **Arcataur does not utilize any high cost ETFs for clients.**
- **Market price and net asset value are not always equal.** The price you pay for an ETF will generally be close to the value of the underlying stocks or bonds in the fund; the net asset value (NAV). However, the market price can deviate from the NAV, meaning you might pay more (or less) than the underlying value per share. **This can be an advantage as Arcataur actively trades ETFs for clients and can find unique trading opportunities for clients.**
- **There is a spread between the bid price and the ask price.** There is typically a difference, or spread, between the bid price (highest price a buyer is willing to pay for a share) and the ask price (lowest price a seller is willing to accept for a share). The amount of the spread varies from one ETF to another, and tends to be higher for ETFs with low trading volume. **Again this can be an advantage as Arcataur actively trades ETFs for clients and can find unique trading opportunities for clients.**

Different types of ETFs and usage by Arcataur Capital Management

ETFs commonly track broad-based market indexes. These are what most investors have in mind when they think of ETFs – they tend to be low cost, highly diversified, and highly liquid. ***Arcataur*** utilizes ETFs in a disciplined way to complement direct investments to truly create a level of diversification that allows for sound investment management. When hired to provide a complete stock investment solution, we will utilize five core broad index ETFs to provide liquidity to our direct large capitalization portfolio, increase diversification to round out domestic stock exposure and gain international diversification as well. The core ETFs utilized are the following:

- iShares Core S&P 500 Index - IVV
- iShares Core S&P 400 Mid-Cap Index - IJH
- iShares Core S&P 600 Small Cap Index - IJR
- iShares MSCI EAFE Index - EFA
- Vanguard FTSE Emerging Markets Index - VWO

Other low cost equity ETFs are considered to gain additional diversification where appropriate. Total equity exposure through ETFs is primarily used for clients with lower asset levels where direct stocks are not feasible due to inability to balance diversification needs and trading costs or if clients hold direct stocks elsewhere. While the ETFs mentioned above are the core index funds utilized, we may also consider other ETFs to gain incremental equity diversification where appropriate for our clients. Below are few examples of ETFs we may consider for broader diversification:

- PowerShares QQQ NASDAQ 100 Index - QQQ
- Schwab U.S. Large Capitalization Index - SCHX
- Vanguard Dividend Appreciation Index - VIG
- Vanguard High Dividend Index - VYM
- Schwab U.S. Mid-Capitalization Index - SCHM
- Schwab U.S. Small Capitalization Index - SCHA
- Schwab International Equity Index - SCHF
- Schwab Emerging Markets Index - SCHE
- iShares MSCI Brazil Capped Index - EWZ

Exchange Traded Funds - ETFs

In a similar fashion for our fixed income portfolios we will utilize broad-based bond ETFs for most of our clients to achieve improved liquidity, diversification and portfolio structure. Total portfolio duration can be adjusted efficiently though targeted bond segment and broad index-based ETFs. This may include inflation protected bonds, corporate bonds and duration-targeted broad-based portfolio ETFs. Typically the fixed income portfolio for clients will be no more than 30% bond ETFs, while the remaining portion will be direct individual bonds. The primary core bond ETFs utilized are the following:

- iShares Treasury Inflation Protected Bond - TIP
- Vanguard Short-term Bond - BSV
- Vanguard Short Duration Corporate Bond - VSCH
- iShares iBoxx Corporate Bond - LQD
- iShares Preferred Stock - PFF

These core bond EFTs enhance liquidity and exposure of the direct bond portfolio. Where additional diversification is required we will also utilize the following bond ETFs:

- Schwab Treasury Inflation Protected Securities - SCHP
- FlexShares iBoxx Three Year Target Duration Treasury Inflation Protected Securities - TDTT
- FlexShares iBoxx Five Year Target Duration Treasury Inflation Protected Securities - TDTF
- iShares 0 to 5 year Investment Grade Corporate Bond - SLQD

For clients who require specific exposure to commodities or targeted sectors we typically will utilize ETFs in these situations. Some examples we utilize on request are the following:

- SPDR Gold Shares - GLD
- iShares Silver Trust - SLV
- Market Vectors Gold Miners - GDX
- Market Vectors Semiconductors - SMH
- Financial Select Sector SPDR - XLF

The availability of these low cost instruments integrated with direct assets Arcataur purchases for our clients truly diversifies a portfolio. The enhanced diversification, liquidity and proper portfolio construction have the potential to improve long-term returns, reduce risk and offer more flexibility for clients of all sizes as well to address special requirements.

Sources: Charles Schwab, iShares, Vanguard, SPDR, PowerShares, FlexShares, Market Vectors and ETF.com

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