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Your Money

Investing for Retirement: Pros and Cons of a Tactical, Defensive ETF

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An exchange-traded fund, or ETF, is a managed, diversified investment portfolio that pools different types of investments into a single entity from which investors may buy shares. Doing so not only gives the owner a proportional share of that investment pool, but also the benefit of professional portfolio management.

Most ETFs track benchmark indices, each investing to match the returns of the benchmark the fund has chosen. A lesser number of ETFs have portfolio managers who actively select their own investments and build portfolio menus around a broad diversification that includes both equity (stock) positions and non-equity positions. These are tactical, defensive ETFs.

Less Restrictive than Mutual Funds

The advantage of a tactical, defensive ETF is most evident during a period of prolonged market correction. Mutual funds and, to a lesser degree, indexed ETFs lack the broad flexibility to fully replace equity exposure with non-equity and respond to changing market conditions in real time if necessary.

Before they can be sold to the public, all mutual funds must submit a filing with the Securities and Exchange Commission. The SEC never offers a judgment, recommendation or approval of a mutual fund. Rather they review the filing to ensure that all the necessary disclosures have been completed. Among those disclosures is a specific description of the fund's investment objectives, and the categories of investments that may be included in the fund offering.

For example, suppose Mutual Fund XYZ files that it will invest in U.S. companies larger than $10 billion in market capitalization with an expectation of long-term growth. Mutual Fund XYZ would be classified as a Domestic Large Cap Growth Fund. If a major U.S. market correction occurs and all domestic large cap corporations are losing value, Mutual Fund XYZ cannot escape this turn of events.

Because of the filing, Mutual Fund XYZ managers may not swap out their domestic large cap holdings for say, bonds, precious metals, real estate or developing nation tech company stocks (that are still going up.) An investor in Mutual Fund XYZ is locked in and his only choice is either ride it out or sell. If the decision is to ride it out and fund losses are substantial, even if it later recovers, what has been irrevocably lost is the time-value of money. If the decision is to sell, not only must something new be bought, potentially with a new set of front load charges, but also potentially with a taxable consequence for any gains made from purchase to sale.

ETFs, particularly those with tactical defensive strategies, do not have these limitations. ETFs may be far more diversified and the fund managers have far greater flexibility in the different classes of investments that are inside the fund. They can change rapidly if necessary; literally as fast as they can type if need be.

For example, the ABC Exchange-traded Tactical Fund may invest in a combination of domestic and foreign equities when equity markets are moving upward, but strategically shift into bonds, real estate, commodities, precious metals or even cash when equity markets move downward. Fund managers also can make adjustments as though by a rheostat, dialing up or down and in or out different components at different levels based on what's happening in real time. They also are not limited to waiting for the close of business in the stock market to complete transactions; they can occur any time and are essentially instantaneous.

ETFs May Be More Tax-Efficient

ETFs may be more tax-efficient than mutual funds because when mutual funds make changes to their portfolios, the fund managers sell, then buy new investments. In non-qualified accounts, e.g. not IRA, 401(k), Roth, etc., those transactions can have a taxable consequence to the investor. When ETFs change portfolio composition, it's done by swapping one position with another and that does not generate a taxable consequence that passes through to the investor.

ETFs May Have Lower Fees

ETFs tend to have a lower fee structure than mutual funds and usually impose no loads on transactions, including purchase or sale. However, the fees on tactical, defensive ETFs may be higher than on indexed ETFs but not significantly more than is typical with managed account fees on traditional mutual fund portfolios. In addition, it's acceptable to pay a higher fee for a tangible benefit; just not pay a fee for nothing.

Another type of fee associated with mutual funds is the breakpoint schedule. A significant proportion of mutual funds sold by brokers are "Class A Share" funds. This means that in exchange for minimal ongoing annual fees, the fund charges a fee up front, called a front-end load. The size of this fee reduces as more money is invested within that fund family. Meeting certain thresholds provides specific reductions of the front load. They're called breakpoints. The function of breakpoints is to reward investors with investing (and diversifying) within one fund family. An investor may purchase many different specific funds within that family and receive a reduced load (breakpoint) but not if he diversifies by investing in different fund families, even if through a single financial adviser at the same brokerage firm.

ETFs do not have front loads and do not impose breakpoints. The fee structure is either by a fixed annual percentage of assets under management or transactional. A prospective investor should discuss these options with their investment adviser but in neither case is there a fee-based incentive to invest exclusively within one ETF family.

Better Risk-to-Return

Tactical ETFs, by virtue of their ability to limit or eliminate equity exposure during periods of market correction, have less volatility than portfolios lacking that ability. Risk is volatility. The overall return of these portfolio's averages are comparable to, or sometimes greater than, traditional in large part because they do not lose as much time when recovering from a loss because their losses during corrections can be mitigated.

This is not to say that ETFs cannot lose money. Any market investor must accept the risk of potential loss of principal. But given two portfolios with identical average return, the one with the lower risk provides a greater degree of confidence in achieving that future performance.

Investment Minimums

Here is one area where mutual funds may offer a strong advantage. Many ETFs require larger minimum initial deposits than mutual funds. This limitation is not only a concern for investors with limited funds to invest who cannot afford the minimums.

For example, one of the more attractive types of accounts is the Roth IRA. Money that is Roth IRA-qualified grows on a tax-exempt basis. It's important to note that a "Roth IRA" is not a type of investment. A portfolio of stocks, bonds, ETFs or even bank accounts, etc., may be a Roth IRA, may be a traditional IRA, or any other type of retirement account -- or may be "regular" (non-qualified) money. The term "Roth" has nothing to do with the underlying investment, it's a label of tax code.

As such, it makes no difference what the Roth IRA is invested in, how much it grows, when money is withdrawn (subject to some IRS rules), or when it's inherited. It is received completely income tax-free. However, the maximum a person can contribute to a Roth IRA (based on 2019 tax code) is $6,000 per year if younger than age 50 and $7,000 per year if age 50 and older. Thus, an ETF that requires, say a $25,000 minimum investment to open won't work until an investor has already accumulated that amount. Moreover, even if an investor has the $25,000 (in this example) but wants to invest in two different ETFs, even if with the same ETF company, it cannot be done.

The role of mutual funds, as well as individual stocks, bonds, etc., in an investment portfolio remains viable. However, the opportunity presented by ETFs, especially those with a tactical, defensive strategy, is to provide a higher level of efficiency and risk mitigation without necessarily sacrificing return opportunity, and potentially at lesser cost. In the current climate of highly and increasingly volatile markets, that is a strategy worth serious consideration.

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