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The Shortcomings of a Fund-Only Approach

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TABLE OF CONTENTS

Introduction

As investment managers, we are often asked to build portfolios that complement investors' overall financial plans. Filtering through the large landscape of financial products can be a daunting task, particularly when it comes to those available for high-net-worth (HNW) investors. In this paper, we will examine:

- Different structures available to investors
- How some of these approaches may be more advantageous
- How some may have drawbacks, making them less attractive to wealthy clients

As we examine fund-based solutions, keep in mind that almost all investment portfolios will have funds included to some degree. Funds can be a good tool to gain exposure to certain asset classes that may not be appropriate for individual securities, and it can also be difficult to build a portfolio with individual securities for smaller portfolios. However, when it comes to HNW investors—which we define as those with $1 million or more in portfolio assets—using mutual funds and ETFs alone, without any individual securities for the core holdings, can lead to certain risks of pitfalls.

DEFINITIONS

A **mutual fund** uses a pool of money collected from many investors to invest in stocks, bonds, or other types of securities. Decisions regarding how the money is invested is made by the fund's manager. There are many different types of funds.

An **exchange-traded fund** (ETF) is a collection of securities that trades on an exchange, similar to a stock. It can contain many kinds of investments, including stocks and bonds. ETFs often track an underlying index, such as the S&P 500, but can use any number of strategies.

Defining the Landscape of HNW Investing

Typically, HNW clients end up with a large sum of cash to invest in one of three ways:

- Selling a business, piece of real estate, or other asset
- Gaining an inheritance
- Working and saving over a lifetime

When putting money to work for these clients, several challenges may arise. Two of the more important factors are finding the appropriate risk management discipline and optimizing the tax management strategies associated with the portfolio. These two factors can be influenced drastically by the method in which the portfolio is constructed.

Fund-Only Choices for Investors and Their Positive Attributes

Many of the options available to investors would be classified as "retail" investor products. These appeal to the masses due to diversification with low minimums, sometimes as low as a few hundred dollars per fund. There are many approaches for investors looking to construct a portfolio. Some of the more popular methods are:

AN ETF-ONLY APPROACH

With this method, exposure to various asset classes is usually fairly accessible due to the many ETFs available in the market. This makes it easy to build a diversified portfolio, and expenses are usually lower than those of 40 Act mutual funds. ETFs also generally have good liquidity due to the fact they are traded on exchanges (much like individual stocks); this liquidity could create a very large risk/cost, which will be examined in more detail in the next section.

A TRADITIONAL MUTUAL FUND-ONLY APPROACH

Just as with an ETF-only approach, a mutual fund-only approach usually gives an investor an easy path to building a diversified portfolio. Another positive feature is the fact that a mutual fund will typically reconcile its "net asset value" at the end of each day. Therefore, if an investor chooses to purchase or sell the fund, it will happen at the end of the day for the exact price of the underlying holdings in the fund.

Risks and Pitfalls of an ETF-Only Solution

While an ETF-only approach may be appropriate for some, it comes with several risks that HNW investors should consider.

DISCONNECT FROM NET ASSET VALUE

One of the main risks present in an ETF-only approach is the potential for disconnect from the Net Asset Value (NAV) during a period of market stress. An example was during the "flash crash" of August 24, 2015. The Dow Jones Industrial Average was down about 1,000 points intraday (about 6%), but some ETFs were down as much as 40% in one day.[1] There was also a "flash crash" that drastically affected ETF prices in 2010.

The main point to emphasize here is that the underlying holdings in the ETFs didn't decline as much as the ETFs themselves; the price drops in the ETFs were far greater than those of the baskets of stocks inside. The 2015 and 2010 incidents highlight the risk present in an ETF-only approach. An investor could buy a basket of ETFs and, during a period of market stress, this portfolio could decline much more than the underlying holdings due to the fact that ETFs trade intraday, and the market is made up of buyers and sellers with no written rule or requirement to reconcile the price at the end of the day to the underlying basket of stocks or bonds.

Due to the vast increase in the size of the ETF market, the risk is that the next decoupling in price/NAV could be prolonged and could spark a crisis.

OVERLAP

Another issue in the ETF-only approach is overlap. An investor could buy a series of ETFs and feel as if the portfolio is diversified properly. The issue arises when we examine the underlying holdings in the ETFs and find that several of them own and trade the same stocks.

HEDGING WITH CORE FIXED INCOME

Another issue that is prevalent in using an ETF-only approach is its potential impact on a core fixed-income strategy. Core fixed income is usually bought for the coupon the bond pays and the stability that comes from having a maturing bond, which typically has a maturity date, at which point investors typically receive the par value back. ETFs tend to be perpetual vehicles that don't mature and therefore defeat part of the purpose of owning a core bond.

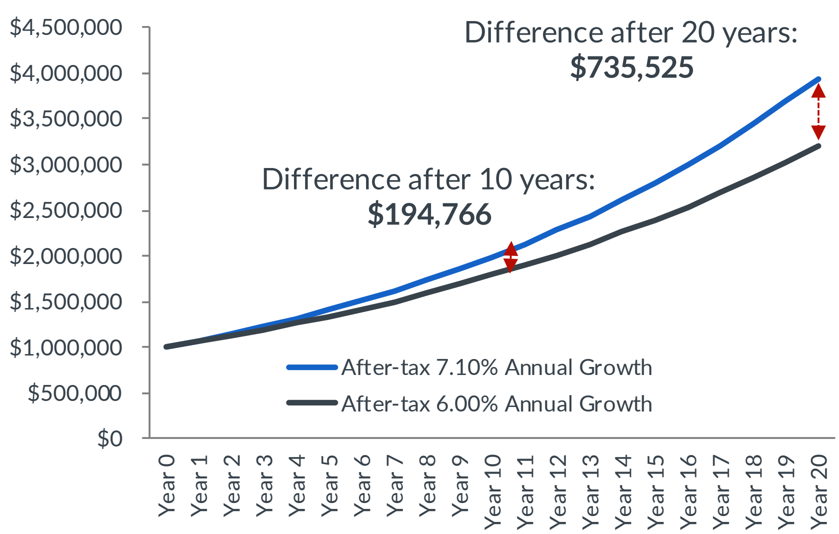
TAX CONSEQUENCES

One of the cornerstones in managing portfolios for HNW clients is the ability to add tax alpha—the value added to an investor's portfolio through active tax management and taking advantage of tax-saving strategies. These may include postponing gains, offsetting gains with losses, asset location, tax lot management, and more (for details, see our white paper *Tax Alpha: Enhancing Returns Through Active Tax Management*). While it's difficult to pinpoint what percentage of returns is added to after-tax returns by tax alpha, according to our internal study, it may be approximately 110 bps per year.[2]

ETFs do not allow us to leverage tax-saving strategies at the same level individual securities do. For example, using ETFs prohibits us from taking a portfolio of large cap stocks and choosing individual holdings (e.g., we could own 50 individual large cap stocks) to sell for gains/losses. In an ETF-only portfolio, we would likely have one ETF exposing the investor to large cap, taking away a major tool in the tax alpha toolbox.

Over Time, a 110 bps Difference Can Have a Significant Impact

Hypothetical Growth of a $1M Portfolio



Source: City National Rochdale. FOR ILLUSTRATIVE PURPOSES ONLY. Your results will vary.

In addition, some ETFs distribute capital gains to shareholders via 1099s. In this case, clients lose control over the 1099 as much and are exposed to an unknown tax bill when they buy into certain ETFs that distribute these gains this way.[3] Not many of the firms do this, but one of the larger ETF complexes in the U.S. employs this type of tax treatment.

MARKET SIZE

One of the largest risks that looms in the ETF space primarily exists due to the size of the market, which is forecasted to reach a staggering $5 trillion in 2020. This is ten times larger than it was in 2008 ($500 billion). This could potentially cause a lack of liquidity should a crisis occur (or start in the ETF space), which could in turn exaggerate declines in the ETFs that may extend far past the underlying value of the holdings, particularly in the less liquid asset classes.[4]

In September 2019, Michael Burry, one of the first investors to signal and profit from the subprime mortgage portion of the 2008 financial crisis and who was depicted in the book *The Big Short*, told Bloomberg News he thinks the next major crisis lies within the ETF space. The method the funds use to trade and provide liquidity to shareholders could cause the price to decouple from the intrinsic value. The crisis could occur due to the exaggeration of declines that can occur in this decoupling, particularly a prolonged one.[5]

In addition, famed investor and DoubleLine Capital CEO Jeff Gundlach told CNBC in December 2018 that passive investment strategies, particularly the use of ETFs, resembled “herding behavior” and cautioned investors that his “strongest advice” was to avoid these types of strategies.[6]

Pitfalls of a Traditional Mutual Fund-Only Approach

First, we find it important to reiterate that we believe mutual funds can be good tools for investors who are:

- Managing smaller portfolios (less than $1 million)
- Seeking exposure to non-core asset classes (such as emerging markets, international stocks and bonds, high-yield bonds, bank loans/floating rate bonds, etc.)

However, using mutual funds only may lead to some issues.

- As with ETFs, mutual funds can have overlap and create more inefficiency and unnecessary trading costs, which has been estimated at 1.44% (on top of the expense ratio).[7]
- Also as with ETFs, bond funds tend to be perpetual and have no maturity.

In addition, tax consequences may arise, as mutual funds send investors a 1099 in taxable accounts that investors have no control over, meaning there is no opportunity to harvest gains/losses. Also, buying a fund today can result in investors inheriting the cost basis of the holdings inside the fund, some of which have stocks that were bought many years ago at much lower prices.

There are about 119,000 traditional mutual funds in the world (what we refer to as "40 Act Funds," created by the Investment Company Act of 1940, which regulates the origination and management of mutual funds). A staggering 40+% of households own these mutual funds, which account for about $46 trillion dollars, $21 trillion of which is in the U.S.[8]

EXAMPLE OF POTENTIAL TAX CONSEQUENCES

An investor decides to buy the XYZ Growth Mutual Fund today. This fund bought stock in a tech company 25 years ago for $5/share. The following day, the fund decides to sell the tech stock, which is now worth $170/share.

That entire capital gain of $165/share comes to the investor as part of the 1099 for the year, along with the fund's other gains/losses during the year, even though that investor only owned the fund for one day. It potentially could have been wiser to own the fund in an IRA account, assuming the client had enough IRA assets to do so, to avoid an unexpected tax bill late in the year.

Mutual funds can also be impacted by the decisions of other investors in the fund. When funds underperform, many investors will redeem their shares. When this happens, the fund must raise cash to meet the redemption. Particularly, if the fund invests in lower liquidity securities, this can create a domino effect and lead to longer periods of underperformance. This causes the investors remaining in the fund to be affected negatively by the decisions of the other investors that were in the fund.

Summary

Fund-Only Approach	Approach Incorporating Individual Securities
Lack of flexibility to take advantage of certain tax-saving strategies	Ability to generate tax alpha through strategies such as postponing gains, offsetting gains with losses, asset location, tax lot management, etc.
Potential for overlap, where a series of funds may appear to diversify a portfolio but in fact own and trade some of the same stocks	Ability to create a truly diversified portfolio through knowledge of exactly what holdings are present
ETF price risk may occur if the ETF's price decouples from that of the underlying basket of holdings within the ETF	Individual securities are traded in the market and there's no underlying holding, thereby eliminating this risk
Mutual fund price risk may occur since mutual funds typically trade at the close of the market (e.g., an investor may like a price early in the day, but can only buy or sell at the 4pm price, which may differ)	Ability to trade intraday prevents this issue

Conclusion

Mutual funds and ETFs can be good tools for investors looking to build smaller portfolios. However, when HNW investors use these strategies alone, without incorporating additional solutions into their financial planning, the benefits these products offer can come at a cost. Our goal with this paper is to highlight these potential risks and illustrate the difference between a retail approach and the more institutional approach to asset management, similar to what we employ at City National Rochdale.

We encourage you to talk to your portfolio manager or senior investment consultant to learn more about the potential pitfalls of a fund-only approach, as well as what additional solutions can be offered.

[1]Source: MarketWatch, as of 8/25/2015.
[2]Average tax alpha generated between 2008 and 2019 from five randomly selected real client accounts (from five separate senior portfolio managers) used in a City National Rochdale internal study.
[3]Source: Morningstar, Ben Johnson, as of 1/31/2020.
[4]Source: institutionalinvestor.com, as of 2/1/2020.
[5]Source: Bloomberg, as of 9/4/2019.
[6]Source: CNBC as of 12/17/2018.
[7]Source: U.S. News and World Report, as of 10/2017.
[8]Sources: statista.com, static1.squarespace.com, as of 2/1/2020.

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