New Frontier

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ETFs vs. Mutual Funds: Two Topical Issues

by Dr. Richard Michaud, CEO

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New Frontier is a multi-asset manager that invests primarily with exchange traded funds (ETFs). ETFs are often compared to mutual funds which are also portfolio based investment products. In most cases, ETFs function similarly to comparable mutual funds. However, a recent instance of market volatility involving high yield securities highlighted an important though not well appreciated difference for investors. On December 10, 2015, the Third Avenue Focused Credit Fund, a mutual fund, suspended the right of investors to ask for their money back. In a run on a mutual fund the manager generally sells the least illiquid assets first. The implication is that those who cash out first get a better price than those who wait. Also, the wait for everything to settle after suspending the right to sell can take a considerable amount of time. This does not happen with ETFs. ETF sales result in a swap of a representative basket of assets with the fund company. No cash changes hands. An ETF investor may lose money in a fund but there will be no need to wait for the money.

Some observers have claimed that ETFs may disrupt the normal functioning of capital markets. This is because in some recent market stress periods ETF pricing was suspended. However, the key issue was not the consequence of any critical flaw in the structure of ETFs but the often temporary illiquidity of some of the constituents of an index at a market stress point. As in mutual funds, ETF risk also depends on the securities in the portfolio.

An ETF behaves as a single stock representing a portfolio of securities. An ETF trade represents a trade of a portfolio of securities. While ETFs are a relatively recent investment product, portfolio trades are nothing new. Index fund managers are portfolio traders. When an index needs to change, there can be temporary illiquidity disruptions. For managers of ETF strategies such as New Frontier with relatively minimal impact on capital markets, portfolio trades may often be executed as swaps from an inventory at an institutional broker with minimal cost. However, in market stress periods components of an ETF index may become illiquid and have pricing suspended. ETF liquidity depends on the relative liquidity of its components. Investors should be aware of the hidden risk that leveraged strategies and exotic securities imply in an ETF or mutual fund. New Frontier limits ETF risk by using only high quality liquid funds with no leverage or counterparty risk.

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