Passives

HOW TO PICK THE RIGHT ETF

With an ever-increasing number of ETFs on the market, selecting the right passive strategy isn't easy. Here are six critical points to check before you make the decision

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Passive investment strategies are on the rise. According to a study by leading risk management consultancy Willis Towers Watson, in 2016 passive strategies accounted for more than 21% of assets managed by the world's 500 largest asset managers.

That's an increase of 30% within five years – and the trend is still developing.

As a quantitative asset manager, we are able to observe the efficiency of the majority of large-cap markets and how, as a consequence, achieving a sustainable outperformance can be extremely difficult. We thus advise investors to focus on passive vehicles for these markets.

However, selecting the right passive instrument can pose a challenge. At Parsumo, we focus on these important characteristics:

- **Benchmark:** There are now 70 times more stock market indices than listed stocks in the world and more than 1,300 ETFs listed on the Swiss Exchange alone. It is thus crucial that the composition of the benchmark, which the index product should replicate, is well understood and in alignment with the investor's objective.
- **Product type:** Recently, issuers in Switzerland have been pushing index funds heavily as an alternative to ETFs. And with good reason: they often cost less and offer tax advantages (no Swiss stamp duty) and fixed spreads. But the investor then forgoes intraday liquidity and the opportunity of narrower spreads. As a rule of thumb, we prefer index funds to form the strategic part of the core portfolio, which we expect to hold over an extended period of time.
- **Replication method:** We prefer physically replicated products, as there's no counterparty risk to worry about.
- **Issuer and assets under management:** We rely on well-known and established issuers, with which we have a personal and in-depth relationship. Furthermore, we prefer index products with sufficient assets under management. These products are able to exploit economies of scale to lower their costs and are less liable to liquidation.
- **Tracking efficiency:** A focus solely on the product's costs (TER) is not enough to assess how well an ETF tracks its benchmark. Some index products have a seemingly attractive cost basis, but still underperform their peers. Thus, we also take into account the overall tracking difference, tracking error and spread.
- **Trading:** Contrary to their name, ETFs are not traded exclusively on an exchange; in fact, more than half of total reported ETP trade value in 2017 took place off-book (over the counter), and there's NAV-based trading, too. A pre-trade analysis is highly advisable, in particular for larger order sizes, in order to assess which trading option is more optimal.

However, this is just one side of the coin. The investor then needs to take a decision on how the portfolio should be rebalanced.

The most common method is fixed periodic rebalancing; i.e. an annual reshuffling. The global markets, however, rarely follow our calendar.

The chances that a sub-optimal rebalancing moment will lead to an unstable risk-return profile are high.

We thus follow a proprietary rules-based approach, which detects different market conditions (from stable and resilient to fragile and risky) and allocates the index products dynamically within the client's portfolio – resulting in a more level risk-return profile.