ETFs Tutorial

Lesson 2: Investment in ETFs

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ETFs Investment - introduction

Different investors have different approaches to portfolio management so whether ETFs really fit your needs depends on how well they help you reach your goals. For long-term fundamental investors, ETFs, indices and actively managed mutual funds, should be considered for the portfolio strategy. For short-term horizons, ETFs can also help achieve your goals of reducing fees, managing risk or getting a substantial return on cash in a low interest environment.

There is a vast spectrum of strategies for using ETFs in your portfolio. Here we present 4 strategies used by active traders and sophisticated investors alike:

Putting your cash to work

While considering which specific stock or bond to buy, you can invest excess cash for returns higher than what is offered through the Money Market. This “cash quitization” strategy can be used efficiently with ETFs to gain cheap and flexible market exposure.

In other words, if you lack conviction on which assets to buy, holding your fund in ETFs allow you to keep a market exposure until the final decision on the path for investment becomes clear.

Needless to say that going for these ETFs strategies require time and effort. However, they will most likely lead to a better overall investment strategy for your portfolio.

Tax Loss Harvesting

Tax gain/loss harvesting is an important tool for reducing taxes now and in the future. If properly applied, it can save you taxes and help you diversify your portfolio in ways you may not have considered. Typically, a capital gain loss in a security can be used to offset taxes on a capital gain from another security.

Tax-loss harvesting during the year can help reduce this cost Because realized losses can be offset against realized capital gains. Also, losses not used in one tax year can be carried forward indefinitely to future tax years.

Tax-loss harvesting also comes with a series of rules. The “wash sale” rule for instance prevents you from selling a security at a loss to realize a tax gain and re-buying a similar security within the same period.

The technicality of the laws surrounding tax-loss harvesting can be daunting and you should consult a tax advisor if you are going to follow this strategy.

Getting tactical

Professional investors often overweight or underweight specific asset types or industry for their overall asset allocation. In these cases, ETFs can be a useful tool. They allow taking easy exposure on sectors, styles or industries in a cheap and flexible manner without the inconvenience of paying short term redemption fees. Still, there is a cost in using ETFs namely brokerage commissions and bid-ask spreads.

ETFs remain a product of choice to focus on a sector or a style without losing the benefit of diversification moreover an ETF can be sold short, a strategy usually used by experienced investors.

Managing your risk

ETFs also represent a powerful tool to control risks in your portfolio.
One approach to reduce your risk is to take exposure in ETF to offset the main risks of your portfolio.
For instance if you are long a Google share, you might want to take the opposite position on an US Technology ETF to offset your risk.
A Second approach is to use ETFs for diversification. They dilute the idiosyncratic risk that comes from taking market exposure with a single stock.

Finally, some investors use ETFs to invest in core segments of the market that are deemed more efficient while actively managing other assets in the less efficient or satellites segments.