What's in that ETF?

Earnings season is upon us, with many of the largest, most well-known companies reporting their 4th quarter 2019 results. This week alone, investors got to hear earnings results from Apple (AAPL), Microsoft (MSFT), Amazon (AMZN), Facebook (FB), Visa (V), Mastercard (MA), and Exxon (XOM), among others. Collectively, these seven companies make up nearly 18% of the S&P 500, and their results have a major impact on the direction of the overall stock market.

For investors holding a portfolio of mutual funds or ETFs, it may not be clear how earnings news from Apple, Amazon, or another household name impacts their portfolio. For many years, there was quite a bit of mystery, since mutual funds are given a 60-day window after each quarter-end to disclose their holdings to the SEC. For actively managed mutual funds in which holdings can change from day-to-day, this data can be stale and introduce uncertainties. Passive, index-based mutual funds and Exchange Traded Funds (ETFs) make it easier to know with more certainty the underlying portfolio exposure. The ETF structure is incredibly transparent because ETF providers publish their underlying positions daily; however, investment-level exposure for index-based mutual funds is also easy to determine since the funds track indices, which provide daily data as well.

Why go index-based?

Over a five-year period, 78.5% of US Large-Cap funds underperformed the S&P 500, per the latest data from S&P Dow Jones Indices LLC. Furthermore, data shows a large degree in turnover within the small peer group of outperformers from year-to-year. In other words, few funds beat the S&P 500 benchmark index, and there is little persistency for most funds from year-to-year. For this reason, as well as transparency, liquidity, and cost considerations (passive, index-based funds are nearly always the lowest cost option), many portfolio managers, including your humble author, have increasingly relied on index-based ETFs when constructing portfolios.

Let's assume you are a growth-oriented investor and your portfolio invested in index-based funds. Looking at your statement, you might show a significant holding in an ETF like SPTM, the SPDR Portfolio Total Stock Market ETF, which tracks the broad-market S&P 1500 Index for just 0.03% in expenses. Watching CNBC, you see that Apple (AAPL) beat earnings again, and the stock is up. You don't own Apple (AAPL) though, you own SPTM, right? Wrong! 4.45% of SPTM is in AAPL! You also hold Microsoft (MSFT), Amazon (AMZN), Facebook (FB), Visa (V), Mastercard (MA), and Exxon (XOM) and around 1500 additional positions.

Top 10 company exposure in Total Stock Market ETF (SPTM) as of 1/28/2020.

Name	Ticker	Weight
Apple Inc.	AAPL	4.45%
Microsoft Corporation	MSFT	4.23%
Alphabet (Google)	GOOGL/GOOG	2.91%
Amazon.com Inc.	AMZN	2.59%
Facebook Inc. Class A	FB	1.75%
Berkshire Hathaway Inc. Class B	BRK.B	1.47%
JPMorgan Chase & Co.	JPM	1.41%
Johnson & Johnson	JNJ	1.32%
Visa Inc. Class A	V	1.16%

Data from State Street Global Advisors (SSGA).

Owning the total market, via a low-cost, index-based ETF, is an excellent way to capture the proven benefits of portfolio diversification. Individual stocks can fluctuate dramatically, adding uncertainty and volatility. Since less than a quarter of professional stock pickers have beaten the index over the past 5 years, why not just buy the entire market as cheaply as possible? There will be ups and downs, but historically over time, the stock market has trended upwards. Focusing on costs and maintaining broad, diversified exposure allows us to participate in the growth, and the transparency makes it easier understand our true portfolio risk and plan accordingly.

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