Why Pay More for Your Investments?

By Herbert Blank

Consumers have never been happy about paying more for the same (or less) from one place than from another. It has only been within the past twenty years or so that investors have gotten wiser to this practice. Financial advisors, planners and the media have increasingly made investors more aware of how much less expensive and tax-efficient ETFs are than mutual funds using the traditional redeem-at-distributor structure. When one adds in tax-efficiency, faster clearing and settlement, intraday liquidity and zero redemption fees, there is almost no reason to pay up for new purchases of traditionally structured mutual funds.

What some find surprising is that there are cost differences, sometimes significant, between expense ratios of ETFs that are identical in terms of which securities they hold. There are at least four categories of ETFs where the better-known ETFs are more expensive than substitutes with enough liquidity to satisfy the needs of most investors.

Example No. 1:
Let's start with the oldest still-offered US ETF and by far the largest, SPDR S&P 500 ETF Trust, **SPY.** Part of the SPDR-branded family by State Street Global Advisors (SSgA), **SPY** has more than $370 Billion assets under Management (AUM) although it briefly topped $400 Billion before 2022 market declines. As the standard-definer of passive index funds, **SPY** owns all the stocks in the S&P 500 Index weighted by float-adjusted market capitalization. Its expense ratio is 0.095% also called 9-1/2 basis points (1/100 of 1%) using industry vernacular to compare ETF fees.

There are two other very large ETFs that also track the S&P 500 Index included in this analysis:
IVV, iShares Core S&P 500 ETF from BlackRock with an expense ratio of 3 Basis points.
VOO, Vanguard 500 Index Fund also with an expense ratio of 3 basis points.

There are other key relative shortcomings that SPY has compared with the less ETFs. SPY was created using a Unit Investment Trust structure and its constituent changes are ordered by its Master Trustee and must be traded on the effective date of the S&P 500 Index change. The trust cannot lend securities or reinvest dividends. **IVV** and **VOO** are funds and have portfolio managers in lieu of the more constrained Master Trustee. reinvest dividends and lend stock shares to generate extra income. **IVV** and **VOO** also have more latitude on how and when the fund executed its trades regarding announced constituent changes.

The result has been an extra few basis points per year in realized return for **IVV** and **VOO** than for **SPY** during the past 10 years. This table shows the annualized return comparisons for 1- 3- 5- and 10-year periods ending 04/29/2022:

ETF	Expense Ratio	Assets Under Mgmt. (AUM)	Year-to-Date	12-month Tot. Ret.	3-Year Ann. Tot. Ret.	5-Year Ann. Tot. Ret.	10-Year Ann. Tot. Ret.	Incept. MM/YYYY
SPY	0.095%	**$375 B**	-11.86%	1.26%	14.30%	13.81%	13.67%	**01/1993**
IVV	***0.030%***	$296 B	***-11.84%***	***1.31%***	***14.34%***	13.89%	13.77%	05/2000
VOO	***0.030%***	$260 B	***-11.84%***	***1.31%***	***14.34%***	**13.90%**	**13.79%**	09/2010

Although 0.125% per year may not seem enormous, after 30 years of compounding, the gross difference is 45%. This can be a substantial amount when dealing with large sums of money. The bottom line is that if your costs are lower and you own the precisely the same assets, you will make more money per year and over time the compounded difference will expand substantially.

Example No. 2:
The next comparison involves ETFs using the same and best-known small cap index, the Russell 2000 Index published by FTSE Russell Indices. This index bypasses the top 1000 US Equities ranked by float-adjusted market capitalization meeting its requirements in order to track the 1001^{st} through 3000^{th} such stocks.

The oldest and most popular Russell 2000 ETF is **IWM**, the iShares Russell 2000 ETF owned by Blackrock. Its direct competitor tracking the identical index's holdings and weights is **VTWO** ("vee 2"), the Vanguard Russell 2000 ETF. **VTWO** has an expense ratio of 10 basis points just over half of the 19 basis points charged by **IWM.**

There is a technical disclosure on the fungibility from one to the other. Since some of the smaller stocks may be difficult to acquire at times, both ETF's prospecti allow for optimization and substitution so that they may not actually hold the identical securities and weights on a given day but are expected to substantially provide the same price-and-yield returns as the Russell 2000 Index. Let's look at the comparison table:

ETF	Expense Ratio	Assets Under Mgmt. (AUM)	Year-to-Date	12-month Tot. Ret.	3-Year Ann. Tot. Ret.	5-Year Ann. Tot. Ret.	10-Year Ann. Tot. Ret.	Incept. MM/YYYY
IWM	0.190%	**$55 B**	*-15.82%*	-17.37%	6.98%	7.14%	10.06%	**05/2000**
VTWO	**0.100%**	$6 B	*-15.82%*	**-17.27%**	**7.14%**	**7.26%**	**10.10%**	10/2010

Once again, the less expensive alternative has provided higher returns.

Example No. 3:

Turning to fixed income, there are two long-term US Treasury Bond ETFs benchmarked to the Bloomberg Long-Term Treasury Index that have been in existence for more than 10 years. The older of the two is **SPTL**, the SPDR Portfolio Long Term Treasury ETF. The newer entry, **VGLT,** the Vanguard Long-Term Treasury Index ETF charges a 50% lower fee, just 4 basis points as compared with the 6 basis points charged by **VGLT.** There is another technical disclosure to be made here in that the holdings of **SPTL** and **VGLT** may not be 100% identical at all times. It is generally not possible to perform full replication with most bond index ETFs. Therefore, both sponsors use a combination of partial replication and optimization to produce results substantially similar to the price and yield performance of the Bloomberg Long-Term Treasury Index. At times, one or the other may be higher before expenses are taken into account. Here is the comparison:

ETF	Expense Ratio	Assets Under Mgmt. (AUM)	Year-to-Date	12-month Tot. Ret.	3-Year Ann. Tot. Ret.	5-Year Ann. Tot. Ret.	10-Year Ann. Tot. Ret.	Incept. MM/YYYY
SPTL	0.060%	**$5.4 B**	*-17.29%*	-11.30%	*0.97%*	**1.89%**	2.61%	**05/2007**
VGLT	**0.040%**	$3.8 B	**-17.26%**	**-11.26%**	*0.97%*	1.87%	**2.65%**	11/2009

This comparison in net total returns is not nearly as cut-and-dried as it was with the two equity ETF comparisons. Bond trading and liquidity is much less standardized and dependable than in the equity markets. In this case, the older and more expensive ETF from SPDR actually outperformed in the 5-year period and tied in the 3-year period. **VGLT** outperformed in the two most recent periods and the 10-year period so coupled with the lower fee, **VGLT** still comes out as the better buy over **SPTL** in this analysis based on this week's data. For someone who owns **SPTL** already, however, there is probably not enough of a difference to justify making the switch.

Example No. 4:

The most dramatic example of needing to read the fact sheets and prospecti deals with Exchange Traded Products (ET**P**s) that hold depository receipts on gold bullion. Most advisors and investors believe that **GLD,** SPDR Gold Trust by SSgA is the ETF they should buy if an allocation to gold needs to be added or increased in a portfolio. They are wrong on both counts!

ETFs are 40-Act mutual funds whose shares trade on the exchange and do not except daily cash redemptions except in creation-size unite. Not all ETPs are ETFs.

GLD is not an ETF at all. Its structure is a grantor trust and its tax treatment when sold is at the higher level of a collectible in lieu of capital gains on a stock (the IRS considers gold a collectible and taxes capital gains on collectibles at a higher rate for many investors – you may wish to consult a tax expert).

Now, let's get back to fees. GLD, SPDR Gold Shares, is by far the largest Exchange Traded Product to own gold with nearly $60 billion in the trust. It is also the most widely traded, a point often used to justify paying its high fee of 0.40%.

The fact is that the three major alternatives that have been in the market for more than three years:

- **IAU**, iShares Gold Trust by iShares (0.25%);
- **GLDM**, SPDR Gold Shares Mini, also by SPDR (0.18%); and
- **BAR**, Granite Shares Gold Trust by GraniteShares (0.17%)

A new entry from Blackrock iShares, **IAUM**, the iShares Gold Trust Micro, is even less expensive with an annual expense ratio of 0.15%. So now, BAR have substantially lower fees, the last two more than 50% less than GLD.

Although the SPDRs and iShares press releases at the time GLDM and IAUM were released state that these "mini" and micro products, brought out at lower prices-per-share were "designed for smaller investors", there has been ample liquidity for purchase without causing market impact in IAU, GLDM and BAR in three years of trading. I suspect the same will be true of IAUM. Let's take a look at the track records of all five products:

ETF	Expense Ratio	Total Asset Value	Year-to-Date	12-month Tot. Ret.	3-Year Ann. Tot. Ret.	5-Year Ann. Tot. Ret.	10-Year Ann. Tot. Ret.	Incept. MM/YYYY
GLD	0.40%	**$66 B**	3.48%	5.28%	13.19%	7.92%	0.86%	**11/2004**
IAU	0.25%	$32 B	3.52%	5.41%	13.38%	**8.08%**	**1.01%**	01/2005
GLDM	0.18%	$5 B	3.56%	5.70%	**13.64%**	N/A	N/A	06/2018
BAR	0.17%	$1B	**3.70%**	**6.38%**	13.48%	N/A	N/A	08/2017
IAUM	**0.15%**	$1B	3.58%	N/A	N/A	N/A	N/A	06/2021

This chart makes it clear that bigger and older do not constitute better when it comes to wealth accumulation. **IAU** charges 15 basis points less per annum than **GLD** and its 10-year annualized return is 15 basis points higher. The difference is even slightly higher when the absolute numbers are larger. Across the board, there's not a precisely proportionate correspondence but it is close. There are subtle differences in the precise nature of the gold being held and some products have gold only in London vaults and others in vaults around the world. All of the above ETPs are backed by gold bullion. BAR has the added twist of issuing shares backed by physical gold shares already in a vault but that is of little consequence to most investors.

In general, however, it is clear that **IAU** has systematically recorded greater rates of wealth accumulation for its owners than **GLD.** In 2017, the price competition became even more focused with the launch of **BAR by GraniteShares** and SPDRs' counter-launch of **IAUM.** Now, iShares has a "Micro" ETP, **IAUM** that now has the lowest fee so, on the surface, seems like the best alternative. An investment adviser buying new shares of **GLD** for a client may have some tough questions to answer if the client eventually discovers that the same exposure could have been bought for the account at less than half the cost.

I need to mention that there are a few exceptions to the above statements. Mega-institutions such as sovereign wealth funds and huge pension plans might indeed need the liquidity present in **GLD** or **IAU** in order to avoid moving prices substantially. More commonly, hedge funds with very short-term holding periods do not care about fees and focus on mega-liquidity instead. There is also an application that some wealth managers may deem appropriate at times for their clients, a buy-write strategy, holding the gold ETP while writing options on the ETP. Only **GLD** and **IAU** currently have listed options and GLD options are much more liquid. If the advisor deems that the options income expected to be derived will greater than the additional fee costs added to the expected taxed on the options income, **GLD** might be the ETP of choice.

Conclusions:
Please keep in mind that fees are generally not the only consideration for investors. For example, there are equity and fixed income ETFs with similar names that can have very different methodologies resulting in very different sets of holdings. In those cases, focusing on fees alone can lead to not buying the products most suitable to the needs of a given investor.

In the four examples just reviewed, however, fees are the most material differences between older ETFs and ETPs and less expensive alternatives. In fact, where subtle differences do exist, they tend to be attributable to better operational efficiencies built into the newer products. This creates a disconnection between perception and reality that can be costly to investors. The first association with buying an S&P 500 ETF might be **SPY.** Ask an advisor about small cap exposure and the most popular answer will probably be **IWM**. Advisors should take the fiduciarily responsible step of going beyond memory to review the alternatives using sources like ValuEngine, ETF.com and ETF database in order to find out how many ETFs fit the category, what the differences are, and which fit the clients' best interests.

Here's a thought that may bring smiles to some faces. Anyone who still believes in the Strong Form of the Efficient Market Hypothesis should take a look at more advisors buying new shares of **SPY**, **IWM** and **GLD** for their clients rather than the less expensive and otherwise identical alternatives. When one considers that the rise of the ETF industry is built on its operational efficiency, the irony of the situation becomes noteworthy.