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Unit Trusts vs Exchange Traded Funds (ETFs)

by Luke Ho

The debate of Unit Trusts vs Exchange Traded Funds (ETFs) are a constant in our investing climate. Both Unit Trusts and Exchange Traded Funds involve a basket of investments that provide diversification and low-cost entry. However, one is considered a passive investment which tracks the index and obtains returns from the market, whilst the other is actively managed by professionals who command higher fees on the basis of potential outperformance.

Today, I will analyse ETFs and UTs to an investor, by comparing ETFs and their Unit Trusts equivalent. This analysis will also focus on Equity funds, and avoid bond/cash or other kinds of funds.

The Case For Passive Investing (ETFs)

Warren Buffett's very public victory over Ted Seides raised credibility of a low-cost, passive index fund compared to having a professional fund manager or fund house invest it. Click **Here**.

Advocates of the FIRE movement (Financial Independence Retire Early) would also support this idea, since high fees from active management typically put investors at a disadvantage. This is highly supported by published data from Vanguard Studies, as well as SPIVA (Standard and Poor vs Indices). We're investors, and we shouldn't believe in absolutes. There is no such thing as "ETFs are definitely better" or "Property investments will always win" and other absolute statements.

The Case for Active

First, a few simple facts.

1. ETFs underperform the benchmarks that they are tracking

2. Indices, which are the benchmarks in question - do NOT pay out returns

To truly analyze these two assets, we must first understand these two points. ETFs always underperform the benchmark, due to tracking error + their fees.

If you need more evidence on this, you can check out MoneyMaverick's article here: https://www.moneymaverickofficial.com/post/every-single-passive-fund-manager-underperform-r eason.

The most common critique for the SPIVA paper is the idea that active funds, which pay out returns to investors, should be compared to indices, which do NOT pay out returns to investors.Only index funds, and ETFs which TRACK these indices reward investors. And these funds have fees. Thanks to this point, instead of comparing Unit Trust to their respective benchmarks, I will be comparing them to their ETF equivalents. So, the question is, do UTs outperform against ETFs net all fees?

Results

	All Returns are 10Y Annualized			Expenses	
	Benchmark	ETF	Unit Trust	ETF	Unit Trust
S&P500	13.13%	12.66%	9.37%	0.09%	1.50%
FTSE World Europe	6.18%	4.46%	3.80%	0.09%	1.72%
MSCI India Index	4.86%	3.64%	6.90%	0.99%	1.50%
MSCI Emerging Marke	3.37%	2.10%	3.42%	0.99%	1.75%
MSCI World Index	9.06%	8.13%	5.16%	0.10%	1.75%

Sources for Data: FSM & Manulife Fund Reports
All returns are in USD

Caption: All returns listed are net of the expense ratios as stated.

TLDR. S&P500 & Europe saw ETFs winning, and India & Emerging Markets saw UTs winning, over a 10Y historical period.

Notice a trend? Efficient Markets saw passive investments winning, and Inefficient Markets saw active investments winning. Almost all "ETF is better" arguments I've seen refers to US ETFs, or other more efficient areas such as ;

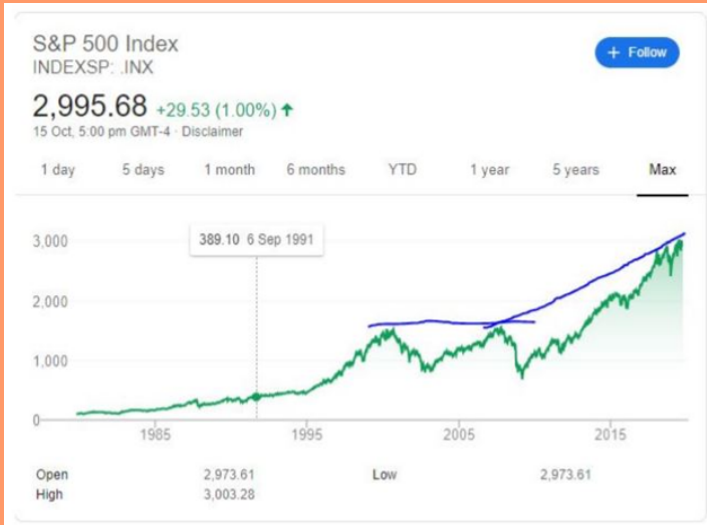
1) Europe
2) Japan
3) Singapore

Why ETFs 'Win' In Efficient Markets

Okay, Lets look at WHY ETFs win in efficient markets.

"The Efficient Market Theory" is the answer. Under the EMT, "Stock prices reflect all publicly available information about companies. Stock prices aren't necessarily "right," but they're as correct as they possibly could be." This basically means that, if you closed your eyes and buy stocks on the US market now, you are getting your money's worth.

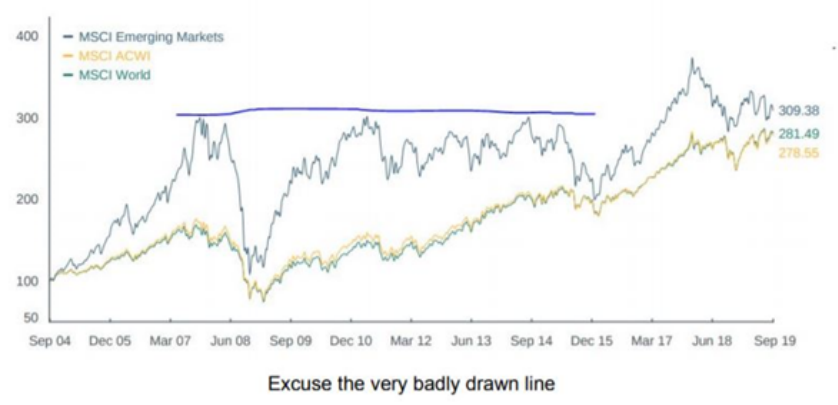
This is because all good news, and bad news will be rapidly priced into stock prices. For example, news of lowering interest rate margins will immediately lead to a fall in prices for bank/financial stocks. Efficient Market Theory supports ETFs, by reducing the importance of picking outperforming(undiscovered) stocks & creating an upward trend for the S&P Index.



Excuse the very badly drawn line

The performance of the S&P500 in the past 10 years is also ridiculously good. Based on this, we can guess that whenever there's a recession or major corrections, ultimately we will end up higher than we were at the peak before the correction. This supports ETF investing.

However, lets take a look at other markets.



MSCI Emerging Markets traded mostly sideways, other than a breakthrough for a short while in 2017. If you had blindly purchased an ETF at 2007's high, you would barely made money now. This goes against the theory that ETFs just need you to buy and hold.

Due to the tracking error (that is more common in inefficient markets) and the slight rise in 2017/2018/2019, MSCI Emerging Market ETF is up 2.1%, compared to the unit trusts' performance of 3.42%. Thankfully, when accounting for USD/SGD these funds did alot better for Singaporeans.

Thoughts/Conclusions

So, what created the large gains for S&P500? And will this be replicated for other areas? The answer to me, is blind capital flows.
The issue with the SPIVA argument, is that it is a self-fulfilling theory. As more and more people believe in SPIVA and pour all their investments into S&P500(and other) ETFs instead of individual stocks, it created two effects.

1. The growth of the entire index, instead of stocks. 2. The "Passive" bubble.

In business we have a rule, good companies can attract financing at lower cost & excel against its peers. ***With passive investments, the entire index grows instead of individual stocks. Which means that bad businesses actually have access to capital.***

Buying individual stocks means that your returns actually depend on the weightage of its stock in an index that people are buying. Stock returns are driven by increases in net profits (constant p/e) and changes in valuation. If stocks are part of an indexes, it is common to see P/E increasingly gradually as people invest in the index. This is because they buy DBS at all P/Es, driving it up (despite having no increases in profits). The weightage of the stock will influence the amount of money invested (hereby affecting the P/E growth rate) whenever people DCA into the index.

Small-Caps Value stocks are underperforming, because they are not weighted in indexes (preventing capital flow to them). Thankfully, as the S&P500 holds a lot of stocks, this effect isnt as prevalent compared to a market like our STI.

If we look at this in Singapore's context, we see many good investments options that have low volume or interest. One notable example I can think of is **Vicom**, a stock that has garnered interest recently. On the other hand, there are companies that may not deserve capital inflow, but are still getting it. The perfect example for this is **Singapore Press Holdings**, a company notable to be struggling in its main business without much hope for reprisal.

Large capitalization companies frequently get larger access to capital because they have larger weights in indexes, but may not deserve it.

This also dragged down the STI. The **STI has not beaten its 2007 highs**, due to various reasons. One reason is the decline of many of our GLCs, which just happen to be **large caps** listed in SGX. Notable companies are **Singtel**, **SPH** and **Keppel**. Large companies may not be good investments, although they have been in the past (pre-2007).

Passive Investing is actually a bubble, just not in the way you think. When we think "bubble" we think of rapid escalation of prices beyond its intrinsic value. This is actually happening, for companies in the US and Singapore.

A lot of our SGX-listed GLCs actually do not deserve their valuations. They are only supported by their STI position. Yes, many of us invested in SPH/Singtel in their glory days, but their current share prices are supported by STI investors despite being accepted as bad investments. In the US, there are companies never heard of, selected as an index component and now have an overwhelming ownership by index funds.

When it comes to bubbles bursting, passive management is the worst. Passive investing does have its uses, as long as there is a consistent uptrend. We all know that bubbles will never have an upward recovery (will bitcoin reach 50k). In areas that may be bubbles, I would definitely avoid ETFs.

For example, there is no way I am buying bond ETFs. This is because bond prices have been driven up and yields down consistently due to falling interest rates. Active management is therefore needed to manage interest rate changes and preserve capital or even profit off interest rate changes.

Conclusion

Passive and Active investing should be used as a diversification or attaining investment exposure. When aiming to have exposure to the S&P500, passive ETFs should be used to maximize returns.

On the other hand, if trying to have emerging market exposure, Active funds might be superior. While others might disagree with me, I would prefer to have active bond funds over ETFs.

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