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ETF Due Diligence

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Contents

- ETFs vs Mutual funds: In-kind Creation/Redemption
- Total Annual Cost of Ownership (TACO)
- Trading & Liquidity
- Economic Exposure

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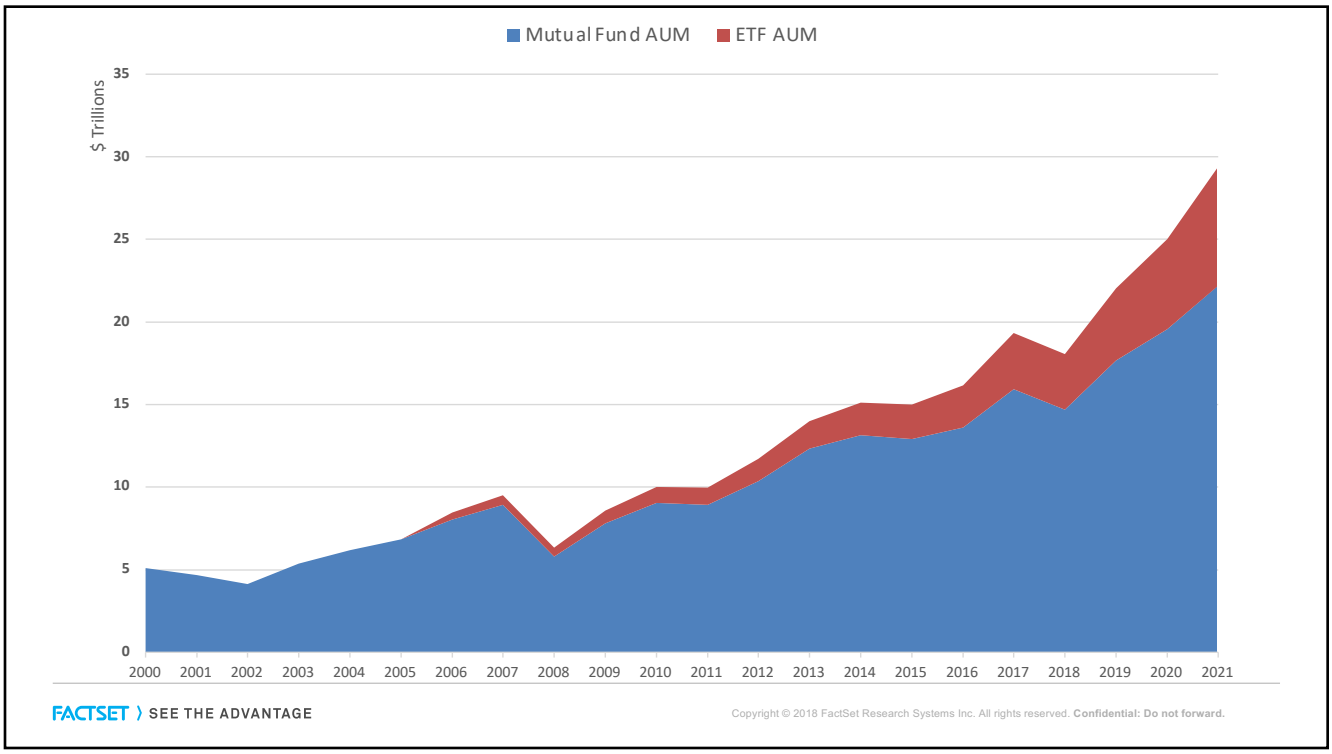

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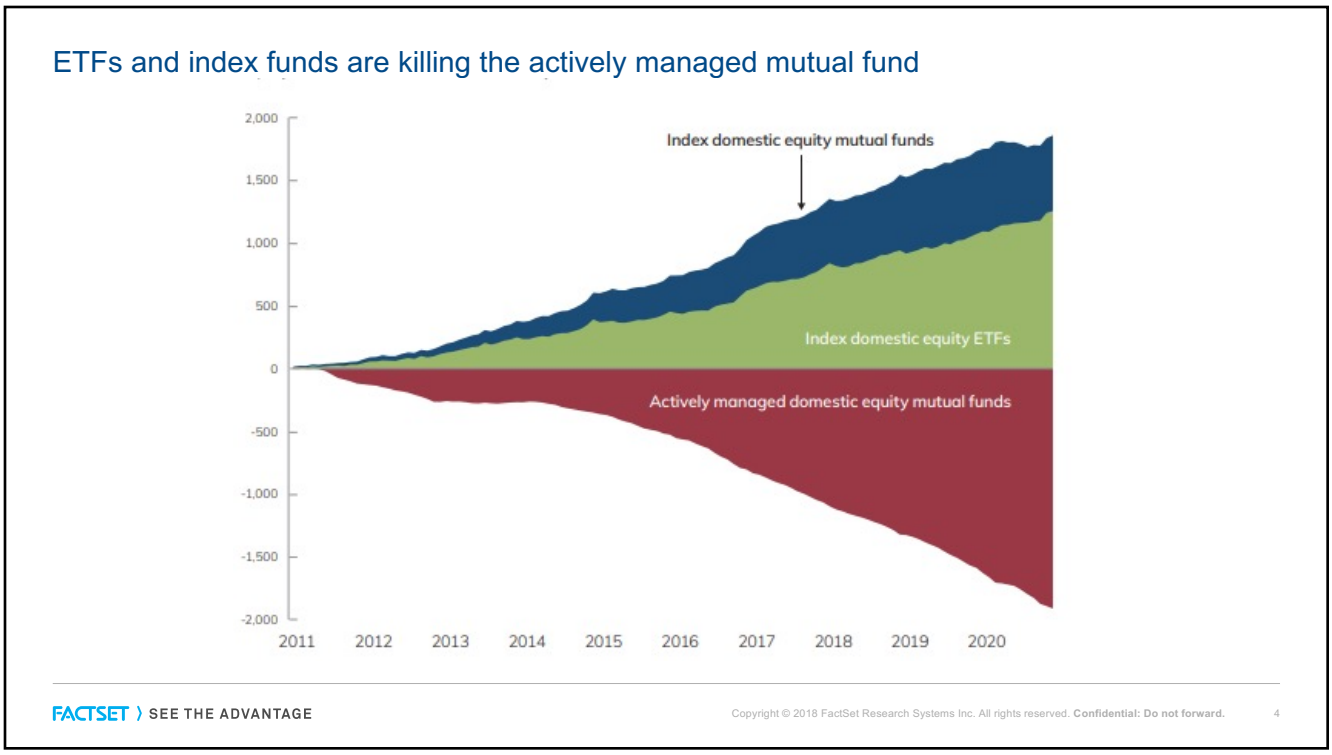

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ETFs vs Mutual Funds

Both offer economies of scale & diversification; both hold a basket of securities in trust for the shareholders

Primary Markets: Share Creation – Mutual Funds

- Shareholders transact directly with asset managers
  - Purchases & Redemptions
    - Must handle small transactions
  - Distribution Reinvestment
- Shareholder transactions at Net Asset Value
- End-of-day only

Primary Markets: Share Creation - ETFs

- Specialized agents, called Authorized Participants (APs) transact directly with asset managers
- In-kind share creation/redemption
  - Marked at security closing price
  - End-of-day only
  - Block size median $1.6 billion (2019)
  - Non-cash transaction
- Portfolio management via in-kind process possible
- Cash creation/redemption allowed

Secondary Markets – Mutual Funds

- Portfolio Managers trade in capital markets on behalf of shareholders
  - Portfolio Additions, Reductions, Deletions
  - Cash inflows & outflows
  - Dividends received

Secondary Markets - ETFs

- Shareholder Transactions
  - Purchases & Sales
  - Distribution Reinvestment
- Portfolio Management via capital markets possible
- Dividends received
- Arbitrage opportunity for APs

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ETFs vs Mutual Funds

ETFs reduce record-keeping requirements on asset managers, allowing for more efficient operations

Mutual Fund companies must maintain shareholder records

ETF record-keeping falls to brokerage firm, same as with stocks or bonds

Mutual Funds & ETFs

- Management fees
- Operating costs

Mutual Funds Only

- Sales loads
- Short-term trading penalties
- Transaction fees
- Account fees
- 12b-1 Fees

ETFs Only

- Trading spreads
- Trading commissions

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ETF Creation/Redemption: The Keys to the Kingdom

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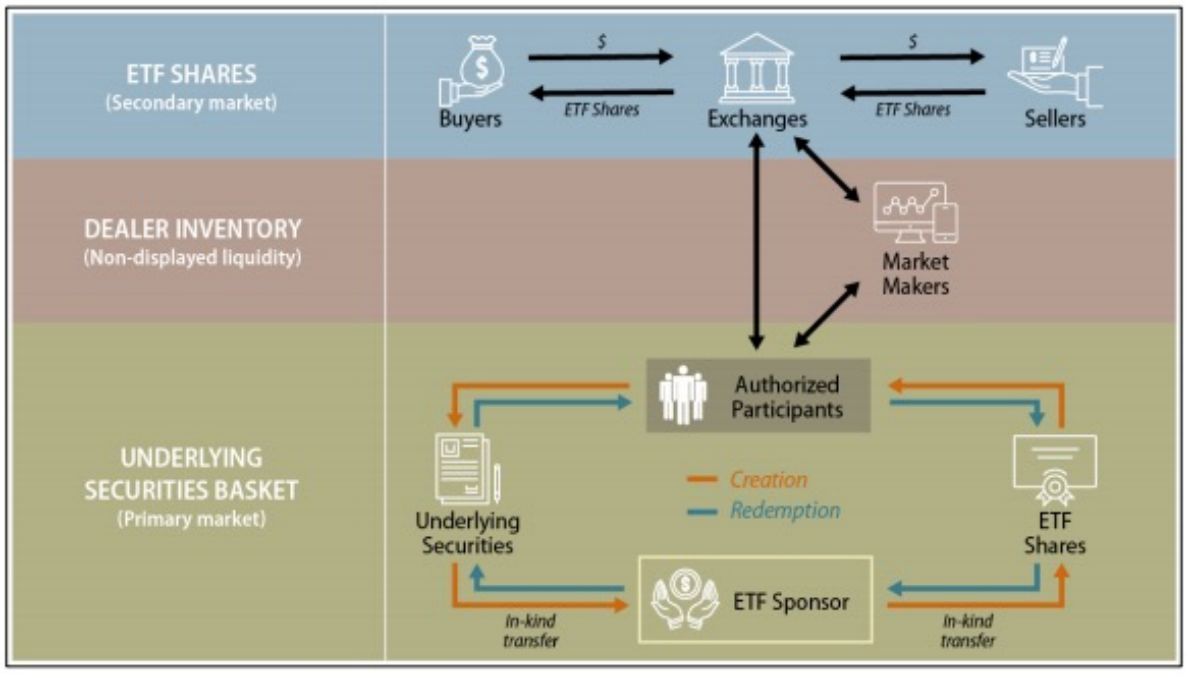

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Time and Sales (@T&S)

RSX

VanEck Russia ETF

Last		Chg	%Chg	Bid	Ask	Vol	CVol	USD Turnover	PC
5.65	H	-0.14	-2.42%	0.00	36.99	2035	16,292,063	88566.64	5

Time	Price	Vol	Exch	Bid	BSize	ASize	Ask
12:01:59			Composite	8.500	5	5	8.600
12:01:59			EDGA	8.160	1	1	8.900
12:01:59			EDGA	8.160	1	1	8.530
12:01:59	8.500	25	ARCA				
12:01:58			BATS	8.500	5	5	8.530
12:01:58			BATS	8.500	5	5	8.530
12:01:58			MEMX	8.100	10	1	8.530
12:01:58			MEMX	8.100	10	19	8.600
12:01:58			Composite	8.500	5	5	8.530
12:01:58			BATS	8.500	5	5	8.530
12:01:58	8.520	8	FINRA ADF				
12:01:58	8.520	40	FINRA ADF				
12:01:58	8.520	50	FINRA ADF				
12:01:58	8.520	100	FINRA ADF				
12:01:57			MEMX	8.100	10	1	8.540
12:01:57			MEMX	8.100	10	19	8.600
12:01:57	8.540	1	FINRA ADF				
12:01:56			MEMX	8.100	10	1	8.540
12:01:56	8.5399	10	FINRA ADF				
12:01:56	8.540	10	BATS Y				
12:01:56			MEMX	8.100	10	19	8.600
12:01:56			BATS Y	8.160	1	1	8.790
12:01:56	8.5042	69	FINRA ADF				
12:01:56			MEMX	8.100	10	1	8.540
12:01:56	8.5399	500	FINRA ADF				
12:01:56	8.540	6	BATS Y				
12:01:56			MEMX	8.100	10	19	8.600
12:01:56			BATS Y	8.160	1	1	8.790

Trades | Trades and Quotes | VWAP Analysis | Volume Analysis | Block Analysis

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Market Makers facilitate trades and provide liquidity, stepping in when they can profit

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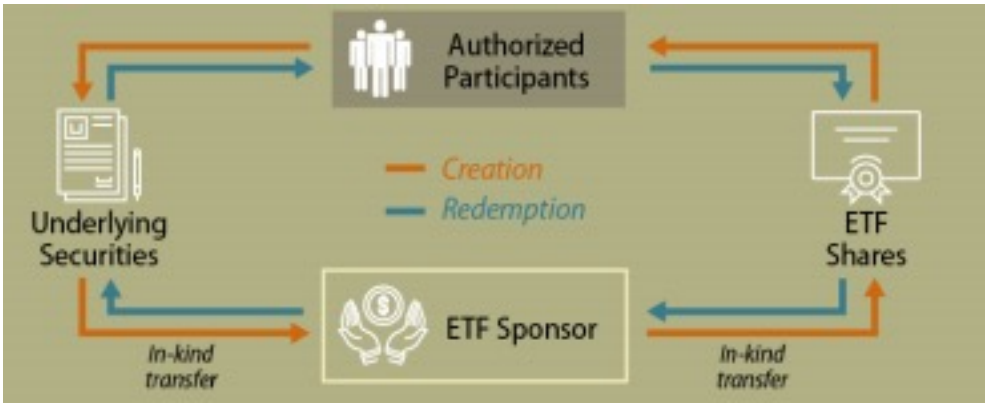
Authorized Participants (APs) are specialized market makers
APs are the only agents with direct ETF sponsor transaction privileges



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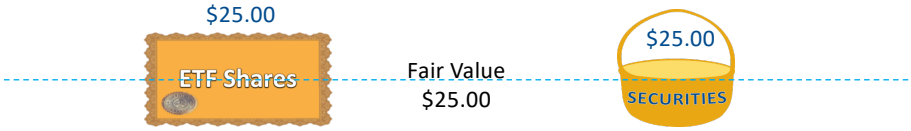
Inside the AP Business:

Profit motive keeps ETF prices and values aligned



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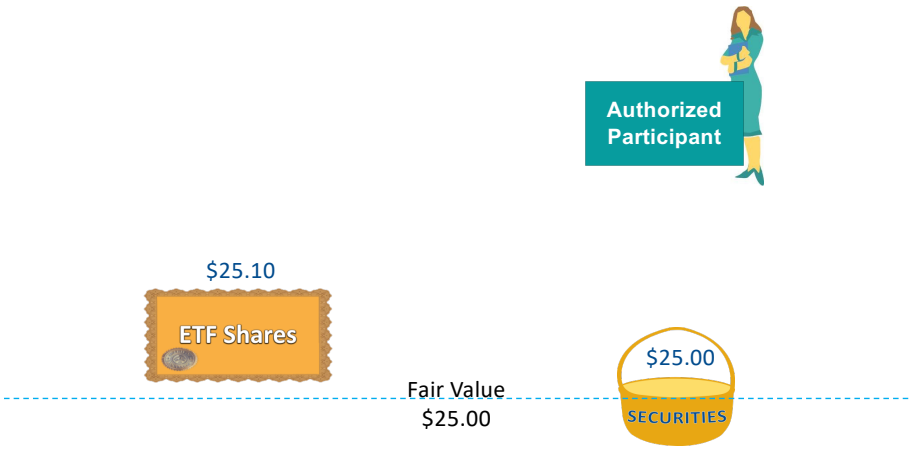
Arbitrage Opportunity



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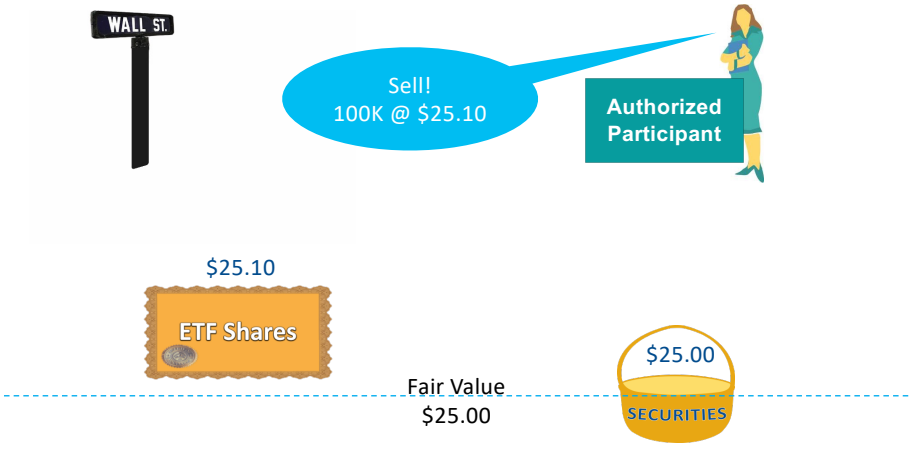
Sell high. The AP shorts 100K ETF shares.



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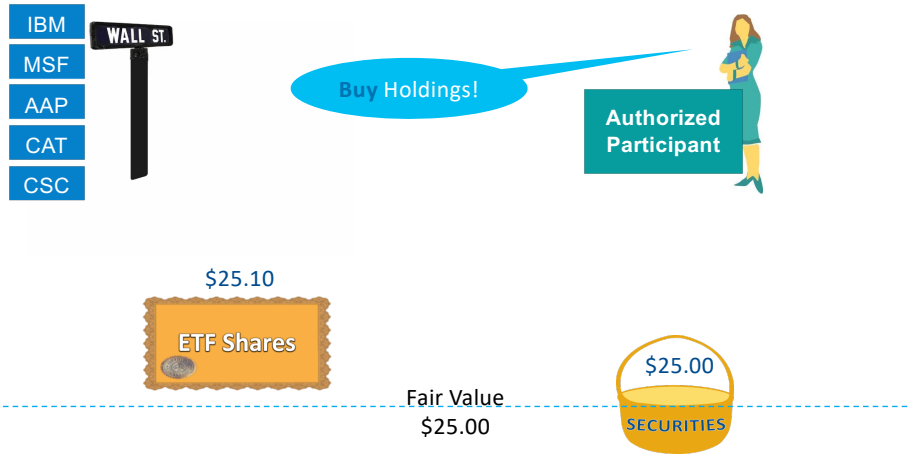
Buy Low. The AP buys the basket.



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The AP books a profit

Bought:	$25.00
Sold:	$25.10
Margin:	$ 0.10

100,000 times
Profit $10,000.00

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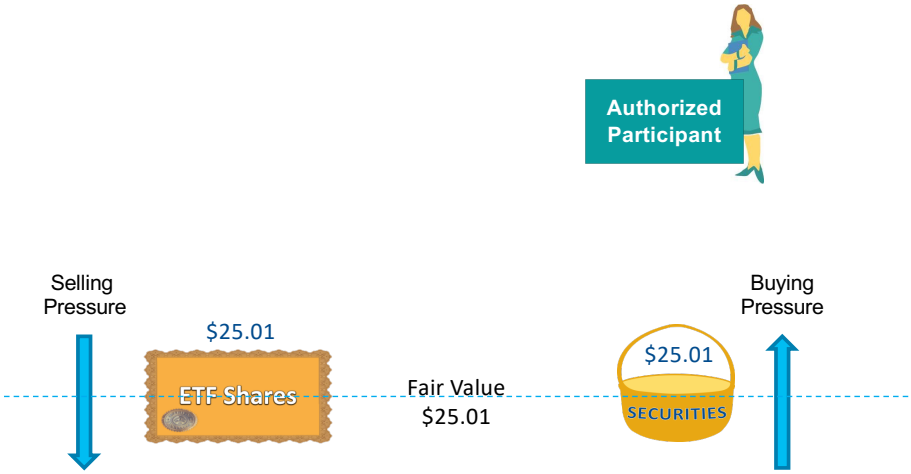
Bonus: The ETF price now aligns with its fair value



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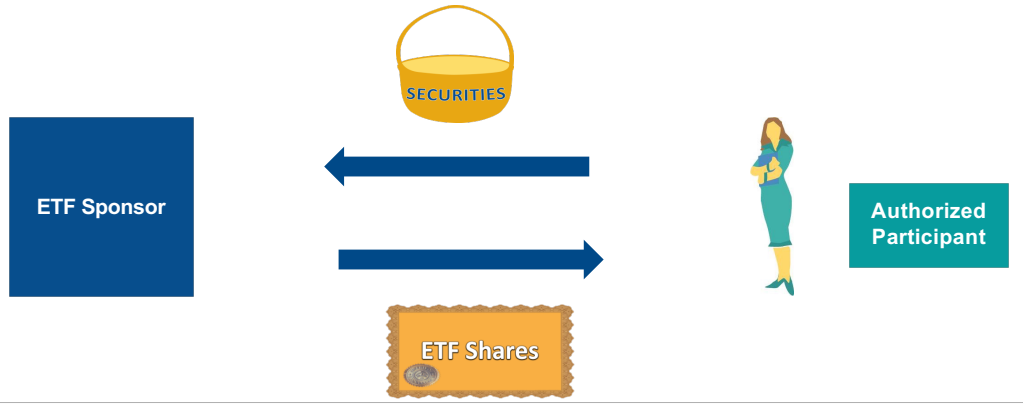
The AP creates new shares via in-kind exchange with the asset manager

The 100K shares received from the ETF Sponsor cancels out the 100K share short position



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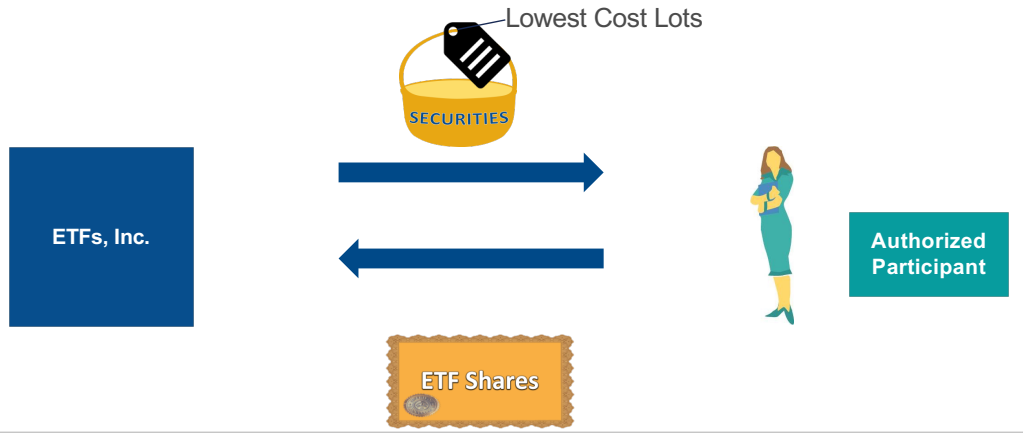
Bigger bonus: Tax Efficiency

In a redemption (a reversed creation), the ETF portfolio manger can remove tax liabilities from the portfolio



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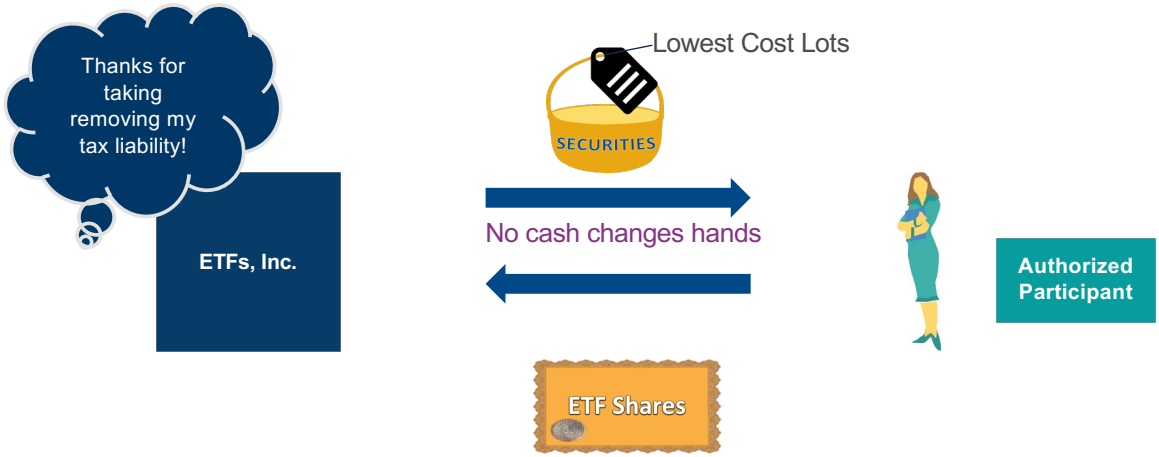
The in-kind redemption is not a sale. The portfolio manager does not realize a capital gain.



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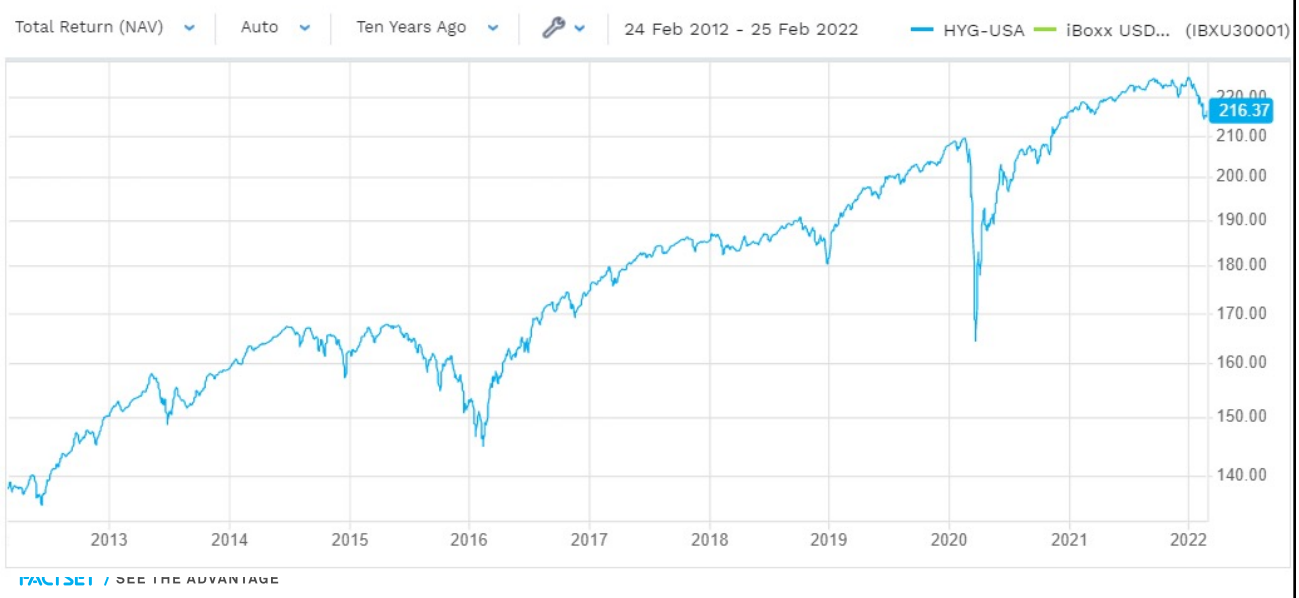
HYG has never made a capital gain distribution



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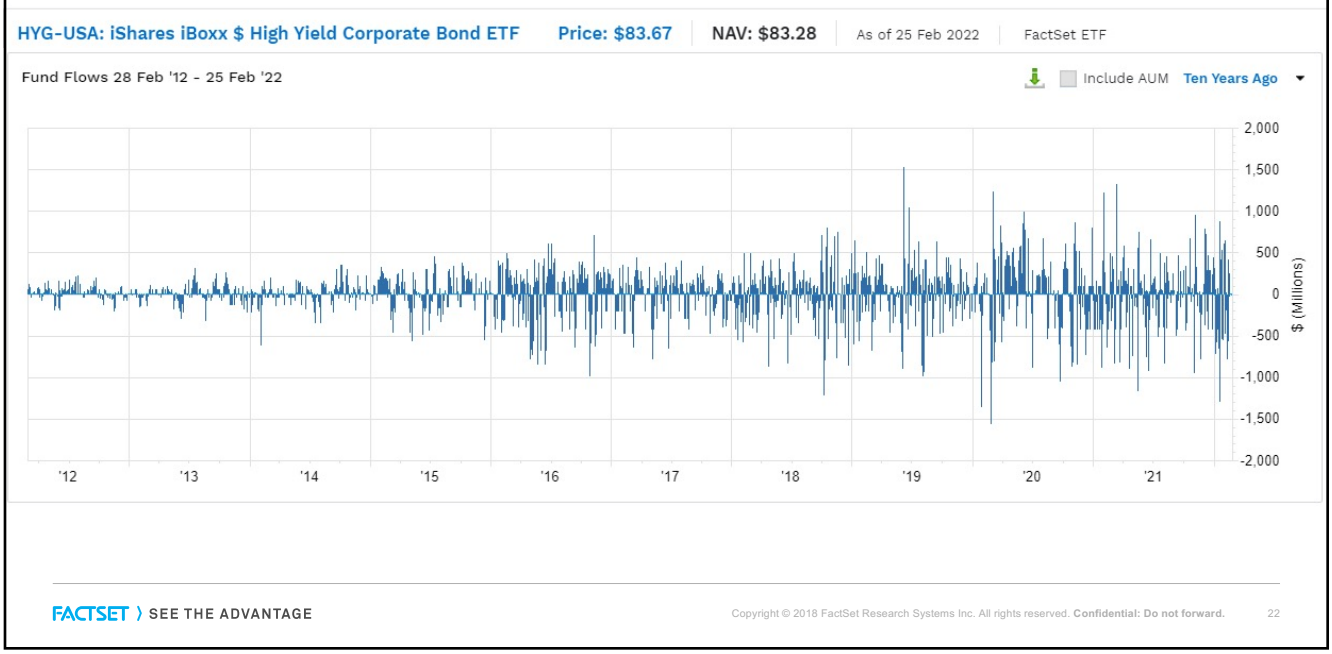
Even Bigger Bonus: Market Impact is borne by traders, not ongoing shareholders



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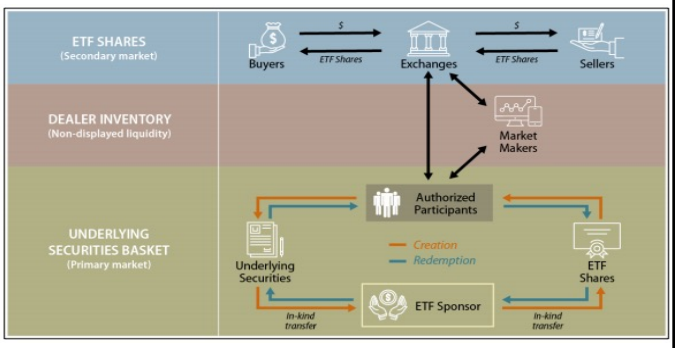
Biggest Bonus: Operating Efficiency

- ETF Sponsor not directly involved in issuing shares to investors.
  - No responsibility to keep shareholder records or provide statements
  - No account support responsibilities
  - Cannot charge sales loads
- Creating/redeeming in blocks creates economies of scale
- Portfolio manager need not keep cash on hand or sell most liquid holdings to meet redemptions
- In-kind redemptions can allow the PM to rebalance portfolio in synch with underlying index reconstitutions
- PM retains the ability to realize capital losses



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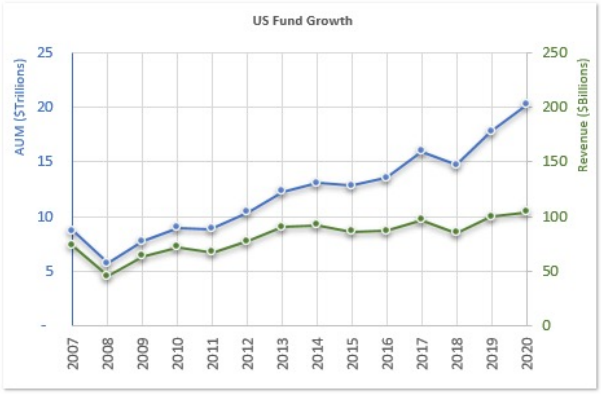
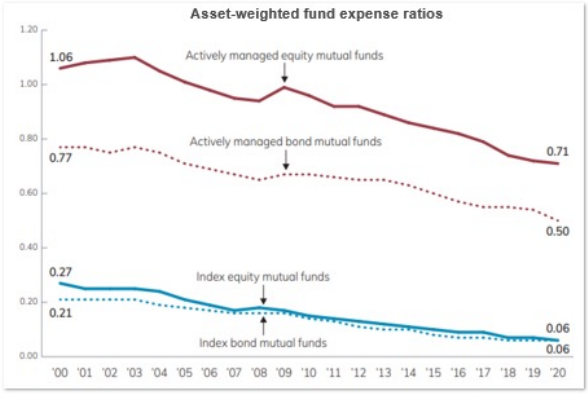
U.S. Fee Compression Counters Organic Growth, Dampening Fund Revenues

Data: ICI





- In the past decade, long-term fund assets grew by 8.7% annually, but fund revenue grew at only half that rate, 4.5% annually. The gap has widened in the past few years (top left).
- Fee compression happens directly, as asset managers slash management fees, and also indirectly, as investors move capital from high-cost (often active) to low-cost (often passive) managers and from mutual funds to ETFs, which are cheaper to operate. The combination has led to steady decreases in asset-weighted average expense ratios (top right).
- ETFs now hold 21.8% of all U.S. long-term fund assets, up from 9.9% at the end of 2010 and 14.0% at the end of 2015.
- 14% of the U.S. stock market was held in passive funds in December 2020, up from 7% in 2010.
- At year-end 2020 passives accounted for 40% of the overall U.S. fund market, including money market funds, up from 19% at the end of 2010.
- The number of fund sponsors peaked in 2015 at 877, ending 2020 at 804. Likewise, the number of funds dropped from 16,913 in 2016 to 16,127 in 2020.

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Total Annual Cost of Ownership (TACO): The Heart of ETF Due Diligence
Case Study: U.S. Midcap ETFs

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Tracking Difference

	Ticker	ETF Name	Expense Ratio	Median Tracking Difference	Maximum Tracking Difference	Minimum Tracking Difference	Tracking Range
1	VO	Vanguard Mid-Cap ETF	.04%	-.02%	.01%	-.29%	.30%
2	SCHM	Schwab U.S. Mid-Cap ETF	.04%	-.05%	-.02%	-.10%	.09%
3	MIDF	iShares MSCI USA Mid-Cap Multifactor ETF	.25%	-.05%	.34%	-.67%	1.01%
4	IJH	iShares Core S&P Mid-Cap ETF	.05%	-.08%	-.05%	-.12%	.07%
5	SPMD	SPDR Portfolio S&P 400 Mid Cap ETF	.05%	-.12%	-.02%	-.35%	.32%
6	IVOO	Vanguard S&P Mid-Cap 400 ETF	.10%	-.13%	-.11%	-.23%	.13%
7	IWR	iShares Russell Midcap ETF	.19%	-.25%	-.17%	-.30%	.13%
8	MDY	SPDR S&P Midcap 400 ETF Trust	.22%	-.31%	-.16%	-.39%	.23%
9	IMCB	iShares Morningstar Mid-Cap ETF	.04%	-.33%	-.29%	-.45%	.16%
10	JPME	JPMorgan Diversified Return U.S. Mid Cap Equity ETF	.24%	-.36%	-.26%	-.46%	.20%
11	XMLV	Invesco S&P MidCap Low Volatility ETF	.25%	-.36%	-.13%	-.51%	.38%
12	FLQM	Franklin LibertyQ U.S. Mid Cap Equity ETF	.30%	-.46%	-.27%	-.68%	.41%
13	EWMC	Invesco S&P MidCap 400 Equal Weight ETF	.40%	-.59%	-.27%	-.96%	.69%
14	EZM	WisdomTree U.S. MidCap Fund	.38%	-.60%	.09%	-1.04%	1.13%
15	JHMM	John Hancock Multifactor Mid Cap ETF	.41%	-.62%	-.41%	-1.01%	.60%
16	DON	WisdomTree U.S. MidCap Dividend Fund	.38%	-.73%	-.30%	-1.19%	.89%

Source: FactSet, as of 3-1-22

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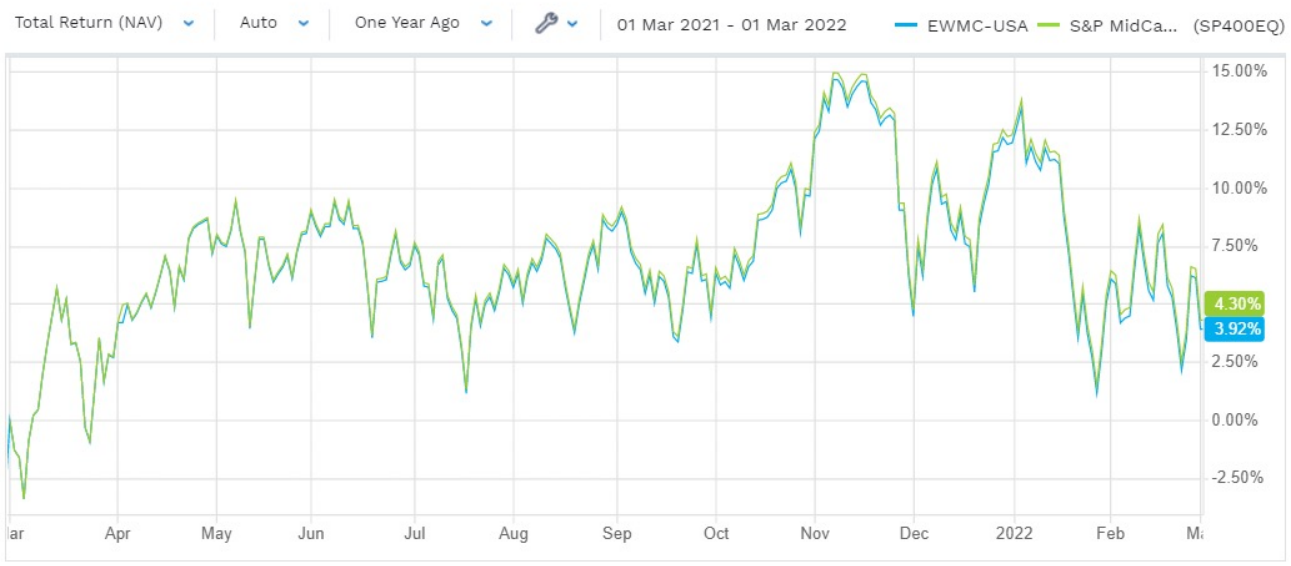
Invesco S&P Midcap 400 Equal Weight ETF (EWMC) Tracking vs. underlying index



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Fund Closure Risk – tax implications

Ticker	Name	Closure Risk	AUM 3-2-22
ARKK	ARK Innovation ETF	Low	12,248,520,900
KOMP	SPDR S&P Kensho New Economies Composite ETF	Low	1,816,015,988
GINN	Goldman Sachs ETF Trust Goldman Sachs Innovate Equity ETI	Low	412,282,000
SARK	Tuttle Capital Short Innovation ETF	Low	323,760,255
GXTG	Global X Thematic Growth ETF	Low	96,252,223
TMAT	Main Thematic Innovation ETF	Low	68,482,500
FMIL	Fidelity New Millennium ETF	Medium	60,859,543
ANEW	ProShares MSCI Transformational Changes ETF	High	32,874,979
MVPS	Amplify Thematic All-Stars ETF	High	12,265,843
BNE	Blue Horizon BNE ETF	High	7,718,910
INNO	Harbor Disruptive Innovation ETF	Low	5,973,750
SPRX	Spear Alpha ETF	High	4,744,150
ILDR	First Trust Innovation Leaders ETF	High	3,657,437
GRZZ	Grizzle Growth ETF	Low	922,832
DTOX	Amplify Cleaner Living ETF	High	912,785

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Trading Spreads: Mind the Gap

	Ticker Symbol	Proper Name	ETF Spread Pct
1	IWR	iShares Russell Midcap ETF	.01%
2	IJH	iShares Core S&P Mid-Cap ETF	.02%
3	MDY	SPDR S&P Midcap 400 ETF Trust	.02%
4	VO	Vanguard Mid-Cap ETF	.02%
5	SPMD	SPDR Portfolio S&P 400 Mid Cap ETF	.02%
6	SCHM	Schwab U.S. Mid-Cap ETF	.05%
8	DON	WisdomTree U.S. MidCap Dividend Fund	.06%
10	IVOO	Vanguard S&P Mid-Cap 400 ETF	.08%
11	XMLV	Invesco S&P MidCap Low Volatility ETF	.09%
13	JHMM	John Hancock Multifactor Mid Cap ETF	.09%
15	IMCB	iShares Morningstar Mid-Cap ETF	.11%
16	EZM	WisdomTree U.S. MidCap Fund	.12%
22	JPME	JPMorgan Diversified Return U.S. Mid Cap Eq	.15%
24	MIDF	iShares MSCI USA Mid-Cap Multifactor ETF	.17%
28	FLQM	Franklin LibertyQ U.S. Mid Cap Equity ETF	.21%
34	EWMC	Invesco S&P MidCap 400 Equal Weight ETF	.26%

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Source: FactSet, as of 3-2-22

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TACO: Total Annual Cost of Ownership

Ticker Symbol	Proper Name	ETF Spread Pct	Median Tracking Difference (Negative)	TACO (3 year)
VO	Vanguard Mid-Cap ETF	.02%	.02%	.03%
SCHM	Schwab U.S. Mid-Cap ETF	.05%	.05%	.06%
IJH	iShares Core S&P Mid-Cap ETF	.02%	.08%	.09%
MIDF	iShares MSCI USA Mid-Cap Multifactor ETF	.17%	.05%	.11%
SPMD	SPDR Portfolio S&P 400 Mid Cap ETF	.02%	.12%	.12%
IVOO	Vanguard S&P Mid-Cap 400 ETF	.08%	.13%	.16%
IWR	iShares Russell Midcap ETF	.01%	.25%	.26%
MDY	SPDR S&P Midcap 400 ETF Trust	.02%	.31%	.32%
IMCB	iShares Morningstar Mid-Cap ETF	.11%	.34%	.38%
XMLV	Invesco S&P MidCap Low Volatility ETF	.09%	.36%	.39%
JPME	JPMorgan Diversified Return U.S. Mid Cap Eq	.15%	.36%	.41%
FLQM	Franklin LibertyQ U.S. Mid Cap Equity ETF	.21%	.46%	.53%
EZM	WisdomTree U.S. MidCap Fund	.12%	.60%	.64%
JHMM	John Hancock Multifactor Mid Cap ETF	.09%	.62%	.65%
EWMC	Invesco S&P MidCap 400 Equal Weight ETF	.26%	.59%	.67%
DON	WisdomTree U.S. MidCap Dividend Fund	.06%	.73%	.75%
XMMO	Invesco S&P MidCap Momentum ETF	.13%	.79%	.83%
RWK	Invesco S&P MidCap 400 Revenue ETF	.22%	.99%	1.06%

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ETF Trading: Primary & Secondary Liquidity

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Ticker	Name	Average Spread	Volume ($, median)
EEM	iShares MSCI Emerging Markets ETF	.02%	2,149,664,631
IEMG	iShares Core MSCI Emerging Markets ETF	.02%	850,782,981
VWO	Vanguard FTSE Emerging Markets ETF	.02%	771,555,317
SPEM	SPDR Portfolio Emerging Markets ETF	.02%	130,008,772
ESGE	iShares ESG Aware MSCI EM ETF	.03%	82,435,845
SCHE	Schwab Emerging Markets Equity ETF	.03%	56,945,723
XSOE	WisdomTree Emerging Markets ex-State-Owned Enterprises Fund	.03%	26,314,269
EMXC	iShares MSCI Emerging Markets ex China ETF	.08%	21,888,946
EEMV	iShares MSCI Emerging Markets Min Vol Factor ETF	.07%	13,219,870
PXH	Invesco FTSE RAFI Emerging Markets ETF	.05%	9,452,812
AVEM	Avantis Emerging Markets Equity ETF	.10%	7,019,398
DFAE	Dimensional Emerging Core Equity Market ETF	.14%	6,855,580
GEM	Goldman Sachs ActiveBeta Emerging Markets Equity ETF	.09%	5,026,036
EMGF	iShares MSCI Emerging Markets Multifactor ETF	.15%	2,962,083
FEM	First Trust Emerging Markets AlphaDEX Fund	.17%	2,396,608
EELV	Invesco S&P Emerging Markets Low Volatility ETF	.15%	1,542,145
NUEM	Nuveen ESG Emerging Markets Equity ETF	.32%	1,319,038
PIE	Invesco DWA Emerging Markets Momentum ETF	.35%	1,057,085
JPEM	J.P. Morgan Diversified Return Emerging Markets Equity ETF	.13%	913,699
FRDM	Freedom 100 Emerging Markets ETF	.46%	883,178

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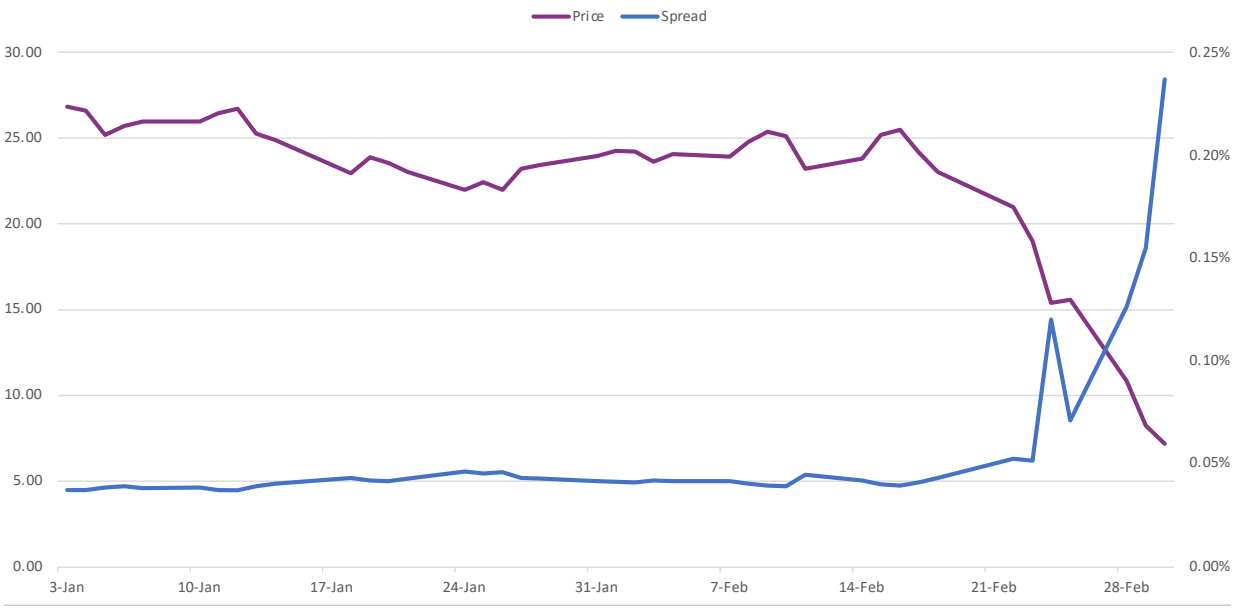

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Security Prices by issuer March 2, 2022

Issuer	Gazprom	Taiwan Semiconductor
Franklin Templeton	$ 0.16	$ 21.42
State Street	$ 0.29	$ 21.42
Blackrock	$ 0.59	$ 21.36
Charles Schwab	$ 0.66	$ 21.42
Goldman Sachs	$ 0.78	$ 21.42
Crestview	$ 0.98	
Cambria	$ 1.10	
Bank of New York Mellon	$ 1.29	$ 21.42
Deutsche Bank	$ 1.30	$ 21.42
Northern Trust	$ 1.65	$ 21.42

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Economic Exposure
Biggest Differences in Investment Outcome

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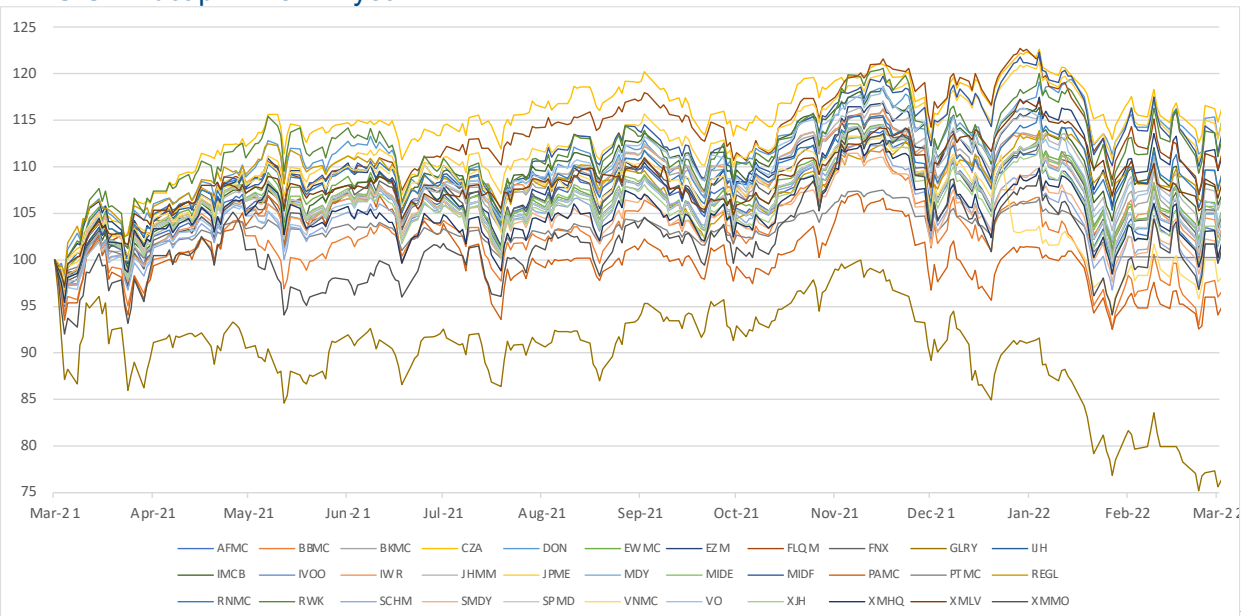
All U.S. Midcap ETFs - 1 year



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VO: Analyst Pick

Description
VO tracks the CRSP US Mid Cap Index, a diversified index of mid-cap US companies.

Fund Insight
VO offers marketlike coverage of US midcaps. Fully replicating the CRSP US Mid Cap Index, VO gives a good sampling of the space without major sector biases, low concentration and low turnover. The exposure aligns well with our large-cap biased midcap basket. VO originally tracked the S&P MidCap 400 Index until May 16, 2003, then switched to the MSCI US MidCap 450 Index, until switching to the CRSP index January 30, 2013.

CZA: Best Performer

Description
CZA holds a proprietary-selected portfolio of 100 midcap US stocks. The fund seeks to outperform pure market-cap indexes.

Fund Insight
CZA aims to outperform the US market by using a proprietary, multi-factor approach to identify midcap securities with potentially superior risk/return profiles. Investors should understand that CZA's portfolio differs greatly from a vanilla market-cap-weighted ETF. The fund comes with significant sector tiltsit heavily overweights financials while underweighting consumer cyclicals. The index is reconstituted on a quarterly basis.

GLRY: Worst Performer

Description

GLRY seeks to maximize growth and outperform its benchmark by actively selecting US midcap stocks that are screened for their alignment with biblical values.

Fund Insight

GLRY is actively managed, selecting US midcaps with high growth potential based on the company's financial health, earnings trends, valuation, risk and relative strength. The selection is narrowed down using a proprietary method of faith-based ESG analysis. The fund's subadviser then select well-known, well-established and well-capitalized companies with above-average growth potential as measured by their earnings or revenue. Weightings are determined using a proprietary scoring called the Inspire Impact Score method, which ranks companies within their industry peer groups. Companies involved in activities that do not align with Inspire's biblical values, like abortion, pornography, human trafficking and many more, receive negative scores and are excluded from the portfolio.

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Top Ten Holdings

Vanguard Mid-Cap ETF			Invesco Zacks Mid-Cap ETF			Inspire Faithward Mid Cap Momentum ESG ETF	
Name	Weight		Name	Weight		Name	Weight
Palo Alto Networks	0.78%		Paccar	2.24%		Forward Air	4.17%
Pioneer Natural Resources	0.78%		Franco Nevada	2.13%		Triton International	4.08%
Cash/Short-Term Investments	0.73%		Wec Energy Group	2.12%		Louisiana Pacific	3.97%
Centene	0.72%		Oneok	2.12%		Walker & Dunlop	3.91%
Xilinx	0.71%		Amerisourcebergen	2.11%		Westlake	3.61%
Synopsys	0.70%		Rocket Cos	2.00%		MKS Instruments	3.58%
Fortinet	0.70%		Laboratory Corp Of America	1.94%		Bank Ozk	3.42%
Amphenol	0.66%		Edison International	1.79%		H&R Block	3.29%
Iqvia Holdings	0.65%		Zimmer Biomet	1.77%		Ternium ADR	3.28%
Cadence Design System	0.64%		DTE Energy	1.74%		Federal Realty Investment Trust	3.22%

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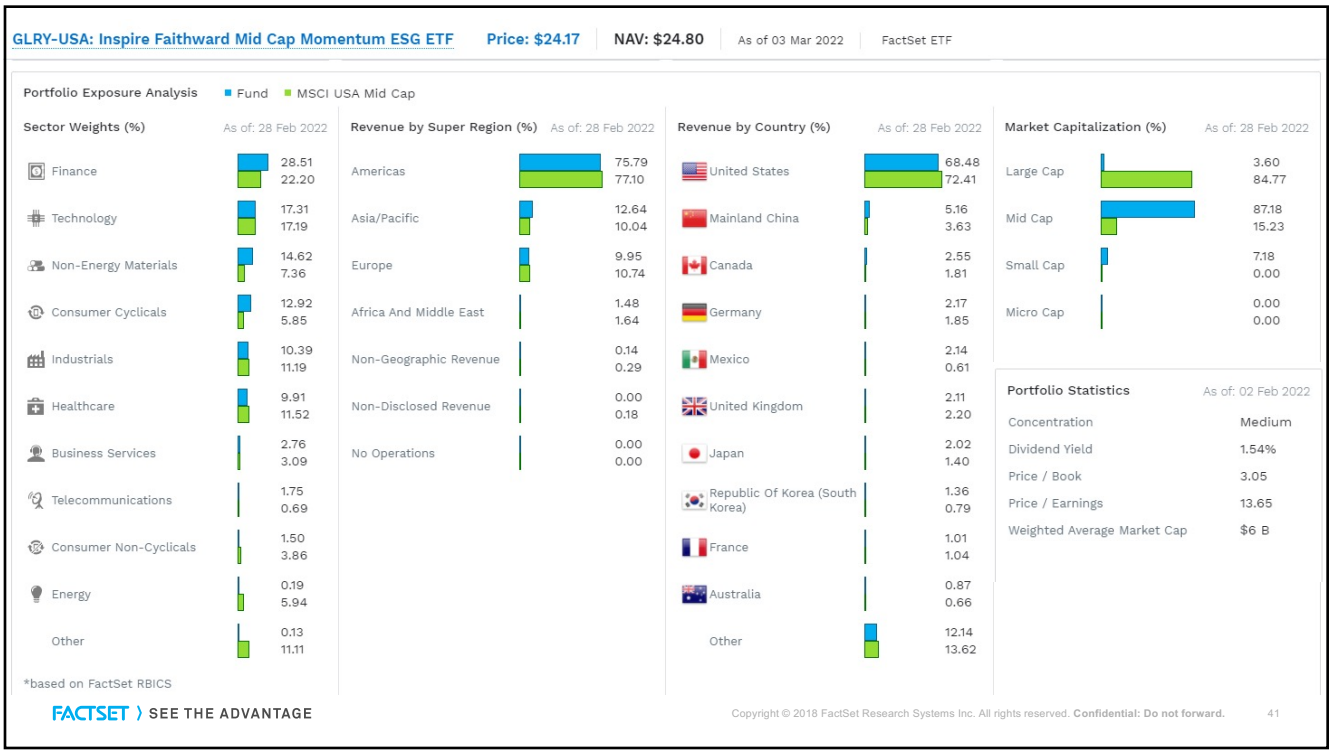

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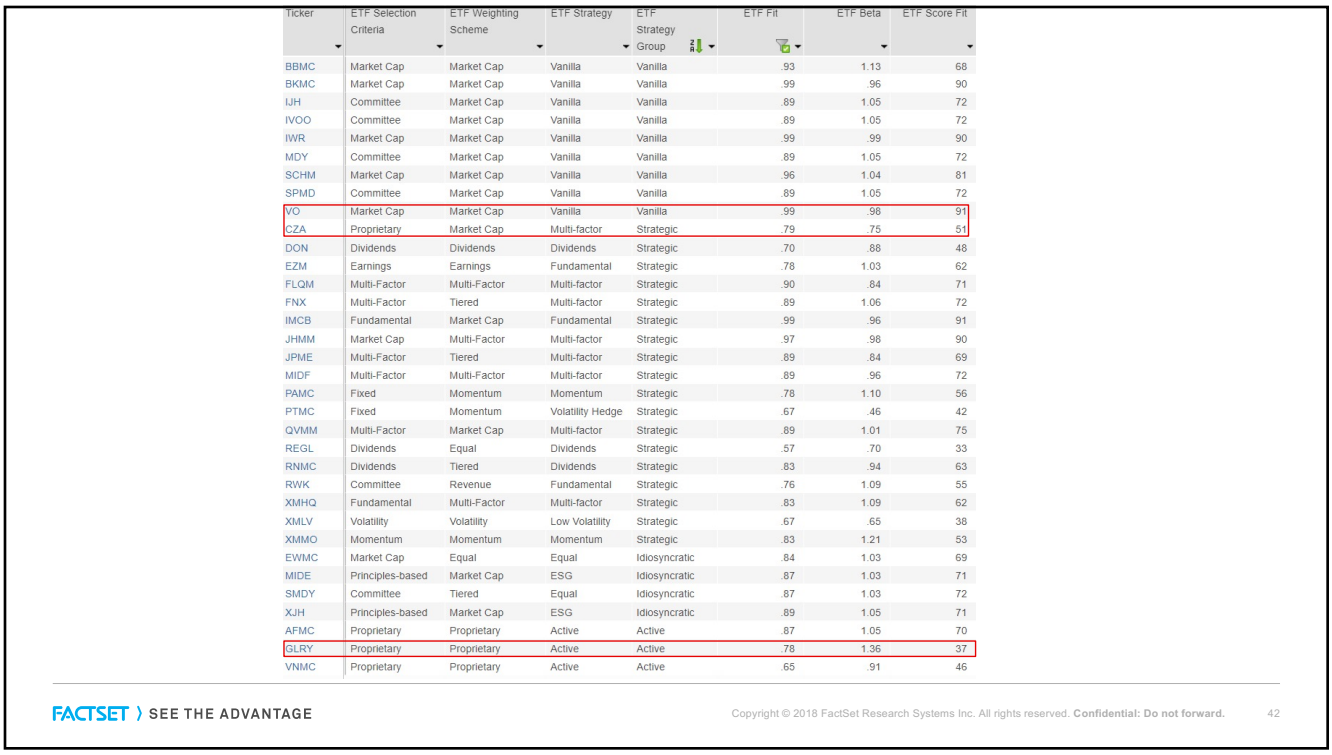

Ticker	ETF Selection Criteria	ETF Weighting Scheme	ETF Strategy	ETF Strategy Group	ETF Fit	ETF Beta	ETF Score Fit
BBMC	Market Cap	Market Cap	Vanilla	Vanilla	.93	1.13	68
BKMC	Market Cap	Market Cap	Vanilla	Vanilla	.99	.96	90
IJH	Committee	Market Cap	Vanilla	Vanilla	.89	1.05	72
IVOO	Committee	Market Cap	Vanilla	Vanilla	.89	1.05	72
IWR	Market Cap	Market Cap	Vanilla	Vanilla	.99	.99	90
MDY	Committee	Market Cap	Vanilla	Vanilla	.89	1.05	72
SCHM	Market Cap	Market Cap	Vanilla	Vanilla	.96	1.04	81
SPMD	Committee	Market Cap	Vanilla	Vanilla	.89	1.05	72
VO	Market Cap	Market Cap	Vanilla	Vanilla	.99	.98	91
CZA	Proprietary	Market Cap	Multi-factor	Strategic	.79	.75	51
DON	Dividends	Dividends	Dividends	Strategic	.70	.88	48
EZM	Earnings	Earnings	Fundamental	Strategic	.78	1.03	62
FLQM	Multi-Factor	Multi-Factor	Multi-factor	Strategic	.90	.84	71
FNX	Multi-Factor	Tiered	Multi-factor	Strategic	.89	1.06	72
IMCB	Fundamental	Market Cap	Fundamental	Strategic	.99	.96	91
JHMM	Market Cap	Multi-Factor	Multi-factor	Strategic	.97	.98	90
JPME	Multi-Factor	Tiered	Multi-factor	Strategic	.89	.84	69
MIDF	Multi-Factor	Multi-Factor	Multi-factor	Strategic	.89	.96	72
PAMC	Fixed	Momentum	Momentum	Strategic	.78	1.10	56
PTMC	Fixed	Momentum	Volatility Hedge	Strategic	.67	.46	42
QVMM	Multi-Factor	Market Cap	Multi-factor	Strategic	.89	1.01	75
REGL	Dividends	Equal	Dividends	Strategic	.57	.70	33
RNMC	Dividends	Tiered	Dividends	Strategic	.83	.94	63
RWK	Committee	Revenue	Fundamental	Strategic	.76	1.09	55
XMHQ	Fundamental	Multi-Factor	Multi-factor	Strategic	.83	1.09	62
XMLV	Volatility	Volatility	Low Volatility	Strategic	.67	.65	38
XMMO	Momentum	Momentum	Momentum	Strategic	.83	1.21	53
EWMC	Market Cap	Equal	Equal	Idiosyncratic	.84	1.03	69
MIDE	Principles-based	Market Cap	ESG	Idiosyncratic	.87	1.03	71
SMDY	Committee	Tiered	Equal	Idiosyncratic	.87	1.03	72
XJH	Principles-based	Market Cap	ESG	Idiosyncratic	.89	1.05	71
AFMC	Proprietary	Proprietary	Active	Active	.87	1.05	70
GLRY	Proprietary	Proprietary	Active	Active	.78	1.36	37
VNMC	Proprietary	Proprietary	Active	Active	.65	.91	46

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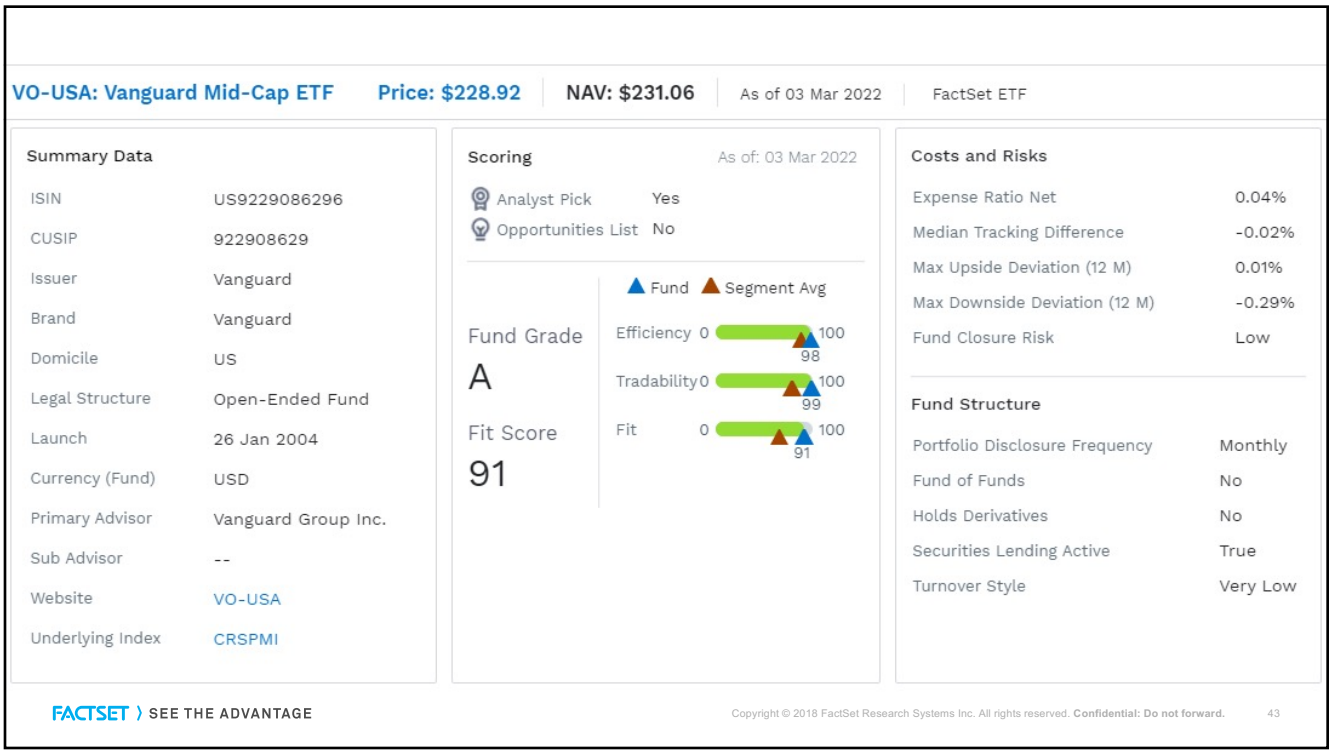

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