ETF Due Diligence

Creating a Customized Process

Rather than assessing ETFs the same way mutual funds are evaluated, advisors should create and implement a customized due diligence process that allows them to match products with what is most appropriate for their clients' needs and objectives.

Financial advisors should establish a process for analyzing the differences between ETFs and evaluating the potential benefits and risks of each ETF. An advisor's objective should be to match the philosophy and structure of a given ETF with client needs. It is important to look at the structure of the ETF, review its underlying index and understand the philosophy of the investment manager.

When creating a customized due diligence process, take care to avoid common misconceptions by considering the following:

- Underlying investments are more important than size;
- A focus on track record length may obscure critical details; and
- Explicit costs, implicit costs and opportunity costs should be considered when determining the costs of investing in an ETF.

Exchange traded funds (ETFs) are an integral part of many portfolios, valued by financial advisors and investors alike for their liquidity, transparency and tax efficiency. In recent years, their popularity has soared, fueled by financial advisors who were transforming their businesses to meet investors' changing needs. As clients asked for assistance with complex wealth management challenges, financial advisors sought potent, flexible investment strategies that would help them solve clients' problems.

Advisors should start by asking what it would take to “invest with purpose.”

Along with their explosive growth, however, ETFs evolved in complexity, structure and usage. Unfortunately for many advisors, their due diligence process vis-a-vis ETFs did not. Too often, they employed the same tools used to evaluate mutual fund and separate account strategies, meaning potentially that they may have been asking the wrong questions.

We believe that financial advisors should establish a customized due diligence process – one that is structured and deliberate in nature. This process should recognize the differences between ETFs and evaluate the potential benefits and risks of each ETF. An advisor’s objective should be to match the philosophy and structure of a given ETF with client needs.

Four vital questions are at the heart of this process:

Does the ETF achieve its objective?	Can investors access it at a fair price?	Does it give the targeted exposure?	Does it align with the real world goals?

To answer these questions, advisors must look at the structure of the ETF, understand its underlying index and understand the investment manager.

STEP ONE: EXAMINE THE STRUCTURE

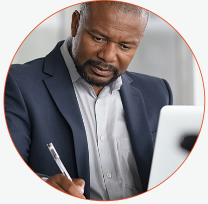
Advisors should examine the structure of an individual ETF, such as its investment program, tax consequences, custodial policies and other nuances that could impact its effectiveness.

STEP TWO: UNDERSTAND THE UNDERLYING INDEX

When it comes to choosing an index, advisors should start by asking what it would take to “invest with purpose.”

- Is the investment objective more important than just beating the benchmark?
- Does the index align with the advisor’s investment thesis and the client’s desired outcome?
- Is the index investable, or does it include holdings that cannot be accessed directly?

Advisors should make sure their understanding is clear. The index must be measurable, appropriate and reflective of current investment options. For equities, determine if it has the desired capitalization weighting, return variance, style, country, sector or manager risk. For fixed income, establish whether the strategy delivers the desired asset class exposure, risk and yield. Advisors should also evaluate the potential challenges and the benefits of beta, alternative-weighted or actively managed indexes.



Firm philosophies on product development, experience and expertise can vary greatly.

Three considerations advisors must take when creating a customized due diligence process:

1. Underlying investments are more important than size
2. A focus on track record length may obscure critical details
3. Reconsider the math of ETF ownership cost

STEP THREE: UNDERSTAND THE INVESTMENT MANAGER

Before selecting an ETF, an advisor should get to know the investment manager – the firm's professionals, process, philosophy and performance. Firm philosophies on product development, experience and expertise can vary greatly. In reviewing the prospectus, especially for an active strategy, examine the manager's investment process.

- Can it employ inverse and leverage strategies?
- Can it use derivatives as part of the investment process, and if so, does the manager use them for risk management or to take bets?
- Can the ETF contain swaps by structure?

Additionally, is the ETF created in-kind or with cash? This could have a financial impact on the client's portfolio.

More broadly speaking, financial advisors should get to know the investment manager by examining the following.

- Depth of investment expertise
- Strategies used to manage tax consequences
- Management of turnover
- Handling of transaction costs
- Tactics used to deal with tracking error
- Use of optimization, replication or representative sampling
- Fiduciary experience
- Philosophy

BE SKEPTICAL

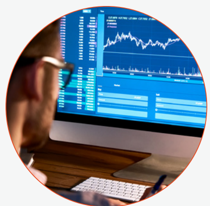
In creating a customized due diligence process, advisors must take care to avoid some of the most common misconceptions. Following are three key considerations.

1. Underlying Investments are More Important than Size

The investments held within an ETF will determine that ETF's pricing and liquidity. Contrary to popular belief, the size of an ETF has little or no relevance to how it will trade. In reality, an ETF trades based on supply and demand in the market for the underlying investments. For example, an investor could have difficulty selling a steel ETF because the price of steel is falling, not because of the size or viability of the steel ETF itself.

2. A Focus on Track Record Length May Obscure Critical Details

We don't think advisors need to see a long track record for every type of ETF. In some cases, they should give more weight to the manager's investment thesis. With newer strategies – for instance, tilted or alternatively weighted indexes – advisors should decide if they believe in the manager's investment thesis. Does the manager have a distinct, logical investment approach that can generate the desired outcome? Analytics can be useful in making this determination.



There are many different cost considerations when investing in an ETF:

Explicit costs
Implicit costs
Opportunity costs

3. Reconsider the Math of ETF Ownership Cost

Many financial advisors use the same industry-standard equation for ETFs that is used to determine the cost of a pure beta mutual fund:

Expense Ratio
+ Trading Spread
+ Tracking Error

= Total Cost of Ownership

This equation falls short, however. In reality, there are many different cost considerations when investing in an ETF.

Explicit Costs. These are the most commonly cited costs in comparative articles or reviews. They include expense ratio, commission and bid/ask spread, all of which are readily identifiable and easy to discuss and understand.

Implicit Costs. Unlike explicit costs that can be researched across many data sources, implicit costs can be harder to quantify. While they may require more effort to unearth, implicit costs are just as important as their explicit counterparts. Implicit costs include capital gains, turnover within the fund, the funds tracking success against its index (or a standard market benchmark) and distribution or platform fees.

It is important to understand that these costs are not independent of one another; sometimes lowering an explicit cost can increase implicit costs or even reduce the effectiveness of the investment strategy.

Opportunity Costs. As the ETF product landscape continues to evolve, interest in alternative index weighting methodologies has grown rapidly, particularly in the last several years. Use of these so-called “nontraditionally weighted” indices offers another perspective on costs: the opportunity cost — and the choice of one product over another dictates opportunity cost.

For an in-depth discussion of these three basic categories of ETF purchasing costs, we urge you to review our paper, “The Total Cost of ETF Ownership, An Important — but Complex — Calculation.”

ONCE PROCESS ESTABLISHED, REVIEW ETFS REGULARLY

In our view, many of the metrics used by financial advisors to evaluate ETFs are obsolete. Rather than assessing ETFs the same way mutual funds are evaluated, advisors should create and implement a customized due diligence process that allows them to match products with what is most appropriate for their clients’ needs and objectives. To do so, they should seek to understand a fund’s construction, methodology and investment philosophy to determine whether it aligns with what they are trying to accomplish. And they should fully understand how to more accurately evaluate the total cost of owning an ETF. We recommend establishing a regular review process to verify that the ETFs in your clients’ portfolios are continuing to meet their needs and have the stability to weather change and uncertainty.

FIND OUT MORE

The FlexShares approach to index-based investing is, first and foremost, investor-centric and goal oriented. We pride ourselves on our commitment to developing products that are designed to meet real-world objectives for both institutional and individual investors. If you would like to discuss the attributes of any of our ETFs in greater depth or find out more about the index methodology behind them please don't hesitate to call us at 1-855-FlexETF (1-855-353-9383) or visit www.FlexShares.com.

DEFINITION

Beta is a statistical measure of the volatility, or sensitivity, of rates of return on a portfolio or security compared to a market index.

IMPORTANT INFORMATION

Before investing, carefully consider the FlexShares investment objectives, risks, charges and expenses. This and other information is in the prospectus and a summary prospectus, copies of which may be obtained by visiting www.flexshares.com. Read the prospectus carefully before you invest.

Foreside Fund Services, LLC, distributor.

An investment in FlexShares is subject to investment risk, including the possible loss of principal amount invested. Investments do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.