GFG CAPITAL
A FAMILY OFFICE

VIEWS FROM THE BRICK

THE INVESTMENT CIVIL WAR

Disruption. It's what moves us forward as a society. Often times led by technology, disruption is what helps us evolve as individuals as well as investors. No idea has been more disruptive to the investment world than the introduction of ETFs. Explosive growth within the ETF space has altered the way investors across global markets approach the portfolio construction process. From one ETF in 1993, the ETF industry has matured (and continues to grow) to over 2,000 products and $3 trillion in assets. This hyperbolic growth has sparked a debate that many investors feel obligated to choose a side. Which solution is best? Active or Passive?

WHICH SIDE ARE YOU ON?

First and foremost we don't subscribe to the 'civil war', as we call it, within the investment industry when it comes to active vs passive investment vehicles. We believe there is a time and place for each and the need for both within a well constructed investment portfolio for almost every investment objective. To us, this is not a binary decision, but a mindful blend of active and passive strategies in different markets and asset classes aimed to benefit from different trends and characteristics of a given cycle. We think the argument can be boiled down to cost, and risk.

BOTH ARE BENEFICIAL

When focusing on younger retail investors in particular, an advantage to the use of index funds and ETFs might be the ease of implementation and lower costs. For these investors who may be new to investing, regardless of age, the wide variety of exposures is attractive in the sense that a mindful portfolio and asset allocation can be generated through these vehicles that can potentially set someone up for a long-term investment time horizon.

Certainly being cost aware within any investment portfolio, once again regardless of age, is an integral role to the investment process. The more capital we as investors can keep in our portfolios the happier we will be when we get closer to our personal goals.

When it comes to other differences between index funds and actively managed strategies such as mutual funds, there are obvious benefits to each. With the index fund, for better or for worse, you're going to move pretty much lockstep with the market on good days and bad ones. But at such low costs, you're not paying for the mindful (maybe?) investment professionals on the other side of the ticker that you buy making these active investment decisions to hold, or not hold, certain securities within the strategy.

The potential downside protection of the actively managed mutual is by far the biggest benefit. And over the long term, downside protection is key to long-term alpha generation. This is what you're paying for when you're selecting an actively managed strategy: the team of professionals who are analyzing individual securities to determine intrinsic value to take advantage mispricing within the market.

This is where the use of both types of strategies can become attractive to a portfolio over the long term. It's important to note that not all markets are created equal. As investment professionals, we seek opportunities on a global scale; part of that process is to understand which types of strategies work in different respective markets. In asset classes where the information advantage may not be as evident today, perhaps it will make more sense to utilize a passive ETF for broad beta exposure. But as an investor, you may evaluate where a market is in its market cycle, coupled with any type of potential external concern (i.e. The United States and valuations) and this may dictate the use of an actively managed strategy in order to allow for the potential for downside protection. Using both active and passive strategies is known as a "core-satellite" approach. It allows for an investor's portfolio to participate broadly with market rallies, while giving themselves the chance for alpha generation and downside protection.

DRAWBACKS OF BOTH

ETFs have grown in sophistication over the years making them viable options for retail investors and institutional investors alike. Two risks that we can identify when diving into the ETF space stem from demand for new ETFs, how quickly new bespoke exposures can and have been brought to the market, and the use of AI within even some of the perceived best ETF offerings on the market today.

Well-constructed ETFs, both index funds and "active beta" strategies, carry a lot of value. But the Baskin Robbins perception of the endless flavors being introduced to investors today should be tasted with caution. Obscure exposures such as return on disability to triple leveraged, easily purchased, short ETFs, is a risk to investors in our eyes.

WHO TAUGHT YOU TO DRIVE?

On a more advanced level, the sophistication of ETFs could be a risk in itself. There's a great analogy out there that compares AI within ETF construction and management to teaching a self-driving car to drive. You typically try to perfect autonomous driving by logging miles and miles and hours upon hours of driving in flat straight desert highway. You then set the car out to the real world where it has this library of data it has constructed from its driving lessons. The problem is, the car reaches the winding mountainous terrain and volatile roads it has never encountered before. The car has spent its entire 'life' learning and driving looking through the rear view mirror. These twists and turns and dips and inclines are uncharted roads. AI learning within ETFs isn't very different. It's widely known that about 90% of the data we've generated as humans has occurred in the last two years. That means as these perceived sophisticated ETFs have been logging their miles on the road, they've been doing it in an environment of low volatility. The factor-based, or rules-based ETF algorithm will take the data it consumes and optimize it based off what it knows (flat roads). So when the machines enter an environment they've never seen before, how they behave can't be completely anticipated.

CONCLUSION

We do not view disruptive technologies, or ideas, as an abandonment of the investment process that has gotten us where we are today as market participants. Instead, we believe that it represents faith in progress. Much like the impact the industrial revolution, the adoption of civil engineering and architectural technology had on society; as portfolio architects we welcome these new tools and philosophies (and the debate that comes with them) as ways to help us move forward.