# On Exchange Traded Funds

*ETFs*

Opportunistic Value Investing

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Since their creation in the 1990s, Exchange Traded Funds (ETFs) have grown to become an increasingly prominent part of the investment landscape. Like a mutual fund, ETFs hold a basket of securities. Unlike a mutual fund, ETFs trade continuously during market hours like a stock. Investors can choose from passive index ETFs, actively managed, regional, or thematic ETFs across most asset classes.[1] In this whitepaper, we will highlight several of the ways we use ETFs at Hudson Value Partners.

## *Fund Only Portfolios*

While fundamental analysis of individual securities is at the core of the HVP process, for many years our portfolio managers have also managed "fund only" portfolios. Such an approach is an effective way to manage a modestly sized account, as well as for those whose employment may create restrictions against owning shares of individual companies. When managing a fund only portfolio, we start with our individual equity portfolios and look to mirror the exposure to economic sectors, styles, and market caps that we have in a diversified portfolio of 25-30 stocks, into a portfolio of 6-8 funds. Fund portfolios will inevitably hold hundreds if not thousands of underlying companies. As part of our portfolio construction process, we run overlap reports which detail the underlying holdings of the funds as we have them weighted in the portfolio allocation. We aim to avoid owning the same companies too many different ways and focus on the alignment of the top 30-50 positions with the types of companies we would seek to own directly. Our fund portfolios often start with a core position in a broad market fund of 25-30%. From that core, we look to tactically allocate to an additional 6-8 funds to create the portfolio. These smaller building blocks take the place of the 3-4 stocks we might own in a given sector. But it is not just an exercise of matching. Given the multitude of ETFs, we look to find unconventional ways to pick up a few of our favored positions within a theme or region.

## *Tactical Allocations*

In some new industries or sectors, it can be difficult to identify market leaders, and the types of franchise businesses we seek. Certain high growth areas face high risks and binary outcomes; owning a basket of companies in such a space can be a more prudent approach. These types of ETFs can become particularly attractive after an economic or sector dislocation that has hurt the shares of an entire group.

Within foreign markets where there are substantial currency fluctuations, and American Depository Receipt (ADR) shares may not be available, many country-specific ETFs exist as an option. In some regions both currency-hedged and currency-unhedged options are available. Prior to the advent of currency hedged ETFs, this type of foreign exposure was exclusively the domain of large institutional investors who could put on the trades necessary to reduce exposure to currency risk and isolate the performance of the underlying businesses.

## *Placeholder Securities*

Investors such as endowments and pension funds with particularly long time horizons have invested in private markets for decades. Funds in Private Equity, Venture Capital, and Real Estate, often operate in a “draw-down” structure where investors first commit capital, and a fund manager then looks to invest it over a few years. When such an investor has made an allocation to one of these strategies, it may be several years before the capital is fully deployed. Numerous studies have shown that the closest correlations to private markets are their public peers. While waiting for capital calls, investors will often put a portion of that allocation into a broad market index ETF as a placeholder for Private Equity, into a technology index ETF for Venture Capital, or a Real Estate ETF for Real Estate funds. This technique gives investors an approximate performance of the asset class they allocated to, offers quick access to funds to meet capital calls, and helps to minimize the cash drag often present in private market investing.[II]

## *Tax Trading*

Under current US tax laws, there is a provision known as the wash-sale rule. An investor may sell an investment to realize a loss which can then be used to offset other capital gains that investor has taken. After realizing a loss, an investor may not buy back that security until 31 days have passed for the loss to be valid – otherwise it becomes a wash sale.[III] For an investor who could benefit from the tax loss, but wants to maintain exposure to the space during those 31 days, we may look for an ETF with that position as a top holding or that correlates to what they need to take a loss in. The ETF can be purchased with the proceeds of tax-loss sale, and then sold after 31 days if the investor wishes to re-enter the original position.[IV]

## *Fixed Income ETFs*

At Hudson Value Partners, we are generally more skeptical of Fixed Income ETFs than their Equity cousins. Passive fixed income exposure generally tracks issuance weighted indices, which can mean that investors end up owning more of the debt of the most indebted companies. We take the words of Ben Graham to heart that credit investing "is primarily a negative art" – about avoiding the less credit worthy.[V] As such, we generally prefer actively managed fixed income funds, when our first preference of owning the genuine articles directly is impractical.

A further distinction we make is to avoid the more illiquid types of credit with ETFs. Some less frequently traded assets and types of assets that may take 30 days to settle, should not be priced or traded minute to minute. We view the possibility of a meaningful deviation between the price of the fund and the underlying assets as too great. What may create a situation for an opportunistic buy, could create a less optimal experience for a long-term investor. Less liquid assets should be owned directly or in less liquid vehicles. Within fixed income ETFs, we favor active management and the most liquid asset types.

***"Since the chief emphasis must be placed on avoidance of loss, bond selection is primarily a negative art. It is a project of exclusion and rejection, rather than search and acceptance."***

-Graham & Dodd in ***Security Analysis*** p.143

# *Special Thanks*

We at Hudson Value Partners are continually awed by the generosity of value investors in sharing their insights and their craft. Perhaps it is because the discipline requires a very specific temperament that most are willing to share, knowing that few will have the patience and persistence to endure. We want to highlight the academic leadership of Professors Benjamin Graham, David Dodd, Roger Murray, Jack McDonald, Bruce Greenwald, James Kelly, and Tano Santos, whose collective body of work has taught generations of value investors. We are grateful to the Heilbrunn Center for Graham & Dodd Investing at Columbia Business School and Fordham's Gabelli School of Business for their decades of quality programing to keep the intellectual tradition alive and thriving. The writings and resources shared by Mario Gabelli's GAMCO and Thomas A. Russo of Gardner, Russo, Quinn we consider invaluable.

We humbly submit these white papers into the long tradition of generosity of thought within the value investing community.

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[I] The Securities & Exchange Commission's Investor.gov site provides a thorough introduction to ETFs and other investment structures on their website:
https://www.investor.gov/introduction-investing/investing-basics/investment-products/mutual-funds-and-exchange-traded-2

[II] No mention of endowment style investing or public market placeholders for private market investments would be complete without an acknowledgement of the tremendous theoretical and practical advances made in the field by the late David Swensen of Yale University.

[III] IRS Publication 550 (2020) https://www.irs.gov/publications/p550#en_US_2020_publink100010601 As accessed September 2021. Tax laws are always subject to change.

[IV] Hudson Value Partners does not give specific legal or tax advice and is not a law or accounting firm. This paragraph is a summary of a commonly used investment strategy and not intended as advice specific to any individual investor. Investors should seek their own legal and tax counsel.

[V] Graham, Benjamin & Dodd, David Security Analysis (New York: McGraw Hill 6th Edition, 2009), 143.

**Disclosure Information**

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