10 Reasons To Make ETFs The Core Of Your Portfolio

by Ken Hawkins (Contact Author | Biography)

Although they would not admit it, most portfolio managers take a core/satellite approach when managing their equity portfolios. The part of the portfolio that might mirror the overall market could be considered the "core" and the part of the portfolio that deviates from the overall market can be considered the "satellite" portion. When you hear portfolio managers say they are trading around their "core" bank holdings - or they are currently overweight oil stocks and underweight technology stocks, or they have a small cap tilt to their portfolios - they are essentially taking the core/satellite approach.

But what about the average investor? The advent of exchange-traded funds (ETFs) provides an easy way of implementing a core/satellite approach. We provide 10 reasons why this strategy can trump securities-only portfolio management strategies.

What Does the Portfolio Look Like?
ETFs provide a simple way to implement a professional style approach to portfolio management. ETFs form the core of the portfolio and provide diversification. Then, you select individual stocks that are expected to outperform the benchmark to form the satellites around the ETFs. Typically, an investor might put 50% of his equity portfolio in an ETF representing a market index and 50% in individual securities. There is no hard and fast rule about the percentages, but the greater the percentage of the portfolio that is in the core holding, the more the overall portfolio will behave like the overall market.

10 Reasons to Consider a Core/Satellite Investment Strategy using ETFs
For investors who manage their own accounts, a core/satellite strategy combining securities and ETFs is often better than a portfolio of only securities for the following reasons:

1. Better Diversification
Typically, the average investor who buys stock tends to have a poorly diversified portfolio. There is often a concentration in sectors or types of stocks with very similar risk characteristics. Using an ETF to buy a core position provides instant diversification and reduces overall portfolio risk. (For more insight, read *The Importance Of Diversification*.)

2. Improved Performance
It is widely accepted that a large portion (more than 50%, by most accounts) of professional money managers underperform the stock market. The average individual investor typically fares worse. An investor who sells some stocks and replaces them with a broad-based ETF core holding may be able to improve the overall performance of the portfolio. (For related reading, check out *Pump Up Your Portfolio With ETFs*.)

3. Easier Rebalancing
A change in an investor's asset mix is easier to implement when you use an ETF as the core position. If an investor wants to increase his or her equity exposure, the purchase of additional shares of an ETF makes it easy to do without having to buy additional shares for current holdings. (To read more on portfolio rebalancing, see our related article *Rebalancing Your Portfolio To Stay On Track*.)

4. Easier to Monitor and Understand
The more stocks in a portfolio, the harder it is to monitor and manage; after all, there are more investment decisions that have to be made and more factors to be considered. With an ETF or index fund representing a core position, the number of stocks can be decreased, resulting in a portfolio that is less complex and easier to understand.

5. More Tax Efficient
A portfolio containing all stocks tends to generate more trading activity as the market and investment outlook changes. With more trading activity, more capital gains will be realized and more taxes paid. ETFs are very tax efficient and, with a larger proportion of the portfolio in a single core ETF, fewer capital gains will be triggered. (Investors should consider the impact of taxes on their returns. Be sure to read *A Long-Term Mindset Meets Dreaded Capital-Gains Tax* for more information.)

6. Lower Transaction Costs
With fewer stocks, there will be fewer trades and fewer commissions. The small annual management fee ETFs carry is easily recovered from the savings on commissions. In an account at a full service broker, the reduction of commissions could be dramatic. This might be why many investment advisors do not like ETFs. (For more on ETF benefits, read *Uncovering The ETF Wrap*.)

7. A Decrease in Volatility
For the typical investor with an ETF representing a core holding, the overall portfolio will likely be less volatile than one made up entirely of stocks. (Learn to adjust your portfolio when the market fluctuates to increase your potential return in *Volatility's Impact On Market Returns*.)

8. Allows For Better Focus
In any well designed and diversified portfolio, an investor will have to invest in sectors or stocks that he or she does not like, but is required to own for diversification purposes. Using an ETF for a core position provides the necessary diversification, allowing the investor to focus on stocks in his or her preferred sectors. (For more on sectors, read *Sector Rotation: The Essentials*.)

9. Can Implement Sophisticated Investment Strategies
Investment strategies such as enhanced index strategies, risk budgeting, portfolio insurance, style tilts, hedging strategies and tax loss harvesting become easier to implement with a core/satellite approach.

10. Improves The Knowledge of the Investor
The proper implementation of a core/satellite strategy requires a certain degree of knowledge and understanding about risk, market indexes, benchmarks and portfolio management techniques. As investors gain the knowledge and experience of applying a core/satellite strategy, the process will, in the end, make them better investors

Conclusion
With the introduction of ETFs, the use of a core/satellite strategy becomes a very practical strategy for the average investor to implement. It will not only make investment management easier, but the underlying portfolio will also be better diversified and future performance will likely improve.

For further reading on portfolio management techniques, be sure to read *Equity Portfolio Management Mechanics*.

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