

Three Major Factors to Consider When Building a Long-Term ETF Portfolio and Using a Commission-Free List

Morningstar Associates LLC

Because of their low costs, tax efficiency and broad diversification, ETFs can be appealing building blocks for long-term portfolios. In addition, the arrival of commission-free lists has eliminated brokerage fees for the ETFs included on these platforms. As a result, many ETFs are now even more cost efficient than ever, and strategies such as dollar cost averaging are now feasible for ETF investors. Long term investors also should consider the tax efficiency provided by many ETFs and frequent portfolio turnover can erode that benefit.

To make the most of a commission-free ETF list, long-term, investors should keep a few guidelines in mind.

1. Selecting the Right ETF Commission Free List

Choice is critical, so look for a commission-free platform that includes a wide variety of ETFs from several established providers. We believe the ETF's size, liquidity and tracking error are also important factors. The list should provide the flexibility needed to construct a long-term asset-allocation portfolio that is appropriate for your time horizon and risk tolerance. It's particularly important to have access to broad-based ETFs in several asset classes to serve as the foundation for a strategic asset allocation plan. By allocating the core of your portfolio to broad-based ETFs you can minimize frequent rebalancing needs, which in turn cuts down on potential trading costs and tax consequences. In general, seek commission-free lists that provide several choices in the following broad groups -- domestic equities, international equities, and fixed-income. Beyond that, it's advantageous if the plan includes broad-basket commodities and real estate ETFs for further diversification potential.

2. Key Factors to Consider Beyond the Commissions

On the other hand, we believe it's less critical for a commission-free list to offer niche ETFs that track narrow slices of the market. These products are typically trading vehicles used for shorter-term calls and they aren't necessary in a long-term strategic portfolio. In fact, adding niche ETFs to a strategic asset-allocation portfolio can increase costs, compromise tax efficiency, and introduce problems with overlap.

It's also important that the commission-free list offers low-cost options in several asset classes. After all, successful index investing depends on minimizing the drag of fees. Most ETFs are designed to provide the returns of the market segment they represent--no more, no less. However, they maintain an edge over the average actively managed fund by keeping expense ratios low. That cost advantage accrues over time, increasing their chances of pulling ahead of the average actively managed fund--which typically has a higher expense ratio hurdle--over the long term. That said this does not mean that a portfolio could not benefit from the presence of actively managed funds.

It's important to remember, however, that expense ratios aren't the only costs associated with trading ETFs. ETFs also have bid/ask spreads, which represents the difference between what a seller is willing to accept and what a buyer is willing to pay for a security. Large ETFs with high trading volumes tend to have tight bid/ask spreads. So to keep all-in costs low, we believe investors should look for commission-free lists that provide access to the more popular and widely traded ETFs in each asset class.

3. Keeping Taxable Events In-Check

Beyond low costs and broad diversification, equity ETFs also tend to be more tax efficient than actively managed funds. Capital gains distributions are rare for most broad-based domestic equity ETFs. However, to take full advantage of that tax-friendly feature it's imperative to maintain a long-term mindset. Remember that every trade increases the chances of a taxable event.

By following these guidelines, investors can choose a commission-free offering that can help them build a well-diversified and efficient portfolio that is flexible enough to meet their needs for years.

