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On this week's *Consuelo Mack WEALTHTRACK*: ETF expert Matt Hougan explains why "the gig is up" for mutual funds as passive, exchange traded funds outperform and attract record amounts of money.

Matt Hougan
CEO, Inside ETFs

CONSUELO MACK: This week on WEALTHTRACK, is the gig up for mutual funds? ETF expert Matt Hougan says exchange traded funds have a big edge and record inflows reflect it. The state of ETFs is next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack. The numbers are pretty staggering. Record amounts of cash poured into exchange traded funds last year and the flood is continuing.

Net inflows into U.S. ETFs alone reached more than $284 billion dollars in 2016. Almost as dramatic was the leakage from mutual funds. Net outflows reached $186 billion. Not surprisingly with more than 90% of ETFs representing passive index strategies, 95% by assets, passive investing was the overwhelming gainer and active strategies lost big time. More than half a trillion dollars flowed into passive mutual funds and ETFs while a net $340 billion fled actively managed ones.

Exchange traded funds are also making their presence known on stock exchanges. Depending upon the day, ETFs account for between 20 and 40% of total trading volume in the U.S. market.

According to this week's guest ETFs have become the investment vehicle of choice for many investors and they are in the process of eclipsing mutual funds in popularity and assets.

He is Matt Hougan, a noted thought leader in the ETF space. He is Chief Executive Officer of Inside ETFs, the world's largest ETF education and events company. Prior to that he was the CEO of ETF.com, a leading authority on ETFs. Hougan was one of the first employees of the company which was launched in 2001 and is an industry pioneer.

I asked Hougan to give us a quick assessment of the ETF industry following its record breaking year.

MATT HOUGAN: It's never been better. As you said, record inflows last year, almost near $300 billion in assets, records inflows in Q1 of this year, about 130, 140 billion. That's huge, particularly if you look at that compared to the traditional fund industry. There was almost a trillion dollar shift between into ETFs and out of actively managed funds last year. The ETF market is huge. It's vibrant. The biggest players are growing really fast. There's some interesting innovation. There's some less interesting innovation, but all in all it's a healthier industry than it's ever been.

CONSUELO MACK: So why are they so popular? You said they are better for investors. Better for investors than mutual funds?

MATT HOUGAN: Better for investors than mutual funds.

CONSUELO MACK: All right, why? What's better about them?

MATT HOUGAN: They are inherently cheaper. They are inherently more tax-efficient. They're inherently more tax-fair which I think is important, and they give you exposure to what you actually want. Most investors don't want exposure to this stock or that stock. They want exposure to broad market categories. ETFs allow you to do that in a way that you haven't been able to do in the past.

CONSUELO MACK: Tax fair. What does that mean?

MATT HOUGAN: It's a big deal. So you know how many mutual funds pay out capital gains distributions at the end of the year, and the reason that happens is if you and I own the same mutual fund and you sell your shares and go on vacation, the mutual fund has to sell a bunch of stocks to raise cash to redeem your shares, send that cash to you. At the end of the year, if in selling those stocks it sold stocks that had appreciated, it pays out capital gains to the rest of the people like me. Why am I paying taxes because you sold? It doesn't make any sense. In ETFs that's not the way it works. When you sell an ETF, you just sell it to another investor, and when shares are redeemed, they get redeemed out in kind. So ETFs almost never pay capital gains and, more importantly, your action has no impact on me. The "mutual" in mutual fund is because we're all in it together, and that means I pay my share of your cost. ETFs make each person responsible for their own activity, so it's more tax-fair. It's more cost fair in addition to being just cheaper and more tax-efficient.

CONSUELO MACK: We haven't had a market correction since the market lows in '09, so aren't they inherently kind of risky if you're basically buying an index?

MATT HOUGAN: So when markets pull back, there's this common perception that that's a great time for active managers. History would suggest that's not necessarily true. Active managers have a little advantage because they tend to keep cash on their balance sheet which lowers their beta to the market, but net-net over any sustainable period, index funds have outperformed active managers. The real reason for that, though, is not that active managers are bad. It's cost, and actually the bigger trend than active to passive is high cost to low cost, and there are a lot of factors driving that, and that's actually the most important thing. I'm fine with an investor buying a low-cost active product. I don't do it myself, but you can find great low-cost active products out there, but the days of high-cost products are over. That's a trend that's not going away. Should an investor be worried year nine of a bull market about their broad-based exposure? Not really.

CONSUELO MACK: No?

MATT HOUGAN: Not if they're super diversified. Where investors got into trouble in 2000 and then 2008 was being concentrated in single sectors. Was being in tech a problem in 2000? Yes. Was being heavy in financials? Broad-based exposure. Will the market pull back? Maybe, but will active managers do better? History suggests no.

CONSUELO MACK: Individual investors who invested in index funds were also heavily exposed to tech. They didn't have as many index funds then but were heavily exposed to tech in 2000, and they were also heavily exposed to financials because they're market cap weighted. So they're exposed to the most expensive sectors as the active managers are. Right? Isn't that a flaw in this model as well?

MATT HOUGAN: I love that because, yes, it's a theoretical flaw in the model. Absolutely 100 percent agree. It makes 100 percent sense. You're most invested in the most overvalued sectors, and yet eight out of ten active managers will underperform over ten years, and yet there's no data to suggest you can find the ones that will outperform. So you're philosophically correct, but practically it's really hard to find that active manager that's going to beat the market. It's not like woebegone. They all think they're better than average, but in practice that's not true.

CONSUELO MACK: What kinds of ETFs are the most popular now?

MATT HOUGAN: So right now the most popular are the big broad-based index funds, buying big, broad-based exposure to every U.S. stock, every international stock, every emerging market stock and just getting complete market exposure at extremely low fees.

CONSUELO MACK: You could do that with ETFs, so for instance the Vanguard World Stock Fund or the U.S. market. You can buy an ETF that replicates that that has 5,000 stocks in it for instance.

MATT HOUGAN: Absolutely. So I track what I call the world's lowest cost ETF portfolio, and it has six ETFs, the lowest cost in U.S. stocks, international stocks, emerging markets, bonds, commodities and REITs. The blended expense of that is 0.08 percent a year which is less than a tenth of the average expense of an actively managed mutual fund. For that you get exposure to over 5,000 stocks in 40 different countries, 17 commodities. It's the greatest deal in the history of finance, and it's the kind of fund, it's the kind of exposure a medium-size institution would have paid 25 or 30 basis points for even ten years ago. I really think it's a remarkable trend. ETF prices have come down 80 percent over the last 20 years while the products have gotten better. It's a great gift.

CONSUELO MACK: Where can one find that portfolio? Whose portfolio is it?

MATT HOUGAN: If you Google "World's Lowest Cost ETF Portfolio," you'll get the link. It's hosted on ETF.com, but there are other great portfolios as well like the Wealthfront or Betterment or one of the robo advisors.

CONSUELO MACK: The robo advisors.

MATT HOUGAN: They provide great core portfolios. People may want to dabble around the edges, but those should be the core portfolios for the majority of people.

CONSUELO MACK: Where the money goes is where Wall Street innovation follows for better and for worse. What kinds of product diversification are we seeing in ETFs now?

MATT HOUGAN: So I think the biggest theme that everyone's talking about is smart beta. Smart beta are indexed funds that use factors in the market to attempt to beat the market. So they'll buy say low-volatility stocks because those tend to outperform. They'll buy value stocks or quality or some mix thereof.

CONSUELO MACK: Or did tend to outperform.

MATT HOUGAN: Exactly right.

CONSUELO MACK: They're expensive now some of those.

MATT HOUGAN: They're expensive now. A lot of those are expensive now, and every ETF issuer is rushing into the space, and every active manager it seems is launching an ETF into that space. Those can be great products. I have deep concerns about them and how they're used, but some of them are great products. For the right investors, they'd be awesome.

CONSUELO MACK: Why do you have deep concerns about how they're being used, some of these smart beta ETFs?

MATT HOUGAN: So they're based on solid academic research and behavioral traits in investors that over five, seven, ten years really will I think give you outperformance in the market, but to get to that outperformance you may have to hold for two, three or four years of underperformance, and I don't know about you, Consuelo, but I couldn't do that. I couldn't look at a fund that I thought was going to beat the market, see it trailing by ten percent and continue to invest. I'm not that strong. Some people are, but with the average holding period of an ETF about two and a half years for retail investors, I'm worried that they will buy high and sell low on these smart beta strategies. For disciplined investors, fantastic products. If you're not really disciplined and really tough, you're just going to end up on the wrong side of the stick.

CONSUELO MACK: How do you overcome that in yourself, Matt? Do you just buy the index ETFs?

MATT HOUGAN: I do. Actually all my money is with a robo advisor actually because the less I think about it, the better off I am, and again if I trusted myself I would do that, but I bought one of the first smart beta ETFs. The ticker was PWC. It was a PowerShares ETF. It beat the market for years, and I bought it just after it had beaten the market for like three or four years, and I sold it right at the bottom of its performance trough, and I got clobbered.

CONSUELO MACK: Because it underperformed for a couple years.

MATT HOUGAN: Of course, of course, because I'm a wimp and not a very good investor in that sense. So I know well enough to leave it alone, broad-based index exposure, extraordinarily low cost, and history shows that pays off over time.

CONSUELO MACK: In a previous interview you had told me that there are, like everything else, there are good ETFs and there are not so good ETFs, and there are bad ETFs. So what makes a good ETF versus a bad ETF?

MATT HOUGAN: So a great ETF is one that is low cost that tracks its index well, that trades well so you can get in and out efficiently and generally provides broad-based exposure to the market. A bad ETF are there sort of quirky, faddy ETFs or ETFs that say they're giving one thing and in fact are giving you something else.
who buy that product are essentially just lighting their money on fire. So those kind of products where I think there's a possibility for investors to be confused about what they are, those are the products that worry me. The broad-based exposure? Those are always good. The smart beta ones? It depends on the investor.

CONSUELO MACK: What intrigued me was I think that you said that 30 percent of the volume on stock exchanges now are from ETFs.

MATT HOUGAN: Absolutely. On any given day, between 20 and 40 percent of all the trading.

CONSUELO MACK: This is exactly the criticism that Jack Bogle, former founder of Vanguard and also who created index mutual funds, says about ETFs, that they're just going to encourage people to trade them. They're going to discourage long-term investing. How do you respond to that criticism?

MATT HOUGAN: I love Jack Bogle, but here I think he's wrong. It doesn't really matter. You can trade an ETF intraday. People get excited about that. That's not what matters. What matters is they're inherently lower cost and more tax-efficient, and also importantly the fact that all these yahoos out there are trading these ETFs back and forth doesn't impact me as an investor. I can buy that ETF, benefit from its low cost. All that stuff I can ignore. So I just don't think he's right. You don't have to be one of those people who buy and sell. You can be the long-term holder that makes use of the more efficient technology.

CONSUELO MACK: One of the things that we're seeing is that we're seeing some actively managed ETFs come to market, and certainly again it's a couple very popular money managers, one being Jeffrey Gundlach of DoubleLine and he is a very hot bond fund manager, and he's come out with a very popular ETF. We've seen a WEALTHTRACK guest, a former WEALTHTRACK guest, Chris Davis of the Davis funds, a value manager, long-term investor. He's come out with three ETFs. What's going on with the actively managed phase of the ETF business?

MATT HOUGAN: So I think both of those are great products and for different reasons. The thing about actively managed ETFs is they have to be fully transparent. At the end of the day you have to tell your investors what you're investing in on their behalf. So what Gundlach has said and what Chris Davis has said is, "Fine. We're not afraid to show what we own." Traditional mutual funds only show things quarterly with a 60-day lag which is an artifact of a fund structure that was developed in the '40s when we didn't have the Internet.
As an investor, you deserve to know. So what those guys are doing is saying, "We'll show you exactly what we own." Importantly, both of those are low-cost products. They're both run by great managers, and in Jeff Gundlach's case, as much as I love indexes, indexes are kind of a crazy idea in the fixed income space, maybe not the best investing idea. So I'm a big fan of both of those products.

CONSUELO MACK: One of the things that you had told me, Matt, at one point was that a smart beta approach in fixed income was actually better than it was in the equity space. Why is that?

MATT HOUGAN: Well, let's start with how crazy the idea of fixed income indexing is. The way fixed income indexing is, is you put the most weight in the most indebted countries or companies. It doesn't make any sense. Those are the ones least likely to pay you back. You wouldn't loan your money to your friend who owes a million dollars. You loan it to your friend who left his wallet and needed ten dollars to get gas, because he'll definitely pay you back. So the fundamental premise of investing in a fixed income index is silly. All that said, most fixed income index investments outperform active managers. So where does smart beta come in? Well, there are a number of different factors you can look at from a factor perspective that might give you better returns in the fixed income space. So if the two big risks are interest rate risk and credit risk, maybe you don't want to take whatever the market is giving to you. Maybe you want to emphasize credit risk and deemphasize interest rate risk in a market where interest rates are going up.T hat's a smart beta strategy that's playing with factors in that space. Or maybe you want to look at the fundamental factors of likelihood to repay debt. That's not actually something that most funds look at, but you could build a smart beta fixed income product that did just that. The beauty of smart beta versus active in the fixed income space is you're only talking about a potential return of four, five, six percent. So if you can drive the cost down, you have a much more likelihood of a good outcome. So I love smart beta in the fixed income space.

CONSUELO MACK: Are we seeing a lot more smart beta in the fixed income space in ETFs?

MATT HOUGAN: Yeah, we're starting to. We're starting to see a few products that play with that interest rate versus credit rate risk or products that score bonds for likelihood to repay and reconstitute portfolios. I think that's an area you'll see increasing innovation in the years to come. I think that'll be successful, and I think active will be successful in the fixed income ETF space.

CONSUELO MACK: You do.

MATT HOUGAN: I do. Yeah, I think Jeff Gundlach will be a huge manager in the fixed income ETF space, because it's the same strategy, just cheaper and more tax-efficient. Why wouldn't you love it?

CONSUELO MACK: More successful than active in the equity space do you think?

MATT HOUGAN: I think fixed income will be the first space that active has a significant impact in ETFs where it's ten, 20 percent, 25 percent of assets. That'll happen in fixed income before it happens in equity.

CONSUELO MACK: Do you see more active fund managers going the ETF route, as well?

MATT HOUGAN: They have to, right? They have to. Right? Because you see the writing on the wall. As I said, last year almost a trillion dollar difference between into ETFs and out of active funds. That's a big number with a lot of commas and zeroes. I think every active manager board is looking at this and saying, "We have to figure it out." Some are figuring it out with smart beta strategies, and some are just saying, "Well, let's just be what we are which is an active manager and just be transparent." I applaud both Chris Davis and Jeff Gundlach for doing that.

CONSUELO MACK: You have said that the trend towards passive, that the meaning of passive is changing and is subject to a lot of different interpretations. What does passive mean? When we see that something is a passive fund, well it really isn't necessarily. Right?

MATT HOUGAN: I don't think it means anything anymore. Honestly.

CONSUELO MACK: Passive doesn't mean anything anymore.

MATT HOUGAN: It doesn't really mean anything. So traditional index funds, what we call plain vanilla index funds like the S&P 500, you know what you're getting, large cap U.S. exposure, but now there are all these smart beta strategies that use multiple factors to trade in and out. Just the other day we saw BlackRock come out and say it's going to fire a bunch of its human managers and replace them with quant-driven algorithms. Is that any different than an index? Like absolutely not. It's just with an active label instead of a passive label. So I think you still have this perception. Maybe active is where there's some subjective override by a human. That's what Chris Davis is doing. It's not like he doesn't have fundamental screens to pick out which stocks to look at. He's just adding a human subjective element on top. But really it's become a spectrum and not a black and white thing. Indexes can be anything.

CONSUELO MACK: What concerns you about some of the developments in the ETF industry? Obviously this is not all positive, and it's not going to turn out to be all positive for individual investors either. What's of concern?

MATT HOUGAN: So I think two things really. As I said earlier, products that say one thing on the tin but are something else underneath, particularly if they're complex products in the levered space or in the commodities space or in the volatility space. I think investors have to know what they own there, and then the biggest one is the behavior piece, products that promise performance and people chasing them because remember. We spend a lot of time arguing over active funds being overpriced at one percent versus 0.1 percent for an index product, but the average investor leaves 300 basis points, three percent annual returns on the table through poor timing. Solving that problem is even bigger. You could buy the most expensive active product in the world if you're a good investor, a disciplined investor.
So what I'm concerned about, these active or these smart beta products that promise performance will encourage performance chasing, and so the realized investor experience will be worse than the products themselves, and that's probably the biggest concern I have right now. There's a big debate in robo advisor space. Is it better to have a human you can call on the phone, or is it better to have a computer? I have a good friend who has a human advisor, and it was a crisis about a year and a half ago, maybe the taper tantrum where the market went down a bunch. He called his advisor on the phone. He left a message, and he heard back a day later. An advisor has 200 clients. It may take him a day or two to get back to you.

CONSUELO MACK: In the meantime…

MATT HOUGAN: I went into my robo advisor account. There was a message about the history of pullbacks and how fast things return. My fund had sold its losers and tax rebalanced into alternative products, so realizing capital losses for me. It was clearly monitoring the situation, and it was in real time. I almost think that's a better experience. Now the best experience would be a blend of those. Right? But I think some of the behavioral nudges you can do through electronic communication could really be transformative in closing that behavior gap.

CONSUELO MACK: Couple more questions. You told me over the phone that the gig is up for the mutual fund…

MATT HOUGAN: Totally. It's over. I mean come on. The mutual fund was created in 1920 whatever. The Fund Act says 1940 in the name. That's a really good run. That's almost 80 years. How many technologies developed in the 1940s are we still using? It's like the potato peeler, and that's about it. So it had a great run, but ETFs are a new technology. It's simply more tax-efficient, more tax-fair, lower cost. I keep coming back to that. It is just a new, better version of a mutual fund, and that's why you've seen all the flows. I mean it's trillions of

dollars in the past few years have made the swing, and that trend is accelerating.
As I said, the first quarter of 2017 was by far and away the fastest growth ever. So I think ETF assets will surpass mutual fund assets by 2023 is what I've said before, and that seems to be coming true a little bit earlier even than I expected. So yes, I think the gig is up. I think it's over.

CONSUELO MACK: Final question. One investment for a long-term diversified portfolio. What should we all own some of?

MATT HOUGAN: I think all investors should own VWO. It's the Vanguard emerging markets ETF. It's extremely low cost, extremely broadly diversified in emerging markets. The vast majority of American investors are way underweight emerging markets. Those emerging markets have been beaten down, and they're way undervalued versus historical norms. Chances are you're underweight that in your portfolio, and chances are that will hurt you in the next three to five years, and you can buy this fund and correct it and have a more balanced institutional quality portfolio.

CONSUELO MACK: Another question. This really is the last one. I think that you had told me that just like we're going to have driverless cars in the future, that driverless portfolios are in our future as well. Just explain that.

MATT HOUGAN: A hundred percent. The idea that a person can drive a car is going to seem insane ten years from now, because wake up on the wrong side of the bed. They had a fight with their spouse. They're distracted. It's a terrible idea, and we all know that's going to happen. That's true in portfolio management too. The idea that we trusted an individual to evaluate and pick stocks and make decisions is going to seem archaic and insane if not in ten years certainly in 20 and probably before that. That was validated by BlackRock's decision. They essentially fired a bunch of portfolio managers and replaced them with algorithms. It's a numbers-driven game, and we've seen this happen in baseball. We've seen it happen in lots of areas. When it's a numbers-driven game, algorithms are going to be better at it. So yes, it will seem insane to us in ten to 20 years that we had humans picking this stock over that stock. It's going to be algos and artificial intelligence making those decisions.

CONSUELO MACK: Matt Hougan, thank you so much for giving us a vision for our future, at any rate our investing future.

MATT HOUGAN: Any time. Happy to be here.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week's Action Point is: Consider adding some ETFs to your portfolio. As Hougan said the best ones are low cost, tax efficient and transparent.They now represent virtually every asset class: stocks, bonds, commodities and alternatives. As Hougan puts it from micro to mega caps, from

Argentina to Vietnam, from treasuries to junk bonds and from aluminum to wheat… you name it there is an ETF for it. And active managers are taking note. At year end there were 168 actively managed ETFs, around 40 of those were added last year. They tend to be less expensive, more tax efficient and are certainly more transparent than their mutual fund equivalents.

The one big negative is since their shares are listed on stock exchanges they are easy to trade. Therefore they are tempting for aspiring market timers, a skill which the vast majority of investors lack.

Next week Social Security guru Mary Beth Franklin and Medicare expert Katy Votava bring us up to speed on Obama era benefit changes taking effect now. What you need to know.
And in our exclusive EXTRA feature on our website find out how Matt Hougan went from selling shoes at L.L. Bean in Maine to becoming an leading expert on ETFs. That's some career climb!

We want to hear what's on your mind so continue to reach out to us on Facebook and Twitter. Thank you for watching. Have a joyous easter weekend, and make the week ahead a profitable and a productive one.