Ruminations on Asset Class Implementation

Developing hard and fast rules for the perfectly optimal implementation of a given portfolio is problematic. The analysis below assumes the use of a custodian such as Charles Schwab & Co.:

- Many implementation options are functionally equivalent – while they may differ in specifics, overall there is little, if any, reason to choose one over another.
- Which option is selected will depend on the size of the transaction. Smaller transactions will tend to favor ETF implementations because of the lower transaction fees while larger transactions make this moot.
- Which option is selected will depend on the size of the account. Fees for trades of different types may differ depending on the size of the account.
- The number of options to pick will depend on the size of the portfolio. Larger portfolios can have more holdings in a particular class. Smaller portfolios will have fewer to reduce the relatively more significant (on a percentage basis) transaction costs.
- Which option is selected will also depend on the existing holdings. In a case where a class is being added to, it may be prudent to add a slightly different holding in the same class rather than add further to an existing position.
- Which option is selected will depend on the tax treatment of the account. Some of the choices are slightly more tax efficient than others (though the differences may be so small they could be considered functionally equivalent).

Given the caveats above, we generally prefer implementations that are effective in giving exposure to the asset class and efficient by doing so at a low total cost. Thus, we typically prefer:

- Value tilts. Academic research has demonstrated to our satisfaction that within a given class value may be a superior style, particularly in smaller market capitalizations.
- Short/Quality tilt. Academic research has demonstrated to our satisfaction that fixed income (excluding high yield) should be high-quality with a relatively short duration.
- ETF bias. We have a very slight bias toward ETFs due to their improved tax efficiency, lower turnover, lower average expenses, and lower trading costs.
- Quality providers. *Ceteris paribus*, we prefer vehicles from well-known, well-regarded providers with a history of excellence and philosophical alignment with our view of investment strategy.
- Low turnover. Due to the hidden (but very real) costs of bid-ask spread, market impact, commissions, and taxes, we prefer lower turnover.
- More diversification. We prefer vehicles with more holdings to those with fewer holdings.
- Lower costs. We prefer vehicles with lower expense ratios.
- Purity. Vehicles should generally give pure exposure to the class in question.
- Passive management. We believe in most cases passive management (of which index funds are a subset) will outperform. However, for some asset classes appropriate passively managed vehicles may not exist.
- Accessibility. Vehicles should be available for purchase and have reasonable minimums.

Notes:

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