Are Expense Ratios a Dependable Predictor of Returns for Large Cap US Equity ETFs?

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In 2010, Morningstar published a study which argued that expense ratios are "the most dependable predictor of performance" for mutual funds.[1] This study included roughly 5 years of mutual fund performance data, based upon which the authors recommended that investors focus on the cheapest 40% of mutual funds as a starting point in the due diligence process. While some have sought to apply similar heuristics to ETFs, the evidence presented below pertaining to US large cap equity ETFs calls into question the sensibility of this application. Over the past 5 years (as of 2/29/16), the cheapest large cap US equity ETFs have tended to underperform ETFs with higher expense ratios, with significantly fewer funds producing excess returns versus their respective S&P benchmarks.[2]

Chart 1 sorts US large cap blend ETFs into three groups by expense ratio. Group #1 includes ETFs with expense ratios below 0.20%, Group #2 includes ETFs with expense ratios between 0.20% and 0.39%, and Group #3 includes ETFs with expense ratios greater than or equal to 0.40%. As of 2/29/16, the average 5-year total return for Group #1 and Group #2, were both 9.76%, compared to 10.10% for Group #3. Interestingly, while only 7% of Group #1, and 18% of Group #2, outperformed the S&P 500 Index, 37% of Group #3 achieved this feat.

Results for the US large cap growth category, as seen in Chart 2, also tended to favor ETFs with higher expense ratios. Group #1 produced the lowest 5-year average annual total return at 11.00%, with zero ETFs outperforming the S&P 500 Growth Index. Group #2 produced a 5-year average annual total return of 11.44%, with 25% of constituent ETFs outperforming the S&P 500 Growth Index. Group #3 produced a 5-year average annual total return of 11.82%, with 60% of constituent ETFs outperforming the S&P 500 Growth Index.

Similar results were generated by US large cap value ETFs. (See Chart 3 on the following page). Group #1 produced the lowest 5-year average annual total return at 9.12%. Group #2 fared better, posting a 5-year average annual total returns of 9.58%. Once again, Group #3 produced the highest average total return at 10.02%. Interestingly, the majority of large cap value ETFs from each group outperformed the S&P 500 Value Index over the past 5 years. Even still, group #1 produced the lowest percentage of outperforming ETFs at 75%, compared to 77% of group #2, and 86% of group #3.

Chart 1: US Large Cap Blend ETFs
5-Year Returns Sorted by Expense Ratio (2/28/2011-2/29/2016)

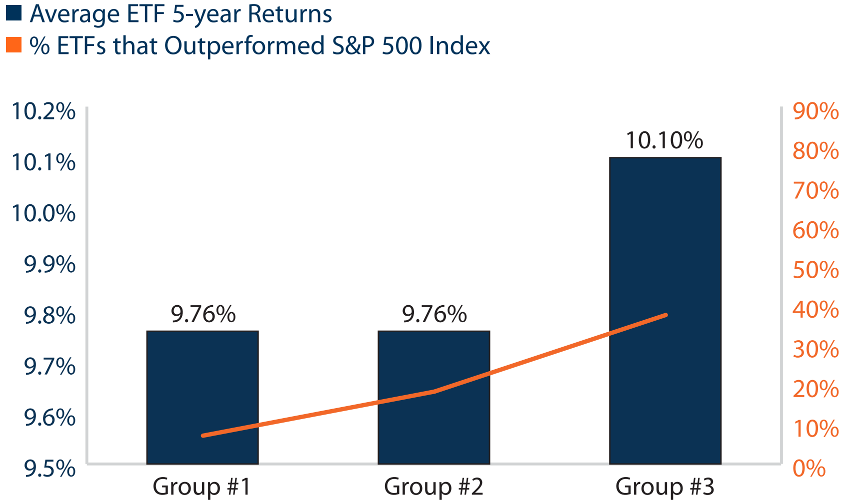
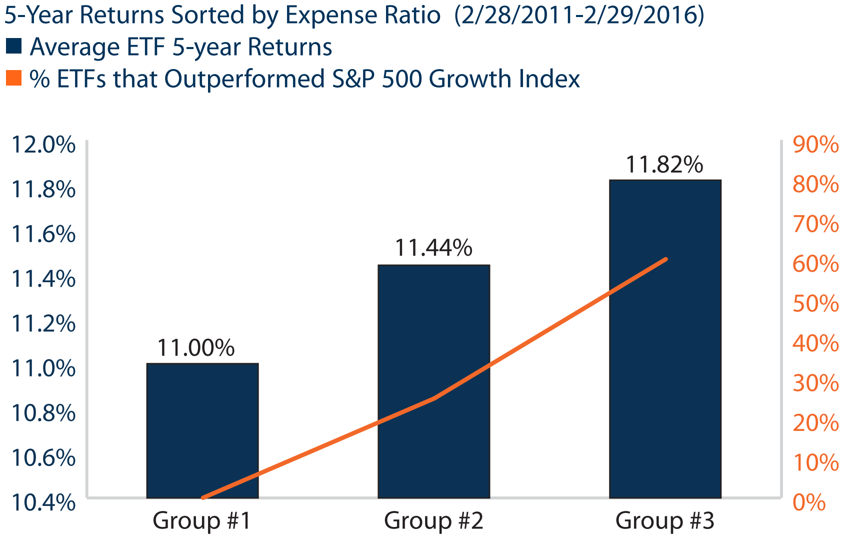


Chart 2: US Large Cap Growth ETFs
5-Year Returns Sorted by Expense Ratio (2/28/2011-2/29/2016)



Source for charts: Morningstar Direct. Past performance is no guarantee of future results.

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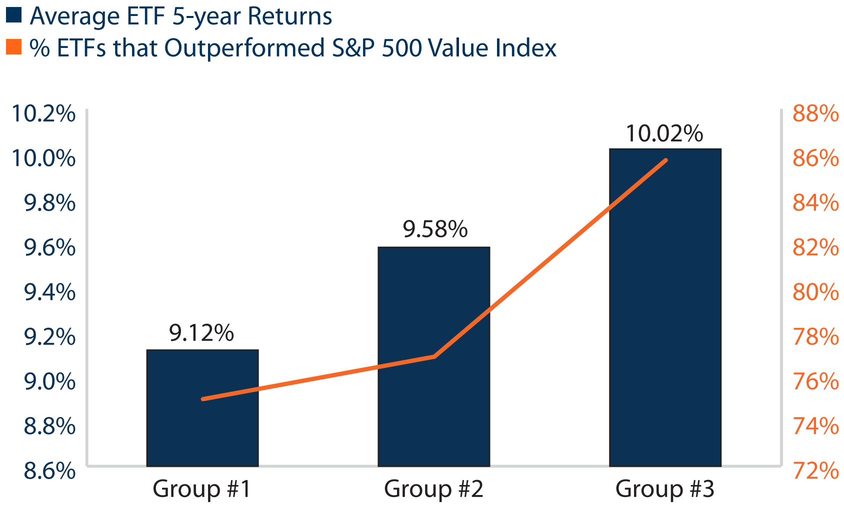
Low fees have been a cornerstone of ETF investing for over three decades, and we believe fee comparisons should remain an important part of the due diligence process. However, investors should recognize that the range of expense ratios between ETFs tends to be much smaller than traditional mutual funds. In 2015, 95% of the US Large Cap equity ETF universe had expense ratios that would have been among the cheapest 40% of traditional large cap US equity open-end mutual funds – the group suggested by the Morningstar study as a starting point.[3] Hence, expense ratio comparisons between ETFs within a category like large cap US equities should not be the starting point in the due diligence process, in our opinion, but should instead follow a more comprehensive analysis of the underlying strategies employed by these ETFs. Admittedly, this process may be more complex than simply using expense ratios to winnow down a category of ETFs. However, it may also provide opportunities for financial advisors to potentially add significant value by selecting ETFs that may be best-suited to meet their clients' goals and objectives.

Chart 3: US Large Cap Value ETFs
5-Year Returns Sorted by Expense Ratio (2/28/2011-2/29/2016)



Source: Morningstar Direct. Past performance is no guarantee of future results.

[1] "How Expense Ratios and Star Ratings Predict Success", Morningstar, 8/9/2010.

[2] Data obtained from Morningstar Direct. Including all ETFs from Large Cap Blend, Large Cap Value, and Large Cap Growth categories, with at least 5 years of performance history on 2/29/16 (80 ETFs). This necessarily excludes ETFs that existed on 2/28/11, but have since become obsolete (23 ETFs). While many of these ETFs would have been included in group #3, poor performance does not appear to be the primary cause of their obsolescence, in our opinion. For the ETFs that would have been included in group #3 that accumulated at least 2 years of operating history (14 of 19 ETFs), 2 of 3 (67%) large cap value ETFs outperformed the S&P 500 Value Index in the 2 years prior to closing, 3 of 5 (60%) large cap growth ETFs outperformed the S&P 500 Growth Index in the 2 years prior to closing, and 1 of 6 (16.7%) outperformed the S&P 500 Index in the 2 years prior to closing.

[3] Morningstar Direct.