

HOW TO CHOOSE THE BEST ETFs FOR YOUR PORTFOLIO: 7 FACTORS TO CONSIDER



By: Martin Dasko - May 30, 2024

According to Statista, 61% of American adults invested some money in the stock market in 2023. If you want your money to work for you so you can build wealth, you'll want to consider doing the same.

However, you won't always know how to decide which company to invest in since you may not have the time to conduct your own research on specific assets or industries. This is why many investors will allocate their money to an exchange-traded fund (ETF), a basket of companies under one fund that trades on an exchange, similar to how stocks do.

When you invest in an ETF, you're purchasing a diverse collection of securities in different industries, markets and even regions. One ETF lets you own a collection of different companies, and the fund is often issued by a financial services company. You just want to ensure you purchase the best ETF for your portfolio based on your goals.

Here's what investors should look into when narrowing down their options to choose the best ETFs for their portfolio.

The Expense Ratio

The expense ratio is the annual fee charged by the ETF provider for managing the fund. A lower expense ratio means you spend less and keep more of the returns in your bank account.

"ETFs vary in price, so it's important to understand the expense ratios and potential trading/transaction fees of any fund that you choose," said Jason Werner, investment advisor and founder of Werner Financial. "Understanding costs is a vital step in ensuring excess charges don't diminish investor returns over the long run."

You'll want to review the fees to see if you're comfortable with them. While sometimes, the fund could have higher expenses with better returns, you want to be positive that it's worth it.

The ETF's Objectives

As an investor looking for an ETF, you want to ensure

that the fund's goals align with your financial objectives and risk tolerance. Since every fund has its own unique objectives, you want to double-check to see if this works for your portfolio based on your timeline.

Werner added, "This includes examining the asset class, geographic exposure, and the underlying index the ETF aims to track."

Liquidity

The liquidity of an ETF is how easily you can buy or sell shares without impacting the price of those shares. Many financial experts recommend looking into the liquidity of the ETF so that you can make an informed decision.

"Evaluate the liquidity of the ETF, as measured by the average daily trading volume and bid-ask spread," noted Taylor Kovar, a CPF and founder of 11 Financial. "Higher liquidity typically results in tighter bid-ask spreads, lowering the cost of trading and providing better prices."

Historical Performance of the ETF

Although past performance doesn't guarantee future results, you'll gather insights into the fund's track record of delivering results by analyzing the historical performance.

Kovar elaborated, "Review the historical performance of the ETF relative to its benchmark index and peer group."

If the fund performs better than the index it tracks, you may want to add this to your portfolio since the results are there. If the fund has provided weak returns, you may want to think twice about investing your money into it.

Risk Tolerance

You'll want to align the ETF you invest in with your personal risk tolerance based on the securities it holds. This will also depend on which type of sector or industry you're comfortable with investing in.

"Choose ETFs that match your risk profile, whether you're seeking growth, income, or capital preservation," remarked Kovar.

You'll want to review the industries and companies the fund invests in so that they match up with your

risk profile so that you're adding the correct securities into your portfolio.

If the Fund Is Active or Passive

You'll want to determine if the fund is an active or passive ETF because it's important to know whether it's using active decision-making to try to beat an index or simply mirroring and generating index returns.

"The average investor should likely stick to passive strategies unless they're working with an advisor and even then, one should be skeptical of heavy active investment usage given the long-term historical track record," shared Tyler Johnson, CFP at StillWater Financial Advisors.

Since some ETFs are active, you'll want to feel confident in how they're managed so that you don't have to stress about your investments.

Johnson added insights on deciding between active and passive ETFs, saying, "If passive, you're picking the one that has the lowest ongoing fees with minimal tracking error (difference between index results minus ETF expenses and the ETF results)."

Specific Holdings

If you're trying to decide between two funds in a similar industry, you'll want to consider the specific holdings. Since ETFs disclose their holdings daily, you can look into the fund to see if the breakdown makes sense for what you're looking for.

Werner advised, "Compare the specific holdings that make up the ETF so that you can have a better understanding of what stocks/funds are being selected to drive results for the specific ETF."

You'll want to feel confident that the asset allocation matches your expectations. You'll want to observe not just the securities that the ETF holds but also how they're weighted.

In summation, you'll want to analyze an ETF's historical performance by examining total return, volatility and risk-adjusted metrics. The goal is to find an ETF with a track record aligned with your investment objectives and fees you're comfortable with so that your investment portfolio works for you.

Jason is the founder of Werner Financial in Indianapolis, Indiana. He has over 10 years in the industry as a registered investment advisor. Werner Financial aims to be the advisor on your team that helps you achieve all the goals you have set for yourself, your business, and or your family.



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