Highly Correlated ETFs Offer Promising Alternatives to Actively Traded Mutual Funds

By Allie Grace Garnett

Financial advisors have long recommended actively-traded mutual funds to private wealth clients. However, with the rise of passively-traded index funds and ETFs (Exchange-Traded Funds) in the past several decades, it has become increasingly clear that passive investing often beats active investing. Not only are the expense ratios of index funds and ETFs substantially lower than those of actively-traded funds, but also passive funds almost always perform better. Researchers at Standard & Poor's in 2017 found that 92 percent of actively-managed large-cap mutual funds performed worse than a S&P 500 index fund over the prior fifteen years. (Small- and mid-cap actively-managed funds fared even worse.) Actively-traded funds incur higher management fees and more transaction costs, and the higher stock turnover rate increases tax inefficiencies.

There must be a better way! Financial advisors, and their clients, who are accustomed to investing in actively-traded mutual funds may be hesitant to switch to a more passive style of investing. Financial advisors obviously do not favor any reductions in management fees, and clients and financial advisors alike may question if passive investing is *truly* the superior approach. In addition, financial advisors already well familiar with the actively-traded mutual funds in the marketplace may be unsure of exactly which passively traded funds are the best substitutes.

Every financial advisor who is worth his or her management fee should be doing everything possible to maximize clients' investment returns while minimizing their expense ratios. Raltin, which daily performs 2.5 billion correlation calculations across 40,000 stocks, ETFs, and mutual funds, can help financial advisors to find similar securities, manage portfolio risk, and identify investment opportunities. While we can't solve the problem of fee-hungry financial advisors, we can help advisors with their clients' best interests in mind to switch from actively-traded mutual funds to passive funds without significant disruptions or risk profile alterations.

Raltin provides financial advisors with the information that they need to determine which passive funds most closely mimic their clients' mutual fund holdings. As demonstrated by the table below, the performance of many ETFs is highly correlated with well-known mutual funds - but with significantly lower expense ratios.

Correlations Between Select Mutual Funds & ETFs

Mutual Fund	Alternative ETF 1 (Correlation Score)	Alternative ETF 2 (Correlation Score)	Alternative ETF 3 (Correlation Score)

FBSOX - Fidelity Select IT Services	IWF - iShares Russell 1000 Growth (0.88)	RYT - Guggenheim S&P 500 Eq Wt Technology ETF (0.88)	IUSG - iShares Core S&P US Growth (0.88)
PRHSX - T. Rowe Price Health Sciences Fund Inc.	VHT - Vanguard Health Care ETF (0.85)	FHLC - Fidelity MSCI Health Care ETF (0.85)	IBB - iShares Nasdaq Biotechnology (0.85)
PARWX - Parnassus Endeavor Fund - Investor Shares	SCHB - Schwab US Broad Market ETF (0.83)	IWV - iShares Russell 3000 (0.83)	VTI - Vanguard Total Stock Market ETF (0.83)

The mutual funds and highly correlated ETFs presented above are just a few examples generated from the Raltin database. Each of these mutual funds are among the largest actively traded funds. Taking a closer look at each, we see that:

- Fidelity's Select IT Services mutual fund and each of the three correlated ETFs are heavily invested in technology stocks and, to a lesser extent, financial services and industrials stocks.
- T. Rowe Price's Health Sciences Fund and each of the three correlated ETFs are nearly 100 percent invested in healthcare stocks. With the exception of the iShares Nasdaq Biotechnology ETF, which only holds NASDAQ-listed stocks, each of these funds is invested in UnitedHealth Group (NYSE: UHF) stock as a significant percentage of the funds' assets. The five-year performances for three of these four funds differ from each other by less 100 basis points.
- The Parnassus Endeavor Fund and each of the three correlated ETFs are heavily invested in technology stocks and, to a lesser extent, healthcare stocks. The five-year performances for each of these four funds differ from each other by less 200 basis points.

All of the correlated funds analyzed above are invested in the same type of financial instrument, in this case common stocks, rather than bonds or other specialized securities.

At Raltin, we perform billions of daily correlation calculations so that you don't have to - saving you time and your clients money. We strive to present useful correlation data in a way that is advantageous for both you and your clients. Learn more about the Raltin correlation methodology and how Raltin serves financial advisors.

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