

The ABCs of ETFs

Exchange-traded funds are one of the hottest investment vehicles of the 21st century, yet they are so new they remain cloistered in financial obscurity. Here's what you need to know to get in on the action.



A lot of people are unaware of what ETFs are," says Gus Sauter, chief investment officer of the Vanguard Group. If you are one of them, you are forgiven.

While ETFs, or exchange-traded funds, are probably the hottest investment vehicle of the 21st century, they're so new that they remain cloistered in financial obscurity. The first ETF was launched in 1993, and by the end of 1999 there were still only 30 such funds, with assets totaling \$34 billion, according to the Investment Company Institute. By March 2006, however, the number of ETFs had exploded to 212, with \$321 billion in assets.

In a world awash in cap-

ital, that's a relatively small pile of money—smaller than the market capitalization of General Electric and dwarfed by the \$7 trillion invested in stock, bond, and hybrid mutual funds. But the rate of ETF growth is dazzling—and with good reason.

ETFs offer major advantages over mutual funds. They're highly liquid, easy to trade, tax-efficient, and inexpensive. Plus, they enable you to add broad diversification—by region, sector, capitalization, style, or asset class—to your portfolio. In fact, every investor should own ETFs.

The typical exchange-traded fund is a portfolio of a few dozen stocks or bonds, based, not on the choices of a human man-

The ETF is the most liquid asset in the world with a greater trading volume than GE, a stock with six times its market cap.

ager but on an index that is designed to represent a sector (such as the Russell Midcap or the Dow Jones Pharmaceuticals) or a market (such as Austria or Latin America). You buy and sell shares of ETFs on major stock markets as if they were shares of individual companies.

Wall Street's Darling

On average during 2005, a new ETF was launched every week. Lately, some of the hottest ETFs involve commodities. StreetTRACKS Gold Trust (symbol: GLD) is "the fastest-growing ETF in history," says Dodd Kittsley, director of research for State Street Global Advisors (SSgA), which manages the fund in a partnership





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Based on NAV	21.25%	12.43%	14.08%	15.16%
Based on Market Price	21.68%	12.46%	14.10%	15.11%

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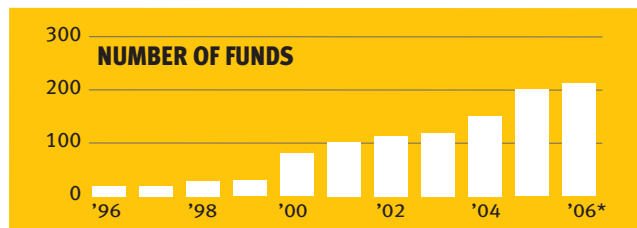
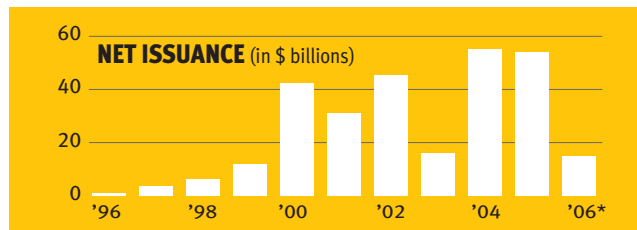
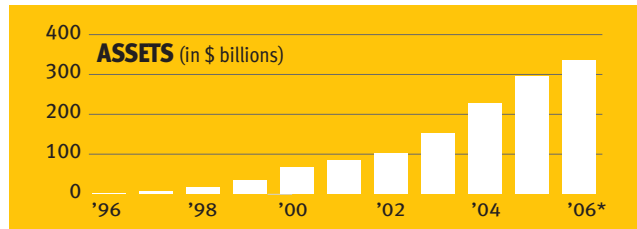
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Billion Dollar Boom

Investors voracious appetite for ETFs cannot be satiated.



*through April 6

Sources: Strategic Insight and Investment Company Institute

with the World Gold Council. From a standing start in November 2004, Gold Trust, whose price is linked to that of an ounce of gold, now has more than \$7 billion in assets.

The champion ETF, however, remains the first. Fondly known as Spiders, from the acronym for Standard & Poor's Depository Receipts. This ETF, also under the SSgA banner, mimics the S&P 500, roughly the 500 largest American stocks. Spiders (SPY) allow investors exposure to about four-fifths of U.S. market capitalization by purchasing a single stock for about \$125 a share (roughly one-tenth the amount of the index). Other popular ETFs mirror the Dow Jones Industrial Average (Diamonds, or DIA) and the Nasdaq 100 (QQQQ).

A total of \$53 billion was invested in Spiders at the end of April, twice as much as Diamonds and QQQQ combined. But even more impressive is the average of \$9 billion worth of Spiders shares that trade hands every day. The ETF is the most liquid security in the world, with a greater trading volume than GE, a stock with six times its market cap.

Broad Market Appeal

As Sauter has written, "The most distinguishing characteristic offered by ETF shares is their liquid-

ity." When markets are open, you can trade ETFs any time you want, within seconds, through a broker. With mutual funds, by contrast, your order to buy or redeem shares is a transaction with a fund company, not another investor, and it doesn't take effect until the end of the day. In addition, many fund houses actively deter jumping in and out too often.

Since ETFs are managed passively (by computers rather than humans), they exact low fees. The expense ratio for Vanguard Small-Cap VIPERS, an ETF that tracks the Morgan Stanley Capital International U.S. Small Cap 1750 Index, is a mere 0.1%, or 10 basis points, while T. Rowe Price Small-Cap Stock, a relatively low-cost managed fund, charges 92 basis points. Even Vanguard's own Small Cap In-

dex mutual fund carries expenses of 23 basis points. "People like the idea of how cheap they are," says Wayne Nelson, a senior vice president of Merrill Lynch in Washington, D.C. Nelson says that some of his clients are redeeming other investments and substituting less expensive ETFs.

As with mutual funds, Vanguard features ETFs (a total of two dozen at last count) with rock-bottom expense ratios: just 7 basis points for Total Stock Market VIPERS (VTI), which provides all U.S. equities in a single entity, or just 18 basis points for European VIPERS (VGK), which tracks the Morgan Stanley International Capital Europe Index.

ETFs also offer an easy way to purchase a diversified portfolio of stocks within more narrowly de-

finer industry and geographical sectors. There are ETFs composed of companies in such industries as insurance, nanotech, business to business Internet, and medical devices. "We try to anticipate investor demand," says Kittsley of SSgA, "and demand is at a more granular level." SSgA in recent months has brought out biotech, homebuilder, and semiconductor ETFs. (An unfortunate roadblock to responding to investors, however, is the Securities and Exchange Commission, which takes about two years to approve a new ETF, compared with about two months to approve a new mutual fund.)

Most ETFs limit capital gains liabilities through low turnover and, in some cases, by engaging tax-free institutional investors to purchase shares with a low basis. And remember that as of this May, the reduction in the maximum rate on dividend income, to 15%, was extended through the end of 2010. Kittsley, whose firm manages 35 ETFs, believes that "high-dividend-paying stocks currently represent a significant opportunity for capital appreciation," and as a result he highlights an SSgA fund that was launched last November.

Called the SPDR Dividend ETF (symbol: SDY), it's based on the S&P High Yield Dividend Aristocrats

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Index, which in turn has two screens. First, find all the stocks in the S&P 1500, a broad market index, that have increased their dividend each year of the past 25. Next, take the 50 stocks in this group that have the highest dividend yield.

SDY collects dividends from the 50 stocks and pays its shareholders every quarter (current yield is 3.4%). Volatility levels are well below the market as a whole, and credit quality is higher. Only five stocks were removed and replaced out of the 50 last year, so turnover is extremely low compared with a managed mutual fund. And the expense ratio is just 30 basis points. By comparison, a managed mutual fund in the same category, Fidelity Dividend Growth, charges 66 basis points. What about performance? The jury is still out, but as of May 23, the Fidelity fund has returned 0.9% while the ETF has returned 3.1%.

A Diversification Play

An ETF like SDY is a good long-term investment—a way to fill out a portfolio that might be heavy on more volatile, non-dividend-paying small-caps. International ETFs, which have become especially popular in recent years, as Sauter notes, are well suited to this balancing function. Instead of buying individual stocks or more

expensive managed mutual funds, you can get exposure in Asia through an ETF like Vanguard Pacific VIPERs (symbol: VPL), with an expense ratio of just 18 basis points. At last report (Dec. 31, 2005), the ETF's portfolio included more than 500 stocks, with Toyota Motor, at 4% of assets, the largest holding.

"At the same time," Sauter says, "ETFs have appeal to short-term traders and speculators." Unlike mutual funds, ETFs offer options and short-selling. In April, short interest in ETFs totaled a hefty \$51 billion. If, for instance, you think health care stocks are headed for a fall, you can call your broker and short any of a dozen ETFs in the sector.

Institutional investors such as pension funds use ETFs to execute sophisticated strategies, like going long and short at the same time. Often, says Kittsley, "it's easier to come up with short ideas"

using sectors rather than individual stocks. He adds that institutions can park inflows of cash in Spiders or other broad ETFs, rather than in money-market funds or Treasury bills, while they wait for advice or inspiration on specific equity plays.

But perhaps the most attractive feature of ETFs is that they give individuals the ability to invest in "any area that's hard to access," says James Parsons, a managing director of Barclays Global Investors Services, which has issued more ETFs than any other firm. For example, it's often difficult to get accurate and fair pricing for bonds during the trading day, but the price of a bond ETF like iShares

Lehman 1-3 Year Treasury (symbol: SHY) is transparent at any second because it's set by buyers and sellers on the American Stock Exchange.

ETFs give investors the opportunity to buy, not just commodities like gold, silver and oil, but also currencies—through the Rydex Euro Currency Trust (FXE)—and microcap stocks, which are often difficult and expensive to purchase. And as Nelson points out, "For people trying to home in on one area"—like Malaysia, U.S. utilities, or global energy—"ETFs are terrific, a real rifle shot."

What's the downside of ETFs? They aren't managed by human professionals, who, at least in theory, can apply intelligence and flexibility that an index based on market capitalization lacks. But judging from the record of many fund managers, you have to conclude that a far more important role for financial professionals than picking stocks is to advise investors how to allocate their assets—and that's where ETFs come in. Big time.

—James K. Glassman

James K. Glassman is a resident fellow at the American Enterprise Institute.

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