

EXCHANGE TRADED FUNDS (ETFs) – AN OVERVIEW

As recently as 1999 there were only 30 ETFs in existence; now there are more than 100. The oldest and most commonly traded ETFs are the S&P 500 SPDRs, “spiders” (symbol is SPY), the Dow Jones “diamonds” (DIA), and the Nasdaq 100 “Qs” (QQQ). Now there are also iShares, streetTRACKs, vipers, HOLDRs, and more. Each is a portfolio of stocks that can be purchased and sold like an individual stock any time during the trading day. They are sort of a combination of individual stock and mutual fund.

Besides the conveniences of being able to buy a portfolio in one purchase and the trading liquidity, there are other **advantages**:

- Diversification
- Lower costs
- Tax efficiency
- Transparency
- Flexibility

DIVERSIFICATION – Instead of purchasing one stock, you have purchased a group of stocks that reflects the general makeup of an industry sector or an index. You don’t have to try to choose the best stock in a group that you think will do well. You can buy an ETF that represents the whole group: small cap growth or the Dow Jones Industrial stocks or the biotech industry or Japanese companies.

Your entire portfolio could be comprised of ETFs, and the asset allocation and industry allocation could be tailored to your liking. There are ETFs for bonds, treasuries, real estate, individual countries, large-, mid-, or small-cap indices, growth and value indices, just about every industry sector, and for the whole market. And each one is a basket of securities.

LOWER COSTS – There are no load fees associated with ETFs, like there are with some mutual funds. Their expense ratios are for the most part lower than their mutual fund equivalent, since they are based on an index or a sector and don’t require management, and because they trade on an exchange. Mutual fund companies have costs related to buying or selling shares to accommodate shareholder purchases and redemptions. The only costs to the ETF shareholder are trading-related—the broker’s commission charge and the SEC selling fee. Because each purchase of an ETF will have a commission charged, dollar-cost-averaging may not be cheaper with an ETF than with its mutual fund equivalent. You would have to work out the details based on the expected incremental purchase amounts and the time horizon.

TAX EFFICIENCY – A shareholder of a mutual fund receives capital gains distributions from the fund each year, and the shareholder pays taxes on the gains, even though the shareholder made no sales for gains. The capital gains are incurred by the fund when they sell stocks in the fund; but those gains are passed on to the shareholders. Sales are made at the fund level either because the fund manager wants to change the fund’s underlying stocks, or because they need to raise cash to pay for shareholder redemptions.

ETF managers seldom need to make sales within the fund. In fact, this occurs only if the underlying index has a composition change that must be replicated. ETFs are structured so that taxable sales are not made at the fund level and passed on to individual shareholders. The ETF “creation units” are created by the sponsors, held at the institutional shareholder

level, and broken down into shares which are bought and sold between individual investors on an exchange. If an institution wants to remove an ETF unit from their holdings, they exchange their block of securities with the sponsor for the underlying securities, an “in-kind” transaction involving almost no cash, therefore no capital gain. Individuals incur capital gains or losses only by selling their ETF shares on an exchange.

TRANSPARENCY – When you buy an ETF, it is easy to determine exactly what underlying securities you own and, therefore, to calculate the net asset value of the fund. Such information on each fund can be viewed at <http://www.amex.com/>, the web site of the American Exchange, where ETFs trade.

FLEXIBILITY – With ETFs you can easily change the focus of your investment portfolio. If your strategy is to move out of large cap stocks into small cap, or to underweight energy and overweight healthcare, these strategy changes can be accomplished simply by selling one ETF and replacing it with another. In two transactions you will have changed dozens of stock investments to your new preferred sector or index.

It is easy to change emphases in your portfolio, as world economies and markets change. Since each fund is diversified within its realm, each new sector, index, asset class, or global region that you add remains broad-based, so that huge changes to your portfolio can be nimbly made.

ETF PRODUCTS

For a complete list of available ETF products visit <http://www.amex.com/>.

DIAMONDS AND SPDRS (“SPIDERS”) – These broad-based funds represent ownership in the 30 stocks of the Dow Jones Industrial Average and the S&P 500 Index respectively.

SELECT SECTOR SPDRS – There are nine of these sector funds, the aggregate of which includes all of the stocks in the S&P 500 Index. These funds are issued by State Street and there is one SPDR for each of these nine industry sectors: Consumer Discretionary, Consumer Staples, Energy, Financial, Health Care, Industrial, Materials, Technology, and Utilities.

NASDAQ - 100 INDEX OR QQQ – This fund represents the 100 largest, non-financial stocks that trade on Nasdaq. At year-end Microsoft, Intel, and Cisco accounted for 20% of this index.

VIPERS – One year ago Vanguard had only two VIPERs; now there are 16. They include the Vanguard Extended Market VIPERs and the Vanguard Total Stock Market VIPERs, to which they have added seven sector funds and several growth-, value-, or capitalization-specific funds.

ISHARES – Barclays has issued a number of new iShares funds in the last year, bringing their total to 82 funds, more than any other ETF product. There are sector funds, country funds, treasury funds, market cap funds, bond funds, global sector funds, growth funds, value funds, and other index combinations.

STREETTRACKS – Seven streetTRACKS index funds, administered by State Street Bank & Trust Co., are available: two sector funds and five broad-based funds.

HOLDRS – HOLDRS are not actually ETFs, but a similarly structured means of owning a diversified portfolio of stocks in one sector. There are 17 Amex-listed sector HOLDRS.

HOLDing Company Depository ReceiptS have all of the advantages of ETFs described earlier, but are different in these three ways:

- HOLDRS must be bought in 100 share lots.
- HOLDRS may be unbundled, allowing you to instead own and trade the underlying stocks separately to take advantage of tax loss realization or other strategies.
- The underlying stocks and their share amounts do not change, except in the case of a corporate action, such as merger, acquisition, or spin-off (of an underlying company), etc.
- There is an annual custody fee of 8 cents per HOLDR.

In my opinion ETFs offer an ideal way to compile a diversified, low cost, tax efficient portfolio. In addition, they allow ample flexibility to change strategies and/or focus frequently without prohibitive expense. Even new investors can own a well-diversified portfolio with a small initial investment by buying shares of SPY (spiders) or VTI (Vanguard's Total Stock Market VIPERs). For the advantages discussed earlier, I think they are a better alternative than mutual funds. And because of their diversification, an investor could improve his or her portfolio by supplementing it with ETFs.

If you already own mutual funds, go to the fund(s)' web site(s) or use Morningstar.com to find out what your total allocation is by industry sector, small and large cap, global and domestic holdings, asset class, etc. If you find that you are underweight in certain areas, you might be able to fill in the holes with an ETF or two.

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