

Consider ETFs for Growth and Diversity

By

Dr. Robert Stepleman

The National Investor – Reprinted in the Venice, FL Herald Tribune

ETFs have been in the news more and more during the past few years. No, they are not a group of friends of Steven Spielberg's 1982 movie character E.T. but securities known more formally as "exchange-traded funds."

ETFs are "baskets" of securities meant to mirror the performance of a market index, for example the S&P 500 – a large-capitalization market benchmark.

In that sense they are similar to a traditional index mutual fund. However, unlike these funds, ETFs are traded on various stock exchanges.

Because of this close relationship to existing index funds, some investors might too quickly dismiss ETF's. However, their phenomenal growth suggests that investors should not dismiss them out of hand.

ETFs began in 1993 with just one that tracked the S&P 500.

Recently, this had mushroomed into 163 ETFs that track almost any conceivable index. There were 111 that tracked domestic equity indexes, 46 that track global equities, and six that tracked various bond indexes.

Because new ETFs are announced almost daily, by the time you are reading this column, those numbers will be out of date.

Those 163 ETFs contained assets worth \$283 billion. In 1993 that one ETF had assets of \$464 million. That is a compound annual growth rate of 34 percent.

Let's look at what is attracting all this investor interest.

Because they are "baskets" of securities, they offer investors a way to diversify by making just one transaction. No longer does an investor interested in investing in an industry need to choose one or two stocks.

For example, an investor with limited capital who thinks the semiconductor industry is ripe for a rebound does not have to make a choice between, say, Intel and Texas Instruments. She could buy the ETF with symbol "SMH" that tracks that industry.

Similarly, an investor who believes the industry is due for a decline can easily participate by selling SMH short. This means borrowing the shares and selling them now, hoping to buy them back later at a lower price.

The latter could not be done with mutual funds, as they can't be sold short.

Another advantage that ETFs have over index funds is ETFs have over index funds is minute-by-minute pricing. Most mutual funds are only priced once a day at close of trading.

That means that if a market-moving development occurs, an investor can buy or sell immediately at a known price, as opposed to waiting until the end of the day to discover at what price the transaction occurred.

Even investors who prefer individual stocks can make limited use of ETFs.

For example, an investor who has losses in the semiconductor industry can sell them for a tax loss and still stay invested in the industry by buying SMH. It comes about as close as you can to having your cake and eating it, too.

ETFs offer several other inducements:

- Generally annual expense ratios (operating costs as a percentage of net asset value) are lower, when compared with index mutual funds. However, this can be overridden by the commission costs ETFs incur when they are bought and sold. Most index mutual funds trade without commissions. This means that ETFs may not be suitable for an investor who wants to make regular periodic purchases, as the commissions may outweigh the lower annual operating costs.
- Generally ETFs are extremely tax efficient. Because they track indexes that tend to be reasonably static, they do not trade very often and thus generate very limited taxable capital gains. Additionally, since unlike index mutual funds that could be forced to sell securities because of investors redeeming shares in the fund, ETFs do not redeem shares for cash and thus do not have to sell securities and realize taxable capital gains. However, when investors sell their shares on a stock exchange they may realize either a capital gain or loss. ETFs do have some negatives:
- Investors may overpay for the underlying assets. Because the price of an ETF is determined by supply and demand it may be more than the net asset value of the underlying portfolio. This can't happen with an index mutual fund.
- Investors may see underperformance as compared with the index due to no dividend reinvestment by some ETFs. Unlike index mutual funds, some ETFs are not permitted to reinvest dividends, so the dividends sit in cash until paid out at the end of the quarter. If the index outperforms cash, they will see some underperformance.