

ETF's made EZ

Making sense of Exchange Traded Funds

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No, this is not an eye exam. Exchange Traded Funds (ETF) are an investment choice that we have studied for several years. Now with their increasing popularity and expanding investment options, we think you should take notice as well. In this month's edition of *Fiscal Fitness*, we share our unbridled enthusiasm (financial advisors don't get out much) about ETFs and why they could make a welcomed addition to just about anyone's investment portfolio.

What are Exchange Traded Funds?

Exchange Traded Funds are portfolios of securities designed to track designated stock or bond market indexes. They are similar to an index mutual fund but trade like stocks on the New York and the American Stock Exchanges. ETFs are passively managed and diversified over a broad range of securities that reflect the underlying index. There are currently 119 different ETFs available with more in development. Almost every major sector and country is now represented.

ETF Advantages

They are numerous (or why would we highlight them this month!). We illustrate these by contrasting the features of ETFs with those of better-understood mutual funds or individual stock investments:

- *Lower expenses.* An average ETF has an expense ratio of around .25% as compared to 1.25% for the average no-load mutual fund. Over time, a 1% improvement in annual return can be huge.
- *Transparency in trading.* You are able to buy ETF's during the trading day just like a stock. Mutual funds are bought/sold at the *end* of the day at an undetermined price. In effect, you control the price you would like to pay or receive.
- *Tax efficiency.* ETF's are passively managed to track an underlying index so, by their nature, there is very little turnover of assets that generate taxable events. Actively managed mutual funds, on the other hand, can be quite inefficient due to forced [taxable] distributions to investors [unless held in a tax deferred retirement account].
- *No style drift.* You will be buying exactly what you expected. For example: a small cap ETF will likely be invested in companies with market capitalization under one billion. But an actively managed small cap mutual fund may have small, mid and even some larger cap stocks in it - depending on the charter of the mutual fund and how closely the manager chooses to adhere to it.
- *Diversification.* Each ETF represents the designated index with the same weighting of companies. For example: a REIT ETF will hold real estate stocks in the same weighting the REIT index holds them. Maybe you may want exposure to the real estate sector but you aren't sure which stocks to pick. Enter ETFs.
- *Simplification* - see above. Instead of having to buy a bunch of different securities and monitoring all of them, a few ETF's can do the job of numerous securities. Imagine cutting down your monthly statements from 6-8 pages to just 2-3?
- *Performance.* Over the last 5 periods, more than 75% of active large cap fund managers failed to equal the performance of the S&P 500 index. Why? See above - lower expenses and taxes, no drift from investment philosophy and proper diversification.

ETF Drawbacks

- ETFs are boring and do not make good cocktail talk. Frankly, people should talk about more productive things at cocktail parties and quit lying about their stock-picking prowess.
- Few fixed-income ETFs. There are currently only 5-fixed income ETF's available but this should increase over time.
- Public awareness and understanding is low. Expect to hear more from us.

Exchange Traded Funds are a truly innovative investment whose time has come. They accommodate just about any portfolio size and objective. Fitness minded consumers should embrace them for their thinner cost structure and tax efficiency. Call us to find out what ETFs can do for your portfolio.