Room to grow

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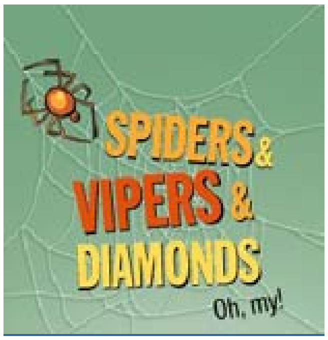
Of the Post-Dispatch
04/03/2005



Spiders, Vipers and Diamonds - Oh, my!

Many investors worry about losing their shirts in the stock market. Believe it or not, Spiders and Vipers stand ready to help.

They sound menacing, but they're nothing more than attention-grabbing brand names for a relatively new type of investment called an exchange-traded fund, or ETF.

They're cousins to mutual funds, the most popular form of investing for individuals. Unlike mutual funds, ETFs are traded on stock exchanges.

They've exploded in popularity since the first, known as SPDR - or Spider - was created 12 years ago on the American Stock Exchange. Today, more than 160 are offered by a variety of companies, with at least 10 added since March 1.

ETFs hold more than $220 billion in assets, paltry compared with the $8 trillion held in mutual funds. But with assets growing more than 50 percent a year, EFTs are becoming formidable investment vehicles.

"I think more and more participants and investors are becoming aware of the benefits of ETFs," said Cliff Weber, the Amex's senior vice president of the ETF Marketplace. "There are enough choices out there to really build a healthy program around this."

Understanding exchange-traded funds requires a basic knowledge of mutual funds.

A mutual fund collects money from investors and puts it in stocks, bonds, commodities or real estate. Most funds have managers who earn fees to pick the investments.

Other funds abandon active management and lower their fees by investing in a basket of stocks or other securities. Such funds are tied to indexes, such as the Standard & Poor's 500.

All of today's ETFs are passively managed index funds.

"It certainly is a convenient platform to gain access to indexing," said Noel Archard, a principal at Vanguard Vipers, the ETFs sold by Vanguard Group Inc., one of the world's largest mutual fund companies.

The first exchange-traded fund was the SPDR, tracking the S&P 500 index. Some are tied to other benchmarks - such as the Nasdaq 100, known as Qs, and the Dow Jones industrial average, known as Diamonds.

Many of the funds are tied to business sectors, such as health care or recreation. Others invest in a basket of stocks based in foreign countries. A few track esoteric indexes, such as the WilderHill Clean Energy Portfolio, described as "businesses that stand to benefit substantially from societal transition toward the use of cleaner energy and conservation."

The marketplace for ETFs is starting to resemble the regular mutual fund industry, with an option for just about any interest or investment style. But there are distinct differences:

Share prices of ETFs change constantly, and ETFs can be bought and sold whenever the markets are open. Mutual funds can be purchased only at a price determined at the daily close of the stock markets.

ETFs can be shorted, just like stocks. With short-selling, investors make money if the price of an ETF falls.

For relatively complex reasons, ETFs generally are more tax-efficient than most mutual funds. This means ETF investors have a smaller tax bite than investors in comparable mutual funds.

Though there are no statistics on precisely who owns ETFs, anecdotal evidence suggests that institutional investors, such as pension funds, have dominated the market.

Kennedy Capital Management of Creve Coeur, which manages about $3.7 billion, uses ETFs to park money in the short term for clients who want to be fully invested in the stock market, said Charles Bryant, the firm's marketing executive.

A.G. Edwards & Sons Inc. has pioneered special individual accounts tied to ETFs. The firm recently introduced five new ETF-based portfolios, giving it 20 such options.

Assets in those accounts, which require a $25,000 to $50,000 minimum investment, have grown 160 percent in the last year. The company would not say how much was invested.

Day traders and market timers have been attracted to ETFs. Most mutual funds restrict rapid movements in and out. Many impose penalties if shares are held for less than a year. ETFs have no such restrictions.

"Exchange-traded funds have such a broad constituency," Archard said. "I think there is a lot of room to grow."

No cure-all

Still, exchange-traded funds have several drawbacks. Because they can be bought only through brokers, investors must pay a commission every time ETFs are bought and sold.

"For the small investor who wants to dollar-cost average, that can easily and very quickly negate the low cost of ETFs," said Dan Culloton, mutual fund analyst for Morningstar Inc., a research firm based in Chicago.

Culloton urges caution. "ETFs, while they are a powerful alternative, they are not a cure for what ails the mutual fund industry," he said. "There are some very strong alternatives."

But the American Stock Exchange, where the vast majority of ETFs are traded, is working to make them more diverse. By the end of this year or early next, investors could see ETFs break their long-standing bond to the index universe, Weber said.

This means a new crop of ETFs could spring up, with money managers picking and choosing stocks and bonds.

"We are optimistic that we will have actively managed ETFs in the market," Weber said.

One of the leading ETF companies, PowerShares Capital Management LLC of suburban Chicago, has moved partly in that direction by offering index funds designed to beat established indexes. The holdings at PowerShares change more rapidly than usual ETFs.

"They're always seeking the stocks with the greatest chance for growth," said Bruce Bond, president.

But getting to actively managed ETFs requires clearing technological hurdles. One system is being tested. It requires regulatory and industry approval.

Vanguard will take a wait-and-see approach on ETFs that are actively managed, Archard said.

"If it's operationally efficient for a fund company to put that together and the cost of purchasing that fund doesn't outweigh the expense-ratio reduction, then, yeah, it could make sense," he said.

Culloton remains skeptical. "One of the biggest selling points is that they are not traditionally actively managed funds," he said. "Does making an actively managed fund available in an ETF format suddenly make it better? No, it doesn't. It's just a change in format."

But that change in format is powerful, Weber said, because investors have so many options on what they can do with an ETF.

"One of the advantages is flexibility," he said. "They're more flexible than different kinds of investments."

What's an exchange-traded fund?
A mutual fund that trades on a stock exchange. ETFs are passively managed, meaning they invest in a

basket of stocks that track specific indexes, such as the Standard & Poor's 500 or Nasdaq 100. Because no managers make stock picks, ETFs tend to have low expenses. Because they trade on a stock exchange, ETF shares can be bought and sold throughout the day.

What's a mutual fund?
A vehicle to invest in all sorts of securities, from stocks and bonds to gold and real estate. Mutual funds have an unlimited number of shares available, and the price is based on the value of the underlying securities. Fund shares can be bought or sold once a day, when U.S. stock markets close.

What's a closed-end fund?
A variant of a mutual fund whose shares trade on a stock exchange. Closed-end funds have a limited supply of shares, and prices don't necessarily reflect the underlying value of the investments.

Who are ETFs for?

Individual investors: People with buy-and-hold strategies could benefit from low expense ratios. ETFs have some tax advantages over mutual funds.

Private money managers: Those who want to keep their clients fully invested in the stock market can buy ETFs for the short term, until they find specific stocks.

Institutions: ETFs can handle the sort of large trades required by pension funds and endowments. As with money managers, ETFs provide a short-term place to remain fully invested in the stock market.

Day traders, market timers: Most traditional mutual funds prohibit market timing, but ETFs do not. In addition, mutual funds can be traded once a day, making them impossible investments for day traders, who move in and out of holdings. ETFs can be traded whenever the stock market is open.

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