Exchange Traded Funds: What's the (Big) Deal?

Exchange Traded Funds (ETFs) are on a roll: In early June, the American Stock Exchange (AMEX) said it had created nine new industry-based Intellidex Indexes as foundations for a new family of ETFs.

By the end of that month, Wheaton, Ill.-based PowerShares Capital Management had already launched eight ETFs based on those indexes. Each index tracks 30 stocks from target industries based on proprietary research designed to offer market-beating investment returns.

At the AMEX, 24 funds have been introduced this year, compared to seven in all of 2003.

According to Morningstar, a Chicago-based provider of independent investment research, 177 ETFs were listed as of August 31 with net assets of $255 billion, compared to 143 funds with assets of $174 billon same period last year. In 2002, there were only 97 funds with net assets of $89 billion.

"None of us envisioned this kind of growth," says Jim Ross, co-head of the advisor strategy group at State Street Global Advisors (SSgA), a unit of Boston-based processing bank State Street, one of the big ETF players. ETF growth is expected to continue, he adds, with assets predicted to increase about 30% over the next few years. Some in the industry have predicted that ETFs will grow at 30% annually for the next five years, Ross adds. "I can see that happening."

Why are ETFs so popular? Because they provide certain benefits that their mutual fund cousins do not. Like index-style mutual funds, ETFs are baskets of stocks designed to provide diversification and to mirror the performance of an underlying stock market index. When you buy a share of an ETF, you are buying shares in the index. Unlike mutual funds, ETFs can be traded throughout the day and can be used in short sales. They also offer some tax advantages over mutual funds.

And the annual expense ratios for ETFs are generally low - just 0.4% to 0.5% a year, compared to 1.4% for stock mutual funds, according to Dan Coulton, a senior analyst with Morningstar. (Investors pay brokerage commissions on ETF trades, while they do not when they deal directly with no-load mutual fund companies. For active traders, commissions can eat up ETFs' low-expense advantage, Coulton said.)

ETFs can trade throughout the day because they use a pricing system quite different from that of mutual funds, which are priced just once a day based on the closing prices of the funds' holdings. ETF share prices, in contrast, rise and fall with supply and demand as they are traded during the day -- the same way ordinary stock prices are set. That could cause ETF share prices to diverge from the value of the stocks owned by the fund. This happens to closed-end mutual funds, which trade throughout the day like stocks.

So to keep an ETF's share price in line with the values of the stocks it owns, market makers and specialist firms are allowed to create or redeem large blocks of ETF shares called "creation units." A market maker purchasing a creation unit, for example, can pay for it with shares of stock in the unit, or it can sell the unit and get the shares. The unit prices and stock prices can thus never move very far apart.

"One of the most attractive things about ETFs is the way prices are kept in check by market makers and arbitrageurs," says Wharton finance professor Jeremy Siegel, who is a director in Index Development Partners (IXDP), a company that develops indexes on proprietary methodology and plans to launch an ETF soon. "You can always go back and forth between the underlying shares and the index, so arbitrageurs will make sure that the prices of these two quantities are extremely close," he notes.

The ETF pricing system also can benefit investors at tax time. With a mutual fund, sales by investors force the fund to sell shares of stock, and net profits must be paid out to investors by the end of the year. That "distribution" may be taxed as a capital gain. But because ETF trades do not force sales of any fund holdings, there are no such distributions -- and no tax bills.

Need for Innovation

AMEX created ETFs 12 years ago as a flexible and tax efficient alternative to index-tracking mutual funds. The first AMEX ETF, issued by SSgA, was the Standard & Poor's Depositary Receipt (SPDR), which tracked the S&P 500 index.

Cliff Weber, senior vice president at AMEX's ETF Marketplace, says there was recognition early on at AMEX of the need and opportunity for an exchange to be innovative. The exchange-traded fund serves both long-term investors and active traders, he notes.

ETFs have proven to be a popular alternative to mutual funds. In addition to tracking standard indexes such as the S&P 500 that use broad criteria like market capitalization, ETFs now track many specialized indexes. Some focus on specific investment styles or market sectors. Others buy dividend-paying stocks or issues from certain countries or regions. Some even track commodities markets.

AMEX alone lists 168 funds, 24 of which were launched this year. The latest include three new "dividend achievers" -- ETFs by PowerShares, based on Mergent's Dividend Achievers Index. These started trading on the AMEX on September 15.

Last month, Barclays Global Investors, the San Francisco-based unit of Barclays of London, launched a micro-cap ETF -- iShares Russell Microcap Index Fund -- that trades on the New York Stock Exchange. Also in the works is a fund tracking yet another specialized index - the FTSE RAFI US 1000 Index - comprising stocks picked up for their "fundamentals" such as cash flow and book value. PowerShares, which was selected as the sole licensee of this index on September 9, hopes to launch an ETF based on it later this year.

Both Barclays' micro-cap fund and the dividend achievers funds embody the latest innovations in ETFs. Although State Street's SPDR (known as Spider) is still the largest ETF, with assets of $51.9 billion as of June 30, other issuers such as Barclays have muscled their way in. Barclays has more than 100 funds tracking the S&P, Dow Jones, Russell, and Morningstar equity indexes as well as Lehman Brothers' bond index.

The Vanguard Group, based in Valley Forge, Pa., has 23 funds in its VIPER family of ETFs, and manages about $9 billion in ETF assets. Earlier this month, Vanguard announced that AMEX has started trading options on 20 VIPER funds. State Street also has 22 ETFs and plans to launch nine more.

Hedge Funds Moving In

Investors have grown increasingly sophisticated with ETFs. Many now use them to hedge or temporarily change their position in a particular industry sector or class of investment. Hedge funds and institutional investors are using ETFs to bet on market declines with short sales -- borrowing ETF shares to sell in hopes of repaying the loan with cheaper shares bought later. Siegel notes that being able to short is a great advantage of investing in ETFs.

Many investors who don't like the high risks of futures markets like to use ETFs to hedge their positions. Many ETFs are now linked to options, which give their owners the right to buy or sell a block of shares at a set price for a given period.

Ross of SSgA said financial services firms and brokers increasingly use ETFs to easily change market sectors emphasized in their portfolios. According to Wharton finance professor Marshall Blume, "ETFs are highly effective if an investor wants to temporarily change his position in the market."

With ETFs growing in popularity, issuers have begun to offer funds that track more and more specialized indexes, such as a fund for socially responsible investors and a fund tracking gold. Indeed, Blume believes that ETFs will continue to gain in popularity, with issuers designing more and more exotic forms, such as funds tracking stocks with high or low price-to-earnings ratios. Siegel agrees. "My personal feeling is that [standardized] index products are pretty much exhausted; most of them have been covered."

Siegel believes ETFs could very well cut into the market share of index mutual funds. And he expects future ETFs to entail actively managed funds, rather than just indexers. Although managed ETFs do not currently have regulatory approval, Amex's Weber said several companies want to offer managed ETFs, and he expects some to be launched by the end of next year.

Already, niche players like PowerShares are edging in this direction. PowerShares funds are classified as "Intellidex" or "Dynamic portfolio" - the indexes are regularly adjusted in hopes of beating the broader market.

PowerShares' Dynamic Market Portfolio (PWC), which evaluates 2000 stocks in 10 sectors every three months, has produced an average annual return of 24% since June 30, 2003, compared to the S&P 500 Index's return of 14.89%.

While some consider the proliferation of specialized funds to be a desirable step, others sound a note of caution. Coulton of Morningstar says that while there are plenty of sound, diversified ETFs, "there are an awful lot of really narrowly-defined, undiversified, gimmicky sorts of funds that are very difficult to use responsibly and well." He worries that "people are going to use them the wrong way by trying to time the ups and downs of the marketplace. History shows that investors do a really poor job of this."
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