

# Is the ETF poised to become the mutual fund of the 21st Century?

# INVESTMENT TOOL

BY DAVID DRUCKER

It all started in 1992 when the American Stock Exchange petitioned the SEC to develop a stand-alone S&P 500 Index-based Exchange Traded Fund, or “ETF.” So was born the S&P Depository Receipt variously called the “Spider” or “SPDR,” first listed on the AMEX in 1993. And SPDRs became the first card in a deck that later included “Diamonds” (indexing the Dow Jones Industrials), “Cubes” (indexing the NASDAQ 100), and numerous other ETFs.

Since 1993, ETFs have proliferated, both as to the versions originated by major financial institutions and the indexes they represent. Merrill Lynch introduced HOLDRs (Holding Company Depository Receipts) in 1998 and Barclays Global Investors followed with iShares in 2000. In the last couple of years, institutions long known for their mutual funds have gotten into the act, such as Rydex Investments with its Rydex S&P Equal Weight ETF (RSP), and Vanguard with its VIPERs, or Vanguard Index Participation Receipts. While the first ETFs indexed the major markets, today’s ETFs span the globe (e.g., Barclays international single-country iShares) or slice up the U.S. economy into sectors (e.g., Oil Services HOLDRs or Pharmaceutical HOLDRs).

Volume data tell us that ETFs have caught on. Since its 1993 inception, the AMEX’s SPDR (SPY) has reached trade volumes of over 100 million shares a day, although it’s down to about 30 million a day lately — possibly because of all the competition between new and old ETF offerings. The total market value of all SPDRs is today approximately \$42 billion, a bit less than half of the \$96 billion invested in the best-known open-end S&P mutual fund: the Vanguard 500 Index fund (VFINX). Is this a glass half full or half empty? Are ETFs merely an alternative to index mutual funds, or are they gradually replacing them?

How would investors answer this question? Most individual investors wouldn’t, because ETFs are still relatively obscure to individuals. According to research done by ETFguide.com, an online publisher of ETF data, institutional investors were the first group to embrace ETFs, followed by financial advisors buying them for client portfolios, and traders — particularly hedge funds basing their hedging strategies on index instruments.

And to what degree are financial advisors using ETFs in client portfolios? Barclays asked that question last year of over 1,000 advisors — from wirehouse reps to independent RIAs — in its “BGI 2003 Usage & Attitudes Survey,” and discovered 23 percent of advisors had yet to discover the benefits of ETFs (or, perhaps, avoided them because of low payouts vis-a-vis mutual funds). But almost 50 percent were dabbling in ETFs — using them for 1 percent to 9 percent of their clients’ investments, and the other 27 percent were “heavy” users with approximately one-third of their clients’ portfolio assets invested in ETFs.

## Many Uses and Nifty Tricks

The main attractions of ETFs are well-known by now: ETFs are tax-efficient; they feature low annual expenses rivaling or undercutting many index mutual funds; they provide diversification; and they track major indexes, making them transparent as to the stocks they hold. And they’re inexpensive to purchase. Claims Steven Podnos of Merritt Island, Fla.-based Wealth Care: “I can establish a \$100,000 investment in the S&P 500 for a commission of \$8 using IVV [iShares S&P 500 Index].”

But are there other reasons why financial advisors have, or should be, backing up the truck to get more of these investment vehicles? One is simplification and improved portfolio design. Says Richard Hall, an LPL rep with B&H





Wealth Management in Albuquerque, N.M.: “Some of my new clients go from having undiversified Merrill Lynch accounts holding dozens of U.S. stocks and sending out complicated monthly statements they can’t make head nor tail of to a statement with nine ETFs covering over 1,000 stocks worldwide.”

Another is the opportunity to short ETFs. Because they trade as stocks, ETFs can be held long or short. Carl Johnson of Ames Planning Associates in Peterborough, N.H., says, “We use them to hedge large industry positions [clients have in individual stocks]. ETFs can be shorted and sold on a down tick.”

Yet another is the way ETFs fit into the “core and satellite” investment philosophy popular with many planners these days. “We’ve found ETFs a great ‘core’ asset-class strategy to lock in index returns for a portion of a client’s portfolio while

market swings.”

And how about tax harvesting? Sure, ETFs don’t make unpredictable capital gains distributions as do most open-end mutual funds, but they can also play a role maintaining a client’s desired market exposure during the IRS’ 30-day wash-sale requirement. Says Bob Gerstemeier of the Gerstemeier Financial Group in Naperville, Ill., “I use iShares ETFs almost exclusively as a place to deposit client funds to keep them invested in the market during the period we are out of the client’s original stock holding.” Gerstemeier calculates the correlation coefficient of the ETF he contemplates using in lieu of his client’s stock to ensure that the market exposure they gain is a close fit to the original. The ETF, then, facilitates the tax harvesting strategy being carried out through the sale of the client’s stock.

Of course, tax losses could be harvested strictly among ETF holdings as well. For example, the iShares Dow Jones U.S. Technology (IYW) managed by Barclays and the Technology Select Sector Index SPDR (XLK) managed by State Street Global Advisors are both ETFs indexing the technology sector, but they track different benchmarks. Nonetheless, they’ve often produced correlation coefficients of as high as 0.99. Therefore, an advisor could easily harvest losses in either of these ETFs by selling his holding and repurchasing the alternative.

Notes Todd Black of Dogwood Capital Management in Cumming, Ga., who has long used ETFs in markets where he believes active management doesn’t add value: “ETFs would also be wonderful vehicles for speculating and making sector bets although, at the moment, neither of these activities characterize my [style of] management.”

However, sector bets — or “sector rotation” as it’s often called — is another reason many advisors use ETFs. Jay Chitnis, Managing Director of Atlanta-based YieldQuest Investment Group, an investment firm dealing only with financial advisors, has for years employed this strategy: “We carve the S&P into those sectors that are available as ETFs and, using a model we developed to compare the relative P/E of each sector to the S&P over 21 years, we identify cheap sectors. If the P/E for sector ‘X’ is the cheapest it’s been relative to the S&P during this historical period, we know there



**Where the Money Is**

NAME	SYMBOL	NET ASSETS
S&P 500 SPDR	SPY	\$41,310,216,440
Nasdaq- 100 Index Tracking Stock	QQQ	23,559,292,000
iShares S&P 500	IVV	8,609,648,000
iShares MSCI-EAFE	EFA	7,608,966,000
DJIA Diamonds	DIA	7,314,650,550
S&P 400 MidCap SPDR	MDY	6,575,515,560
iShares Russell 2000	IWM	5,398,776,000
iShares MSCI-Japan	EWJ	4,708,884,000
Vanguard Total Market VIPERs	VTI	3,020,731,560
iShares Russell 1000 Value	IWD	2,731,590,000

Data as of April 2, 2004 **Source:** The American Stock Exchange

affording the opportunity for some out-performance of the index through active management,” says Tom Batterman of Vigil Trust & Financial Advocacy in Wausau, Wis. “It has been interesting to us to observe that funds that rack up an impressive gain relative to their index in one year get a lot of press and seem to really lag the first six months of the following year. We suspect that is because they get flushed with funds that the manager can’t deploy, so investors become impatient and cash out. The point is, with an ETF you don’t suffer this problem. In the long run the ETF probably outperforms, even if the fund has a good long-term track record, because the ETF doesn’t have these kinds of

may be some value. Of course, we must also look at the fundamentals and, if we like what we see, we'll buy a sector-X ETF."

In fact, ETFs pose so many advantages over mutual funds, why wouldn't we replace mutual funds with ETFs wherever and whenever we could? Because there are a few drawbacks, say some advisors — some permanent and some temporary. Mark Gleason, a CFA with Wescap Management Group in Burbank, Calif., says, "Many ETFs still aren't ready for prime-time core use. Many are cap-weighted and too concentrated, particularly sector funds like health care and energy." Indeed, the Health Care Select Sector SPDR (XLV) is almost 30 percent invested in just two stocks: Pfizer and Johnson & Johnson. And the Energy Select Sector SPDR (XLE) is 36 percent invested in Exxon and Chevron. Of course, if one believes in indexing as a strategy, then presumably one accepts cap weighting and high concentrations. Or perhaps one employs a threshold — that is, a degree of concentration beyond which one chooses a managed mutual fund instead of an ETF.

Coverage is another problem. Says Louis Kokernak, a CFA with Haven Financial Advisors in Austin, Texas: "I use mutual funds for domestic micro-cap stocks, foreign bonds and commodities. ETFs currently do not address these asset classes well." Yet, at the rate new asset classes, stock market segments and economic sectors are being addressed by ETF "manufacturers," we probably won't have to wait too long for Kokernak's desired asset classes to appear in ETF form.


Notwithstanding these observations, ETFs seem to trump mutual funds in almost every scenario. And let's not forget the politics of mutual funds. The once untarnished mutual fund industry has taken what some would say was its inevitable fall under the temptation of benefits from allowing privileged investors to engage in late trading. From a competitive standpoint, this was probably not an entirely unwelcome event to Cliff Weber, the Senior VP of AMEX's ETF Marketplace, who notes: "Now, with the concern over late-trading and market timing, ETFs [provide an opportunity] for more active buyers and sellers to meet directly in the market rather than transacting with a fund."

Weber, who has worked with all of the AMEX-based ETF issuers, says ETFs are more relevant than

ever these days: "When ETFs first came out, lots of education needed to be done. Part of AMEX's responsibility over the last 10 years has been educating the marketplace. We have a team that does just that. Now there's much less of a need for education since ETFs are finally well known. And their relevancy is growing with the breadth of product offerings. Barclays has done a lot to push the envelope in product categories and different asset classes beyond just the S&P 500."

### ETFs vs. SAMs

If ETFs have the potential to supersede mutual funds, how about separate accounts? Separate accounts became popular as a way to bring "indi-



YEAR	NO. OF AMEX ETFs	ASSETS	ANNUAL GROWTH
2003	124	\$154,786,044,692	47%
2002	122	\$105,607,653,942	21%
2001	116	\$87,434,162,679	24%
2000	91	\$70,316,552,223	96%
1999	32	\$35,889,911,748	130%
1998	29	\$15,628,426,259	133%
1997	19	\$6,709,527,026	179%
1996	19	\$2,404,187,633	128%
1995	2	\$1,053,498,984	151%
1994	1	\$419,173,362	-9%
1993	1	461,270,700	—

Source: The American Stock Exchange

vidualized management" to affluent investors. Yet, many separate account management (SAM) programs have morphed into vehicles for the common man. We have no problem with the alleged benefits of SAMs filtering down to the smaller investor, but does that really happen?

"No," says Bob Siefert, a principal of Back Bay Financial Group in Boston. Through personal experience, Siefert has discovered that, "In most instances, a separate account relates to a specific product offering by the sub-advisor. Very little customization is provided. Let there be no mistake that a *separate* account can differ greatly in its customization from a *private* account. Of course, private account minimums are usually much higher. In our view, most separate accounts are mutual funds with lower expenses." Siefert now uses SAMs (or "private accounts") only for clients with

investable assets of \$3 million or more, who can segregate at least \$500,000 into a specific asset class with its own manager.

Comparisons between the two can still be made, though, if we confine them to those characteristics independent of the ETF's basic nature as an indexing strategy and the SAM's alleged benefit as a managed stock strategy. Comparing SAMs and ETFs as such we find:

**Embedded Gains.** SAMs are heralded for their lack of embedded gains. When an investor signs on with a SAM, he isn't buying into the unrealized gains inherent in actively managed mutual funds. However, index funds — whether of the open-end mutual fund variety or the ETF — are virtually devoid of embedded gains as well. Minor gains may occur when they periodically revise their holdings, on the margin, to readjust to changes in the indexes they track.

**Tax-Loss Harvesting.** One can harvest tax losses with ETFs just as readily as with individual stocks held under a SAM arrangement. The question for

the smaller investor who falls outside of Siefert's parameters is — will the separate account manager go to the trouble to harvest losses on this investor's smaller account?

**Account Tailoring.** Again, SAMs are theoretically tailored to the individual, but are they really in the case of smaller portfolios? Advisors keeping the asset management function in-house can tailor a portfolio to an individual client's unique asset allocation requirements quite easily with the breadth of ETF offerings now available.

**Flexibility and Liquidity.** Getting accounts set up with a SAM takes time. Each SAM program works with some custodians and not with others. Dismantling a SAM portfolio is likewise potentially difficult, as individual securities must be moved to another manager or custodian. ETFs are not similarly restricted.

**Diversification.** Diversification is where ETFs really shine. In the case of smaller accounts, let's say a client has \$500,000 to be divided into five asset classes, each with a separate manager holding perhaps 10 to 20 stocks per asset class. Using ETFs, much broader diversification can be achieved while still seeking some of the out-performance implied by an individual stock selection strategy of a separate account manager. For example, broad ETF indexes can form the "core" of an asset class with sector ETFs the "satellites."

To answer our initial question, it is not likely that ETFs will completely replace mutual funds because they're an indexing strategy; what they will more likely do is take significant market share from index mutual funds. And they won't completely replace SAMs for the same reason: There will always be investors who believe in active management and like the excitement of betting on individual stocks.

For the rest of us who don't believe that we, or anyone else, can beat the markets in which we invest, indexing will continue to gain in popularity. And as it does, ETFs will emerge as the product of choice for most advisors and many individual investors once they get the news. IR

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## NEWS

### You Can Use

**New twists in the world of ETFs surface weekly. The latest ETF developments include:**

- ✓ **ETFs are now showing up** as investment options in corporate 401(k) plans, suggesting wider acceptance at the individual investor level.
- ✓ **Barclays** recently introduced nine new ETFs based on the Morningstar style-box indices.
- ✓ **ProFunds**, a Bethesda, Md., mutual fund company, has filed with the SEC for approval to launch Leveraged ETFs.
- ✓ **Barclays** will likely consider issuing more fixed-income ETFs.
- ✓ **The AMEX** may receive SEC approval for actively managed ETFs.
- ✓ **Barclays and the World Gold Council** are seeking SEC approval for a gold ETF, marking the entry into commodity ETFs.

—DJD