

UNDESTANDING EXCHANGE TRADED FUNDS

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Exchange Traded Funds, or ETFs, are simply a basket of securities that trade just like stocks on the major exchanges. For individuals who want to invest in the market quickly and cheaply? ETFs are the most practical vehicle. They help the investor focus on what is most important, choice of asset classes. All the major stock indexes have ETFs based on them, including the Dow Jones Industrial Average, the Standard & Poor's 500 Index and the NASDAQ Composite. There are ETFs for large US companies, small ones, real estate investment trusts, international stocks, bonds, and even gold. Investors can pick almost any asset class that is publicly available and there is a very good chance that it is represented by an ETF or will be soon.

ETFs differ fundamentally from traditional mutual funds, which do not trade midday. Traditional mutual funds take orders during Wall Street trading hours, but the transactions actually occur at the close of the market. The price they receive is the sum of the closing day prices of all the stocks contained in the fund. This is not the case for ETFs, which trade instantaneously all day long and allow an investor to lock in a price for the underlying stocks immediately.

ETFs are economical to buy and especially to maintain over the long-run, making them especially attractive for the typical buy-and-hold investor. Annual fees are as low as .09% of assets, which is breathtakingly low compared to the average mutual fund fees of 1.4%. Tax effects are also not to be ignored, and ETFs perform well after-tax. They can be margined, and options based on them allow for various defensive (or speculative) investing strategies.

Their safety as a securities instrument is the same as stock certificates themselves. Internally, ETFs are far more complex entities than mutual funds. ETFs are a class of mutual fund as they fall under many of the same Securities Exchange Commission rules that traditional mutual funds do. But their different structure means that the SEC has imposed different requirements from traditional mutual funds in how they are bought and sold.

Another advantage of ETFs is the fact that they have a low cash drag. Mutual funds must keep a supply of cash on hand at all times to meet redemptions. Managers of traditional mutual funds also have to deal with investing large cash inflows. Therefore traditional mutual funds tend to have large cash positions which offer a low rate of return for the investor. This cash position can bring down the overall performance of the mutual fund, this called "cash drag." ETFs are bought and sold over an exchange so fund managers do not have to manage cash flow.

ETFs are not priced like mutual funds at their net asset value, in other words an ETF will not necessarily trade at the same value its underlying securities would sell for. Often, ETFs will trade higher or lower than its net asset value. This is an advantage because investors can bargain shop for ETFs by looking for funds that are trading at a discount to their net asset value.

Current tax laws allow for investors to use capital losses to offset an unlimited amount of capital gains, and up to \$3,000 of income a year (\$1,500 for married couples filing separately). An investor who holds a fund or ETF that lost \$3,000 since it was bought; you can sell it to offset capital gains on another investment or \$1,000 in income. If an investor does not have enough income or capital gains against which to match the loss he or she may carry that loss forward to be applied in subsequent years. However, you may not purchase the security back that you sold for a loss for at least thirty days or you will be in violation of the IRS "wash sale" rules.