July 2006 – Exchange-Traded Funds

In our last letter we discussed the strengths and weaknesses of the most common type of mutual fund, which is termed the open-end fund. This quarter we will cover a newer type of fund, the exchange-traded fund (ETF) and contrast it with its older sibling. An ETF is typically a basket of securities designed to track an index but which is traded like a stock on an exchange. Since it is traded like a stock, the buyer purchases shares from another investor rather than from a mutual fund company. In addition, large investors can create new shares in kind by depositing the required component securities with the custodian in exchange for incremental ETF shares. Likewise, large investors can redeem ETF shares for the component securities. The implications of this in-kind mechanism will be discussed below.

Some common strengths of open-end funds and ETFs are as follows:

- They both can provide diversification efficiently for small investments where individual stock portfolios would be uneconomical.
- For smaller portfolios they provide professional management at a lower cost than managers investing in individual stocks can offer although in the case of index funds and ETFs there is little managing to be done.
- They offer liquidity in that open-end funds and ETFs can be converted to cash within one and three business days, respectively.
- They are both convenient from an ease of investment, record keeping and tax preparation standpoint.
- Open-end funds facilitate reinvestment of dividends and thus dollar-cost averaging (a plan of regular investment that results in purchasing more shares when prices are low than when they are high, producing a lower average cost). ETFs, on the other hand, do not provide dividend reinvestment programs, but brokers often do, thus making the difference transparent for the investor. Commissions on small ETF purchases, however, can render dollar cost averaging cost prohibitive.

Some important advantages of ETFs over open-end funds are listed below:

- ETFs, whose fees average .42%, often are more economical than open-end index funds, which average .86%, and open-end managed funds, which average 1.41%.
- ETFs offer a wider variety of sector index tracking choices than do open-end index funds.

- They are usually more tax-efficient since the manager does not have to sell shares of the component stocks to fund redemptions, as is the case for open-end funds.

- They typically experience low turnover as compared to open-end funds other than open-end index funds.

- They can be purchased and sold all day long unlike traditional funds which can be traded only once a day. The likelihood of abuses similar to those which recently plagued open-end funds is thus diminished.

- They can be sold short and consequently can serve as a hedging tool.

- They can be purchased on margin, giving the purchaser greater flexibility

The in-kind purchase and sale capability mentioned above (although not providing an advantage other than tax efficiency over open-end funds which trade at net asset value) offer a terrific benefit over closed-end funds, which are otherwise very similar to ETFs. Arbitragers utilize the in-kind capability to profit from differences between the market price of the ETF and its component stocks. Consequently, arbitragers prevent the occurrence of significant premiums or discounts often found in closed-end funds.

Finally, we feel that ETFs share with index funds a common risk that merits mention even though it was discussed in our last letter. Both vehicles mirror the performance of an index such as the S&P 500 and thus are usually market-value weighted. For example, if the total market value of a stock is 5% of the market, then 5% of the index fund or ETF is invested in that stock. As a result, the most overvalued stocks and sectors are over-represented and the most undervalued are under-represented.

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