Chapter 1

The New Kid on the Block

In This Chapter

- Discovering the origin of ETFs
- Understanding their role in the world of investing today
- Getting a handle on how they are administered
- Finding out how they are bought and sold
- Calculating their phenomenal growth

There are, no doubt, a good number of pinstriped ladies and gentlemen in and around Wall Street who froth heavily at the mouth when they hear the words *exchange-traded fund*. In a world of very pricey investment products and very lucratively paid investment-product salespeople, ETFs are the ultimate killjoys.

Since their arrival on the investment scene in the early 1990s, more than 300 ETFs have been created, and they have grown faster in asset accumulation than any other investment product. And that is a good thing. ETFs have allowed the average American investment opportunities that do not involve shelling out fat commissions or paying layers of ongoing, unnecessary fees. And they've saved investors oodles and oodles in taxes.

Hallelujah.

SPDRs, DIAMONDS, Qubes . . . Why the plurals?

Many ETFs have names that end in an *s*. That can be confusing. After all, you would never refer to the Fidelity Magellan Fund as *Magellans*. So why the plural when talking about a single ETF? The convention is to refer not just to the fund but to the components of the fund. Thus, *DIAMONDS* refers to the 30 companies that make up the Dow Jones Industrial Average index. *Qubes* refers to the 100 companies that make up the NASDAQ-100 Index. But rest assured that when brokers talk about DIAMONDS and Qubes, they are talking about a single ETF.

In the Beginning

When I was a lad growing up in the 'burbs of New York City, my public school educators taught me how to read, write, and learn the capitals of the 50 states. I also learned that anything and everything of any importance in this world was, ahem, invented in the United States of America. I've since learned that, well, that isn't entirely true. Take ETFs. The first ETF was introduced in Canada. It was a creation of the Toronto Stock Exchange — no Wall Streeters were anywhere in sight!

I'm afraid that the story of the development of ETFs isn't quite as exciting as, say, the story behind penicillin or the atom bomb. As one Toronto Stock Exchange insider once explained to me, "We saw it as a way of making money by generating more trading." And so, thus was born the original ETF known as TIP, which stood for Toronto Index Participation Unit. It tracked an index of large Canadian companies (Bell Canada, Royal Bank of Canada, Nortel, and 32 others) known as the Toronto 35. That index was then the closest thing that Canada had to the Dow Jones Industrial Average index that exists in the United States.

Enter the traders

TIP was an instant success with large institutional stock traders, who saw that they could now trade an entire index in a flash. The Toronto Stock Exchange got what it wanted — more trading. And the world of ETFs got its start.

TIP has since morphed to track a larger index, the so-called S&P/TSX 60 Index, which — you probably guessed — tracks 60 of Canada's largest and most liquid companies. The fund also has a new name, the iUnits S&P/TSX 60 Index Fund, and it trades under the ticker XIU. It is now managed by Barclays, the British financial powerhouse that has come to be the biggest player in ETFs in Europe, Canada, and the United States. (Barclays has since introduced another ETF in the United States that uses the ticker TIP, but it has nothing to do with the original TIP. The present-day TIP invests in U.S. Treasury Inflation-Protected Securities.)

Moving south of the border

The first ETF didn't come to the United States (oh, how my public school teachers would cringe!) for three or so more years after its Canadian birth.

On January 29, 1993, the Mother of All U.S. ETFs was born on the American Stock Exchange. It was called the S&P Depositary Receipts Trust Series 1, commonly known as the SPDR (or Spider) 500, and it traded (and still does) under the ticker symbol SPY.

The SPDR 500, which tracks the S&P 500 index, an index of the 500 largest U.S. companies, was an instant darling of institutional traders. It continues to be one of their darlings, but it is also a major holding in the portfolios of many individuals.

Fulfilling a Dream

ETFs were first embraced by institutions, and those institutions very much continue to this day to use ETFs for institutional use. They are constantly buying and selling ETFs and options on ETFs for various institutional purposes, which I touch on in Chapter 18. For us noninstitutional types, the creation and expansion of ETFs has allowed for the construction of portfolios of institutional-like sleekness.

Goodbye, ridiculously high mutual fund fees

A mutual fund investor with a $150,000 portfolio filled with actively-managed funds will likely spend $2,505 (1.67 percent) or more in annual expenses. By switching to an ETF portfolio, that investor will incur trading costs (because trading ETFs costs the same as trading stocks) of, oh, perhaps $100 or so. But he can then lower his ongoing annual expenses to about $600 (0.4 percent). That's a difference, ladies and gentlemen of the jury, of $1,905, which is compounded every year his money is invested.

REMEMBER

Loads, those odious fees that some mutual funds charge for getting into or out of the fund, simply don't exist in the world of ETFs.

Capital gains taxes, the blow that comes on April 15th to many mutual fund holders with taxable accounts, hardly exist. In fact, here's what my clients and I have paid in capital gains taxes in the past three years: $00.00.

In Chapter 2, I delve much deeper into both the cost savings and the tax efficiency of ETFs.

Hello, building blocks for a better portfolio

In terms of diversification, my own portfolio and those of my clients include large stocks; small stocks; micro cap stocks; English, French, Swiss, Japanese, and Korean stocks; long-term bonds; short-term bonds; and real estate investment trusts (REITs) — all held in low-cost ETFs. I talk all about diversification, and how to use ETFs as building blocks for a class A portfolio, in Part II.

Yes, you could use other investment vehicles, such as mutual funds, to create a well-diversified portfolio. But ETFs make it much easier because they tend to track very specific indexes. They are, by and large, much more pure than mutual funds. An ETF that bills itself as an investment in, say, small growth stocks is going to give you an investment in small growth stocks, plain and simple. A mutual fund that bills itself as an investment vehicle for small growth stocks may include everything from cash to bonds to shares of General Electric. (No, I'm not exaggerating, and I give a specific example or two in the next chapter.)

Will you miss the court papers?

While scandals of various sorts — hidden fees, "soft-money" arrangements, after-hours sweetheart deals, and executive kickbacks — have plagued the world of mutual fund and hedge fund investments, here are the number of scandals that have touched my life or the lives and fortunes of any of my clients: 0. That's because ETFs' managers, forced to follow existing indexes, have very little leeway in the investments they choose or the proportions in which they choose them. ETFs are closely regulated by the Securities and Exchange Commission, which not all investment vehicles are. And ETFs trade during the day, in plain view of millions of traders — not after hours, as mutual funds do, which can allow for sweetheart deals when no one is looking.

I talk much more about the transparency and cleanliness of ETFs in Chapter 2.

Not Quite as Popular as the Beatles, But Getting There

With all that ETFs have going for them, I'm not surprised that they have lately begun to sell like wildfire. The Investment Company Institute, an organization that obsessively tracks the whims of investors, tells us that from the beginning of 2000, when there were only 80 ETFs on the U.S. market, to the end of 2005, when there were over 200, the total assets invested in ETFs rose from $52 billion to $300 billion. At the time of this writing — several months into 2006 — the total is $320 billion.

Certainly, $320 billion pales in comparison to the amount of money invested in mutual funds: $9+ trillion. But if current trends continue, ETFs may indeed become as popular as were John, Paul, George, and Ringo.

Part of ETFs' popularity stems from the growly bear market of 2000–2003. Investors who had been riding the double-digit-yearly gravy train of the 1990s suddenly realized that their portfolios weren't going to keep growing in leaps and bounds, and perhaps it was time to start watching investment costs. There has also been a greater awareness of the triumph of *indexing* — investing in entire markets or market segments — rather than trying to cherry-pick stocks. Much more on that topic in Chapter 2.

The little kid is growing fast: ETFs' phenomenal growth

Following are a few facts and figures that indicate how the ETF market compares with the mutual fund market and how rapidly ETFs are gaining in popularity.

The amount of money invested in ETFs and mutual funds as of March 2006:

- ETFs: $320 billion
- Mutual funds: $9.2 trillion

The total number of ETFs and mutual funds available to U.S. investors as of March 2006:

- ETFs: 203
- Mutual funds: 7,800

The number of ETFs available to U.S. investors in recent years:

- 2000: 80
- 2001: 102
- 2002: 113
- 2003: 119
- 2004: 151
- 2005: 201

The amount of money invested in ETFs in recent years:

- 2000: $52 billion
- 2001: $75 billion
- 2002: $100 billion
- 2003: $150 billion
- 2004: $220 billion
- 2005: $300 billion

Moving from Wall Street to Main Street

Investment trends work sort of like fashion trends. In the world of fashion, trendsetters — movie stars, British royals, or Paris Hilton (wherever she came from) — wander out into public wearing something that most people consider ridiculous, and the next thing you know, everyone is wearing that same item. It took from 1993 until about, oh, 2001 or so (around the time I bought my first ETF) for this newfangled investment vehicle to really start moving. By about 2003, insiders say, the majority of ETFs were being purchased by individual investors, not institutions or investment professionals.

Today, Barclays, which controls about 55 percent of the U.S. market for ETFs, estimates that approximately 60 percent of all the trading in ETFs is done by individual investors. The other 40 percent is being done by both institutions and by fee-only financial advisors, like me.

(*Fee-only,* by the way, signifies that a financial advisor takes no commissions of any sort. It's a very confusing term because *fee-based* is often used to mean the opposite. Check out Chapter 20, where I talk about whether you need a financial professional to build and manage an ETF portfolio.)

REMEMBER

Actually, individual investors — especially the buy-and-hold kind of investors — benefit much more from ETFs than do institutional traders. That's because institutional traders have always gotten, and continue to get, the very best deals on investment vehicles. They often pay much less in management fees than do individual investors for shares in the same mutual fund. (Fund companies often refer to *institutional class* versus *investor class* shares. All that really means is "wholesale/low price" versus "retail/higher price.")

Keeping up with the Vanguards

It may sound like I'm pushing ETFs as not only the best thing since white bread but as a replacement for white bread. Well, not quite. As much as I like ETFs, good old white-bread mutual funds still have their place in the sun. And that's especially true of inexpensive index mutual funds, such as Vanguard's and Fidelity's. They still have very much to offer. Mutual funds, for example, are clearly the better option when you're investing in dribs and drabs and don't want to have to pay for each trade you make.

One of the largest purveyors of ETFs is The Vanguard Group, the very same people who pioneered index mutual funds. In the case of Vanguard (and only Vanguard at this point), shares in the company's ETFs are the equivalent of shares in one of the company's index mutual funds. In other words, they are different class shares in the same fund — the same representation of companies, but a different structure and slightly lower costs for the ETFs.

The ripple effect: Forcing down prices on other investment vehicles

You don't need to invest in ETFs to profit from them. They are doing to the world of investing what Chinese labor has done to manufacturing wages in the United States. In other words, they are driving prices down. Thanks to the competition that ETFs are giving index mutual funds (already ETFs have claimed one-third of the $800 or so billion invested in such funds), mutual fund providers have been lowering their charges. Fidelity Investments, for example, in 2005 lowered the expense ratio on some of its index funds from as much as 0.47 percent down to 0.10 percent. With many mutual funds, however, you must keep a minimum balance. Fidelity's minimum for its lowest-cost index funds is $10,000

TIP

Because Vanguard funds allow for an apples-to-apples comparison of ETFs and index mutual funds, and because the company presumably has no great stake in which you choose, Vanguard may be a good place to turn for objective advice on which investment is better for you. But rest assured — a point that I'll make again in this book — we're not talking rocket science. For most buy-and-hold investors, especially in taxable accounts of more than $50,000 or so, ETFs will almost always be the winners, at least in the long-run.

I look much more closely at the ETFs versus mutual funds question when I design specific portfolios and give actual portfolio examples in Chapters 15 and 16.

Ready for Prime Time: Becoming Household Words

One survey in the summer of 2005 found that only about one-third of investors with at least $50,000 in investable assets said that they were very or somewhat familiar with ETFs. My guess is that by the time *Exchange-Traded Funds For Dummies* appears on bookshelves, at least half of U.S. investors will be familiar with ETFs. And I believe that in a couple of years, the vast majority of investors will be at least somewhat familiar with ETFs. But will ETFs surpass mutual funds as the nation's favorite investment vehicle? They should. But they won't.

People just aren't that logical.

Can you pick next year's winners?

Okay, study after study shows that most actively managed mutual funds don't do as well in the long-run as the indexes, but certainly some do much, much better, at least for a few years. And any number of magazine articles will tell you how to pick next year's winners.

If only it were that easy. Alas, studies show rather conclusively that it is anything but easy. Morningstar, on a great number of occasions, has earmarked the top-performing mutual funds and mutual fund managers over a given period of time and tracked their performance moving forward. In one representative study, the top 30 mutual funds for sequential five-year periods from 1971 to 2002 were evaluated for their performance moving forward. In each and every five-year period, the "30 top funds," as a group, did worse than the S&P 500 in subsequent years.

Index mutual funds, which most resemble ETFs, have been in existence since Vanguard rolled out the First Index Investment Trust fund in 1976. Since that time, Vanguard and other mutual fund companies have created literally hundreds of index funds, tracking every conceivable index. Yet index funds remain relatively obscure. According to figures from Vanguard, index mutual funds hold only a scant 3 percent of all money invested in stock mutual funds; bond index funds represent less than 1 percent of all money invested in bond mutual funds.

Why would anyone want to invest in index funds or ETFs? After all, the financial professionals who run actively-managed mutual funds spend many years and tens of thousands of dollars educating themselves at places with real ivy on the walls, like Harvard and Wharton. They know all about the economy, the stock market, business trends, and so on. Shouldn't we cash in on their knowledge by letting them pick the best basket of investments for us?

Good question! Here's the problem with hiring these financial whizzes, and the reason that index funds or ETFs generally kick their ivy-league butts: When these whizzes from Harvard and Wharton go to market to buy and sell stocks, they are usually buying and selling stock (not directly, but through the markets) from *other* whizzes who graduated from Harvard and Wharton. One whiz bets that ABC stock is going down, so he sells. His former classmate bets that ABC stock is going up, so he buys. Which whiz is right? Half the time, it's the buyer. Half the time, it's the seller. Meanwhile, you pay for all the trading, not to mention the whiz's handsome salary while all this buying and selling is going on.

Economists have a name for such a market; they call it "efficient." It means, in general, that there are soooo many smart people analyzing and dissecting and studying the market that the chances are slim that any one whiz — no matter how whizzical, no matter how thick his Cambridge accent — is going to be able to beat the pack.

That, in a nutshell, is why actively managed mutual funds tend to lag the indexes, usually by a considerable margin. If you want to read more about why stock-pickers and market-timers almost never beat the indexes, I suggest picking up a copy of the seminal *A Random Walk Through Wall Street* by Princeton economist Burton G. Malkiel. The book, now in something like its 200th edition, is available in paperback from W. W. Norton & Company. There's also a Web site — `www.indexfunds.com` — run by something of an indexing fanatic (hey, there are worse things to be) that is literally choked with articles and studies on the subject. You could spend days reading!

The proof of the pudding

According to Morningstar analysis, the average annual return of all index funds over the past 15 years has been 10.08 percent. Compare that number with the average annual return for all actively managed mutual funds: 8.70 percent. That difference — 1.38 percent — is largely due to differences in fees. It may not seem like a big number, but compounded over time, it is *huge.*

REMEMBER

Let's plug in a few numbers. An initial investment of $100,000 earning 10.08 percent for 15 years will be worth $422,305 at the end of the day. An investment of $100,000 earning 8.70 percent for 15 years will be worth $349,497. That's $72,808 extra in your pocket if you invest in index funds. And in fact, that figure would likely be much higher after you account for taxes. (Taxes on actively managed funds can be considerably higher than those on index funds.)

You may be thinking, "Well bully for index funds, but what does this have to do with ETFs?" Index funds are the investment vehicles that most closely resemble ETFs, and because index funds have been around a lot longer, we have better data on them. I can't yet tell you how ETFs perform over a 15-year period. However, I do have some long-term data on the earliest ETFs to be created:

- **SPY:** The very first ETF to enter the U.S. market, the SPDR 500 (SPY), has seen an annualized return of 8.86 percent in the past 10 years. Over the same period, the average return for actively managed large cap mutual funds has been 7.94 percent. (I discuss large cap funds in Chapters 5 and 6.)
- **MDY:** The Midcap SPDR Trust Series 1 (MDY) has enjoyed a 10-year annualized average return of 14.41 percent versus 12.11 percent for all actively managed mid cap stock funds. In the case of the mid caps, $100,000 invested 10 years ago would now be worth $384,273. That same money invested in an average actively managed fund would now be worth $313,649. That's a difference of $70,624. And, depending on your tax bracket over the years, the tax difference beyond that would be even more substantial. You may easily have scored an extra $75,000 going with the ETF over the actively managed mutual fund.

By the way, the very first ETF — SPY — is still by far the largest ETF on the market, with total assets of $54 billion. (In contrast, the largest mutual fund, American Funds Growth A, has total assets of $78 billion.)

The major players

In Parts II and III of this book, I provide details about many of the ETFs that are on the market. Here, I want to introduce you to just a handful of the biggies. You will likely recognize a few of the names.

In Table 1-1, I list the six largest ETFs on the market today, as calculated by the number of shares traded.

Table 1-1 The Six Largest ETFs by Number of Shares Traded

Name	*Ticker*	*Average daily trading volume*
NASDAQ-100 Trust Series 1	QQQQ	95 million shares
SPDR 500	SPY	68 million shares
iShares Russell 2000	IWM	30 million shares
iShares MSCI Japan Index	EWJ	25 million shares
Energy Select Sector SPDR	XLE	21 million shares
Semiconductor HOLDRS	SMH	18 million shares

In Table 1-2, I list the six largest ETFs based on their assets. You'll notice some overlap with the funds listed in Table 1-1.

Table 1-2 The Six Largest ETFs by Assets

Name	*Ticker*	*Assets (in billions)*
SPDR 500	SPY	$53.7
iShares MSCI EAFE Index Fund	EFA	$25.0
NASDAQ-100 Trust Series 1	QQQQ	$18.0
iShares S&P 500	IVV	$15.9
iShares MSCI Japan Index	EWJ	$13.8
iShares MSCI Emerging Markets Index	EEM	$12.5

Twist and shout: Commercialization could ruin a good thing

Innovation is a great thing. Usually. In the world of ETFs, a few big players (Barclays, Vanguard) jumped in when the going was hot. Now, in order to get their share of the pie, a number of new players have entered the fray with some pretty wild ETFs. (“Let’s invest in all companies whose CEO is named Fred!”) Okay, I’m just kidding about the Fred portfolio, but if things keep going the way they are going . . . I dunno.

I tend to like my ETFs vanilla plain, maybe with a few sprinkles. I like them to follow indexes that make sense. And, above all, I like their expense ratios looooow. At present, the average ETF carries an expense ratio of 0.40 percent. Some of the newer ETFs have expense ratios edging up into the ballpark of what you usually see for mutual funds.

I’m not saying that ETFs must follow traditional indexes. There may be room for improvement. (Actually, when I think about it, some of the traditional indexes, like the Dow, are darn dumb. I explain why in Chapter 3) But I do hope the ETF industry can maintain its integrity and not go too far astray into the field of high expenses and silly investment schemes. Future editions of this book will tell the tale.