Chapter 1

The (Sort of Still) New Kid on the Block

In This Chapter

- Discovering the origins 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
- Tallying 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 well paid investment-product salespeople, ETFs are the ultimate killjoys.

Since their arrival on the investment scene in the early 1990s, more than 1,300 ETFs have been created, and ETF assets have grown faster than those of any other investment product. That's a good thing. ETFs enable the average investor to avoid shelling out fat commissions or paying layers of ongoing, unnecessary fees. And they've saved investors oodles and oodles in taxes.

Hallelujah.

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 atomic bomb. As one Toronto Stock Exchange insider once explained to me, "We saw it as a way of making money by generating more trading." 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 different name, the iUnits S&P/TSX 60 Index Fund, and it trades under the ticker XIU. It is now managed by BlackRock, Inc., which, upon taking over the iShares lineup of ETFs from Barclays in 2009 (part of a juicy $13.5 billion deal), has come to be the biggest player in ETFs in the world. I introduce you to BlackRock and other ETF suppliers in Chapter 3. (A completely different BlackRock-managed U.S. ETF now uses the ticker TIP, but that fund 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 for three or so years after its Canadian birth. (Oh, how my public school teachers would cringe!) On January 22, 1993, the Mother of All U.S. ETFs was born on the American Stock Exchange (which, in January 2009 — a big year for mergers and acquisitions — became part of NYSE Euronext). The first U.S.-based ETF was called the S&P Depositary Receipts Trust Series 1, commonly known as the SPDR (or Spider) S&P 500, and it traded (and still does) under the ticker symbol SPY.

The SPDR S&P 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 has since branched out to become a major holding in the portfolios of many individual and institutional investors — and a favorite of favorites among day-traders.

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

Many ETFs have names that end in an *s.* I don't refer to ETFs this way in this book because doing so can be confusing, but you will often hear people talk about the DIAMONDS and the Qubes. Why is that? 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 refers 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.

Fulfilling a Dream

ETFs were first embraced by institutions, and they continue to be used big-time by banks and insurance companies and such. Institutions sometimes buy and hold ETFs, but they are also constantly buying and selling ETFs and options on ETFs for various purposes, some of which I touch on in Chapter 18. For us noninstitutional types, the creation and expansion of ETFs has allowed for similar juggling (usually a mistake for individuals); but more importantly, ETFs allow for the construction of portfolios possessing institutional-like sleekness and economy.

Goodbye, ridiculously high mutual fund fees

The average mutual fund investor with a $150,000 portfolio filled with actively managed funds will likely spend $2,000 (1.33 percent) or so in annual expenses. By switching to an ETF portfolio, that investor may incur trading costs (because trading ETFs generally costs the same as trading stocks) of perhaps $100 or so to set up the portfolio, and maybe $50 or so a year thereafter. But now his ongoing annual expenses will be about $375 (0.25 percent). That's a difference, ladies and gentlemen of the jury, of big bucks. We're looking at an overall yearly savings of $1,575, which is compounded every year the money is invested.

REMEMBER

Loads, those odious fees that some mutual funds charge when you buy or sell their shares, 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: $0.00.

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 and my clients' portfolios include large stocks; small stocks; micro cap stocks; English, French, Swiss, Japanese, and Korean stocks; intermediate-term bonds; short-term bonds; and real estate investment trusts (REITs) — all held in low-cost ETFs. I discuss 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" investments 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 kidding, and I give other examples 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 funds and hedge funds, this is the number of ETF scandals that have touched my life or the lives and fortunes of my clients: 0. That's because the vast majority of ETFs' managers, forced to follow existing indexes, have very little leeway in their investment choices. Unlike many investment vehicles, ETFs are closely regulated by the U.S. Securities and Exchange Commission. 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.

In Chapter 2, I discuss in greater detail the transparency and cleanliness of ETFs.

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 spread like wildfire on a hot day in July. From the beginning of 2000, when there were only 80 ETFs on the U.S. market, to the end of August 2011, when there were slightly more than 1,300 ETFs, the total assets invested in ETFs rose from $52 billion to just about $1.1 trillion.

Certainly, $1.1 trillion pales in comparison to the $12 trillion or so invested in mutual funds. But if current trends continue, ETFs may indeed become as popular as were John, Paul, George, and Ringo.

The little kid is growing fast: ETFs' phenomenal growth

Following are a few facts and figures from the Investment Company Institute 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 U.S.-based ETFs and mutual funds as of August 2011:

- ETFs: $1.1 trillion
- Mutual funds: $12 trillion (Index mutual funds: $1 trillion)

The total number of U.S.-based ETFs and mutual funds as of August 2011:

- ETFs: 1,300
- Mutual funds: 7,600 (Index mutual funds: 366)

The number of U.S.-based ETFs in recent years:

- 2006: 359
- 2007: 629
- 2008: 728
- 2009: 797
- 2010: 923
- August 2011: 1,301

The total net assets invested in ETFs in recent years:

- 2006: $442.6 billion
- 2007: $608.4 billion
- 2008: $531.3 billion
- 2009: $777.1 billion
- 2010: $992.0 billion
- August 2011: $1.1 trillion

Part of ETFs' popularity stems from the growly bearish market of the first decade of this millennium. Investors who had been riding the double-digit annual returns 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 — over trying to cherry-pick stocks. Much more on that topic in Chapter 2.

Moving from Wall Street to Main Street

In the world of fashion, trendsetters — movie stars or British royals — wander out into public wearing something that most people consider ridiculous, and the next thing you know, everyone is wearing that same item. Investment trends work sort of like fashion trends, but a bit slower. It took from 1993 until, 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.

BlackRock, Inc., which controls about 45 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 institutions and 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 and what kind of financial professional you need 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 enjoyed the benefits of the very best deals on investment vehicles. That hasn't changed. For example, institutions 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 sliced bread but as a replacement for sliced bread. Well, not quite. As much as I like ETFs, good old mutual funds still enjoy their place in the sun. That's especially true of inexpensive index mutual funds, such as the ones offered by Vanguard and Fidelity. 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 . . . although a number of brokerage houses, including Charles Schwab, TD Ameritrade, and Fidelity, allow customers to trade certain ETFs for free.

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 share classes of the same fund — the same representation of companies but a different structure and generally slightly lower management fees for the ETFs.

In addition, Vanguard allows its customers to trade all Vanguard ETFs for free.

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 — this ain't rocket science. For most buy-and-hold investors, ETFs will almost always be the better choice, at least in the long run. I look more closely at the ETFs-versus-mutual-funds question when I design specific portfolios and give actual portfolio examples in Chapters 15 and 16.

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 global manufacturing wages. That is, they are driving prices down. Thanks to the competition that ETFs are giving to index mutual funds (ETFs now claim about one-half of the $2 trillion or so invested in all index funds), mutual fund providers have been lowering their charges. Fidelity Investments, for example, has over the past several years lowered the expense ratio on some of its index funds from as much as 0.47 percent down to as low as 0.07 percent. With many mutual funds, however, you must keep a minimum balance. Fidelity's minimum for its lowest-cost index funds ranges from $10,000 to a whopping $100,000. ETFs impose no such restrictions.

Ready for Prime Time

Although most investors are now familiar with ETFs, mutual funds remain the investment vehicle of choice by a margin of 12:1. The reasons for the dominance of mutual funds are several. First, mutual funds have been around a lot longer and so got a good head start. Second, largely as a corollary to the first reason, most company retirement plans and pension funds still use mutual funds rather than ETFs; as a participant, you have no choice but to go with mutual funds. And finally, the vast majority of ETFs are index funds, and index funds are not going to become the nation's favorite investment vehicle anytime soon. They should, but they won't. People just aren't that logical.

Index mutual funds, which most closely resemble ETFs, have been in existence since 1976 when Vanguard first rolled out the Index Investment Trust fund. Since that time, Vanguard and other mutual fund companies have created hundreds of index funds tracking every conceivable index. Yet index funds remain relatively obscure. According to figures from the Investment Company Institute, index mutual funds hold less than 8 percent of all money invested in mutual funds.

Why would anyone want to invest in index funds or index 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.

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 better, at least for a few years. And any number of magazine articles will tell you exactly how to pick next year's winners.

Alas, if only it were that easy. Sorry, but 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 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.

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 Down 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 website — `www.indexfunds.com` — run by something of an indexing fanatic (hey, there are worse things to be) that is packed with articles and studies on the subject. You could spend days reading!

The proof of the pudding

One study, done in 2010 by Wharton finance professor Robert F. Stambaugh and University of Chicago finance professor Lubos Pastor, looked back over 23 years of data. The conclusion: Actively managed funds have trailed, and will likely continue to trail, their indexed counterparts (whether mutual funds or ETFs) by nearly 1 percent a year. That may not seem like a big deal, but compounded over time, 1 percent a year can be *HUGE.*

REMEMBER

Let's plug in a few numbers. An initial investment of $100,000 earning, say, 7 percent a year, would be worth $386,968 after 20 years. An initial investment of $100,000 earning 8 percent for 20 years would be worth $466,096. That's $79,128 extra in your pocket, all things being equal, if you invest in index funds. And if that investment were held in a taxable account, the 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.)

Moving from the world of academia and theory to the real world, let's look at that very first ETF introduced in the United States, the SPDR S&P 500 (SPY). Since inception in January 1993, that fund has enjoyed an average annual return of 8.26 percent — not bad, considering that it survived two very serious bear markets (2000–2002 and 2008–2009). Very few actively managed funds can match that record. (You'll find some performance specifics in the next chapter.)

By the way, SPY, as well as it has performed, has several flaws that make it far from my first choice of ETF for most portfolios; I will divulge these in Chapter 5. But despite its flaws — and I'm certainly not the only investment professional privy to them — SPY remains by far the largest ETF on the market, with total assets of $90 billion. (The largest fund of any kind is the PIMCO Total Return mutual fund [PTTRX], with total net assets of $136 billion.) In terms of number of shares traded daily, nothing even comes close to SPY.

The major players

In Parts II and III of this book, I provide details about many of the ETFs 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 as of mid-August 2011, 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*
SPDR S&P 500	SPY	244 million shares
Financial Select Sector SPDR	XLF	100 million shares
iShares Russell 2000 Index	IWM	76 million shares
PowerShares QQQ	QQQ	70 million shares
iShares MSCI Emerging Markets Index	EEM	60 million shares
iShares Silver Trust	SLV	40 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 of dollars)*
SPDR S&P 500	SPY	$78.6
SPDR Gold Shares	GLD	$70.4
Vanguard MSCI Emerging Markets ETF	VWO	$44.8
iShares MSCI EAFE Index	EFA	$35.4
iShares MSCI Emerging Markets Index	EEM	$33.4
iShares S&P 500 Index	IVV	$25.6

Twist and shout: Commercialization is tainting a good thing

Innovation is a great thing. Usually. In the world of ETFs, a few big players (BlackRock, State Street Global Advisors, Vanguard) jumped in early 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, there's no Fred portfolio, but the way things are going, it could happen.

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, plenty of ETFs carry expense ratios of 0.20 percent or less. Some of the newer, more complicated ETFs, however, have expense ratios edging up into the ballpark of what you usually see for mutual funds. There are now several dozen ETFs charging 0.75 percent a year or higher, and at least six carry net expense ratios of 1 percent or more.

I'm not saying that all ETFs must follow traditional indexes. The ETF format allows for more variety than that. (Actually, when I think about it, some of the traditional indexes, like the Dow, are darn dumb. I explain why in Chapter 3.) But the ETF industry has lost some of its integrity over the past few years with higher expenses and some awfully silly investment schemes.

The rest of this book will help you to sidestep the greed and the silliness — to take only the best parts of ETF investing and put them to their best use.

RIP these ETFs

New ETFs are being born every week, but at the same time, others are dying. About 150 ETFs in the past several years have been zipped up, closed down, folded, and sent to that Great Brokerage in the Sky. No need to shed tears for the investors; they are okay.

If you are holding shares in a particular ETF that closes down, you will generally be given at least several weeks notice. You can sell, or you can wait till the final day and receive whatever is the value of the securities held by the ETF at that point. It isn't like holding a bond (or an exchange-traded note) that goes belly up. You may have a bit of a hassle redoing your portfolio, and you may face sudden tax consequences. If the ETF tracks a very small segment of the market, there may be a bit of investor panic that could depress prices. But you aren't going broke.

As for the purveyors of the ETFs that have closed, I may shed only a crocodile tear or two. Most of the ETFs that have gone under are exactly the kinds of ETFs that I try to steer you away from in this book: They tracked narrow segments of the market (companies based in Oklahoma, for example); or they tracked somewhat silly and complex indexes (dividend rotation); or they were highly leveraged, exposing investors to excessive risk; or they were overpriced; or all of the above! The public simply would not buy. Bravo, public.

Here is just a small sampling from the ETF graveyard:

- Bear Stearns Current Yield Fund (YYY)
- Claymore/Beacon Global Exchanges, Brokers & Asset Managers ETF (EXB)
- Claymore/Robb Report Global Luxury Index ETF (ROB)
- Claymore/Zacks Country Rotation ETF (CRO)
- Claymore/Zacks Dividend Rotation ETF (IRO)
- Direxion Daily 2-Year Treasury Bull 3x ETF (TWOL)
- Geary Oklahoma ETF (OOK)
- Geary Texas Large Companies ETF (TXF)
- JETS DJ Islamic Market International ETF (JVS)
- Guggenheim Inverse 2x Select Sector Energy ETF (REC)
- WisdomTree Earnings Top 100 Fund (EEZ)

On the Internet, where there's a blog for anything and everything, I found a blog called ETF Deathwatch. According to ETF Deathwatch, any ETF that is at least six months old that has an "Average Daily Value Traded" of less than $100,000 for three consecutive months — or that has assets under management of less than $5 million for three consecutive months — is probably not an ETF you should get overly attached to. To find the Deathwatch blog, go to `www.investwithanedge.com`, and type "deathwatch" in the search box.