

IN THIS CHAPTER

- » Discovering the origins of ETFs
- » Understanding their role in the world of investing today
- » Getting a handle on how ETFs are administered
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Chapter **1**

No Longer the New Kid on the Block

There are, no doubt, a good number of pinstriped ladies and gentlemen on 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 have been the ultimate killjoys.

Since their arrival on the investment scene in the early 1990s, some 3,300 ETFs have been created, and ETF assets have grown faster than those of any other investment product, by far. 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 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, this 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 modern rocketry. 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.



TECHNICAL
STUFF

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 iShares S&P/TSX 60 Index ETF, and it trades (in Canada) 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 Depository

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.

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 23. 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 \$945 (0.63 percent) in annual expenses, per the Investment Company Institute and Morningstar. By switching to an ETF portfolio, that investor might incur — if they incur any trading costs at all — perhaps \$50 or so to set up the portfolio, and maybe \$20 or so a year thereafter. But now the investor's ongoing annual expenses will be about \$270 (0.18 percent). That's a difference, ladies and gentlemen of the jury, of big bucks. We're looking at an overall yearly savings of \$625, or more if your brokerage has eliminated trading commissions altogether, which many have. Keep in mind that your \$625 or more a year will be 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 predominately buy-and-hold clients with their taxable money in ETFs 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 Parts 2 and 3.

Yes, you could use other investment vehicles, such as mutual funds, to create a well-diversified portfolio. But ETFs — at least most 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 Microsoft (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 in good part because the vast majority of ETF 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 mad. Per the Investment Company Institute, there were, at the beginning of 2000, only 80 ETFs on the U.S. market; by mid-year 2021, there were nearly 2,300 ETFs, and the total assets invested in ETFs rose from \$66 billion to just about \$6 trillion. Yes, trillion. That's just in the U.S. alone. In the world, we're looking at \$9 trillion invested in ETFs.

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 mid-year 2021 is as follows.

- ETFs: ~ \$6 trillion
- Mutual funds: ~ \$25 trillion

The total number of U.S.-based ETFs and mutual funds as of mid-year 2021 is as follows.

- ETFs: ~ 2,300
- Mutual funds: ~ 7,600

The number of U.S.-based ETFs in recent years is as follows.

- 2005: 204
- 2010: 923
- 2015: 1,597
- 2020: 2,204
- Mid-2021: 2,300

The total net assets invested in ETFs in recent years are as follows.

- 2005: \$300.8 billion
- 2010: \$992.0 billion
- 2015: \$2.1 trillion
- 2020: \$5.5 trillion
- Mid-2021: \$6.0 trillion

Six trillion isn't quite the \$25 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. And I would bet that the current trends will continue to gain popularity, especially among institutions and younger investors. Among my own clients, I can tell you that those under 40 tend to think of mutual funds as akin to landline telephones and disco music.

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. Then, as the first decade of the millennium turned into the second decade, there was also a huge awakening to the power of *indexing*, aka *passive* investing (investing in entire markets or market segments) and its superiority to so-called *active* investing (trying to cherry-pick stocks and time markets). 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 in 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 more than a third 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 consists of institutions and fee-only financial advisors, like me.



TIP

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 26, 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.") And institutions almost always bypass nefarious "loads" (high commissions to buy and sell) on mutual funds.

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, Fidelity, and Schwab. 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, starting a couple of years ago, a number of brokerage houses, including Charles Schwab, TD Ameritrade, Vanguard, and Fidelity, started to allow customers to trade 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, 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.



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 — 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 Chapter 21.

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 more than 60 percent of all money invested in all index funds), mutual fund providers have been lowering their charges. If you look at all funds in America, the average fee has declined from 0.81 percent in 1990 to 0.49 percent today. Zeroing in on just index funds — both traditional index mutual funds and ETFs — the average cost has fallen from 0.30 percent in 1990 to 0.18 percent today.

Ready for Prime Time

Although most investors are now familiar with ETFs, mutual funds remain the investment vehicle of choice by a margin of almost 4:1. Several reasons exist for the dominance of mutual funds — at least for the moment. First, mutual funds have been around a lot longer and so got a good head start. (The first mutual fund, called the Massachusetts Investors Trust, was founded in 1929.) 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, unlike mutual funds, are index funds, and index funds have only fairly recently — after a long, uphill battle — caught the eye of millions of investors.

Index mutual funds, which most closely resemble ETFs, have been in existence since 1976 when Vanguard, under visionary John Bogle, 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. But it has taken a long time for them to catch fire. As recently as 1998, actively managed stock funds had 6.5 times the assets as index funds. By 2020, index funds finally caught up to actively managed funds, and in 2021 surpassed them. Yes, Americans now have more money invested in index funds — initially referred to by many as “Bogle’s folly” — than actively managed 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 sooooo 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.ifa.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.)

But wait, what if you carefully pick which actively managed funds to invest in? Good luck! Every year, Standard & Poors issues what they call the SPIVA Scorecard, which shows your odds of beating the indexes by investing in actively managed funds. It's scary (like, Stephen King–scary) reading. In 2020, 57 percent of active U.S. stock funds lagged the S&P 500 index, and that was an exceptionally good year for active funds. In 2019, 70 percent lagged the indexes; in 2018, 69 percent.

But it is over longer time periods that active funds really show their lack of spine. Again, according to the 2020 SPIVA Scorecard, only 17 percent of actively managed stock funds beat their benchmark indexes over the 10-year period prior to December 31, 2020. Actively managed bond funds tended to do even worse.

Moving to a real-ETF-world example, let's look at that very first ETF introduced in the United States, the SPDR S&P 500 (SPY). Since its inception in January 1993, that fund has enjoyed an average annual return (as of mid-2021) of 10.4 percent — not bad, considering that it survived several very serious bear markets (2000–2002, 2008–2009, and 2020). 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 flaws 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 \$363 billion. In terms of average number of shares traded daily, nothing even comes close to SPY: 83 million shares.

The major players

In Parts 2, 3, and 4 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 based on their assets, as of mid-August 2021.

In Table 1-2, I list the six largest ETFs on the market as of mid-August 2021, as calculated by the number of shares traded.

TABLE 1-1 **The Six Largest ETFs by Assets**

Name	Ticker	Assets (in billions of dollars)
SPDR S&P 500	SPY	\$363
iShares Core S&P 500 ETF	IVV	\$278
Vanguard Total Stock Market	VTI	\$239
Vanguard S&P 500 ETF	VOO	\$220
Invesco QQQ	QQQ	\$160
VEA	IVV	\$97

TABLE 1-2 **The Six Largest ETFs by Number of Shares Traded**

Name	Ticker	Average daily trading volume
ProShares UltraPro Short QQQ	SQQQ	96 million shares
ProShares Ultra VIX Short-Term Futures	UVXY	86 million shares
SPDR S&P 500 ETF	SPY	83 million shares
Financial Select Sector SPDR Fund	XLF	58 million shares
Invesco QQQ	QQQ	52 million shares
iShares MSCI Emerging Markets ETF	EEM	42 million shares

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, Vanguard, State Street Global Advisors) 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 loooooow. When ETFs first hit the market, most had expense ratios, I’d say, in the 0.20–0.40 percent range. Strangely, the growth in the market has created a big divide. The more basic ETFs, such as those that track the S&P 500, have, due to a lot of

competition, come down in price. At present, there are dozens upon dozens of ETFs that carry expense ratios of 0.10 percent or less. Heck, all the competition out there has forced down mutual fund fees, as well.

Conversely, many of the newer, more complicated ETFs (and I don't use "complicated" as a compliment), have expense ratios edging up into the ballpark of what you would pay — even what you would've paid several years back — for mutual funds. Approximately 140 ETFs now carry net expense ratios of 1 percent or more; 19 of these have an expense ratio of over 2 percent.

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. Over 1,000 ETFs in the past several years have been zipped up, closed down, folded, and sent to that Great Brokerage in the Sky. In 2020 alone, according to the Investment Company Institute, as 313 ETFs came into existence, 182 disappeared.

No need to shed tears for the investors, however; 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:

- WisdomTree Middle East Dividend Fund (GULF)
- Forensic Accounting Long-Short ETF (FLAG)
- HealthShares Dermatology and Wound Care ETF (HRW)
- Goldman Sachs Human Evolution ETF (GDNA)
- Global X Fertilizers/Potash ETF (SOIL)
- Claymore/Zacks Country Rotation ETF (CRO)
- Claymore/Zacks Dividend Rotation ETF (IRO)
- Geary Oklahoma ETF (OOK)
- JETS DJ Islamic Market International ETF (JVS)
- Guggenheim Inverse 2x Select Sector Energy ETF (REC)

According to ETF Deathwatch, any ETF that is at least six months old and 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.thestreet.com and type “ETF deathwatch” in the search box.

