Exchange Traded Funds (ETFs)

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The Exchange Traded Fund (ETF) is a relatively new investment vehicle that has exploded in popularity in the last few years. It seems a new, more esoteric version is announced almost weekly. Originally introduced as low-cost, passive funds with tax and intra-day trading advantages, ETFs have changed dramatically to include a wide (and wild) variety of investment approaches. But as innovative and exciting as ETFs may sound to the retail investor, even the average investor has access to funds that offer more consistent performance with lower (and fully disclosed) costs.

So why are we writing about ETFs? Because their usage has exploded, and the marketing of them has become relentless. Unfortunately, they are not the investment panacea they are portrayed to be, and users seem unaware of some of their pitfalls and important disadvantages. They are mainly useful for:

1. Hedge funds and day traders who trade them (long and short) frequently and in large volume.

2. Brokers who like to execute transactions and otherwise cannot offer their brokerage customers good funds.

Key Information

- ETFs are no longer exclusively index funds, and ETF investment can vary widely by type of investment (stocks, bonds, commodities), strategy (indexed, active, leveraged), and fees.

- ETFs, while advertised as low-cost, come with hidden trading costs (as described below) that are not included in quoted fees, which may cause substantial underperformance versus benchmarks.

- ETFs have, in fact, significantly underperformed their benchmarks, particularly in more recent measurement periods.[1]

- ETFs have not provided substantially better after-tax performance.

Contango!

In the decade ending in 2009, investments in commodity ETFs (and other commodity securities) grew at an astonishing rate, from $5.5 billion to $277 billion. Commodities were once considered a far too speculative investment for inclusion in most portfolios. By 2008, buy and hold investors held the equivalent of 3 years of production of soft red winter wheat. Many commodity ETFs create exposure by trading futures contracts.

Contango describes a trading situation where long-term futures contracts are more expensive than near-term futures contracts for the same commodity. When futures contracts that an ETF owns are about to expire, they are sold and new longer-term contracts are purchased. (This must be done to avoid taking delivery of raw materials!) When they buy the more expensive futures contracts, the fund loses money.

In fact the fund can lose money even if the commodity is increasing in value. And, professional futures traders take advantage of this trading opportunity to profit at the expense of fundholders. Reviewing commodity funds that use futures shows that the 10 most well-known funds underperform the underlying raw materials.[1]

[1] Bloomberg News. "Investors in commodity ETFs getting 'eaten alive'." *Investment News.* Crain Communications Inc., 22 July 2010. Web. 19 August 2010. <www.investmentnews.com>

Should I Use ETFs?

ETFs provide quick access to the markets via intra-day trading and have been a marketing boon to their provider companies. If you listen to the advertisements from companies selling these products, you should be using them. But should you? Where are they appropriate? And what are the costs and risks to be aware of?

As an investor, you will need to evaluate which of the myriad investment choices each ETF represents in order to determine how it fits (or doesn't fit) into your portfolio. Is the ETF an index investment, an active investment, a leveraged investment, or an ETN (Exchange Traded Note)? Is the ETF providing equity, bond or commodity exposure? Since the ETF structure and strategy may vary, performance and investment characteristics will also vary.

How ETFs Work

Trades of ETFs are executed on an exchange like equity trades and involve commissions, bid/ask spreads, traders with varying amounts of information (including institutional investors) and market fluctuations.

The market maker on the exchange determines the bid/ask spread for the ETF trade at the time your trade is executed, which reflects risk of trading and liquidity at that moment.

While initial ETFs approved by the SEC were indexed strategies, ETFs are not synonymous with indexing. The SEC has now approved active ETFs and leveraged ETFs, and the variety is growing every day.

Challenges of Using ETFs

Costs. Most marketing materials describing ETFs characterize them as low-cost, but that is often inaccurate.

ETFs generally do have lower explicit fees than *active*, *retail* mutual funds. The fees for an ETF are similar to a retail index mutual fund, but there are some other large components of cost that are not obvious. And they are not necessarily more cost-effective than the institutional share classes of similar mutual funds.

Since ETFs trade on an exchange floor, each trade incurs:

- A commission (may be temporarily waived as a marketing inducement to purchase an ETF product)
- A Bid/Ask Spread
- Intra-day fluctuations in market prices

These costs are not easily quantified but add to the advertised cost of investing in ETFs both when buying and selling.

Flash Crash

It is likely that we may never be able to recreate the series of transactions that triggered the May 6 Flash Crash, when the Dow Jones Industrial Average dropped 1,000 points before rebounding, all in a matter of minutes.

However, a current review is focusing on market orders for ETFs. More than two-thirds of the trades that were canceled on that day involved ETFs, which has led regulators to review those orders. Many ETF trades are entered as automated market orders- an order to buy or sell the ETF at the current market price.

The mention of regulating such trades has been met with high resistance. When asked how they would view a prohibition on market orders for ETFs, most were opposed. The ETF providers see this as a problem in the way that advisers are generating automated market orders. But a full 77% of advisers surveyed (380 advisers were included) indicated that they will use market ETF orders in the same way in the future.[1]

[1] Toonkel, Jessica. "ETF providers consider curbing market orders: Such Trade are thought to have intensified May 6 'flash crash'." *Investment News.* Crain Communications Inc., 10 Aug 2010. Web. 19 August 2010. <www.investmentnews.com>

Taxes. ETFs are also characterized as a tax-advantaged choice.

Their structure allows for in-kind redemptions of securities in order to avoid capital gains within the fund, thereby potentially conferring a tax advantage. However, there are some countries and some classes of investments where this structure is not possible, and these ETFs do not carry a structural tax advantage. These include commodity ETFs, some leveraged ETFs and certain foreign country ETFs. You must carefully research each ETF to ensure that it is appropriate for you.

Each ETF has a slightly different implementation approach. However, any time that there is a need to trade within a fund you are exposed to a trade that may generate a capital gain tax obligation. You cannot control for the trading pattern of others (including institutional investors in the ETF) or of the fund's rebalancing trades. The capital gain is reported to you at the end of the year just as with any fund.

It is also true that an index fund tends to incur much lower trading volume, and therefore much lower possible exposure to taxes, than an actively managed fund. However, ETFs will trade *more* than most index mutual funds, and these days many ETFs are not index funds anyway. This is not an advantage for ETFs at all, even though people believe it to be.

An ETF must be registered as an RIC (Registered Investment Company) in order to carry tax losses forward. An ETF may be an RIC, publicly-traded partnership, commodity fund or other type of fund. Only an RIC will be able to improve tax efficiency via carrying tax losses forward. Mutual funds are RICs and can carry tax losses forward.

After tax-performance is the real benchmark and in recent down markets ETFs have not experienced greater tax efficiency.[2]

What ETFs do not do is long-term tax management the way many tax-managed mutual funds do, and the way you can in a tax-managed separate account.

Performance. In the past year, there has been a greater variability of performance among various ETFs as well as versus their benchmarks. In 2009, ETFs underperformed their benchmarks by an average of 1.25%.[3] This is double the gap that was experienced in 2008.

Liquidity. Since they trade on an exchange, it appears that you can buy and sell an ETF or an ETN any time during any trading day. However, trading has been halted in several ETNs, meaning that if you own them you may not sell them during the trading halts at any price. The bid/ask trading spread may also be significantly wider during certain market environments.

Some Sensible Uses for ETFs

ETFs can provide short-term market exposure and exposure to the equities of small countries, such as Indonesia, or sectors such as the Dow Jones US Home Construction Index. These types of investments tend to be short-term specific bets.

ETFs are used by hedge funds (and market timers, sector allocators, etc.) who trade frequently. These hedge funds need to pay the higher costs to trade in and out of an investment during the day. As a longer-term investor in ETFs, you have the privilege of subsidizing all this hedge fund trading activity.

Some Thoughts for Long-Term Investors, especially Taxable Investors

As a long-term investor, you want to set an appropriate asset allocation and implement that allocation in the most efficient way possible, to maximize your wealth.

If your assets are taxable, you need to consider tax-optimized implementation choices. While much of the original appeal of the ETF was the tax-advantaged structure, that advantage is more marketing than reality. Many mutual funds and separate account managers take an active approach to tax management, producing superior after-tax returns.

When you invest in an ETF, you pay a lot for the opportunity to trade throughout a trading day on an exchange. In fact, if you are a long-term investor, you are paying for other investors that trade in and out of these funds during the day while you hold yours. And you pay the taxes on realized gains that cannot be offset in the investment structure.

After setting a target asset allocation, a long-term investor should choose to implement each asset class in an investment that shows consistently good performance versus the benchmark. There is quite a bit of variability among the ETFs, and many have underperformed their benchmarks by significant amounts.

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[1] Salisbury, Ian. "ETFs Were Wider Off the Mark in 2009." *The Wall Street Journal.* Dow Jones & Company, Inc., 09 February 2010. Web. 19 August 2010. <http://online.wsj.com/>

[2] Dion, Don. "Back to Basics: Tax Benefits of ETFs." *The Street.* TheStreet.com, Inc., 27 April 2010. Web. 19 August 2010. <http:/ thestreet.com>

[3] Salisbury, Ian. "ETFs Were Wider Off the Mark in 2009."

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