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Who's Afraid of Spiders?

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Wall Street's latest darlings, exchange-traded funds, are useful -- and they're cheap.

Those wizards of Wall Street, the folks who begot IOs and POs, Quids and Quips, Percs and Perqs, have created a new generation of acronyms. Some, such as Spdrs (or Spiders) and Vipers, sound thoroughly unappetizing. Others, like Diamonds, Holdrs and iShares, sound more palatable but are equally baffling -- at least on the surface. But once you get past the off-putting jumbles of letters, you may conclude that the financial engineers' latest investment tool -- the exchange-traded fund -- is their best invention ever.

Money managers are going gaga over ETFs, which are low-cost, easy-to-trade products that let you track a market index or a slice of one. "Once you're hooked, you'll never let go," says one manager. "It's the second evolution of mutual funds," says another. A third admirer says the ETF is the most tax-efficient investment product he's ever seen.

Individual investors are just as enamored. Take Lonnie Williams, a Detroit graphic designer. As his investments fizzled during the bear market, Williams, 38, decided he really wasn't cut out for selecting individual stocks and funds, and he wanted a new way to build a diversified portfolio. He read about **Spiders** (SPY), which track Standard & Poor's 500-stock index, checked them out, and invested. Williams is so enthralled with the ETF concept that he no longer invests in anything else for the stock portion of his portfolio.

Trade just like stocks

New financial creations often seem incomprehensible, but ETFs are simple to understand. An ETF owns a fixed basket of stocks that represents a slice of the investment world -- either an index, a subsector of an index or an industry. The main difference between ETFs and regular index funds is that you buy and sell ETF shares like stocks instead of asking the fund sponsor to create or redeem fund shares. You need a brokerage account to trade ETFs, and you'll have to pay a commission. But management fees are minuscule, and there are no loads or other charges.

ETFs sound a lot like closed-end funds, which have been around for some 80 years. Closed-ends also trade like stocks, but their share prices often diverge dramatically from the value of the funds' underlying assets. By contrast, ETF prices rarely stray more than one-half percentage point from the value of the funds' assets. That's because ETF sponsors continually create new units as investors need them. That prevents a supply-demand imbalance that could pull ETF prices well above the value of the assets. And if heavy selling of ETFs threatens to push the funds' prices well below the value of their assets, big investors swoop in to take advantage of tiny price discrepancies.

In the nine years since ETFs were invented, their assets have mushroomed to $81 billion. There are currently 117 ETFs. Some represent broad measures of the market. **Diamonds** (DIA), for example, mimic the Dow Jones industrial average; Spiders and **iShares S&P 500** (IVV) follow the S&P 500. Others track narrower slices of an index, such as the **Russell 1000 Growth** (IWO; large, faster-growing companies) and the **Russell 2000 Value** (IWN; small, bargain-priced stocks). Still others own the biggest companies in a given industry, such as health or real estate. There are also single-country funds and diversified international ETFs. Bond ETFs aren't available in the U.S. yet, but are on the way.

Most ETFs trade on the American Stock Exchange. The Amex Web site is a veritable encyclopedia on the subject. Another excellent resource is iShares.com, from Barclays Global Investors, sponsor of the iShares family of ETFs.

The planners' favorite

So why the buzz? Lower costs and taxes, mainly. ETFs slash costs to the bone and help minimize the tax bite that often comes with regular funds. In fact, the ETF boom owes a lot to those financial planners who tend to obsess over expenses and Uncle Sam's share. Such planners are predisposed toward index funds in the first place, and some are so taken with ETFs that they say investors need hold nothing else in taxable portfolios. That's an extreme position. Still, ETFs have a lot going for them.

Advantage 1: Rock-bottom costs. Using an ETF instead of a mutual fund is "like giving yourself a raise," says Steve Wightman, an adviser in Lexington, Mass. The most heavily traded ETF is the **QQQ** (QQQ), which tracks the Nasdaq 100, an index of the 100 largest nonfinancial companies on the Nasdaq market. The index is essentially a proxy for big technology stocks, with Microsoft, Cisco Systems, Intel and Dell Computer among its top holdings. The expense ratio of QQQ, often called Cubes, is 0.2% a year, or $2 per $1,000 invested. The cheapest regular no-load mutual fund that tracks the Nasdaq, Summit Nasdaq 100 Index, has an annual expense ratio of 0.65%. The cheapest no-load technology funds, E*Trade Technology Index and T. Rowe Price Science and Technology, cost about 0.85% per year. The average no-load tech fund charges 1.43% in expenses. These are large hurdles for traditional funds to overcome.

Some of the ETFs that focus on broader indexes are even cheaper -- as low as 0.09% a year for iShares S&P 500. ETFs' low expenses are due in part to the economics of indexing, which eliminates legions of managers and analysts. Neither ETFs nor regular index funds incur substantial trading costs. Moreover, ETF sponsors keep expenses down because they court institutions with millions to invest. And although individual investors are ineligible to buy institutional shares of mutual funds, you can buy the same ETFs that institutions do.

Advantage 2: Taxes. Frankly, we think the issue of mutual fund tax efficiency is vastly overrated (see "Penny Wise," Dec. 2001). Most investors don't hold on to their funds long enough to benefit from claims of tax efficiency. If, however, you plan to hold on to a fund for many years (or better yet, never sell it and pass it on to your heirs tax-free after you die), you will appreciate the tax efficiency of ETFs.

The structure of an ETF means there is no reason to distribute anything except dividend income, when there is any. For example, the Diamonds fund has never paid a capital-gains distribution since its inception in 1998, even though the ETF rose strongly along with the Dow Jones industrials in 1998 and 1999.

Some advisers say the smaller and more specialized ETFs, such as the single-country funds, will pay out small capital-gains distributions in the next major bull market. But those payouts should be much less than those of traditional funds. Sameer Shah, a financial adviser in Tampa, Fla., says there are two ways an index mutual fund can generate tax liabilities. The first is when too many investors redeem shares, forcing the manager to sell stocks and realize gains. The second comes when changes in the underlying index require managers to sell. "ETFs take away the first taxable event and have ways to mitigate the second," says Shah.

Advantage 3: Immediacy. If you place an order to buy or sell a mutual fund when the market is open, your trade is executed (with a few exceptions) at a price determined as of 4 p.m. eastern time that day. You could place a sell order at, say, 3 p.m. when stocks are up and assume that your fund would gain for the day, only to see a collapse in the final hour of trading. Vanguard, the biggest marketer of index funds, limits customers to two phone or Internet trades per year out of each of its index funds. It also doesn't permit any phone or Web exchanges between 2:30 p.m. and 4 p.m. eastern time.

ETFs are not subject to the pricing rules of mutual funds. They trade like stocks. If you want to sell your **iShares Sweden** (EWD) at 2 p.m. because you think there are better opportunities in **streetTracks Wilshire Real Estate Investment Trust** (RWR), you can do so midday at each ETF's current price. Instant pricing is one reason Mark Dio Dati, a 43-year-old firefighter from Hopewell Junction, N.Y., has switched entirely from traditional funds to ETFs. "I hate buying a mutual fund because you never know what price you're buying at," he says. "I don't have that problem with ETFs."

Advantage 4: Transparency. Mutual funds are required to report their holdings only once every six months. That means you can never be sure what your fund holds at any given moment. That doesn't matter when a fund tracks the S&P 500, but it does with sector funds. For example, Holdrs, exchange-traded sector portfolios, are seeded with what sponsor Merrill Lynch decides at the outset are the 20 or 50 most representative stocks in the group. When you buy a Holdr, you won't be sure of each stock's specific weighting in the ETF because that depends on individual price fluctuations. But you can be sure that Merrill hasn't added any names or deleted any unless a stock no longer trades (for Holdrs holdings, visit Holdrs.com).

Trading tricks

Because ETFs trade like stocks, they offer features that generally aren't available directly from fund companies. If, for example, you want to bet against the whole market, a slice of the market or just one country, you can sell an ETF short. If you want to leverage your wager, you can borrow from your broker and buy an ETF on margin. You can also impose stop-loss and limit orders that trigger, say, an automatic sale if an ETF you own falls to a certain price that you predetermine.

Perhaps the biggest shortcoming of ETFs is that they're not amenable to systematic investing programs. With a no-load mutual fund, it's no sweat to invest $100 a month or quarter in one or more funds. If you embark on a similar program with ETFs, the repeat commissions will sting.

Lonnie Williams socks $60 a week into a portfolio of four ETFs. He divides his money among iShares S&P 500; **iShares S&P 600 Barra Value** (IJS), which focuses on small, undervalued stocks; **iShares S&P 350 Europe** (IEV); and QQQ. Williams pays a fixed $12 a month through ShareBuilder.com, an online brokerage that caters to small investors. So you could say he's paying about a 5% load, although the freight, as a percentage of his investment, would fall if he were to raise his contribution. Williams could invest in Vanguard's low-cost index funds, but he prefers the flexibility and variety of ETFs. "I can waste $12 a month in late fees at the video store," he says. If you trade ETFs less frequently or invest bigger sums, the commissions virtually dissolve. But even with transaction costs, the opportunity to own the whole S&P 500 for 0.09% -- or play a technology rebound for less than 1% -- remains enticing.

The cost structure is all the more amazing when you consider who created ETFs. When was the last time the fee-hungry securities industry invented something this nice and cheap and made it available to everybody?