

MAY 2008



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## A Newer, Better Index Fund?

For decades, mutual funds have formed the cornerstone of the well-built portfolio. Their sheer diversity—from low-cost index-trackers to those relying on a basket of fixed income securities or commodity stocks—makes them a convenient means of broad market exposure.

However, exchange-traded funds, or ETFs, are poised to claim a larger share of this key portfolio role. They are similar to index funds inasmuch as they are not actively managed. Both invest in a fixed basket of securities, usually a stock market index or subset of an index. ETFs cover a wide variety of niches, from the transportation stocks of the Dow Jones to country-specific stocks.

But unlike mutual funds, ETFs are generally less expensive to maintain, more versatile to trade and more tax-efficient. The Investment Company Institute, an industry trade group, reports that the ETF industry has grown in

assets by 300% over the past five years—from \$150 billion to \$600 billion. While that amount pales in comparison to the \$11.7 trillion in mutual fund assets out there, this growth significantly outpaces that of mutual funds.

**THE PROS AND CONS**

Like any investment product, an ETF comes with advantages and disadvantages. ETFs are both extremely flexible to trade and less expensive to maintain. (See table.)

The typical ETF's 0.7% annual management fee is half the amount of a typical mutual fund—and with that comes a sizable difference in your eventual savings. For example, say you have \$100,000 in an ETF charging 0.7%, and \$100,000 in an actively traded mutual fund charging 1.4%. After 20 years, assuming identical 8% return rates, your ETF will be \$50,000 ahead of the mutual fund.

	EXCHANGE-TRADED FUNDS	OPEN-END MUTUAL FUNDS
Buying/selling	Investors can buy and sell on an exchange as they would with a single stock.	Bought from fund company, prices rise based on net asset value, calculated once daily.
Can you sell short?	Yes	No
Total assets	\$600 billion	\$12 trillion
Average fees	0.7%	1.4%
May charge sales loads or redemption fees	No	Yes
Passes on capital gains tax to shareholder	Rarely	Yes

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ETFs also add up to tax savings. Because of its underlying structure, an ETF's sales are nontaxable share-for-share transactions. However, when mutual fund managers sell stocks at a profit, they pass the resulting capital gains liabilities on to shareholders. Such costs were likely responsible for mutual fund investors shelling out more than \$30 billion—a record—to Uncle Sam in 2007, according to research from Lipper, the fund data company.

However, this great ETF advantage is lost in a 401(k), since investors incur trading costs when buying shares every pay period. For this reason, you won't see an ETF in this kind of account.

## THE DOWNSIDE OF BEING NEW AND POPULAR

With 65% of the 643 ETFs in the U.S. being less than two years old, they're untested for volatile market conditions. While the majority of the trading volume is confined to the largest ETFs, some newer

offerings may trade only a few hundred shares a day. When liquidity dries up in this manner, so does the ETF's trading flexibility.

That could lead to volatile trading and price swings for retail investors, and make it difficult for those smaller ETFs to accurately keep up with their underlying indexes. Larger ETFs won't often have this problem. For instance, the largely followed iShares FTSE/Xinhua China 25 ETF, which tracks 25 of China's largest publicly traded companies, posted a 45.6% average return over the last three years, in line with the underlying stocks' growth.

ETFs are popular—and that's sometimes a problem. New funds are introduced covering ever more exotic market niches. Some firms have started funds “just to cover the space,” says David Fry, editor of *ETF Digest* ([www.etfdigest.com](http://www.etfdigest.com)). “I get the sense there will be a lot of failure.” Fry thinks that such faltering may rid the market of some underperformers.

Like any investment, it's essential to examine fund risk. Look for heavily traded ETFs focusing on broader, less esoteric markets, then ask your financial advisor to help you identify the right ETFs for you.

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