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How Many Stars Does Your ETF Have?

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How many Morningstar stars does your ETF have? Maybe a better question is - Does it really matter? I asked myself these questions last week when Morningstar announced a new service ranking Exchange-Traded Funds (ETFs). As ETFs continue to proliferate, let's look more closely at how they operate and if Morningstar's new ranking service will help investors.

A discussion of the underlying structure of ETFs is probably the best way to begin. ETFs are a type of mutual fund and like all mutual funds are highly regulated under the Investment Company Act of 1940.

ETFs differ from traditional mutual funds principally in the way they transact with retail customers. In a traditional mutual fund investors deal directly with the fund when they buy or sell shares. If purchasing shares from the fund they deliver cash and receive shares. When investors sell, the fund company gives them cash for their shares.

ETFs do not deal directly with individual investors. Investors buy and sell ETFs on a stock exchange where intermediaries called "Participating Parties" handle the trading. Buying and selling ETFs is just like buying and selling stock. What goes on behind the scenes is a bit more complicated, but the individual investor does not need to do anything special.

When a Participating Party builds a large position of \$5 million or more they will transact with the ETF fund itself. However, unlike when they dealt with the public, the Participating Party and the ETF will not use cash; they use what is called an "in-kind" share exchange. For instance, when buying shares in the ETF the Participating Party delivers a basket of stocks worth \$5 million to the fund in return for \$5 million worth of ETF shares. The basket of stocks is specified each day by the ETF and in the case of a S&P 500 index fund the basket would be the 500 stocks in the same proportion as in the index.

The "cool" part happens when an investor sells. Reversing the purchase transaction, the investor sells his ETF shares to a Participating Party on the exchange and receives cash. When the Participating Party has a large position and sells those shares back to the fund, it receives an "in-kind" distribution of a basket of stocks in return for the fund's shares.

The beauty of ETFs is that the fund never sells any shares for cash to accommodate investors leaving the fund. And if the fund does not sell shares for cash, there are no capital gains or losses.

The “in-kind” trading technique of ETFs affects investors in two main areas. The first is that ETFs trade all day long, just like stocks. This flexibility is advantageous to traders, but of little benefit to long-term investors. Exchange trading also has some drawbacks that should be monitored. Investors pay commissions and unlike traditional mutual funds there is no guarantee of buying and selling at the fund’s Net Asset Value.

Taxes are the second area where ETFs “in-kind” trading affects investors. When investors move money in or out of the fund, the fund itself never buys or sells shares for cash and therefore it avoids creating capital gains or losses.

There are currently 226 ETFs listed in the U.S. with \$333 billion of assets. By my calculations, 161 or 71% of them are index funds, which follow pre-identified established indexes. These funds hold over 90% of assets in all ETFs.

The remaining 29% of ETFs are not index funds in the classic sense. Some follow commodities such as gold and a few are semi-active as they adjust their holdings on a regular basis. Still others follow dividend strategies or “socially acceptable” indexes.

This brings us back to Morningstar’s new service. Without commenting on the usefulness of Morningstar’s rankings for actively managed funds, I think using the same system to rank passively managed index funds is almost worthless. Well run index ETFs are likely to earn 3 stars in the short term and possibly 4 stars in the long run when actively managed mutual funds fall further and further behind.

If Morningstar wanted to add more value, I recommend they rank index funds on criteria such as how they perform relative to their benchmark and tax efficiency.

Morningstar’s system may have more value when analyzing the 65 ETFs that are more actively managed but they cover only 13 of these. To be fair, many of these funds are not covered due to their small size.

In summary, ETFs are excellent investment vehicles for most investors but as the number of ETFs continues to explode, deciding which ones best fit your needs is more difficult. Unfortunately, Morningstar fails in this attempt to provide investors a useful tool for evaluating index oriented ETFs.

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