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The Growing Exchange-Traded Funds Industry

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Readers know that I am a big fan of Exchange-Traded Funds (ETFs). Many of these funds have low expense ratios and are often very tax-efficient. Overall, money invested in these ETFs grew \$56.6 billion in the first four months of the year to around \$352.6 billion. I estimate that over half of this year's increase is due to market appreciation and the other half the result of new investments. In short, the ETF market remains very robust.

The number of ETFs in the U.S. also continues to grow. Again, in the first four months about 20 new ETFs were launched to bring the total to 239.

The largest ETF continues to be the SPDRs (SPY), which tracks the S&P 500 index. The granddaddy of all ETFs had assets of \$52.5 billion at the end of April, although the fund's assets are actually falling slightly. The iShares S&P 500 (IVV) fund, on the other hand, continued to show growth and is now the fourth largest ETF.

The Nasdaq-100 Index Tracking Stock (QQQQ), known as the Qs, is also seeing its assets drop after years of growth and now holds less than \$20 billion. For many years, this fund was the second largest ETF and a favorite trading vehicle of hedge funds, but it has now fallen into third place. I think there are a few reasons behind this fund's slide.

The first is the Qs is only a trading vehicle for taking short-term positions in the market. There are no fundamental asset allocation reasons for investors to hold a fund that follows the Nasdaq 100, as the index lacks an intellectual underpinning. It is just the 100 largest non-financial stocks traded on the over-the-counter market. Some investors mistakenly look at the Qs as a technology index, when in fact only 55% of the fund is invested in tech stocks.

Unlike the Qs, most mainstream indexes attempt to follow a definable group of stocks, regardless of the exchange where the stocks trade. For instance, the S&P 500 index is composed mostly of New York Stock Exchange listed companies although some companies listed on the American and NASDAQ Exchanges are included.

A second reason for the decline in the QQQQs may be due to the success of other new ETFs. As more ETFs have flooded the market, traders can use other ETFs to move in and out of the market in a more targeted and precise fashion.

Many of the ETFs showing the largest increase in assets are internationally oriented. The iShares MSCI EAFE fund is now the second largest ETF with over \$29 billion in assets.

This fund has grown by over \$6 billion this year due to a combination of market appreciation (15%) and inflows of funds (12%).

Rounding out the five largest ETFs is the iShares MSCI Japan fund. It has grown 15% this year with about one third of that growth coming from market appreciation.

Some of this year's notable new funds are commodity related. The DB Commodity Index Tracking Fund (DBC) was first offered in February and now has almost \$500 million in assets.

The first oil fund started trading in April. The United States Oil Fund LP (USO) has already attracted over \$266 million.

The most spectacular launch was the iShares Silver Trust (SLV). This fund was highly anticipated and rocketed off its launching pad and gathered over \$700 million in assets in just a few weeks.

Should mainstream investors use commodity ETFs? For most investors the answer is no and there are a couple of reasons behind my response. First, using a buy and hold approach with commodities makes no sense as there is no economic rationale for prices to go up in the long run. High prices in fact increase supply, which ultimately forces prices to go back down.

With stocks a buy and hold approach, makes sense as we can point to productivity and population increases as fundamental reasons for stocks to hopefully increase over time.

The other alternative is to make money by trading in and out of commodity ETFs to time the market. As with all successful trading strategies, this depends on skill or/and special insight which most individual investors are unlikely to possess. If you want to test yourself, follow this routine for a month to see how good you are. In the morning, after reading all the news, write down how various commodities will end the day and give yourself a grade each day. At the end of the month this "paper" exercise will show you how difficult it is to beat the market and save you lots of money that you would otherwise have lost.

Commodities can have long price runs, both up and down. Given that many have already gone up, investors looking to join the party may find they are closer to "last call" than they think.

In summary, the ETF market continues to grow, but many of the newer products, especially commodity related, are not appropriate for long-term buy and hold investors.

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