



Farm Creek Securities, LLC
Farmcreeksecurities.com
fc@farmcreeksecurities.com
89 Roton Avenue, Rowayton, CT 06853
(203) 838-1025

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Expanding ETF Market Gives Investors More Choice; & Responsibility

Ed Hynes, CFA

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The Exchange-Traded Funds (ETFs) market continues to expand and gives investors greater choice and access to financial markets. This growth can be confusing - even overwhelming - for investors in the short-term, but I believe it is a “good thing” longer-term.

A few years ago there were just a few ETFs and investors could only use them in a limited number of investment strategies. For instance, at the end of 2000 there were 80 ETFs listed in the U.S. with assets totaling \$66 billion. Now there are almost 300 funds with over \$350 billion in assets.

This expansion allows individuals to invest in areas that were previously only accessible by sophisticated institutional investors. I do not recommend most investors take advantage of these products, but I applaud that we have more choice.

One regular reader wrote me asking about the new currency ETFs offered by Rydex. Rydex introduced an extremely popular ETF linked to the movement of the Euro at the end of last year and its assets have grown to \$634 million. To capitalize on the obvious investor interest, Rydex recently introduced additional currency funds which individually track the Australian Dollar, British Pound Sterling, Canadian Dollar, Swiss Franc, Swedish Krona and Mexican Peso. These funds have expense ratios of 40 bps.

Investors, who agree with Warren Buffet that the U.S. Dollar will weaken, could buy these funds to speculate on the Dollar's direction. As the reader correctly pointed out, before these funds were available, the only way to take a position on the dollar was with foreign stocks or bonds. Now investors can crystallize their bet on only the movement of the Dollar, without “contaminating” their investment with stocks or bonds.

Some of the new commodity ETFs have also proved to be very popular. Gold ETFs have seen tremendous growth and now have assets of \$8.2 billion. A new silver ETF was introduced a few months ago and has already taken in \$913 million. Investors can also speculate on the price of oil with the United States Oil Fund ETF.

A new fund management company called WisdomTree has introduced 20 new ETFs that track different groups of stocks on markets around the world. Unlike most index products, which weight the stocks they hold by market capitalization, WisdomTree uses dividends to determine each stock's weight in the index. Whether or not this proves to be a winning strategy remains to be seen. However, index investors who are looking to track the overall market should stick to capitalization weighted indexes, such as the S&P

1500 or Dow Jones Wilshire 5000 index, as they are the only ones which capture the performance of the “average” dollar invested.

Investors looking to supercharge their investments may be interested in a group of ETFs managed by ProShares. Some of their new ETFs leverage the holder’s exposure to 2 times the investment. For instance, if the market moves up 1% and the investor is long, their return would be double, or 2%. The leverage can also work against the holders and investors can lose money twice as fast as the market. ProShares also offers ETFs which are effectively “short” the market. With these, an investor makes money if the market falls and loses money if it goes up.

As I said earlier, most of these products are NOT for long-term investors. But that doesn’t mean they are useless for investors. For instance, it is very difficult for individual investors to obtain good benchmark information to measure their investment performance. ETFs solve this problem, in a rough fashion, because investors can compare their stocks or funds to an ETF tracking the same area. Investors can also choose a starting and ending date which exactly matches their investment.

One simple example is comparing a gold fund you own with a gold ETF to see how you performed. Another example would be comparing your small cap fund with the performance of an ETF tracking small cap stocks like the iShares Russell 2000 Index (IWM). Most of the free charting services accommodate these requests very easily.

Looking out over the next year or two we will probably see actively managed ETFs which combine the trading and tax protection of ETFs with the “skills” of portfolio managers. More on this as it develops.

In summary, ETF offerings are exploding and this is giving individual investors access to markets as never before. This freedom is welcome, but investors need to realize that along with this freedom comes additional responsibility to use the products with care.

Please send me an e-mail if you have any comments, or questions for future articles (ed@farmcreeksecurities.com).

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal. Please contact Farm Creek for a prospectus on any of the funds mentioned.

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