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## The Sound Investor Series #6

### What are Exchange-Traded Funds (ETFs)?

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Exchange-Traded Funds (ETFs) are very useful and relatively new investment tools. These products give individual investors the ability to manage their money with the same precision and costs as large investors.

One provider of ETFs describes their funds as “Industrial Strength Tools” and I agree. But, as with any good tool, you need to be careful and thoughtful when using them.

Most ETFs are like passive index funds, which attempt to match the performance of a stock index like the S&P 500. Almost all of the indexes are covered and over 150 different ETFs exist.

ETFs are set-up like mutual funds, and since they are highly regulated, investors should feel confident using these products. You will lose money if the market goes down, but fraud is very unlikely.

There are a few major differences between ETFs and traditional mutual funds. The most obvious is that ETFs trade like stocks on exchanges such as the American Stock Exchange. And like stocks, ETFs have bid/ask spreads and investors pay a commission when buying and selling. Mutual funds are different and can only be bought or sold once a day, at the closing Net Asset Value (NAV) and investors pay little or no commission.

If trading throughout the day was an ETF's only advantage, I would be lukewarm about them for long-term investors. But ETFs also have very low fees and a unique trading structure that makes them extremely tax efficient.

ETFs use something called in-kind trading. This happens behind the scenes and investors do not have to do anything special or even know about it. In a nutshell, in-kind trading is where a fund swaps its own shares for stocks to create new shares and reverses the process when investors sell. This method allows the fund to grow and contract without using cash to buy or sell. And since the fund does not directly buy or sell, it has no tax liability.

This tax efficiency is a big advantage as holders are insulated from most capital gains distributions. However when you sell an ETF, you will still (hopefully) have a capital gain to be taxed at that time.

Another benefit of ETF's in-kind trading is that investors are shielded from the costs of other investors moving in and out of the fund.

On the fee front, ETFs which track the broad stock market have annual expense ratios of less than 0.15% (15 basis points) and some are as low as 0.07%. Expenses on bond ETFs run around the 0.15-0.20% range. These fees are far lower than the 0.45% charged by the average index fund and of course, well below the average of 1.25% charged by actively managed funds.

ETFs have grown dramatically in the last few years. While the first one, nicknamed "Spiders" (SPY) and tracking the S&P 500 was introduced in 1993, trading didn't take off until the QQQQs, tracking the NASDAQ-100, came out in 1997.

One important innovation was the 2003 introduction of ETFs which track bonds. Bond ETFs are available that track US government bonds, TIPS, corporate bonds and combinations of these.

As many readers know, I think investors are most successful when they stick to low-cost, passive investment strategies and ETFs are a critical tool in this strategy. Now that both stock and bond ETFs are available, it is easy and cost effective for investors to build well diversified portfolios with just a few ETFs.

If you have questions or suggestions for future columns, please let me know.

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