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The Sound Investor Series #9

Stock Market ETFs – There Sure Are A Lot!

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July 26, 2005

Today we are going to discuss the Exchange-Traded Funds (ETFs) that focus on the stock market.

First a quick review for readers unfamiliar with ETFs. ETFs are relatively new investment products that are becoming increasingly popular. They are similar to mutual funds but have important differences. Most noticeably ETFs trade all day at stock exchanges and both buyers and sellers normally pay a commission.

I recommend investors use ETFs due to their very low expenses and high tax-efficiency. The fact they are also easy to trade is an added bonus.

Most ETFs are index based just like index funds. The funds buy and hold all the stocks in the particular index they follow such as the Dow Jones Industrial Average or S&P 500.

A few ETFs use “semi-active” investing strategies, but at the current time, there are no ETFs using active investing strategies - like picking individual stocks everyday. Most observers expect we will see such products in the next few years.

ETFs have been growing rapidly and the field is becoming much more competitive. There are currently over 150 stock ETFs which track the major stock indexes published by companies such as Dow Jones, Morningstar, MSCI, Russell and S&P.

I believe that ETFs which cover the broad market are excellent investment products for individual investors. With one product an investor can take care of all his or her stock investments. My two favorites are the iShares S&P 1500 Index Fund (ticker: ISI) and the streetTracks Total Market ETF which tracks the Dow Jones Wilshire 5000 Index (TMW).

I strongly believe that passive investment techniques are more effective than active strategies. But for investors who want to more actively slice and dice the market, ETFs are very useful. Here are some of the major variables investors can control.

- **Market Capitalization.** ETFs are available all along the capitalization spectrum. For the very largest stocks in the market investors can invest in the Diamonds

ETF (DIA) which tracks the Dow Jones Industrial Average. On a broader scale various ETFs are available which track large, mid and small cap stock indexes. Representative examples are “Spiders” S&P 500 (SPY), S&P mid-cap 400 (MDY) and the Russell 2000 (IWM) respectively.

- **Value vs. Growth.** Many indexes are split into value and growth and these subdivisions also have corresponding ETFs. Each index family uses a different method to determine value and growth so investors should be careful.
- **Market Sector** ETFs are also popular. But just as the index publishers define value vs. growth in different ways, the same happens with market sectors. For instance, if you are interested in the technology sector; you can choose an ETF tracking technology stocks based on an index from Dow Jones, Goldman Sachs, MSCI or S&P, but they are all different.
- **Foreign Stock Indexes.** There are ETFs for investors seeking overseas exposure to developed markets using the EAFE index (EFA) as well over 30 ETFs covering individual countries and regions of the world. Investors can also invest in global sectors via ETFs based on Dow Jones indexes.
- **Specialized ETFs** are starting to appear. There are a few funds which concentrate on dividend paying stocks while a few others hold “environmentally friendly” stocks. At this early date it is very difficult to determine how these funds will perform over time.

One final thought about the Nasdaq 100 ETF (QQQQ) which is nicknamed the “Qs” or “cubes.” The “Qs” are very liquid (you can buy and sell a lot at one time) and great for trading (little or no spread between the bid and ask). Traders use “Qs” to bet on the market’s direction, particularly the movement of technology stocks as they account for almost 60% of the index with large companies such as Microsoft, Qualcomm, Intel and Apple dominating. My problem is there is no intellectual investment framework for this index; it is just the largest companies on this particular exchange. So unless you are a trader, I would not use this product.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This series of articles is available at farmcreeksecurities.com. 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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