## Getting Started with ETFs

Conceived more than 80 years ago and now owned by 91 million individuals from 54 million households in the U.S., mutual funds owe their strong appeal to a combination of features: professional management, instant diversification for low minimum investments, prices based on net asset value (NAV) and marked to market daily, and easy reinvestment of dividends and capital gains.

Known legally as open-end investment companies, they issue new shares when investors want to buy them at NAV per share—plus sales charges unless they are no-load funds—but they must redeem shares at NAV (less sales charges unless they are no-load funds) when holders want to sell.

These characteristics have long distinguished mutual funds from a second type of investment company, closed-end funds, whose issued shares are fixed at creation. This means that bid-and-ask prices may be above or below NAVs.

The third type of investment company are Unit Investment Trusts, which are a fixed basket of stocks (not an evolving index) held for a pre-determined time.

If mutual funds have been found by some to be lacking a feature, it often has been the opportunity to buy or sell their shares at any time when markets are open at known prices—just like publicly traded stocks, bonds, and closed-end investment companies.

Exchange-traded "equity" funds (ETFs) were introduced in 1993 by a subsidiary of the American Stock Exchange. They are designed to give investors a vehicle that resembles mutual funds but also provides the opportunity to have buy or sell orders promptly executed at known prices on a securities exchange (through a broker) whenever markets are open.

Named the SPDR Trust, whose shares were referred to as "Spider  (for SPDR, or Standard & Poor's Depositary Receipt), the first ETF was formed as a UIT with the investment objective of tracking the S&P 500 Index, thereby permitting its portfolio to be changed when S&P changed the composition of its index.

Its investment policies thus were similar to those of the mutual funds that had been passively managed to match the performance of the S&P 500, beginning with Vanguard 500 in 1976, or other domestic and foreign stock and bond price indices.

Over the next three years, three more ETFs, organized as UITs, followed the SPDR model, matching the following underlying stock indices, the S&P MidCap 400, the Dow Jones Industrial Average, and the NASDAQ 100. By 1996, a major change occurred when the first two ETFs organized as open-end investment companies were introduced.

ETFs have experienced phenomenal growth. By the end of 2005, ETF total assets had reached $296 billion. Some193 ETFs were organized as open-end funds, representing 68 percent of total ETF assets and eight were organized as UITs, representing 32 percent. At the time, as much as 63 percent of ETF assets were broadly diversified across domestic equity sectors while

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10 percent were concentrated in individual market sectors or industries. Another 22 percent of ETF assets were invested internationally; the remaining 5 percent, in bonds.

Why have ETFs been so successful in attracting investors?

1. Whatever their investment characteristics, the offer of professionally managed portfolios resembles mutual funds—whether invested in diversified or concentrated pools of domestic or foreign stocks and bonds.

2. The cost of ETFs is much-debated, but many financial planners tend to agree these vehicles can be cost-effective when used correctly. For instance, shares of ETFs structured like index funds may have even lower annual expenses than index mutual funds, which, in turn, tend to be lower than those of actively managed, low-cost mutual funds. ETFs must, however, be bought and sold through brokers and those trades do involve sales commissions. Of note, some financial planners say ETFs tend to be good vehicle to use when a large amount of new cash comes into an account. But, due to commission charges, ETFs are not recommended for people with small accounts or those that are dollar cost averaging.

3. ETFs are transparent investments. Unlike traditional mutual funds, ETF holdings are fully transparent. Investors know what holdings are in the ETF at any given time. Each ETF also has a NAV tracking symbol for even more precise analysis. This helps keep ETFs trading within pennies of their intra-day NAV.

4. Taxes may be managed. While well-managed index mutual funds may distribute less in taxable capital gains than actively managed funds, the SEC's 2001 release noted that "the ETF structure may allow an ETF to avoid capital gains to an even greater extent…"

"This is a really big deal for taxable accounts – it is almost an unfair competitive advantage for ETFs," said one financial planner member of the Financial Planning Association.

Many ETFs have not distributed any long- or short-term capital gains in five years or more and if they have, the distributions are very tiny. Financial planners also note that because ETFs trade like stocks, an investor is able to control the tax treatment of an investment. By holding an ETF for at least one year and a day, capital gains will be treated as long-term capital gains which are currently taxed at 15 percent (10 percent for low tax bracket investors.)

5. Trading flexibility—the ability to buy and sell ETF shares any time during the trading day and at a known price—that index mutual funds cannot provide. Unlike mutual funds, ETFs can be bought on margin or sold short, the normal up-tick rule when shorting ETFs is not applicable.



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