

# Financial Foresight

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## ETFs: What are They?

Since their launch back in 1996, Exchange Traded Funds (ETFs) have gathered a lot of momentum and now pose a serious challenge to active and passively managed mutual funds. What are ETFs? Are they better than active and passive mutual funds? Should you own them? While there may be no clear cut answer to that question there are many features that make ETFs especially appealing to individual investors all the way up to institutions with billions of dollars to invest.

What are ETFs? ETFs are securities that track an index, a commodity, or a basket of assets like an index fund, but trade like stocks on an exchange. They offer the low cost and diversification advantages of index mutual funds and the liquidity and tax advantages of individual stocks.

The SPDR S&P 500 ETF by State Street Global Advisors was the first US-based ETF, launched on January 22, 1993. It is now the largest and most widely traded ETF around with over 63 billion in assets. There are now over 700 ETFs with a combined value of nearly 600 billion. While many new ETFs are being launched all the time, we are now seeing a trend towards some ETFs closing. 42 have closed so far this year.<sup>1</sup> “We expect to see continued closings as there are still over 150 US-listed ETFs with less than 10 million in assets,” said Paul Mazzilli, Senior Advisor of Index IQ, publisher of ETF Insight. As the major ETF players continue to gain assets at a impressive pace you will most likely see many new ETFs launched and quite a few of these and older, smaller funds closed. These funds pose a serious threat to the mutual fund industry.

Major Advantages: Perhaps the greatest benefit of many ETFs is their low cost. While many of the ETFs have fees of around 0.2-0.4%, Vanguard offers a total

stock market index ETF with an expense ratio of only 0.09%.<sup>2</sup> That equals an annual fee of \$90 for a \$100,000 investment. This compares very favorably to mutual funds whose average annual operating expense ratios are typically about 1%-1.5% with some sector, international and aggressive funds even higher than this. Liquidity is also a major advantage. Unlike traditional mutual funds that are only priced at the end of the day ETFs trade throughout the day so you can buy and sell anytime the market is open. Consider that there are some days where market volatility can create 2-4% market swings and you begin to appreciate the liquidity. It would have been very easy last fall to see the market down 5-7% in the morning and you decided you want to get in. You enter your mutual fund order only to find out that when it was executed at the end of the day the market had rebounded and was now up 3-5%. That is a 10% swing that could have changed your decision on whether to make the purchase.

Players and Trends: The major providers of ETFs are Blackrock (who just purchased the Barclays group of ETFs under the iShares name), State Street Bank, and Vanguard (who is gaining popularity due to their low cost structure.) There are many niche players like WisdomTree whose focus is on dividend paying ETFs and currency ETFs. Pro Funds, Direxion and Rydex are known for their inverse and leveraged ETFs. Inverse ETFs are set up to move opposite the market. Leveraged funds (which can be bearish or bullish) seek a return of 100%-300% of the daily return of an index or benchmark. One asset class I am particularly optimistic about and use frequently is the fixed income ETF category. Along with Vanguard, State Street Bank, and Blackrock Advisors, Pimco has released news of their launch of fixed income ETFs. Widely known for their reputation in the fixed income field, Pimco has a cost structure of only 0.09%. In an era of low yields on bonds, fees are the one

area you can control. When you compare 0.09-0.20% to 0.75-1.00% (which many bond mutual funds charge) most Fee-Only advisors and independent investors are going to heavily lean towards the ETFs.

Types of ETFs: Initially launched to match basic indexes like the S&P 500, Wilshire 5000 or MSCI International, there are now ETFs for every major index, sector indexes, fixed income ETFs, themed ETFs, commodity ETFs (such as GLD which tracks the price of gold, and SLV which tracks silver), and even ETFs that let you invest in foreign currencies. While many of these niche ETFs are fairly small, GLD is now the second largest ETF with a market cap of over 33 billion.<sup>4</sup>

Risks: Any investment product should be considered a tool to help you achieve a goal. Like a double edged sword some of the features that make ETFs so great also pose a risk to many investors. Liquidity can cause people to trade too frequently. Sector bets can cause some investors to be overweight in one sector and avoid the diversification that ETFs were originally intended for. By far the biggest risk that I see in ETFs is the inverse and leveraged ETFs. Investors are often their own worst enemies because they get bullish at market tops and bearish at market bottoms. So in addition to being wrong on the sentiment, your errors can be multiplied by two or three. It's one thing to lose money when the market is going down, it could be frightening to lose three times your money when the market is going “up”. Also it is very important to note that many of these leveraged ETFs do not produce the returns one would expect. Consider the following item found in a Vanguard research note from June 2009. The Russell 1000 Financial Services Index was down 5.9% YTD as of 05/15/09.<sup>5</sup> A rough prediction would have the 3x leveraged financial ETF bear fund up 18% but it was down 83.4% while the 3x leveraged bull ETF should have

lost 18% yet it lost 65.6%.<sup>6</sup> The problem arises from a daily reset of option prices and the cost of leverage. The math gets tricky, but suffice it to say you could be right about the market and still get burned.

Who Should and Should Not Buy ETFs?  
One area where ETFs don't make much sense is for smaller accounts and for frequent purchasers. As a ballpark, if you are looking to invest less than \$3,000 in each investment or are adding monthly, then a no-load mutual fund may be better for you due to trading cost and the added time

required to make monthly transactions. I think ETFs are a great option for mutual fund investors, fixed income investors and clients who are unable to build a diversified professionally managed stock portfolio.

If you are looking to learn more about ETFs please let me know. Whether active or passive, ETFs may deserve a spot in your portfolio.

<sup>1</sup>Mazilli, Paul. "Mazzilli's Musings." *Index IQ: ETF Insight*. June 2009. <<http://www.indexiq.com/docs/ETF-May09.pdf>>

<sup>2</sup>Vanguard.com. (27 June 2009).

<sup>3</sup><[http://www.pimcoetfs.com/fund\\_info.aspx](http://www.pimcoetfs.com/fund_info.aspx)>. (28 June 2009).

<sup>4</sup><<https://www.spdrs.com/product/fund.seam?ticker=GLD>>. (28 June 2009).

<sup>5</sup>Philips, Christopher B., and Donaldson, Scott J. "Research Note: Why Leveraged ETFs Can Pack a Surprise." <[www.vanguard.com](http://www.vanguard.com)>. (June 2009).

<sup>6</sup>ibid.



## Vermont Residential Real Estate Market Perspective

By Brad Chenette, REALTOR, Broker/Owner

To say we've experienced altered trends over the last 12-18 months due to the economic turmoil would be an understatement. 2008 third and fourth quarters were dismal for real estate sales in Vermont. Early 2009 activity was sluggish, but has picked up notably since March in Chittenden County. This year's track was due in part on buyers waiting for the Federal government to finalize real estate buyer incentives in the massive stimulus legislation. More on this tax credit in a moment.

Many factors affect the real estate market. These include mortgage interest rates, the unemployment rate, money supply, bond prices, consumer confidence and even local, regional, national and world events. While the news media reports the easy to quote national statistics, the truth we know is "all real estate is local".

Little old Vermont is at the positive end of many indicators. We have one of the lowest foreclosure rates in the USA and had one of the lowest percentage of subprime mortgages issued to borrowers. These facts all helped the Vermont Real Estate market stabilize sooner than many areas of the country which are still experiencing difficulty.

So while you will hear the grave national averages that include Florida, California, Nevada and Arizona that have the very highest foreclosure rates and highest percentage of subprime residential mortgages, huge inventory of unsold homes, your first questions should be "how is our local real estate market"? For example, did you hear Vermont was only one of two states in May that did not have a rising unemployment rate compared to the previous month? Although most expect the rate to rise in the near future, the rate of increase may not be as great as in other states. IBM recently announced they will be hiring, that has to help the confidence return to the market.

The past few weeks have seen mortgage interest rates move slightly higher from their historic lows of around 4.5% for a 30 year conventional fixed rate mortgage. We all knew they could not remain at record lows, but the current rates are still fantastic.

In Chittenden County, the numbers of single family homes that have sold are down 7% year to date according to the Vermont Real Estate Information Network (Vermont MLS). There were still over 350 homes sold. The total dollar volume of sold homes are down 9% year to date which indicates there are fewer homes in the upper price ranges being sold this year. This does not mean home prices have dropped that much, but most appraisers agree some properties have

had their values decline slightly in the last year or two. This decline is not across the board or uniform, and varies widely depending on price range and location.

The Federal \$8000 First Time Buyer Tax Credit (not just a tax deduction) has moved many purchasers off the sidelines and into the game. The definition of First Time Buyer includes anyone who has not owned a home within the last 3 years. This incentive has started to move the logjam of excess inventory of homes on the market. We currently have fewer single family homes now listed for sale than last year at this time, and the number of pending home sales is also rising.

Lastly, contrary to the media reports, there are still several 100% or low down payment mortgage financing options available to buyers. These programs do have maximum income and purchase price limits, but are sometimes easier to qualify for than conventional financing options.

I sense real estate buyers and seller are more optimistic and the worst of the recession has passed in our Burlington micro-economy. They are looking forward to moving on with their long term real estate goals.

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