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EXCHANGE TRADED FUNDS (ETF)

A Brief History

Over the past decade, the investment markets have experienced a few distinct cycles as participants sought the most appropriate strategies for trading and investing. During the Internet boom of the late 90's, many investors focused more on security selection and attempted to find that hot "stock-tip-of-the-day" that was expected to escalate in price over a very short time frame. Some began to "time" the markets, basing decisions on earning announcements, new public offerings, and economic releases.

For a few years, such strategies seemed to work as certain investors experienced significant returns, though often with portfolios accompanied by substantial "unknown" risks. When the bubble began to burst in 2001, investors came to realize the excessive risk they had undertaken; certain stocks tumbled virtually overnight, and those "hot stock picks" rarely performed as expected.

During the past few years, the concept of asset allocation began to emerge again as brokers, advisors, and financial planners alike talked more about the risk/reward relationships associated with structuring the optimal portfolio. Among other insight, they stressed the importance of asset allocation and diversification within an entire portfolio over individual stock selection and market timing. Still, new concerns were raised.

- Just how many securities are needed to create a diversified portfolio?
- Isn't it expensive to trade that many securities?
- Won't such a strategy entail very active investment management?

The Emergence of the ETF

With that in mind, Exchange Traded Funds (ETFs) have rapidly become among the most popular investment vehicles as investors desire diversification opportunities, trading ease, and overall cost efficiencies. At year-end 2004, over $225 billion was invested in ETFs representing various markets and asset classes. Structured to track specific benchmark indexes, ETFs are actual security certificates that allow individuals to participate in certain markets (and all the securities that comprise the underlying index) with the ease of a single transaction. They represent legal ownership of a pro-rate share of an underlying basket of securities. ETFs are extremely liquid and allow investors great flexibility in structuring diversified portfolios.

ETFs have been structured to track virtually every major index in virtually every market, and new ones are being created on a regular basis. Some are more broad in nature and follow asset classes such as large-, mid-, and small-cap equities (S&P, Russell) and fixed income (Lehman Bond); others track international markets (MSCI-EAFE) and even more specific sectors (Basic Materials, Healthcare, Energy) or other themes (REITs). By combining multiple ETFs into a single portfolio, an investor can create substantial diversification and hope to earn a return consistent with the underlying markets captured.

Of course, merely buying ETFs is not enough to create the optimal portfolio. Further analysis should examine the correlation of the various indexes vs. each other and make sure that no significant overlap in securities exists which may create undesired large concentrated positions. Bear in mind, mutual funds and separate account managers structure portfolios that attempt to outperform (with varying degrees of success) the market indexes; investors should remain aware of their overall personal financial goals when creating their portfolios.

Process of Creating ETFs

While many investors have gravitated to these investments, few truly understand how they are structured or the nature of the underlying securities that comprise these investment vehicles. While investors may not need to know all the specific nuances involved, a brief overview of the structuring process should prove helpful.

Application: A very large financial institution known as the *fund manager* files a detailed proposal with the SEC that describes its intent to structure an ETF and discusses its composition, operations, and redemption features. Only the largest institutional managers such as Vanguard and Barclays Global Investors can participate in such a structured venture and be approved by the SEC. They begin to identify the largest pension fund managers and other institutions from across the world that would be willing to sell or "loan" various underlying securities that comprise the related index. They also solicit demand from retail and institutional investors who will participate in the ETF offering.

Accumulation: Once approved, a *market maker* or specialist starts to accumulate all the shares needed to structure the basket of securities that comprise the underlying index. While the size of the ETF may vary based on its objective, they need to gather significant shares sufficient to create a very liquid and marketable security allocated in the same percentage proportion to the index.

Safekeeping: Once purchased, the market maker directs the individual underlying securities to a *custodian* who receives them for safekeeping purposes and verifies that they conform with those described in the proposal. The new ETF certificates are then forwarded to the market maker for sale in the offering. The custodian continues to hold the basket of securities that underlie the ETF.

Trading: The market maker then offers the newly created ETF to the open market. An active secondary market should follow as investors begin trading these securities similar to any others that trade on that exchange. All securities are cleared through the

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Depository Trust Clearing Corporation (DTCC) which keeps all official records of the transactions. This government agency also lends additional credibility to the entire process and protects against any potential trading fraud.

Redemption: This process is simply the opposite of the transactions described above. The market maker buys back shares of the ETF, sends them to the custodian, receives the underlying basket of securities in return, and sells (returns, if on loan) them on the open market, often to those large international pension fund investors involved early in the process.

Benefits

ETFs help provide instant diversification by allowing an investor to participate in the ownership of many securities across a single or multiple markets at once. They can trade within margin accounts and often have available options listed on the exchange. ETFs typically maintain lower expense ratios and fees than mutual funds, including index funds that are structured with similar goals in mind. Since they trade on an exchange, investors can execute transactions throughout the course of the day and are not subject to similar timing restrictions as mutual funds (which can only trade based on the price at the day's end). They also possess certain additional tax efficiencies.

A portfolio consisting of multiple ETFs of various major markets and specific themes can be helpful in allowing investors to meet their various return objectives given an acceptable level of associated risk.

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