

February 29, 2004

Warming Up to Funds That Trade Like Stocks

By PAUL J. LIM

FOR most of her investing life, Reta Richardson managed money in a conventional way: she sought the advice of a broker, in her case a [Merrill Lynch](#) adviser. When she retired in 1999, Ms. Richardson of Ninety Six, S.C., decided to pilot a portfolio of individual stocks on her own.

Now, at 68, she is experimenting with a third approach. Tired of spending six hours a day researching stocks and mutual funds, and wanting to spend more time with her 17-month-old grandson, Ms. Richardson is selling what had been a 102-stock portfolio, worth about \$211,000, and putting the money into a low-cost and low-maintenance collection of about nine exchange-traded funds.

"By June or July, I hope to be near my goal of making a total E.T.F. portfolio," she said.

Exchange-traded funds, or E.T.F.'s, are hybrid securities that have characteristics of both stocks and mutual funds. Like stocks, these funds trade on an exchange, so investors can buy and sell shares throughout the day, not just once a day at the closing price. But, like those of traditional index funds, the shares represent a basket of dozens - or even hundreds - of securities, typically those that make up an index like the Standard & Poor's 500 or more specific benchmarks like the Dow Jones consumer noncyclical sector index. Moreover, like index funds, they charge low annual fees.

Since exchange-traded funds were created in 1993, they have been used primarily by institutional investors and active traders. Shares of one of the most popular E.T.F.'s, the Nasdaq 100 Index Tracking Stock, known as QQQ's, for its ticker symbol, are often used by aggressive investors to jump in and out of the volatile technology sector.

But after the creation of the first United States bond E.T.F.'s two years ago and, more recently, the scandals in the traditional fund industry, some buy-and-hold investors have been warming to these hybrid alternatives.

In December, investors poured \$12.6 billion of new money into exchange-traded funds, according to the Investment Company Institute, and industry trade group, pushing the funds' total assets to more than \$150 billion for the first time. Although that is much less than the \$7 trillion invested in traditional mutual funds, the December inflows were nearly on par with investments in traditional stock funds. By the end of January, assets had grown to \$155.8 billion.

Investors can choose among 132 exchange-traded funds, up from 30 in 1999. Many financial advisers say investors can build a diversified portfolio with E.T.F.'s alone.

Ms. Richardson, who considers herself a moderate-risk investor, is doing just that. For her core portfolio, she invests in exchange-traded funds that track the S. & P. 500 index of large-capitalization stocks, the S. & P. 600 small-cap index, the Dow Jones Select Dividend index, the [Lehman Brothers](#)

Aggregate Bond index and the short-term Treasury market. She also has smaller amounts in E.T.F.'s that track the Japanese stock market, the domestic energy sector and utility and technology stocks.

In addition to sector-specific and country-specific varieties, there are E.T.F.'s that allow investors to emphasize growth or value stocks within a particular index. The major sponsors of exchange-traded funds, Barclays Global Investors, State Street and now even the mutual fund giant Vanguard, are racing to bring new ones to market.

That has spurred brokerage firms and money managers to begin offering E.T.F.-only accounts. "For me, this is a quantum step forward in managing my clients' assets," said Thomas Mench, chairman of Mench Financial, a money management firm in Cincinnati that specializes in the funds.

"As a strategist, I can now concentrate my time on that which we've always said produced 90 percent of performance: asset allocation, instead of individual stock selection," Mr. Mench said.

Among the major brokers, A. G. Edwards offers managed E.T.F. accounts for people who invest at least \$25,000. Annual fees for such an account are 2.25 percent of assets, though the fees drop on a sliding scale to 1.25 percent for accounts of more than \$1 million. [Ameritrade](#), the discount broker, plans to introduce by early summer an asset allocation tool that will recommend E.T.F. portfolios to small investors.

Joe Moglia, the chief executive of Ameritrade, said his company regards exchange-traded funds as better for clients than mutual funds. He noted that many actively managed funds had not proved that they can beat indexes consistently over long periods. Indeed, over the last five years, fewer than half of all large-cap funds beat the S.& P. 500, and fewer than 20 percent of mid-cap funds beat the S.& P. 400 midcap index.

The average domestic stock mutual fund has an annual expense ratio of roughly 1.5 percent, according to Morningstar, while the typical exchange-traded fund that tracks a domestic stock index charges annual fees of 0.36 percent. The cheapest version, iShares S.& P. 500 Index, from Barclays, charges just 0.09 percent. That is less than the 0.18 percent charged by the Vanguard 500 Index, the big mutual fund that tracks the S.& P. 500 and is known for low expenses.

"E.T.F.'s are extremely cost effective if you're putting money in and leaving it there," said Harold Evensky, a financial planner in Coral Gables, Fla., who uses the funds as core holdings in his clients' portfolios.

The cost advantage can help E.T.F. portfolios outperform those with actively managed funds, said J. D. Steinhilber, founder of AgileInvesting, a subscription service that offers investors recommendations on how to build all-E.T.F. portfolios.

Mr. Steinhilber said a simple diversified portfolio could be built from exchange-traded funds with these allocations: 25 percent to the S.& P. 500 index; 20 percent to the Lehman Brothers Aggregate Bond index; 15 percent to the MSCI EAFE index of international stocks; 10 percent each to the S.& P. 400 midcap index, the S.& P. 600 small-cap index and the Lehman Brothers 1-3 Year Treasury index; and 5 percent each to the MSCI index of emerging-market stocks and the Dow Jones real estate index.

A portfolio with those allocations that used iShares E.T.F.'s from Barclays would have an average expense ratio of just 0.24 percent, Mr. Steinhilber said. By comparison, a similar portfolio using actively managed funds with fees at the industry average would have an expense ratio of 1.35 percent.

The totals, however, do not include brokerage commissions for buying and selling shares of E.T.F.'s.

This E.T.F. portfolio is also slightly cheaper than an equivalent portfolio of Vanguard index mutual funds. (Vanguard also offers exchange-traded funds based on the indexes used by some of its mutual funds.)

Financial planners caution small investors to consider other factors before building an all-E.T.F. portfolio.

William J. Bernstein, a principal at Efficient Frontier Advisors in Eastford, Conn., studied the performance of seven E.T.F.'s that track domestic stock indexes from their inception to 2003 and compared it to that of parallel stock index funds from Vanguard.

"In all seven cases," he said, "the Vanguard index funds did better even though they're cheaper." He said that this was partly attributable to the trading skills of Vanguard managers who must periodically tweak their portfolios as the composition of the underlying index changes.

The biggest concern may be commissions. Because exchange-traded funds are bought and sold like stocks, investors incur such costs whenever they trade these shares; such fees can be avoided in no-load mutual funds. The problem is particularly difficult for investors with low account balances who use dollar cost-averaging - investing small amounts each month or quarter, as is often the case with 401(k) retirement plans. If you invested \$200 a month, divided equally between two E.T.F.'s, at \$20 a trade, your commission costs would amount to 20 percent of each monthly contribution.

"You're never going to earn that back" in lower annual expenses, said Lee T. Kranefuss, head of E.T.F. products for Barclays Global Investors.

At what point does it make sense for investors to consider exchange-traded funds over index funds?

According to a study written by Leonard Kostovetsky, a doctoral student in economics at Princeton, and published last summer in *The Journal of Portfolio Management*, short-term investors may want to consider E.T.F.'s if they want to invest more than \$60,000 to start.

David Jackson, who runs Tech Uncovered www.techuncovered.com, a Web site that discusses E.T.F.'s, said investors should not overlook the tax advantages of these funds. A traditional index fund may realize capital gains in one of two ways: when the underlying index is reconstituted each year, and when shareholders leave the fund, forcing it to sell stocks to meet redemptions. An E.T.F. may realize gains only when the index it tracks changes composition.

Convenience is another factor: E.T.F.'s can be bought through any brokerage firm. That is one reason Clarence Perry, a software developer in Houston, started investing in the funds two years ago.

Mr. Perry, 59, considered himself a buy-and-hold mutual fund investor until he became disenchanted with the performance of his actively managed stock funds in the recent bear market.

Mr. Perry has built an all-E.T.F. portfolio for the individual retirement account of his wife, Joncia, using a buy-and-hold approach. But in his I.R.A. and the couple's taxable accounts, he said, "I'm headed toward a strategy where I can use E.T.F.'s for trading as well as long-term holdings."

[Copyright 2004 The New York Times Company](#) | [Home](#) | [Privacy Policy](#) | [Search](#) | [Corrections](#) | [Help](#) | [Back to Top](#)