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ADVISOR RESEARCH

Rounding Out the U.S. ETF Product Range

by J.D. Steinhilber

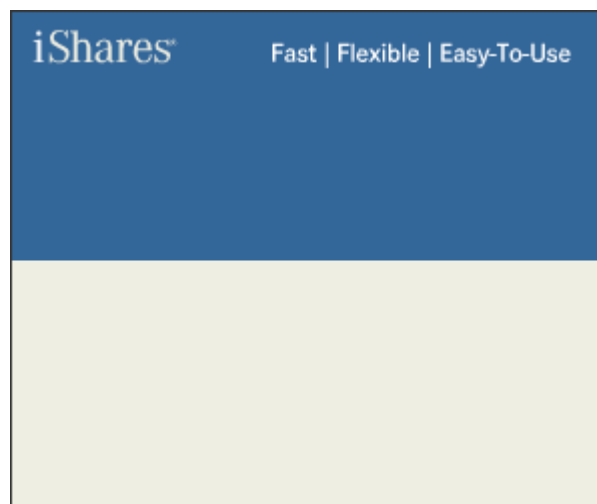
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The ETF marketplace took a giant step forward in July 2002 when Barclays Global Investors introduced four funds that track the performance of fixed-income indexes. Finally, ETF investors had access to bonds as an asset class and could construct balanced, all-ETF portfolios in the traditional sense of having a mixture of stock and bond investments.

These four initial bond ETFs track the performance of an intermediate-term, investment grade corporate bond index and three Treasury indexes – short-term, intermediate-term and long-term. It was hardly a complete bond ETF menu, but it was a good start. Combined with the wide assortment of domestic and international equity ETFs then available, investors could assemble well-diversified, all-ETF portfolios. Still, there were important gaps in the ETF universe. In the 19 months since July 2002, some but not all of these gaps have been filled.

In April 2003, BGI addressed one major void by introducing the iShares MSCI Emerging Markets Free (EMF) Index Fund -- symbol: EEM. BGI's timing, as it turned out, was impeccable. Emerging markets was one of the best-performing asset classes in 2003. As of February 25, 2004, EEM had appreciated over 70% from its inception date. GI had been managing country-specific and regional emerging markets ETFs for several years, but for most individual investors, a broad-based emerging markets fund makes the most sense. Six months prior to the launch of the iShares fund, The Bank of New York introduced a diversified emerging markets ETF made up strictly of American Depository Receipts (ADRs), but in my opinion the MCSI EMF fund offers superior diversification and trading liquidity.



Other than this emerging markets fund, three recent ETF product introductions stand out as offering exposure to important asset classes not previously accessible to ETF investors:

- The iShares Lehman Aggregate Bond Fund (symbol: AGG), which was launched in

{ "One of the world's fastest growing investments is attracting some attention." }

September 2003, allows investors to access the most diversified, widely-followed bond benchmark in the U.S. The Lehman Aggregate Bond Index provides exposure to all of the key sectors of the investment-grade taxable bond market, including Treasuries, agencies, corporates and mortgage-backed bonds.

- The iShares Dow Jones Select Dividend Index Fund (symbol: DVY), launched in November 2003, provides exposure to a diversified portfolio of high-yielding domestic equities. In the current yield-starved environment, DVY's 3.5% yield – before any potential return from stock price appreciation – is attractive.
- The iShares Lehman TIPS Bond Fund (symbol: TIP), which was launched in December 2003, provides access to inflation-protected Treasury Notes. With the Federal Reserve and the U.S. Treasury pursuing aggressive reflationary policies, the launch of this fund was indeed timely.

There have been many other new ETFs introduced since bond ETFs came on the scene in July 2002, but none seems to have broken as much new ground as the aforementioned funds in terms of providing the ETF investor exposure to new asset classes that can potentially enhance the risk/reward characteristics of a portfolio.

So what weapons are still missing from the ETF investor's arsenal? My own "wish list" for new ETFs would look something like this (*and the Editors of IndexUniverse.com invite you to add your ETFs to the "new ETF wish list" thread on the site's [discussion board](#)*):

1. Additional Fixed-Income ETFs. The ETF market is very developed with respect to equity asset classes, but much less so for fixed-income, notwithstanding the new bond funds described above. Currently, there are over 100 ETFs linked to equity indexes but only six linked to fixed-income indexes. Consequently, investors seeking income as well as growth have a more difficult time constructing effective all-ETF portfolios. The primary gaps in the fixed-income ETF universe include tax-exempt, high-yield and international bonds. Tax-exempt, or municipal, bonds are widely used in taxable accounts not only for their tax-exempt status but also because they often provide attractive taxable-equivalent yields versus bonds of comparable credit quality. High-yield bonds can be attractive to income-oriented investors willing to tolerate greater volatility and credit risk in return for yields that have historically been in the 10% range. Lastly, it certainly would have been nice to have had an international bond ETF in 2003 to take advantage of weakness in the U.S. dollar. The Salomon Brothers non-U.S. Dollar World Government Bond Index was up 18.5% in 2003.

2. A Gold ETF. ETF investors have eagerly anticipated a gold bullion ETF for close to a year. The World Gold Council filed a registration statement for a gold ETF in May 2003, but it is still awaiting SEC clearance (*see [previous article](#)*). Barclays Global Investors recently made a filing as well, so hopefully one or possibly two gold ETFs will be launched in the near future. Given its low or even negative correlations with traditional asset classes like stocks and bonds, there is a place for a modest allocation to gold in a diversified portfolio. In the current environment, gold has the additional appeal as a hedge against currency devaluation and inflationary monetary and fiscal policies. A gold ETF that tracks the price of bullion is obviously much more convenient than owning the physical metal. Gold ETFs also provide an attractive alternative to gold stocks, which is how investors have traditionally gotten exposure to precious metals as an asset class. Gold stocks introduce management risk and are more volatile than the metal itself. In addition, bullion provides greater diversification benefits. While gold stocks historically have had a low but positive correlation to the broad stock market, bullion has had a negative correlation.

3. A Broad-based Commodities ETF. In addition to a gold ETF, a broader commodities ETF would be very useful. Such a fund would provide exposure to a basket of commodities, including petroleum, natural gas, industrial metals, precious metals, and agricultural commodities. Like precious metals, broad commodities indexes are uncorrelated with stocks and bonds. In addition, there is a persuasive bullish case for the prospects of commodities as an asset class based on favorable supply and demand dynamics. An ETF tied to a diversified commodities index would be straightforward

enough to develop. Mutual funds such as the PIMCO Commodity Real Return Fund have done it. The PIMCO fund, which has already attracted over \$1.4 billion since its July 2002 inception date, tracks the performance of the Dow Jones-AIG Commodity Index. An ETF could presumably track the same index, or a similar one, at a lower expense ratio than PIMCO's 1.24%.

With these additional asset classes at their disposal, ETF investors would have an impressive collection of portfolio-building tools. The U.S. ETF industry has come a long way in its relatively short 11-year life. There is every reason to expect product innovation to continue as increasing numbers of investors assemble portfolios made up principally or entirely of ETFs.

J.D. Steinhilber is the founder of AgileInvesting.com, an investment advisory web site that recommends ETF-based portfolios.

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