

When Flexibility and Diversification Matter: An Introduction to ETFs

Popular Liquid Investments, Past and Present

Although the very first stock exchange was founded in Belgium in 1531, the first American stock exchange was established at 22 Wall Street in 1792.ⁱ Securities were auctioned every day at noon and sold to the highest bidder, with the seller paying the exchange a commission on each sale.ⁱⁱ

For 130 years, American investors were content with buying and selling individual stocks, which evolved from investments in hides and molasses to investments in energy and computer software. In 1924, the game changed when three Boston securities executives created the first mutual fund, the Massachusetts Investors Trust. The trust pooled the funds of investors, giving them mutual ownership in the trust's assets, which were managed by trustees. The investors benefited from diversified portfolios as well as professional money management. Between 1926 and 1928, the Massachusetts Investors Trust earned 88% for its investors.ⁱⁱⁱ

More than 50 years after this first mutual fund appeared on the scene, John Bogle created the first retail index fund, a mutual fund designed to mimic the performance of a stock market index. Known as the First Index Investment Trust when launched in 1976, Bogle's fund later became the Vanguard 500 Index Fund. By November 2000, it had become the largest mutual fund, with \$100 billion in assets.^{iv}

Mutual funds skyrocketed in popularity in 1981, when Individual Retirement Accounts (IRAs) and 401(k) plans were created. IRAs provided a means for individuals to contribute up to \$2,000 per year, tax-deductible, toward their own retirement, with all

earnings tax-deferred until withdrawal. 401(k) plans sanctioned the use of voluntary employee contributions, usually supplemented by employer matching, for the tax-deferred accumulation of funds for use upon retirement.

That these two innovations were major impetuses for mutual fund growth is indisputable. In 1980, there were 564 mutual funds in the U.S., with \$135 billion invested. A year later, the number of mutual funds had jumped to 665, with \$241 billion invested.^v Mutual funds attracted retirement funds because they offered built-in diversity at low-entry cost. To have a sufficiently diversified stock portfolio, research suggests an investor should hold 15 to 20 stocks.^{vi} Some experts maintain that a significantly higher number of stocks is necessary.^{vii} A single mutual fund, such as the Vanguard 500 Index Fund mentioned previously, offers the diversification of hundreds of stocks while accommodating small monetary contributions made each pay period.

In 1980, there were 1,533 U.S. companies listed on the New York Stock Exchange (NYSE),^{viii} with a total market capitalization of \$1.2 trillion^{ix}. In that same year, as noted earlier, there were 564 mutual funds with total net assets of \$135 billion.^x By 2006, there were 2,313 U.S. companies listed on the NYSE,^{xi} with a total market capitalization of \$15.4 trillion.^{xii} Mutual funds exploded over the same period, such that by 2006 the number of mutual funds had grown to 8,120, with total net assets of \$10.4 trillion.^{xiii}

As managed mutual funds and index funds grew in number and trading became more accessible to the individual investor, investors desired a vehicle offering the diversification of mutual funds combined with the trading flexibility of stocks. Thus, the exchange traded fund, or ETF, was born in the early 1990's. Spiders, whose name derives

from the acronym of their formal name, “Standard & Poor’s Depository Receipts,” were based on the S & P 500 Stock Index. They were first traded on the American Stock Exchange January 29, 1993.^{xiv}

ETFs Versus Mutual Funds: Similarities and Differences

When it comes to investing in an ETF or a mutual fund, ETFs can be a favorable choice because of their trading flexibility, targeted investing and lower costs.

Trading Flexibility

The trading flexibility of ETFs makes them immensely popular among investors. Because ETFs trade like stocks, they can be bought or sold at any time of the day as market conditions ebb and flow. Although traditional mutual funds take orders during Wall Street trading hours, purchases and sales actually occur only at the close of the market. The net asset value of the mutual fund is calculated as the weighted average of the closing prices of all the stocks held by the fund, but the calculation is made only once daily, after the market close. (There are some non-traditional mutual funds, notably the hourly-priced Fidelity Select Funds, which trade more frequently, but not continuously.)

In our modern, often extremely volatile markets, the fact that ETFs can be traded anytime throughout the day is viewed as a tremendous benefit in contrast to the once daily trading of mutual funds, which often leaves investors as helpless bystanders watching unexpected late-in-the-day market moves after they’ve placed their orders.

Also, because ETF's trade like stocks, they may be purchased and sold at specific predetermined prices via "good till cancelled" and "stop-loss" orders.

Targeted Investing

ETFs also offer targeted investing, which provides an investment vehicle focused on a single industry or economic sector. This concept was introduced in 1981, when Fidelity Investments launched the first Fidelity Select Fund. To this day, the Fidelity Selects, which have grown to include 41 funds, comprise the largest number of industry sector funds offered by any mutual fund company. In recent years, however, ProFunds has launched an array of high-beta, inverse, and sector funds altogether more appealing than Fidelity's products, partly because ProFunds may be traded without restriction, load charges, or redemption fees.

ETFs, however, have taken targeted investing to a whole new level. As an example, consider the health sector. Fidelity Select Funds currently offer three health-related funds that expose investors to companies involved in health care, pharmaceuticals, or medical equipment and systems. But for the investor looking to specialize his or her portfolio even further, HealthShares Inc. offers eighteen ETFs with specific niche categories within health care: categories such as cancer, infectious diseases and neuroscience.

As ETFs have grown in availability and popularity, they have given the average investor the ability to invest in specific industry sectors, industry sub-sectors, geographic sectors, and single countries. "ETFs are known for slicing the stock market into dozens of

market niches, allowing investors to buy baskets of all kinds of companies,” says Ian Salisbury in an article published by the *Wall Street Journal* on May 20, 2007. “Among the portfolios introduced in recent months are ones that own steel companies and foreign real-estate concerns. Other ETFs provide exposure to alternative assets like gold or foreign currency that can otherwise be hard for small investors to trade.”^{xv}

Lower Costs

ETFs tend to provide lower costs than mutual funds. According to the *ETF Investing Guide*, ETFs can have lower expense ratios than even the lowest-cost index mutual funds. “A diversified portfolio of index funds with a common asset allocation costs about 18% less in annual expenses using ETFs than using Vanguard index funds.”^{xvi}

Besides expense charges, the typical mutual fund imposes one to three additional types of charges. These include a load, which is a one-time front-end or deferred sales charge; 12b-1 fees, which are management fees charged for distribution and service costs; and short-term early redemption fees, which are a percentage of the sales price charged to discourage investors from trading the fund. Some mutual funds impose trading frequency limitations in lieu of, or in addition to, short-term early redemption fees.

Investors in ETFs, like investors in stocks, pay a commission associated with the purchase or sale, though commission costs have been trending down in the past year. Sales loads charged on mutual funds are almost always higher than the commissions charged on ETF purchases, and ETFs do not have 12b-1 fees or short-term redemption

fees. Thus, ETFs appeal to long-term, buy-and-hold investors as well as intermediate-term traders, because buy-and-hold ETF investors don't incur frequent trading costs, and can reap the benefit of the lower expense ratios of ETFs.

The Latest Generation of ETFs

From the first ETF launched in 1993, the ETF universe had grown to include 359 funds, 252 of those domestic, with total assets of \$422.6 billion, by the end of 2006.^{xvii} By mid-July 2007, the FastTrack database included 475 ETF's. Some predict the number of ETFs will surpass 1,000 sometime in 2008.^{xviii}

As ETFs continue to expand and gain popularity, the introduction of ProShares in June 2006 has signified the future of ETFs, just as the introduction of ProFunds in the 1990s took mutual funds to a new level.

In June 2006, ProShares launched eight new ETFs on the American Stock Exchange, including four Short ProShares and four Ultra ProShares. Short ProShares are designed to deliver the inverse, or opposite, of the daily return of their associated market indices. Ultra ProShares seek to magnify the performance of certain indices, offering 1.5 or 2.0 times the performance of the underlying index, whether the index value increases or decreases.

In just one year, ProShares has grown to include 52 ETFs that offer innovative means of gaining exposure to market indexes. As companies like ProShares continue to push the envelope with ETF investing, the possibilities for investing in anything, anywhere, at any time, will be endless. This investment vehicle has made it easier now

than ever for investors to see their savings multiply with smart investments in the market, while enabling portfolio managers to construct fully diversified cost-and tax-efficient portfolios.

ⁱ “Wall Street & Stock Market History,” A to Z Investments, www.atozinvestments.com/history-of-wall-street.html, last visited July 17, 2007.

ⁱⁱ “Wall Street & Stock Market History,” A to Z Investments, www.atozinvestments.com/history-of-wall-street.html, last visited July 17, 2007.

ⁱⁱⁱ Warsh, David, ed. “A Short History of the *Other* MIT,” economicprincipals.com, www.economicprincipals.com/issues/04.01.25.html. January 25, 2004 (last visited July 17, 2007).

^{iv} Woodard, Dustin. “The History of Mutual Funds,” About.com: Mutual Funds, http://mutualfunds.about.com/cs/history/a/fund_history.htm, last visited July 17, 2007.

^v Investment Company Institute, “2007 Investment Company Factbook,” Data Tables, Table 1. http://www.icifactbook.org/fb_data.html (last visited July 17, 2007).

^{vi} Investopedia, “The Importance of Diversification,” <http://www.investopedia.com/articles/02/111502>, November 15, 2002 (last visited July 17, 2007).

^{vii} Bernstein, William J. “The 15-Stock Diversification Myth,” Efficient Frontier, <http://www.efficientfrontier.com/ef/900/15st.htm>, last visited July 17, 2007.

^{viii} “NYSE Number of Listed Companies (1929-2002), NYSEData.com, Market Data Products, Facts & Figures. <http://www.nysedata.com/nysedata/Home/FactsFigures/tabid/115/Default.aspx>. Last visited July 17, 2007.

^{ix} “Market capitalization of NYSE companies,” NYSEData.com, Market Data Products, Facts & Figures. <http://www.nysedata.com/nysedata/Home/FactsFigures/tabid/115/Default.aspx>. Last visited July 17, 2007.

^x Investment Company Institute, “2007 Investment Company Factbook,” Data Tables, Table 1. http://www.icifactbook.org/fb_data.html (last visited July 17, 2007).

^{xi} “NYSE Group – Number of Issuers (2003-present),” NYSEData.com, Market Data Products, Facts & Figures. <http://www.nysedata.com/nysedata/Home/FactsFigures/tabid/115/Default.aspx>. Last visited July 17, 2007.

^{xii} “Market capitalization of NYSE companies,” NYSEData.com, Market Data Products, Facts & Figures. <http://www.nysedata.com/nysedata/Home/FactsFigures/tabid/115/Default.aspx>. Last visited July 17, 2007.

^{xiii} Investment Company Institute, “2007 Investment Company Factbook,” Data Tables, Table 1. http://www.icifactbook.org/fb_data.html (last visited July 17, 2007).

^{xiv} Richards, Archie. “Understanding Exchange-Traded Funds.” McGraw-Hill, 2007, p.52.

^{xv} Salisbury, Ian. “Special Report: ETFs—What You Need to Know: Evaluating Exchange-Traded Funds.” The Wall Street Journal, May 20, 2007 p.2.

^{xvi} “ETF Investing Guide: ETFs are Cheaper Than Index Mutual Funds.” Seeking Alpha, <http://etf.seekingalpha.com/article.15170>. Last visited July 27, 2007.

^{xvii} Investment Company Institute, “2007 Investment Company Factbook,” Data Tables, Table 12. http://www.icifactbook.org/fb_data.html (last visited July 17, 2007).