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ETFs give investors few surprises

by ***Russ Wiles*** *- Jan. 5, 2011 12:00 AM*
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Victims of Bernard Madoff's Ponzi scheme should have invested in exchange-traded funds.

Known as ETFs, these funds offer an advantage that has become more obvious: Unlike the secretive Madoff scheme, they're highly visible and transparent. It's not surprising that Madoff's name surfaced a few times at a recent Phoenix conference devoted to ETFs.

If you're looking for something that's 180 degrees different from what Madoff was up to, it would be these vehicles.

"With ETFs, you don't get hit by surprises, where the manager invests in things you didn't know about," said Alan Rosenfield of Harmony Asset Management in Scottsdale and a speaker at the Super Bowl of Indexing conference held at the Arizona Biltmore.

Many investors already have come to appreciate ETFs for other reasons. They tend to be among the lowest-cost ways to enter the stock or bond markets. They also tend to be easy to buy and sell. You can trade them at prices throughout the day, as with individual stocks.

These advantages have translated into increased popularity. Domestic-ETF assets now approximate $1 trillion, double the level of five years ago.

They're not as old as mutual funds, with which they're commonly compared, but they offer better deals in some respects. One underappreciated aspect is transparency. Unlike the secretive Madoff, what you see with ETFs is what you get.

ETFs share many similarities with index mutual funds, which predated them by two decades. But they've taken it to another level in terms of offering more intriguing investment choices.

You can buy ETFs pegged to the Dow Jones industrial average, the Standard & Poor's 500 index and other widely followed market barometers, including foreign ones.

You can also find ETFs that invest in bonds, commodities, foreign currencies, and sectors like technology or real estate.

"You can drill down to industries and subindustry groups," Rosenfield said. "Maybe you want not oil stocks but oil-services firms, or maybe just Vietnamese stocks (rather than Asian companies in general)."

Some ETFs get highly specialized. The Rydex family offers various indexes that give an equal weighting to each stock, unlike most index portfolios that are dominated by the most valuable firms.

The ProShares group offers more than 50 funds that let you short or bet against the stock market or various subgroups and leverage those bets. The firm also just introduced funds that rise and fall in value as market volatility changes.

The EGShares group focuses on funds that aim to capitalize on the development of power systems, transportation links, telecommunications and other infrastructure projects in China, India and other emerging nations.

The firm's Brazil Infrastructure fund "is a nice, liquid way to play Brazil's World Cup and Olympics bids," said Richard Kang, the firm's chief investment officer.

Fund groups have been busy coming up with new ways to slice and dice the financial markets, proving that suitable investment indexes, like beauty, are in the eyes of the beholder.

Joanne Hill, head of investment strategy at ProShares, calls ETFs a "democratic tool" because so many strategies once reserved for institutional investors now are available to the masses.

This isn't to imply that ETFs are risk-free - far from it. If the underlying index like the S&P 500 drops 10 percent, your fund will fall by the same degree.

Those funds that are leveraged are even more speculative, allowing you to double or triple your return but with two or three times the risk.

Some indexes, and thus the ETFs that track them, are obscure and can be hard to analyze and value, Rosenfield said. Others aren't as diversified as you might think.

Rosenfield cites iShares MSCI Brazil, in which three large Brazilian companies account for more than 40 percent of fund assets.

"So there you are, taking big bets on a few stocks when you thought you were getting nice diversification," Rosenfield said.

He said many of the funds that invest in commodities, currencies or bonds or make use of shorting or leverage can be confusing as well as dangerous.

As for the more plain-vanilla ETFs that have attracted the bulk of investor dollars, such as those focused on S&P 500 stocks, it's important to note that they aren't trying to beat the market's performance but match it.

The problem with trying to beat the market is that it's hard to do consistently, even for pros.

ETFs save money because they aren't paying for high-priced manager salaries or azcentral.com ARIZONA'S HOME PAGE

expensive tire-kicking research junkets. They can, and do, pass those savings along to investors.

Some of the most penny-pinching ETFs charge about 0.1 percent in annual expenses, which is equivalent to $1 on a $1,000 investment.

As another plus, ETFs tend to be highly tax-efficient. That means they don't distribute much, if anything, in the way of capital gains on which you must pay taxes.

They're like individual stocks in that respect because you lock in taxable gains only when you sell your position.

This contrasts with the situation for most mutual funds, which can saddle you with a taxable distribution in any year, whether or not you hang onto your shares.

Tax efficiency is important because nobody likes to incur a tax bill early. But in light of scandals like Madoff's, the transparency angle can't be understated.

Because ETFs hold the same stocks that are part of a defined market index or barometer, you know what you own.

This provides comfort to those seeking predictability in their portfolios.

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