By Danielle Schultz

Investing

Ideas, Strategies, and Cautions from the Morningstar ETF Conference

Before you put your eggs in a market basket of ETFs, you'd better know what's in the basket. The original crop of ETFs was composed mostly of index funds based on established market indexes, but as the industry has expanded, so too have the variations. Any planner seeking to diversify client holdings by strategic asset allocations to ETFs or tactical selections of sectors or industries needs to know more about the underlying collection of investments, the dollar amount of the ETF's portfolio, how closely the share price tracks the actual net asset value, what the spread is between the bid and ask prices, how to place an order, and whether the fund's orientation is primarily aimed at strategic or tactical investors. The Morningstar ETF Conference in Chicago in September had plenty to say on all these points. Here are some highlights:

Indexes ain't what they used to be. Originally, ETFs were composed of investments designed to track a recognizable index, hold a huge collection of securities, and offer strategic asset allocators the benefits of a mutual fund and the trading facility of stocks. While ETFs galore still track war horses like the S&P 500 or the Russell 2000, now anyone can create an index. The popularity of ETFs has caused the industry to create more and more products to attract investors seeking specific sectors or strategies. The indexes for these sectors are not necessarily well-verified or broad enough to provide the hoped-for reflection of the market.

Is it a basket or a thimble? ETFs that focus on sectors may contain an insufficient number of different securities. Commodities ETFs, for example, may focus on only a few sectors, and they may contain fewer than 50 different underlying investments. Commodities ETFs haven't tracked the applicable indexes very well, and those indexes haven't tracked the market very well, either.

Bond ETFs are popular right now. But bond funds may need to hold thousands of bonds in order to reasonably approximate the appropriate bond market. The narrower the sector, the closer an investor should look at whether the number of securities in the portfolio can really produce the desired diversification.

Investors and advisors should be aware of just how large the ETF actually is. Some ETFs have assets under $10 million, but there are some indications that $30 million or so may be a cut point for survivability. In fact, companies have terminated ETFs where management costs exceeded revenue. Also, for a small ETF, a large individual investment may not be possible, or it might inadvertently influence the market.

The tortoise or the hare? ETFs are beloved of ticker watchers because they trade just like stocks, but the "flash crash" on Wall Street in May 2010 demonstrated an inherent vulnerability: Unlike mutual funds, an ETF's price can plunge or soar independently of its actual net asset value (NAV). While ETFs quickly recovered to reflect their actual NAV, investors with stop-loss orders on their ETFs saw huge losses as the market plunged and those orders were executed. As with stocks, when the market rode back up, these investors were shut out. About 70 percent of the trades in ETFs during the flash crash were cancelled.

Numerous speakers at the Morningstar conference cautioned against not only stop-limit orders, but also against placing market orders. On a trading day with low volume or high volatility, the spread between the bid and ask prices for ETFs can widen, and the prices can diverge from the NAV. This is especially critical for smaller or thinly traded ETFs. The investor placing an order should select a specific price/limit for the order. Richard Ferri, founder of Portfolio Solutions® LLC, recommended trading ETFs between 10 a.m. and 3:30 p.m. Eastern Time, since bid/ask spreads are higher at the beginning and end of the trading day.

No one agrees on commodities. Everyone wants an alternative-investment ETF, but it's not so clear what that is. In 2009, $30.1 billion in new money flowed into commodities ETFs (pushing the asset class to $277 billion total) as investors sought alternatives to conventional investments with low current returns. But more than perhaps any other area of the ETF market, indexes designed to track commodities are unstable and do not necessarily produce the return of the market. Part of the problem is the disagreement over how, exactly, to measure that market.

Currently, the bulk of investor dollars has flowed into physically backed precious metals funds, designed to track the spot price of gold, silver, or stored bullion. A second style of ETF aims to track indexes of securities of companies whose underlying business is commodity-related. A third kind of commodities ETFs is derivatives based, so it holds futures contracts and incurs the risk that the futures will be caught in contango if the

commodities' prices drop. This third type was featured in the recent *Business Week* article, "Amber Waves of Pain," as the worst investment in America.

Jim Green of Rosetta Capital Management pointed out that contango exists in a market that has a surplus, but the inverse can produce excellent performance for investors. However, noted Green, "Storage and interest charges [for commodities] cost a lot. The price must outrun the cost of carrying the product in order to make money," a factor that usually does not influence conventional securities so directly. "'Commodities' is not an asset class. Each commodity has its own fundamental," cautioned Green.

It might be wise to view any commodities investing as a special situation, and the investor needs to have a good understanding of the idiosyncratic risks of a specific commodity. In addition to spoilage, storage, crop yield, and weather, cultural factors may have surprising influence. Fred Jheon, of ETFs Marketing LLC, told investors to look for gold prices to rise during the Indian wedding season, from September to December. "Fifty-five percent of gold demand is jewelry-based, 40 percent goes to investors, and the remainder is industrial—dental, electronics, etc.," he said.

Finally, investors in commodities are faced with a choice of ETFs or ETNs (exchange traded notes). ETNs may actually track their indexes more faithfully, but they also introduce an added risk—the creditworthiness of the bank backing the note. So, investors need to be aware of not only the risks of the investment itself, but also the sturdiness of its backers.

Several speakers said they believe it is futile to invest in commodities at all. "It's a zero-sum game [for futures-type funds]," said Ferri. "There's no dividends, no interest, no share buy-backs. They don't belong in a passive portfolio. They're a tactical maneuver."

Can't follow the leader. The variety of alternatives points up a problem that is to some extent a danger with all ETFs (or mutual funds, for that matter): tracking error. The index might not accurately reflect the actual market, and the ETF or fund might not accurately track the index. The index itself can have faulty design, non-representative components, or lack of sufficient quantity of investments. In more widely recognized or well-established indexes, the fund's failure to track the index may be because either the fund's management expenses are so high that the gap between the index and the fund is costly, or because some element of manager choice introduces tracking error.

Investors and managers should take a close look at how any fund tracks its index, but special attention should be given not only to alternative or sector funds, but also to more conventional bond funds.

Both Ferri and Michael Iachini, director of Investment Manager Research at Charles Schwab, suggested that investors pursuing a passive strategy may want to avoid bond ETFs in favor of bond mutual funds, especially with munis, corporate, or total bond funds. Since bonds are traded over the counter, the prices of the ETF intraday can diverge sharply from the NAV and may reflect investor sentiment more than the underlying values of the bonds.

Many more flavors than plain vanilla. If you can imagine it, it's probably available as an ETF: hedge funds ETFs, long/short strategies, bear market, currencies, and a myriad of other alternatives. Even some actively managed ETFs are being introduced, with the ETF advantage of transparency and instant valuation. It's a big ocean for the tactical manager who can use ETFs to turn the ship much faster than with mutual funds.

Sidestepping the tax man. Besides (usually) offering much lower management costs than similar mutual funds, ETFs offer tax advantages inherent in their structure. Whereas the mutual fund manager may need to redeem securities in order to pay fund holders who are redeeming shares, potentially generating both long-term and short-term capital gains, an ETF trades only in its own shares. Mutual fund redemptions may therefore generate taxable gains for fund holders who have simply held shares, while ETF investors will only have capital gains if they sell their own shares.

Watch the clock. Settlement times can vary between mutual funds and ETFs. While mutual funds held within the company (for example, Vanguard mutual funds held at Vanguard) will usually not cause a problem, some advisors have seen long settlement times on "outside" mutual funds traded through fund supermarkets. ETFs, like stocks, have a three-day settlement requirement, so advisors who are rebalancing or re-allocating client portfolios need to be sure that money for settlement will be there when a trade has been placed.

What's an ETF, anyhow? Don't feel stupid if ETFs are not yet second nature. Morningstar's ETFs 101 session was very well-attended by a well-heeled assortment of apparently experienced advisors. Although ETFs have been available since the 1990s, whether and how they fit into a portfolio is still a subject up for grabs. With the increasing variety and proliferation of ETFs, and the occasional surprises in their behavior (think flash crash or tracking error), advisors may find themselves explaining ETFs to clients for some time to come, beginning with the fact that we're not talking about electronic fund transfers.

For those who are particularly gripped or befuddled by the subject, Morningstar has extensive summary notes and interviews with many of the presenters. Go to Morningstar's website, and search "ETF Conference." Rick Ferri has a classic work on ETFs, The ETF Book*, and an extensive discussion of active vs. passive fund investing in his upcoming* The Power of Passive Investing**.** NA

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