

Sizing Up Exchange-Traded Funds



Steven A. Schoenfeld is the chief investment officer of the Quantitative Management Group at Northern Trust Global Investments. He chairs NTGI's Global Quantitative Investment Committee, which focuses on delivering world-class product capabilities and investment performance to clients. He also is the editor of *Active Index Investing* (Wiley Finance, 2004, Toyo-Keizai, 2006).

Exchange-traded funds are increasingly popular tools for investors trying to broaden their exposure to global equities markets. But how do you decide which ETFs measure up best to suit your goals?



With stock-like trading characteristics, low costs, transparency and tax efficiency, exchange-traded funds (ETFs) have wooed and won many retail and institutional fans during the past 15 years.

Now, more than 700 ETFs collectively offer investors broad industry and geographic coverage. During the first half of 2008, firms unveiled approximately 120 new ETFs, according to mutual fund analysis firm Lipper, while assets in U.S.-listed ETFs now top \$600 billion. Although that pace has slowed with a more bearish market environment, the long-term trend of ETF

growth is expected to continue. In fact, the U.S. Securities and Exchange Commission is currently implementing a streamlined ETF approval process to move them into the marketplace faster.

Choosing Wisely

Several retail ETF screening programs are available to help narrow the field of choices, but these programs assume you already have some idea of what type of ETF you need, and they generally are not customized to address specific portfolio needs.

So how do you choose? Whether you are a self-directed, hands-on investor, or you largely

leave those decisions to your financial advisor, there are some concepts you should keep in mind. The best overarching tip is this: Think long-term, think strategic and ask yourself the following basic questions when evaluating whether an ETF makes sense for your circumstances and needs.

Does It Fit?

How does this new ETF fit into your overall portfolio? Is it the best vehicle to accomplish the goal? Find out what the ETF brings to your portfolio that is new. It might offer exposure to a new asset category not already in your portfolio, or maybe it deepens or broadens existing exposure to a category.

For instance, your international investments might be built on a core of capitalization-weighted index funds with regional exposure across the entire non-U.S. equity asset class. Then you can add a strategic or tactical overweight in certain individual countries. But if you have exposure only to developed markets, that's not the full international product set. So investing more broadly to include emerging or even frontier markets might be useful to your overall portfolio. You may want to use ETFs to accomplish those goals.

Does It Provide Proper Exposure?

Does the ETF provide efficient exposure to a defined asset category and/or index? Is the index well-known and transparent in its construction? How accurately does the index reflect the market it intends to capture? Beware of so-called "label risk" and check whether the index actually delivers the exposure that its name leads you to think it does. For instance, nearly 50% of the first frontier market ETF's investments were in Poland and Chile, which really are standard emerging markets and not frontier markets. So make sure that what you see is what you really get — that the ETF actually delivers the exposure you want in your portfolio.

Is the Manager Experienced?

Does the ETF sponsor or manager have experience developing and maintaining index-based products? One benchmark you can use is whether the manager, even if it is new to the ETF marketplace, already has assets in that particular category. If you're considering international equity index ETFs, find out whether the manager already has several billions or tens of billions of dollars under management in that category. In addition to the amount of assets under management, consider the manager's overall breadth of experience.

Understanding ETFs Novel Idea, Many Choices

The ETF concept is novel yet quite straightforward. An equities-based ETF wraps together a basket of stocks tracking a specific index into a single instrument that trades like a stock on a securities exchange. You can trade ETFs at intraday prices instead of only at the once-daily net asset value price used by mutual funds. Also, because most ETFs are index-based investment programs, they offer a more efficient delivery mechanism and tend to have lower expense ratios than comparable mutual funds. In addition, because of the way ETFs are built, they rarely distribute capital gains, a key benefit for investors holding them in taxable accounts.

The success of the biggest ETFs has spawned a huge array of offerings, from plain-vanilla U.S. blue-chip stocks to wind-powered energy and commodities. There also are single-market ETFs that enable an investor to target specific developed- or emerging-market exposure. The ever-broadening range of ETFs may make it more challenging to pinpoint which specific ETFs are optimal for your particular financial needs and goals. But chosen with careful research and analysis, these vehicles may serve a valuable role in your portfolio.

How Well Has the Manager Performed?

What is the expected "tracking error" of the ETF versus the index benchmark? A manager may have the experience, but tracking error provides a useful way to measure the manager's performance for that index.

How Liquid Is the ETF?

What is the liquidity of the ETF, both in the secondary market and in the underlying basket of stocks comprising the ETF? Liquidity is important because less-liquid markets can make trading potentially more expensive.

As the industry continues to evolve, interest and investment in ETFs likely will grow, including in newer iterations based on frontier markets, fixed income and even actively managed ETFs. But just because it sounds sexy or tracks a current theme within the financial industry doesn't mean a particular ETF is the best one for your portfolio. Investors will have to be increasingly diligent about understanding what's inside these ETFs. And that makes education and a long-term focus even more crucial. ■