The Rennie Quarterly Return

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ETFs – Exchange-Traded Funds

In the context of stocks, bonds, mutual funds and other popular financial instruments, exchange-traded funds (ETFs) are the new kids on the block. Innovation, usually driven by necessity, introduced ETFs in 1993 to fill a void in the marketplace. However, the tremendous popularity of ETFs today is evidence of a more mass appeal.

Filling the void

Before 1993, large financial institutions lacked a highly -liquid investment vehicle that provided broad market exposure with all the ease of purchasing a single stock. Sophisticated trading strategies, hedging, and maintaining market exposure throughout manager transitions all drove the institutional demand.

Mutual funds, which can provide broad market exposure, cannot be purchased or sold intraday on an exchange; shares are transacted at end-of-day prices. Swaps, futures, and other derivatives which existed at the time were not "user friendly" either.

Enter the first modern ETF launched by State Street Global Advisors. The SPDR ("spider," symbol SPY) tracks the Standard & Poor's 500 Stock Index and is not only the oldest, but also the most widely held ETF today.

To the masses

Following the SPDR, new ETFs designed to track other market indices, sectors, and commodities were introduced. With each new iteration, their appeal expanded beyond institutional investors. The rapid individual investor adoption observed has been attributed to several factors.

The late '90s and early '00s witnessed a technology stock "bubble" and, hardly coincidentally, the rise and subsequent fall of "day-trading." ETFs covering the technology sector, among others, were tailor made for the speculative and fast-buck mentality that permeated the market. Some ETFs even allowed investors to "short" the market, positions that profit when the market falls, a privilege previously reserved for "sophisticated investors" only.

ETFs versus mutual funds

It is important to note that even today, dollars in mutual funds exceed dollars in ETFs by a factor of 10. That said, ETFs share many of the advantages of mutual funds including instant diversification, liquidity and low transaction costs. However, besides intraday tradability, there are other important differences for investors to consider.

ETFs do not provide the opportunity for professional management outperformance. However, recently a few actively-managed ETFs have been introduced.

Top 10 ETFs By Average Daily Trading Volume

ETF	Symbol	Avg. Daily Volume
SPDR S&P 500	SPY	132,923,100
iShares MSCI Emerging Markets Idx	EEM	52,593,430
Financial Select Sector SPDR	XLF	51,394,140
iPath S&P 500 VIX ST Futures ETN	VXX	42,868,260
iShares Russell 2000 Index	IWM	39,698,060
PowerShares QQQ	QQQ	36,192,930
iShares MSCI Japan Index	EWJ	31,114,760
Vanguard FTSE Emerging Markets	VWO	19,279,300
iShares MSCI EAFE Index	EFA	18,348,710
ProShares Ultra VIX Short-Term Fut	UVXY	17,317,800

The trend toward indexation, widely supported by Academia and some mutual fund companies, also drove ETF creation; most ETFs are index funds.

Finally, a financial industry trend towards "fee-based" advice, a departure from the commission-based sales model of the past, has driven advisor acceptance of ETFs. The moral hazard of selling 500 stocks versus a single ETF no longer exists in a fee-based model.

Unlike an open-end mutual fund, an ETF's price can trade at a premium or discount to the net asset value of the underlying portfolio. Paying a premium for an ETF entails additional risk.

Annual expenses are typically lower for ETFs than their index mutual fund peers. This is primarily due to real operating efficiencies available to ETFs.

ETFs are typically more tax efficient than mutual funds. Mutual funds must realize capital gains/losses daily due to security changes within the fund, and purchases/sales to meet shareholder cash flows. For ETFs, capital gains/losses are realized only when the ETF owner decides to sell. However, this is moot in tax-deferred accounts.

Gary B. Rennie, CFP®, AWMA®
Chief Executive Officer
Phone/Fax: (949) 679-4775
Cell: (949) 769-1343
Email: gbrennie@cox.net

E. P. Rennie, CFP®, CFA®
President
Phone: (949) 650-8622
Fax: (949) 650-6683
Email: ecrennie@att.net

www.rennieandassociatesfp.com

Our Two 

"Gold gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head.".

Warren Buffett.

Quarterly Trivia:

What is the leading energy source for US electricity production today?

Coal – 40% of US Electricity