Exchange-traded funds (ETFs): A brief guide

They go by unusual names: Vipers and Diamonds. Spiders and Cubes. As a group, they're more formally known as *exchange-traded funds*.

Although they have been around for some time now, it is only in recent years that ETFs have begun to receive significant attention and grown in popularity.

Both fund and stock

ETFs are a hybrid.

In some respects they are much like index mutual funds: ETFs are registered investment companies that provide investors with the benefits of professional management and diversification of their investments by replicating an index's holdings and performance.

An ETF also may track a sector of an index, such as the S&P MidCap 400. As with a mutual fund, each share of an ETF entitles the holder to a proportionate amount of any income or any gains or losses that result from the fund's holdings.

But the purchase of an ETF bears an important resemblance to the purchase of shares of stock. EFTs may be traded on the American Stock Exchange (currently, most available offerings trade there) and are bought and sold through a broker at any time that the Exchange is open. (When you buy and sell mutual fund shares, the shares are valued at the end of the trading day.) They are flexible as well—ETFs can be shorted, optioned and margined.

Back to those exotic nicknames: "Vipers" are ETFs that track the total of stock market indexes. You own "Diamonds" when you have an ETF that tracks the Dow Jones Industrials. "Spiders," or SPDRs, track the S&P 500; "Cubes," the Nasdaq 100. Another common moniker, "iShares," refers to various U.S and international indexes issued by Barclay Global Investors.

Weighing the benefits

In terms of the annual expenses charged to investors, ETFs may be less costly than the majority of mutual funds. However, in some cases, the difference may not be significant

and could well be offset by the fact that investors must pay commissions to buy and sell ETFs, just as they do for any stock transactions.

ETFs may be tax efficient. Investor selling can force a mutual fund manager to sell stocks to meet redemptions. The fund recognizes taxable capital gains that are passed on to shareholders. By contrast, most trading in ETFs takes place between shareholders, shielding the fund from the need to sell stocks to meet redemptions. (However, *tax efficient* does not mean *tax free*—nearly all ETFs have distributed gains at some point—and tax efficiency varies significantly depending upon the underlying index.)

As mentioned, ETFs can provide a great deal of flexibility. That benefit can turn into a drawback if an investor is not careful. When used as a short-term investment, jumping in and out of ETFs may absorb any cost benefit by adding on trading costs. John Bogle, the "father of index investing," likened ETFs to a shotgun: "They can be used for self-defense, or they can be used for suicide."

Are ETFs right for you?

The answer to that question will depend upon your current investment activity. For instance, consider ETFs if you are engaging in large transactions so that the brokerage commissions that you pay are spread across sizeable sums. On the other hand, mutual funds may make more sense if you don't make frequent trades.

In the end, perhaps, you may want to explore a different approach. We would be glad to tell you about our investment management and advisory services. We can offer you a systematic, personalized approach to the development and management of your portfolio. Call upon us at any time to find out how our professional asset management services can benefit you and your family.

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