The ABCs of ETFs

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When a paradigm shift occurs, new opportunities arise for those who can appreciate and effectively utilize it. Paradigm shifts in orthopaedics occurred in the last 25 to 35 years with the development of arthroscopic and joint replacement surgery, and exchange traded funds (ETFs) represent a paradigm shift to the investing world. Just as it is hard to imagine orthopaedic practice in 2010 without these standard therapeutic modalities, ETFs provide significant advantages to those who understand them, appreciate them, master them and employ them in their daily practice. ETFs were introduced about 18 years ago. In this article, I will delineate the features that are responsible for their increasing use and popularity as a wealth-enhancing tool.

An ETF is a security that tracks an index, a commodity or a group of assets. In this respect it is similar to index mutual funds, but that is where the similarity ends. ETFs trade like a stock on a stock exchange. Investors are now flocking to this new investment tool, mainly because of lower costs and lower taxes when compared to alternatives. In addition, we see many other advantages to ETFs, including:

- Tax efficiency
- Lower costs
- Diversification
- Enhanced asset allocation and portfolio management
- Trading effectiveness
- Tactical strategies
- Risk management & transparency

Tax Efficiency

A few factors provide tax efficiency to ETFs as compared to mutual funds or other investments, which must sell stocks when clients redeem shares. This can trigger capital gains income and taxes, even if the value of the mutual fund drops. ETFs do not share this problem. Another tax saving feature involves *wash sales*. Such a sale occurs from taking a loss on the sale of a stock that you repurchase within 30 days. It is possible to circumvent this restriction by selling one ETF and purchasing a second ETF that tracks a similar index.

Cost Efficiency

ETF costs are lower because most are passively managed index funds avoiding expensive managerial fees. Mutual funds are subject to 12b-1 fees, which are annual marketing or distribution fees. ETFs are not subject to these burdensome and inappropriate fees. These fees do not serve investors' interests or inflate mutual fund costs, and I view them as anachronistic in today's investing environment.

Diversification

ETFs exist that cover almost every equity, commodity, sector, geographic location and debt instrument. *Broad-spectrum* diversification, so important today in minimizing risks to one's portfolio, is thereby enhanced.

Trading Effectiveness

Margin, stop, limit orders, short selling and the ability to trade during regular stock exchange hours form the basis for considering ETFs a *paradigm shift*. These allow the investor the flexibility to move away from picking individual stocks or mutual funds. It gives the investor advantages of diversification as ETFs consist of baskets of securities. This diversification reduces the risks inherent in investing in individual stocks. ETFs can be traded intraday, while mutual funds can only be traded at 4:00 p.m. daily. Basic trading tools, such as limit orders and margin purchases, can be profitably utilized with ETFs and are not available to mutual fund owners.

Tactical Strategies

Inverse ETFs move opposite to the direction of the market. These enable the investor to efficiently invest in the direction she/he anticipates the market is heading. Leveraged ETFs can magnify these investments either positively (*super bull*) or negatively (*super bear*) in order to enable the investor to best act on his advice, information, instincts or goals. ETFs also can be used to *hedge*. This is a strategy in which one investment is used to offset the risk of another investment.

Risk Management & Transparency

Transparency of ETFs is another important advantage. In investment jargon, transparency refers to the extent to which investors have access to financial information about a company or fund. Mutual funds provide information on their holdings quarterly, ETFs daily. Transparency, the availability of inverse and leveraged ETFs and trading during regular market hours have all enhanced trading strategies and made ETFs very attractive.

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No lunch is free, however, and negative features that accompany ETF's advantages include:

- Trading costs that must be factored in
- Dollar cost averaging trading costs may be higher
- Sparsely traded ETFs may be more expensive to trade
- The designated index may be defined differently than you think

Trading costs must be considered. High fund costs are infrequent, but possible. At times, the designated index may not be tracked accurately or may use a derivative to match tracking. The risks inherent in ETFs are the same as the commodities or securities they contain.

It is exciting to witness this disruption in traditional investing and modification of the investment paradigm. You must learn about ETFs in order to master them and profit from them or hire a manager to provide that skill set. Modern portfolio management and asset allocation are fundamental to asset growth and protection. ETFs can enhance these, improve performance and can be a wealth enhancer.

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Glossary of Useful Terms

12b-1 fee: annual fee charged by some mutual funds to pay for marketing and distribution activities

Expense ratio: mutual fund's operating expenses/average dollar value of its assets under management

Inverse ETF: moves in the opposite direction of the equity or bond market

Limit order: order placed with a broker to buy or sell a specific number of shares at a specified price or better

NAV (Net Asset Value): market price of a mutual fund's total assets, minus liabilities, divided by the number of shares outstanding

Stop limit order: combines a stop order with a limit order; the trade is executed at a specific or better price after a given stock price has been reached

Stop order: order to buy or sell a stock when its price passes a particular point

Wash sale rule: IRS rule that prohibits claiming an investment loss if that investment or a substantially identical investment is purchased within 30 days before or after the sale