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ETFs - The Next Bigger Thing: More Individual Investors Expected to Jump in This Year

by: Rob Luke

They've been the star investment products of the past few years. And if most experts get it right, 2005 will be yet another stellar year for exchange traded funds (ETFs).

ETFs continued to pile up assets and expand into ever-more specialized niches throughout 2004 as more institutional and individual investors discovered their cost, tax and flexibility advantages. According to Morgan Stanley (reported in The Economist, July 31, 2004), assets in ETFs grew by more than 16 percent in just the first half of '04 and were on pace to match that by year-end.

Although institutional investors by assets account for 70 percent of ETF usage, most of the numerical growth in ETF investment has come from individuals, particularly those who like to take shorter-term positions in the market. Two well-known ETF analysts, Frank Kollar of FibTimer.com and Deron Wagner of Morpheus Trading Group, whose alert systems both are aimed at such individual "market-timers," say their small-investor client bases have grown steadily to where they now constitute 90 percent of the total. That reflects overall-reported growth in customer numbers among similar market-timing services.

Each expects more growth in '05 given that, for many, ETFs are the easiest and cheapest way for individuals to gain exposure to the market or any part of it tracked by an index. For Kollar, founder of Charlottesville, Virginia-based Kollar Market Analytics, ETFs are "the perfect vehicle" for more active investors like pattern traders and trend followers. "Where else can you buy the [entire] oil industry?" he asks.

Frank Minssieux, president of market-timing strategy firm TimingCube, which provides buy and sell signals for ETF-based trend-traders, also has his eye on that surging wave of growth. He notes that ETF assets have grown from $60 billion in 2000 to 100 billion by mid-2004, $70 billion of it in the two most liquid ETFs, the QQQs and the SPDRs. "It's been a tremendous increase, and we don't see it stopping in 2005," Minssieux says.

Surf's Up

The rise in individual investor interest in ETFs comes from two sources. The first is disgruntled mutual fund and long-term equity investors who have soured on those industries after recent, well-publicized troubles but still want to stay exposed to the markets. Their numbers are expected to grow rapidly because of ETFs' cost and tax advantages compared to other managed funds – not to mention the fact that index-based funds almost always beat actively managed funds over the long term.

Analysts like John McClure, president and CEO of EquiTrend, a market-timing newsletter service for ETF investors, predict that ETFs will continue to take business away from mutual funds, although the latter still dwarfs them in assets. But he says that "ETFs are now appearing in 401(k)s and are becoming a lot more mainstream." That's true, and to add an exclamation to that claim, says McClure, "Even mutual funds are using ETFs now."

The other source of individual-investor interest in ETFs is the same thing that brings those mutual funds in: short-term exposure to a trending market. For individual investors who profit by riding market waves up or down (variously called momentum traders, trend investors or market timers), ETFs are nowadays the investment vehicle of choice because they are both cheaper and easier to use than any other type of basket-trading investment.

The American Stock Exchange (Amex), the largest exchange for ETFs with more than 100 offerings, is clearly marketing them to both groups of individual investors. In the ETF "Individual Investor Education" section of its website (www.amex.com), Amex lists a string of advantages that ETFs offer for individual investors. While some clearly are aimed at disgruntled mutual fund investors (much lower expense ratios, access to dividends, tax advantages), others clearly target the active investor. These include touting ETFs' intraday pricing, short selling with no uptick rule, plus the availability of margin, stop orders and limit orders.

More active market-trend investors, who typically make four to twenty trades per year depending on how aggressive or conservative their strategy, also like the monetary advantages that are luring mutual-fund holders into ETFs. But for these particular investors, say the experts, ETFs have two other key advantages.

The first is diversity. Because a single ETF share can have the effect of "owning" the whole market at once, there's no need to buy anything else (thereby saving transaction fees); consequently, there is a very low risk of over-exposure to a single stock (like Enron) – which often happened when traders tried to create their own baskets of securities. The second is flexibility: investors can buy and sell ETFs on an exchange and also short them with no uptick rule (i.e., you can short sell them even if the price has dropped), meaning more active traders can use ETFs to ride trends up and down. From the point of view of individual investors, says Kollar, "To be able to trade both long and short in a specific industry is a very attractive option."

SIDEBAR

What's in a Name? Deciphering the Nomenclature Of Exchange-Based Index-Fund Trading

Nobody disputes the certainty of death or taxes. But the surety that the investment industry will churn out lots of similar products with a plethora of confusing names and nicknames must rank a close third, at least to the frustrated individual investor.

So it's been for exchange traded funds (ETFs), the most talked-about newer investment product among individual investors of the past few years. Some of that talk, no doubt, has focused on what the heck the difference is between all these funds and "shares." We'll try to keep it simple.

The main ones you probably already know are the biggies – the original ETFs launched by the American Stock Exchange (Amex) that track major American trading indexes. The oldest and best known are those following: the S&P 500 (SPDRs or "spiders"), the Nasdaq-100 (QQQs or "cubes") and the Dow Jones Industrial Average (DIAs or "diamonds"). Lately the ETF that tracks the Russell-2000 (ticker symbol IWM) has joined that list. There also are a vast array of Amex-traded ETFs that track individual sectors within these larger ETFs - one of the best known and most popular, thanks to its volatility, is the semi-conductor ETF (SMH).

According to Helen Modly of ratings agency Morningstar, in her publication "A Pocket Guide to Exchange-Traded Funds Part 2" (http://advisor.morningstar.com/advisor/doc/article/0,8832,3827,00.html), all these ETFs are unit investment trusts (UITs) – essentially that means they are like mutual funds but without the high management fees. But UITs also redistribute dividends to the investor, either directly or later through re-investment. A similar product, also classified as a UIT, is Bank of America's Basket of Listed Depository Receipts (BLDRS or "builders"), which are international ETFs that track indexes of American Depository Receipts (ADRs), Modly writes.

Yet another group of ETFs well known to individual investors – iShares, PowerShares and Streettracks – are classified slightly differently. These are known as "40-act funds" because of the name of the legislation that allows them; they are almost identical to UITs – tracking similar indexes and trading on the Amex – except that these funds re-invest dividends immediately, thus "reducing tracking error to the underlying index caused by cash holdings." Perhaps the best known 40-act ETFs are iShares, produced by Barclays Global Investors, America's largest producer of ETFs. The Amex-traded iShares are ETFs that mostly follow Goldman-Sachs technology indexes.

A more recent entry has been the Vanguard Index Participation Receipts (VIPRs), which Modly says are an additional share class of Vanguard's index mutual funds. Vanguard's 16 VIPRs offer what Modly calls "some of the most broadly diversified ETFs available today." But because of their structure, she points out, VIPRs also are potentially subject to capital gains tax due to activity by other shareholders in the fund, a problem that does not exists with other classes of ETFs.

Finally, there's what Modly calls "probably the most unique form of ETF" - Holding Company Depository Receipts (HOLDRs). Marketed by Merrill Lynch, HOLDRs are baskets of 20 stocks that track specific sectors or industries, and investors are considered owners of underlying stock, with all attendant rights. HOLDRs also allow the investor to swap them for the underlying shares non-taxably, allowing owners to sell losses and defer gains. They are especially popular with active traders, she notes, because they are sold in lots of 100 and, so, offer the increased volatility of a concentrated portfolio.
It seems a solid ETF, by any other name, will return as sweet.

What Are You, Nuts?

But not every observer approves of all this enthusiasm for ETFs, especially the active trading part. A recent report in The Economist, entitled "Entirely Too Frenetic?", questioned whether investors – those dedicated followers of fashion – were jumping into ETFs because they seem to be "the coolest thing on the planet." It also quoted the response of John Bogle, founder of index-fund pioneer Vanguard, to the claim of some ETFs that investors can now trade the S&P 500 all day in real time: "What kind of a nut would do that?"

Hard to say, seems to be the answer – there appear to be too many different kinds of nut from which to choose. While most analysts realize that Bogle's comment, which he has repeated in speeches and interviews, represents the buy-and-hold investor, some resent the notion that investors who trade ETFs actively may be acting irrationally. "I think day traders will decide what is best for them and would be better served by taking advice from professionals who have successful track records in the trade," says McClure. "Would you go to your CPA to get legal advice?" (Mr. Bogle could not be reached for comment on this article).

McClure also advocates ETFs as a day-trading as well as a market-timing and pattern-trading vehicle. Because day traders trade volatility available throughout the day, McClure says they need a vehicle "with enough trading volume to place their trades with the least amount of slippage." He says because the major ETFs have "some of the greatest volume on the street...ETFs are, in fact good day-trading products."

Other respondents took a similar view. "Vanguard is a mutual fund company that would not look favorably on short-term trading," remarks Kollar at FibTimer. "But there are traders who obtain excellent returns [by] pattern-trading and trend-trading ETFs." Likewise, Wagner at Morpheus Trading says the comment reflects the fact that "institutional traders turn up their noses at the short-term guys." He adds that Bogle's statement is justified "only for someone who doesn't understand the risks" of market timing.

Still, few ETF specialists believe such comments will do anything to derail the ETF growth engine going into 2005. Typical is Minssieux's outlook for the ETF sector in 2005: "More ETFs and more people [invested] in them, more sector-based ETFs and more niche ETFs."

I Just Love Spiders and Cubes

Veteran market-timing traders like Randy Murray, who trades from his home in Toccoa, Georgia, long have been enthusiastic users of ETFs. Murray, who also is a customer and ardent proponent of McClure's EquiTrend market-timing service, has been using ETFs to trade short-term market trends for several years and is a particular fan of the QQQs and the SPDRs.

Most individual investors who've successfully traded ETFs short-term favor the more liquid vehicles like the QQQs ("qubes," pronounced "cubes") and the SPDRs ("spiders"). "I like to go with the basket approach, and the spreads on those have narrowed," says Murray. He says he also likes to play spreads when trading ETFs, using Bollinger bands and incorporating options by using tactics like naked strangles – buying and selling put and call options around a security's price to help protect the value of a trade.

Other individual trend-traders favor ETFs because it's so easy for the smaller player to go short as well as long on them. Tom Taulli, author of The Street-Smart Guide to Short Selling (McGraw-Hill, 2002) has, perhaps not surprisingly, long been an advocate of ETFs for profiting during markets that are trending either downward or sideways, such as those of the past four years. "The main reason I like ETFs is that they don't have an uptick rule," Taulli told SFO in an earlier interview. "If you're [figuring] on some market going down, ETFs are often the better play." (By the way, futures have no uptick rule either and there are a bunch of highly liquid stock indexes that individual traders can use as well. ETFs are regulated by the SEC and futures by the Commodity Futures Trading Commission. But, generally, futures indexes don't have the variety of market sub-sectors that ETFs do, like semi-conductors, etc.)

Not surprisingly, SPDRs and QQQs account for almost 70 percent of the assets of all ETFs in the U.S. market. And though the QQQs are more popular among smaller trend-traders because they follow the technology-heavy NASDAQ-100 index and, so, are usually more volatile, the S&P 500-linked SPDRs are the largest individual ETF with $42 billion. But the smart money this coming year will be watching the growing array of niche ETFs linked to all manner of indexes here and abroad.

Take a Rain Check?

It's in these smaller ETFs, based on market sectors, industries, or foreign markets, where ETF analysts expect the most growth in 2005 and beyond. They expect to see a lot more new, sector-based ETFs launched and expect more individual investors to enter the market than in 2004.

Morpheus Trading's Wagner hopes to see a big increase in the range of financial markets covered by ETFs in the coming year, including ETFs covering the gold spot price as well as other commodities markets. He also says there should be demand for new ETFs covering specific foreign countries. "Traders want to target individual countries they're bullish or bearish on," he says. Likewise, in commodities markets, "ETFs [would be] great if you were bullish on coffee beans but didn't want to take leverage."

McClure at EquiTrend predicts that ETFs soon will spawn a hybrid ETF product that would allow more efficient hedging for smaller investors. It will, he hopes, be structured more like a futures contract but traded and costed like an ETF. “I see them as an intermediate play between futures and equities,” McClure says. “It would be like a swap that would be [marketed] to individual investors.”

But although Wagner says each new ETF release “seems to create more excitement than the last one,” established funds linked to the major indexes might still remain more popular with individual investors. Murray, for example, says he did so well trading the QQQs that he then was lured into some niche-market ETFs, especially those on foreign markets. He switched back to more familiar turf after getting hammered by brokers in what he claims were “manipulated markets.”

Murray says the problem was particularly acute in ETFs based on individual countries. “Every time I tried to buy on an uptick, I couldn’t buy, and the same when I tried to sell. I just got very disillusioned,” he says. He also notes that on smaller ETFs that trade less frequently, investors often paid higher spreads than advertised and did not get the buy or sell prices they expected. As a result, says Murray, he’s gone back to trading more volatile, individual, quality stock and the bigger ETFs. “I’m disappointed with ETFs, but I still use them,” he says, “especially the SPDRs and QQQs that are very difficult to manipulate.”

Individual investors have heard this one before: do your homework.

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