

# Exchanging Views

Plain-vanilla index funds may be in a slowdown, but new ETFs are cropping up. A trio of experts survey the playing field. By Brad Zigler



WHILE FILINGS FOR LEVERAGED AND active exchange-traded funds (ETFs) are in the pipeline at the SEC, interest in index funds, once hotbeds of innovation, seems to have cooled. During this lull, we sat down with three industry pundits to talk about the utility of ETFs and index funds for advisers.

Rick Ferri is president and senior portfolio manager of Portfolio Solutions, an investment adviser in Troy, Mich. He has written three books on investing, including *All About Index Funds*. Jim Novakoff is president of Levitt Novakoff & Co., an advisory firm specializing in fee-based mutual fund and ETF portfolio programs. Novakoff also writes for *IndexFunds.com*. And Jim Wiandt, editor of *The Journal of Indexes*, dropped by. Wiandt also co-wrote

*Exchange-Traded Funds: An Insider's Guide to Buying the Market* with Will McClatchy.

**FP:** Let's start with ETFs. Of the dozens launched recently, which have proven most popular with advisers?

**Ferri:** Based on volume, the S&P Depository Receipts (SPY) and the Nasdaq-100 Tracking Stock (QQQ) are the most frequently used ETFs industry-wide. But we most frequently use the Vanguard VIPER Total Stock Market Index Fund (VTI).

**Novakoff:** Barclays Global Investors' iShares are specifically designed for and marketed to advisers. They are most useful because of BGI's tools, information, and marketing support.

**FP:** Are there too many ETFs now?

**Ferri:** We have further to go. We could use more fixed-income ETFs,

factor ETFs, and ETF share classes of active funds. There are no factor ETFs yet. Some examples would be low price-to-book ETFs, low price-to-earnings ETFs, and high dividend yield ETFs. It would be so easy for a portfolio manager to change the dynamics in a portfolio by going long or short a low price-to-book ETF, instead of having to buy or sell individual stocks.

**Novakoff:** There needs to be a wide choice of ETFs. For some tax strategies, you need to be able to switch between similar ETFs, like those tracking the S&P 500 and Russell 1000 large-cap benchmarks. But there are enough index-based equity ETFs now. And between iShares and ETF Advisors' Fixed Income Trust Receipts (FITRS), we're getting enough fixed-income index ETFs, although managed muni bond ETFs would be a good idea. Whether we need leveraged ETFs, which Rydex and ProFunds are now working on, remains to be seen.

**Wiandt:** *The Journal of Indexes* recently surveyed its readers, and more than 70% of respondents are financial advisers who said "no" [to the question of too many products]. Only 8% felt having an assortment of choices is "not important." About a third did say they can be confused by all the offerings.

**FP:** Why are assets still so heavily concentrated in SPDRs (SPY), Qubes (QQQ), and Diamonds (DIA)?

**Ferri:** SPY is big because it tracks the S&P 500. QQQ is popular with market timers. Its beta is about 1.5, so market timers get more bang for the buck.

**Wiandt:** Asset concentration comes down to brand recognition. People are using the ETFs they know, although this is gradually changing.

**FP:** Which ETFs stand out among all the rest? Why?

**Ferri:** VIPERS stand out because they are share classes of open-end funds rather than stand-alone products. Hundreds of open-end mutual funds will eventually follow Vanguard's lead.

SPY and QQQ also come to mind because liquidity is so good. The spreads between bids and offers are rarely greater than a penny or two. That's good news for investors.

**Novakoff:** State Street's streetTracks are good but often overlooked. These ETFs are based on the old Muldex indexes. The Fortune 500 ETF (FFX) is interesting because it offers a core holding that is not the S&P 500. Among the iShares, the S&P 600 Small Cap-based ETFs are good alternatives to the Russell 2000 products because S&P uses a profitability screen.

**Wiandt:** I like the iShares Dow Jones Total Market Index Fund (IYY), the VIPER Total Stock Market Index Fund (VTI), and the iShares Russell 3000 Index Fund (IWV). All have low turnover, broad market diversity, good tax efficiency, and minimal costs.

**FP:** What happened to Vanguard's big VIPER push? Did the S&P lawsuit derail marketing prospects? Or are advisers waiting for Vanguard to re-key its mutual funds (and, by extension, its ETFs) to the MSCI benchmarks?

**Ferri:** Vanguard isn't backing away from VIPERS. The delay can probably be attributed to the conversion to MSCI benchmarks, which may take place some time this year.

**Novakoff:** Vanguard has mixed feelings about ETFs. On one hand, they're cost- and tax-efficient, which appeals to Vanguard. But ETFs can be abused. They can be shorted, leveraged, margined, and traded, which doesn't appeal to Vanguard. By lowering the expense ratios and tightening the tax efficiency of their mutual funds, they can get the same results as using VIPERS.

**FP:** Are there differences between ETFs tracking the same asset class?

**Novakoff:** The most important feature of an ETF is the makeup of the underlying index. Factors such as the number of holdings, median market cap, and differences in the way value and growth stocks are characterized can

vary considerably for each index set.

**Wiandt:** There can be significant differences among ETFs. Since expense ratios are comparable, the question is three-fold: Is the underlying index representative of the asset class? How is turnover? Does the portfolio need to be optimized, and if so, how does that affect performance, tracking, and taxes?

**FP:** Turning to traditional index products, are there any new mutual funds that allow advisers to do more than just plain vanilla investing?

**Ferri:** There are plenty of asset class funds. The only missing links are low-cost emerging market debt funds and funds that benchmark certain hedge fund styles like bond arbitrage. Rydex is coming up with a S&P Hedge Fund Index Fund, which is a start. But I'm afraid to look at the fees.

**Novakoff:** The interesting part of index strategizing is combining benchmark-tracking products to create efficient portfolios. There are so many possible combinations that we could be busy for years to come.

**FP:** If investors need plain-vanilla investments, which brand goes down the smoothest?

**Ferri:** Total stock market funds always go down easy. That includes Vanguard's Pacific Stock Index Fund (VPACX) and European Stock Index Fund (VEURX).

**Novakoff:** S&P 500- and Dow Jones Industrial Average-based funds are emotionally the easiest. They go down when CNBC is downbeat. They go up when CNBC is upbeat.

**Wiandt:** I like total market benchmarks better than the S&P 500 for a core investment, because they're more broadly diversified. Turnover and taxes are lower. The S&P 500 is essentially a large-cap and a sort of managed index.

**FP:** Are there advantages to using Dimensional Fund Advisor (DFA) products versus Vanguard's funds?

**Ferri:** We don't see any great advantage of using DFA over Vanguard.

Nevertheless, we are authorized to use DFA funds and do use several equity funds in most portfolios. DFA small value, micro-cap, REIT, small international, and emerging markets funds are unique. We don't like DFA bond funds or tax-managed equity funds.

**Novakoff:** DFA funds are powerful because they accomplish their objectives so well. The value positions are very value-concentrated. Thus, they offer advantages to advisers who know what they're doing and no place to hide for advisers who don't. Advisers need bigger capital commitments to use DFA funds, though.

**FP:** There are lots of funds based on the S&P 500, all with different expense ratios. Why pay more than Vanguard's 18 or fewer basis points for what is a commodity product?

**Ferri:** Convenience. Lower trading costs. For example, Schwab has an S&P 500 fund (ISLCX) with an expense ratio of 35 basis points. We use it in smaller Schwab accounts because the overall cost is lower than paying a commission to buy a Vanguard fund or ETF. Later, when we rebalance the smaller Schwab accounts, there are no commissions to swap the Schwab index funds. In large accounts, though, there is no reason to buy the more expensive fund, except to use it in small amounts to tailor an allocation.

**Novakoff:** Some fund companies may spend more on customer support, which may represent added value. Some funds may have lower minimums than others. And some may just be doing a better job with tax management. These factors may justify the cost differences, but in other cases, investors are getting ripped off. **FP**

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