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A CAUTIONARY TALE OF SPIDERS, WEBS, DIAMONDS AND CUBES

One of the hottest forms of investing these days is exchange-traded funds. While financial planners are using them with some of their clients, ETFs are not for everyone, they caution.

Exchange-traded funds, or sometimes called index shares, are a hybrid of index mutual funds and stocks. Like index funds, ETFs track a particular market index by holding the stocks of that index. Spiders, nicknamed SPDRs, or Standard & Poor's Depository Receipts, track the S&P 500 index. Diamonds track the Dow Jones Industrial Average, Cubes follow the Nasdaq 100, and WEBS stand for World Equity Benchmark Shares, which track the stocks of individual foreign nations. In addition, dozens of new exchange traded funds are being added that track other indexes and sectors of markets. Also like index funds, some exchange-traded funds will reinvest dividends.

Unlike index mutual funds, however, ETFs trade like stocks. Spiders, for example, trade on the American Stock Exchange under the ticker symbol SPY, and Cubes trade under QQQ. Like any stock, the price of an ETF moves up and down during the day, while mutual fund shares are priced at the end of the market day. You can sell an ETF short, buy on margin or set limit orders-all tactics you can't use with an index fund.

Planners who like ETFs like them for several reasons. Perhaps the most attractive feature for many clients is the tax advantages. One of the problems with any type of stock mutual fund is that the fund generates capital gains through the buying and selling of stocks, thus creating a tax liability for shareholders. This is especially a problem during a down market when shareholders may force the sale of holdings through heavy redemption demands. These tax liabilities aren't a problem for funds held inside tax-favored accounts such as individual retirement accounts and retirement plans,

but they can be a big issue for any taxable account.

But ETFs don't buy and sell stocks, except to replace a stock that has been replaced on an index. Readjustments might generate small capital gains for investors, but generally the main tax liability the investor will face is when he or she sells ETF shares for a gain. ETFs could even be bought and sold to offset other investment tax liabilities. This control of tax liability has long been the attraction of owning individual stocks instead of funds. But many investors can't afford to buy enough different stocks to be well diversified. ETFs solve that problem because they track all the stocks in their index.

Another attraction of ETFs is that they usually are cheaper than corresponding index mutual funds. This is offset somewhat by brokerage fees, since ETFs must be bought through a broker like any stock, but the fees shouldn't be a big problem if you don't trade ETFs often. (For more information about ETFs, go to the Web site for the American Stock Exchange, www.amex.com, and go to the FAQ section under index shares.)

Some of the same features that make ETFs attractive substitutes for index mutual funds also can make them inappropriate for some investors, say financial planners. For example, because ETFs are stocks, investors may be more prone to try to time trades. Mutual fund investors are less likely to watch the markets minute by minute or make trades as often as stock traders. Not that ETFs can't be invested in for the long term, but they are more tempting to trade more often than index funds.

Planners also note that ETFs aren't appropriate for investors who dollar-cost average their purchases or redemptions. Buying small amounts of ETF shares every month is expensive because of the brokerage fees.

A risk less well known to ETF investors is that like closed-end mutual funds, exchange-traded funds can trade at premiums or discounts that vary from the net asset value of the underlying index of stocks. An investor could thus lose money buying at a premium and selling at a discount, even if the underlying index is doing well. Some experts say the premium/discount risk is more likely to occur with ETFs that track market sectors or international stock indexes.

Clearly, say planners, exchange-traded funds offer some features that help broaden an investor's options. But don't automatically jump into them until you determine whether they are really appropriate for your needs.

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