

Lowly Analyst Free Newsletter

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The Market

Markets are moving as predicted. The upward momentum is far from exhausted. Lower volatility draws some investors back into the market, but many people still doubt the sustainability of the rally and keep on the sidelines. As long as unemployment remains high there is still the possibility of a downturn.

Manufacturing has gained in the US, Europe, and Asia. In the US the residential market has stabilized as indicated by the unexpected quarterly increase in the [Case-Shiller home price index](#), the first time in three years.

As long as the [US Government 10 year bond yield](#) continues to stay below 4%, stocks are more attractive than bonds and can continue their rally.

Currencies: August, Japan up 1.4%, Switzerland 0.5%, US\$ 0.5%, Euro 0.1%, China 0%, Mexico -0.8%, Britain -1.5%.

Asset Classes: RAFI US 1000 10%, RAFI US1000 Sml-Mid 8%, S&P Sml Cap Pure Val 7%, Mid Val 6%, Lrg Val 5%, Micro 4%, Lrg Grw 2%, Sml Grw 1%.

Sectors: August, Real Estate up 15%, Financials 12%, Gbl Carbon 8%, Lumber 8%, Silver 7%, Aerospace 6%, Intrnl Energy 5%, Gaming 5%, Cnsmr Srv 5%, Industiral 4%, Oil Eqp & Srv 4%, Listed Private Equity 3%, Basic Material 3%, Agric Cmmdties 3%, Software 3%, Transportation 3%, Intrntl Real Estate 2%, Metal Mining 2%, Steel 3%, Gbl Telecom 1%, Managed Futures 1%, Technology 1%.

Foreign Investments: August, Austria up 16%, Pacific-J 9%, RAFI Dev Mrkts-US 7%, Australia 7%, EAFE Value 7%, European Monetary Union 6%, Intrntl Sml 6%, Europe 6%, Frgn Lrg Div 5%, Europe Div 5%, Wrld-Us Sml 5%, So Africa 5%, Mexico 4%, US 4%, Japan 4%, World-US% 4%, Emerg Europe 3%, EAFE Growth 2%, Russia 2%, Latin Am 2%, Brazil 1%, So Korea 0%, BRIC -1%.

Fixed Income: August, Insured Ntl Munis up 3.5%, 1-3 Mo Treas 2.4%, USD Emerg Market Bnds 2.0%, 20+ Yr Treas Bnds 1.9%, Strategies 1.5%, Corp Bnds 0.9%, BuyWrite 1.2%, Intrntl Treas 0.8%, Intntl Gvt Infl-Prctcd Bnds 0.8%, GNMA 0.8%, TIPS 0.4%, High Yld -0.1%, Preferreds -2%.

Correction to August Newsletter. Vanguard offers an Inflation-Adjusted Immediate Annuity through AIG. If AIG fails, the annuity holder could lose-- not a good outcome.

Exchange Traded Funds

1. Introduction

Exchange Traded Funds (ETFs) are generally similar to mutual funds. Arbitrage keeps their value close to net assets. We will describe various kinds of ETFs and their advantages and disadvantages. ETFs are attractive as investments because they enable a convenient way to diversify a portfolio. They are generally low cost index funds that are tax efficient.

2. What are Exchange Traded Funds?

[Exchange Traded Funds \(ETFs\)](#) are an investment vehicle traded on stock exchanges like a stock. An ETF holds assets such as stocks and bonds and trades approximately at the same price as the net asset value of the underlying assets. Most ETFs track an index such as the S&P 500 and have characteristics similar to stocks.

With ETF's there are no minimum investments or penalties for early withdrawal. ETFs are traded whenever the exchange is open, not only at the close of the day. ETFs do not offer the option to reinvest dividends.

3. Advantages of Index ETFs

Most ETFs are index funds. There is a division in the investment community on [returns of index funds compared to actively managed funds](#). Index funds will never have the best or the worst returns. By definition, they will always have average returns.

It is important to avoid below-average returns that destroy your capital even at the cost of foregoing a chance for above average returns. If your capital decreases from 100 to 50, a 50% decrease, you need a return of 100%, not 50%, to get even. If the investment turns around at 50, you have only a small amount invested at the low point when you would like to invest much more.

In actively managed funds, managers pick stocks that they think will outperform the market. It is of course impossible for all managers to pick stocks that will outperform the appropriate index. All managers cannot be above average. Thus an investor must identify outstanding managers -- an impossible task. In addition, managers are inconsistent in their performance.

There are about 1000 ETFs, 500 in [registration](#), 300 actively traded. An index is well diversified in its asset class. Some index funds hold thousands of stocks, providing an easy way to diversify a portfolio. Index funds are always fully invested even at the bottom of the market

when the market turns. Actively managed funds, on the other hand, generally are partially out of the market at the bottoms and do not reenter until the market has made substantial advances.

Index funds outperform active management in markets where information is freely available. Actively managed funds can outperform in inefficient markets with small stocks and with some foreign stocks.

4. Tax Advantage of Index Funds

Index funds are generally tax advantaged. When the fund needs cash the fund can get it through tax free exchanges, avoiding taxable capital gains. Indexes restructure infrequently, again reducing capital gains.

5. Cost of Index Funds

Index funds trade like stocks. They are bought at one price, the ask price and sold at another lower price, the bid price. The difference between the bid and ask price is called the spread. This spread depends on trading volume and stock price. 200 ETFs have spreads greater than 0.5%. Below are examples of spreads and daily volume.

Fund	Spread	Volume
SPY	0.01%	200,000,000
DBC	0.05%	2,000,000
IWC	0.11%	165,000
PSP	0.2%	135,000
FAA	0.5%	8,000

Because ETFs trade like stocks, there is a commission as low as \$1.75 on each purchase or redemption.

ETFs have no load, hold cash to fund redemptions, and can have low operating costs since they need little human management or marketing. The average cost of an ETF is 0.56% compared to up to 3% for mutual funds.

6. Types of Exchange Traded Funds

- Index ETF. [Not all indexes are created equal](#). Some indexes like the S&P 500 are well established. Many firms are now trying to get into the ETF business. They try to create all sorts of indexes. Stick to broad indexes. Do not buy ETFs with trading volume below 200,000 because of large bid-ask spreads. Spreads at open are sometimes large. Volume is highest at open and close.
- [Exchange Traded Notes \(ETN\)](#). ETNs fundamentally differ from ETFs. They are senior, unsecured, unsubordinated debt securities. The issuer promises to pay the value of a benchmark. The note has no assets. There is counterparty risk. If the issuer cannot pay, the holder may lose.
- Commodity ETFs (ETC). ETFs are a good way to invest in [real assets](#). [Exchange Traded Commodities \(ETCs\)](#) are investment vehicles (asset backed bonds, fully collateralized) that track the performance of an

underlying commodity index or a single commodity. Commodity funds often invest in commodity futures, not the commodity. Futures prices move differently from commodities. The major risk of futures comes from their high leverage. ETCs are generally not leveraged. There are also actively managed commodity funds. The [Commodity Futures Trading Commission \(CFTC\)](#) is currently [considering regulating](#) the ETCs which could change them.

- Private Equity ETFs. [PowerShares Listed Private Equity \(PSP\)](#) is such a fund that invests in about 34 listed private equities. A small investor can of course buy any of these listed private equities directly.
 - Target Date ETFs. Target date ETFs change the asset mix, depending on the planned retirement date. [They are not a good choice](#). They fail to provide income for a 40 year retirement and the need to preserve purchasing power in the face of inflation. Preserving assets is not enough. The [iShares S&P Target Date 2010 Index Fund](#) (as well as the 2015, 2020, 2035 and 2040) all had spreads of 0.8% or more this year through July.
 - [Exchange Traded Grantor Trusts](#). An Exchange Traded Grantor Trust share represents a direct interest in a basket of stocks from a particular industry. The leading example is [Merrill Lynch Holding Company Depository Receipts \(HOLDRS\)](#).
 - Currency ETFs. Rydex has launched a [series of funds](#) tracking all major currencies
 - Hedge Fund ETFs. A hedge fund ETF tracks a hedge fund or a group of hedge funds.
 - Leveraged ETFs. Leveraged ETFs, both bull and bear, track 2 or 3 times the value changes of an index once daily. They do not in the long run track the index 2 or 3 times. [They are toxic](#). Suppose the index goes up one day and down the next. The leveraged fund will be highly invested on the day the market goes down and it will have small investment on the day the market goes up. They offer a way to obtain leverage or sell short in an IRA. Not a good idea.
 - Actively Managed ETFs. There are several actively managed funds in registration. Currently the funds are managed by a clearly stated rule.
- #### 7. Bottom Line
- ETFs are a good alternative to mutual funds.
 - Do not invest in ETFs that have a daily trading volume of less than 200,000 shares.
 - Leveraged Bull and Bear ETFs are toxic.
 - ETFs are a good way to invest in [real assets](#).

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