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By Steven M. Sheldon

Attack of the Spider

Heard your friends talking about buying “Spiders” and “Diamonds” lately? Given the dismal state of the economy, the chances are they’re not putting in orders for Italian sports cars or fine jewelry. Rather, they’re likely referring to the biggest investment craze since mutual funds became popularized in the 1960’s and 1970’s.

“Spiders” and “Diamonds” are two examples of the phenomenon known as Exchange Traded Funds, or ETFs for short. Since their introduction in 1993, ETF assets have grown tremendously and have become an important and useful investing tool for both institutional and retail investors.

What are ETF’s?

Described simply, ETFs are a cross between exchange listed corporate securities (just like IBM or Walmart) and open-ended index mutual funds (like Vanguard 500 Index). ETFs, which are listed on the AMEX stock exchange, can be bought and sold throughout the day like a stock through any brokerage account whenever the market is open. Mutual funds, on the other hand, can only be purchased at the end of the day at the fund’s Net Asset Value (NAV). Due to a built in arbitrage mechanism, ETF’s share prices do not stray from the NAV of the fund’s underlying securities as is the case with traditional closed-end funds.

Both ETFs and index mutual funds are passive funds in that they represent interests in a portfolio of securities that track a particular market benchmark. As with mutual funds, owners of ETFs will receive dividends that can be reinvested. Since ETFs and index funds save on research costs, both types of funds have extremely low expense ratios (generally less than .50% with some ETFs as low as .11% compared to over 1.0% for most actively managed mutual funds) and appeal to institutional and retail investors desiring to passively and inexpensively track the market returns.

Unlike mutual funds, ETFs have the flexibility of stocks in that they can be bought with market orders, limit orders, bought on margin, or sold short, making them an attractive vehicle for betting against the market. In addition, some ETFs even have options associated with them, enabling an investor to buy or sell puts and calls on the ETF.

You Name It, They Track It

ETFs that track various benchmarks are being rolled out quickly and competing head to head with index mutual funds for investors’ dollars. For example, Barclays



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Bank, an aggressive marketer of ETFs, has sponsored many new funds under the brand name of iShares. Currently, Barclays has over 75 different iShare funds that track benchmarks and indexes that include major U.S. benchmarks, industry sectors, and foreign countries.

The chart below illustrates a sample of the different types of ETFs that investors can freely purchase.

| ETF NAME | TICKER | TRACKED |
|--------------------------------------|--------|--------------------------|
| Spiders | SPY | S&P 500 |
| Diamonds | DIA | DJIA |
| Cubes | QQQ | Nasdaq 100 |
| iShares Russell 3000 Index | IWV | Russell 3000 |
| iShares Dow Jones U.S. Energy Sector | IYE | S&P 500 Energy Companies |
| iShares MSCI Canada Index | EWC | MSCI Canada Index |

In addition, there are even ETFs that invest in fixed income portfolios such as the iShares Lehman 7-10 Year Treasury Bond Fund.

Which are Better...Mutual Funds or ETFs?

As mentioned earlier, ETFs combine the benefits of index mutual funds with the advantages of individual securities listed on exchanges. So which are better for those investors desiring to have all or a portion of their portfolio passively managed?

The chart below outlines some of the key points to consider when deciding between mutual funds and ETFs.

| CATEGORY | COMPARISON | WINNER |
|------------------------|--|---|
| Annual Management Fees | Both have considerably lower annual expense ratios than actively managed funds | ETFs; annual expense ratios are lower than the least expensive index mutual funds |
| Trading Costs | Index funds can generally be purchased without any trading costs while ETFs require paying brokerage commissions | Index funds; as long as there is no transaction fee (NTF) to purchase the mutual fund |
| Flexibility | ETFs are more versatile in that they can be bought and sold throughout the day, shorted, etc. | ETFs |



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| | | |
|-----------------------|---|---|
| Holdings Transparency | Will generally know at any time what the underlying holdings are of the ETF. Index funds only report holdings quarterly (this may change with proposed legislation increasing frequency of mutual fund holdings) | ETFs |
| Market Coverage | Domestically, both offer exposure to broad market benchmarks. ETFs offer sector and country specific exposure that are generally offered by higher cost actively managed mutual funds rather than index mutual funds. | A tie for broad U.S. coverage ETFs offer better sector and country specific coverage |
| Tax Efficiency | As passively managed funds, both have low turnover and are much more tax efficient than most actively managed mutual funds. | ETFs have the edge since they have a better mechanism for dealing with fund redemptions or changes in the securities making up the fund causing taxable distributions |

Unless you require the trading flexibility and specific functionality of ETFs (shorting, limit orders, etc.), the answer to the question “Which are better?” really boils down to costs. For those investors that anticipate a fair amount of trading or utilize dollar cost averaging to build a position in the market over time, index mutual funds will work just fine and result in lower overall costs. The commissions resulting from active trading of ETFs may more than offset the reduced costs and other benefits of indexing.

How Does SMS Utilize ETFs?

As part of its “Index Plus” investment methodology, which involves the blending of index-oriented funds with select actively managed funds, SMS utilizes both index mutual funds and ETFs. SMS evaluates each client’s particular situation and investment objectives to determine which vehicle is best suited for their portfolio.

To learn more about SMS Capital Management and its investment philosophy, please visit our website at www.smscap.com or email us at info@smscap.com.