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How to Cut Risks and Costs of ETFs

By MIKE HOGAN

Don't trade on the market open, watch expense ratios, avoid illiquid markets.

EXPERTS LIKE TO POINT OUT that investment returns are usually proportional to risks taken. But not all risks have to be taken. Attentive investors can improve their returns from the hugely popular exchange-traded fund and note market by minimizing risks that only boost costs.

Depending on market conditions and the timing of a trade, there are several risk measures, including bid-ask spreads and tracking error, that should be checked regularly. Most are standard expenses for buying and selling ETFs, and normally won't cost the investor more than a few basis points (hundredths of a percent). But they can get out of whack, and costly, when funds or sectors have liquidity problems.

It's a good idea to avoid market orders to buy ETFs at the market open, cautions Melvin Herman, president and CEO of ETF research and advisory service Marco Polo XTF. A market order tells your broker to buy a certain amount of stock at the best price available. However, not all of an ETF's underlying stocks necessarily open at the same time, and a liquidity glitch can widen bid-ask spreads—the difference between the prices buyers are offering and sellers are asking. Inattentive investors may be down a few pennies a share before they've even started.

Use a limit order—which tells your broker to buy a certain number of shares at or below a set price, advises Herman, though they can backfire if the price of an ETF takes off and you can't buy it. You can instead try a conditional limit order that brackets your desired price, suggests Paul Weisbruch, vice president of ETF Sales and Trading for Street One Financial.

"It's easy to overpay for an ETF," says Weisbruch. "But when spreads get up around 10 cents, you might be able to save a nickel a share with the right limit order."

Don't assume that the ETF universe, despite its \$1 trillion-plus size, is homogenous and liquid. Of the more than 2,200 funds traded on U.S. exchanges, just 100 account for almost 65% of their assets, reports BlackRock, sponsor of the giant iShares fund family. Obviously, the remaining 2,100 funds have significantly fewer assets to divvy up—and, usually, comparably lower average daily trading volume.

New funds and those based on exotic, narrowly focused or small-cap indexes often experience intermittent volatility and liquidity issues, says Herman. That can lead to wider bid-ask spreads and

other costly risks for the investor, such as tracking error—the lag between a fund's performance and that of its underlying index. Volatility and illiquidity also can cause a fund to trade at either a premium or discount to its net asset value (NAV). Buyers can overpay or sellers get less than what the NAV says a fund's holdings are "worth"—or they could profit, if they're on the right side of the trade.

So long as you're aware of them, liquidity problems shouldn't prevent you from buying a favored sector, says Morningstar Director of ETF Research Scott Burns. All funds encounter these risks to some degree.

Tracking error can even be a useful measure of the effectiveness of fund weighting and portfolio-management strategies, says Burns. Rather than duplicating index holdings exactly, some funds buy only enough shares to mirror index returns and thereby save some money. "Tracking error shows who is executing better," says Weisbruch. "It's an even better predictor of future performance than past performance is."

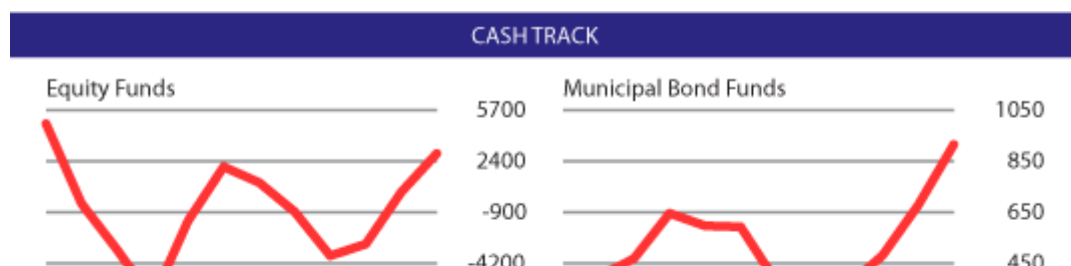
ETFs differ in a lot of ways other than size and focus.

The average ETF expense ratio is currently 0.55%, or 55 basis points, reports Morningstar, compared with a 1.44% average for management fees alone among actively managed mutual funds. But again, averages can be deceiving. Some emerging-market and other narrowly cast ETFs charge as much as 95 basis points, while the ratio for the broad market index **S&P 500 SPDR** (ticker: SPY) is just 10 basis points.

Likewise, by passively mirroring market indexes, ETFs usually turn over holdings far less than actively managed mutual funds, many of which replace their entire portfolios every year, for a 100% turnover ratio. But catastrophic events can affect any investment. The 2009 collapse in bank-dividend payouts pushed turnover for many bank-heavy, dividend-focused ETFs up to 50% and even 80% this year. High turnover usually results in more trading costs and taxes. But again, high turnover is normal for leveraged equity funds and certain bond funds, adds Morningstar's Burns. Turnover alone isn't reason enough to avoid them.

A related and more common issue for both ETFs and mutual-funds investors is concentration risk – the idea that too few holdings account for too much of a fund's assets or some holdings are outside the fund's style mandate. If a fund's top 10 holdings represent less than 20% of its assets, it is diversified, says Michael Johnston, senior analyst for ETF Database. Investors just need to know what's inside because diversification isn't always desirable. **SPDR Gold Trust** (GLD) has only one holding, notes Burns, but is often used to balance the rest of a portfolio.

The costs and risks from factors like tracking error and premium or discount valuations for ETFs are eclipsed by the savings that can be realized on management fees. But they are all stars to steer by when it comes to picking a fund, picking a price or timing a trade.



All in: Equity fund net inflows averaged \$2.9 billion for the four-weeks ending Wednesday, according to Lipper FMI. Net inflows to money fund came to an average weekly rate of \$884 million; taxable-bond funds at \$7.2 billion weekly and municipal funds \$915 million.

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