Sigma Breakthrough Technologies, Inc.®
123 N. Edward Gary, 2nd Floor
San Marcos, TX 78666-5703
Ph: (512) 353-7489
Fax: (512) 353-7488
Toll-free: (888) 752-7070

Exchange Traded Funds
Written by Joe Ficalora

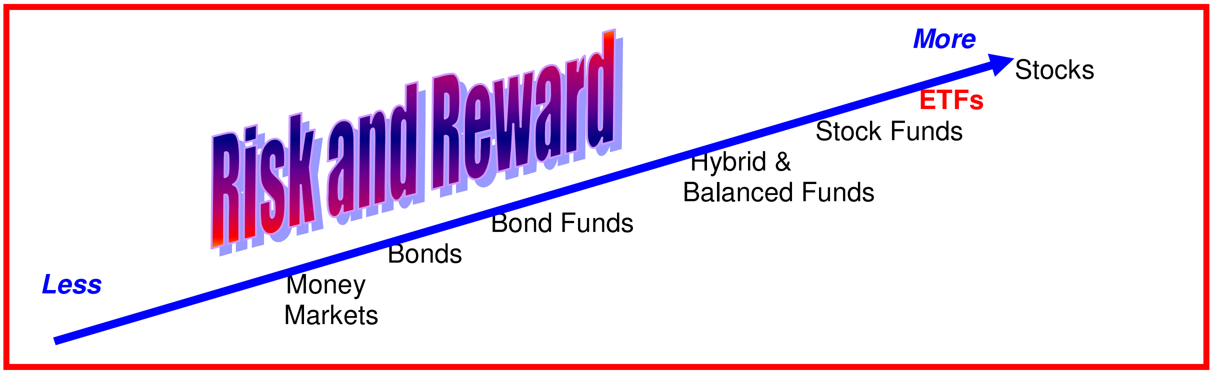
In prior Investment Corner articles, investment vehicles such as mutual funds, stocks, bonds and real estate have been discussed. In this quarter's article we will cover something of a hybrid which probably has a unique value to offer your investment portfolio. Exchange traded funds, or ETF's have some of the advantages of index mutual funds and some of the advantages of a stock[1]. As you may recall from the very first Investment Corner article, all rewards carry some risk and they tend to go hand in hand. That does not change with ETFs, which fall somewhere between index mutual funds and stock on the risk/reward scale. The illustration from the first article is shown in Figure 1, with ETFs added.

<u>What are ETFs and Why would I want to own them?</u>

An Exchange Traded Fund (ETF) is a group of securities traded on a particular exchange designed to mirror or create an index of a market sector[2]. In this fashion they are like an index mutual fund, but trade more like a stock than a mutual fund. Thus, ETFs are more volatile, may rise and fall faster than an index mutual fund and may need more of your time to actively manage them. So in effect you are purchasing a piece of a pre-set group of stocks representing a certain slice of the market. You have the advantages of stocks for higher returns, with some amount of diversification. These may have better overall return than a mutual fund in the short term, and cost less as they are not actively managed like a mutual fund. However, since ETFs are traded like stocks and other securities, commissions are charged[3]. So to be fair, expense adjusted returns must be used when making comparisons to index mutual funds or other types of investment vehicles. A typical ETF may have an expense fee of 0.4% of assets, while the average mutual fund fees are 1.4% or three times higher. This makes ETFs attractive for the long term buy and hold investor. The websites of the New York Stock Exchange, NASDAQ, and others provide more information about different types of ETFs and how they work. An ETF will have annual operating expenses and may also impose certain shareholders fees that are disclosed in the prospectus[4].

Likewise, ETFs may be shorted, or bought on low margins, and may be bought or sold throughout the trading day. So if breaking news occurs in your selected market sector, good or bad, you have the opportunity to quickly change your investment position, unlike a mutual fund. ETFs exist for market indexes like the Dow Jones Industrials, NASDAQ composite, REITs, large US companies, small US companies, and even gold. So if there is a particular market sector you have researched or of which you are intimately knowledgeable, chances are there are ETFs you can invest in that will allow knowledge and savvy timing to be turned into profits. There are over 400 choices out there right now so if index investing or buying parts or all of the market is in your strategy, ETFs may be right for you.

Figure 1
Risk and Reward Illustration with ETFs added



Disadvantages of ETFs
The primary disadvantage of ETFs over mutual funds is one of increased volatility or increased risks in a market or sector downturn. Please see Figure 1 to be certain that you understand this disadvantage and can live with it before pursuing ETFs as part of your investment strategy. A secondary disadvantage of ETFs is the cost of commissions, which will be larger than most mutual funds. These can be minimized with on-line brokers, which generally have lower security buy and sell commissions.

Getting started with ETFs
Nearly all ETFs deliver a prospectus to potential investors. However, not all do, depending upon whether you are an individual investor or a large investment company purchasing many shares. ETFs are technically investment companies or Unit Investment Trusts that create large share blocks or “Creation Units”. Generally institutions buy these Creation Units and sell shares on the open secondary market. Generally a prospectus is offered to both Creation Unit purchasers and individual investors like you and I on the secondary market.

ETFs that do not deliver a prospectus are required to give investors a document known as a Product Description, which summarizes key information about the ETF and also explains how to obtain a prospectus. All ETFs will deliver a prospectus upon request. You should always obtain a prospectus and read through it before making any investment decision[4].

Potential ETF strategies:

- For investors with accounts likely to be managed with a “buy and hold” strategy, ETFs offer advantages because they have lower cost over a long term, yielding a better overall return on the investment.
- If you are interested in broad market investing, ETFs offer a simple and convenient way to ‘buy the market’ at lower cost than Mutual funds. Many indexes tend to equal or exceed managed fund returns, which have higher operating expenses as well.
- For those just getting started in saving for the future and making investments, many mutual funds have a minimum entry purchase amount. These initial amounts can be a barrier, as some exceed thousands of dollars to get started. ETFs, with their generally lower initial cost to start than Index Funds ($150 versus $3000) offer a way to get into indexing for the smaller investor or those just getting started.
- For the sector-focused investor or specialty focused investor, chances are there is an ETF that is available with the right focus. A technology -focused ETF, for example, would allow a tech-savvy investor to time their investments and withdrawals around the

technology sector's up and downs. If you have great and current knowledge in a key sector, specialty-focused ETFs can allow you to turn that knowledge into profits.

- Some investment sectors provide returns that must be timed well in order to lock-in profits. Quick turns on the investing road require investment vehicles that can be bought or sold quickly like stocks; ETFs provide this flexibility to timing-sensitive sectors.

Some ETF Questions and selection criteria

If ETFs are new to you as an investment vehicle, here are some key considerations to think about before jumping in:

- How does this ETF fit into your overall investment strategy? Are there specific sector you want to index with some higher risks? Or do you just want to buy a slice of the market in certain areas and hold for a long time with less cost?
- Which market index is the focus? Is this a market with which you are very familiar? Or has it suddenly become an emerging opportunity to augment your portfolio? Why have you decided to focus upon this particular index? You should carefully list the answers to these questions in writing before proceeding.
- How does it compare to other aspects of your portfolio? If there is duplication, which one is the better alternative? Remember that ETFs will add more potential reward to your portfolio, but also higher potential risks.
- What is the expected performance of your ETF in the short term and long term versus your 'other investment choices'? The ETF should be augmenting your overall portfolio and be part of a larger investment strategy, including stocks, bonds, real estate, cash and diversification in market sectors too.

Guidelines for ETF selections should include[5]:

- A simple and understandable selection criteria; how does this ETF select the stocks, bonds etc to hold in the index?
- Stability of included items – how often are components of the index changed? What are the criteria for removal and admittance to the index?
- Expenses – how are expenses incurred in the ETF? What is the history of expenses, and is that expense history relatively stable over time?

Summary

In summary, an ETF is a useful vehicle for investing in specific markets or market sectors. These funds allow for: low initial investment sums, quick trades, low overall expenses and may provide higher returns than other market index investment choices[6]. However, the higher returns come with higher risks for market and segment downturns and the potential to incur high commissions in buying or selling ETF shares.

Lean Six Sigma deployments require sound financial analysis as part of the deployment planning steps. If you would like expert help with a Strategic Deployment of Lean, Lean Sigma or Six Sigma, please contact this author at JFicalora@sbtionline.com or SBTI through www.sbtionline.com

References:

1. About.com, financial planning on ETFs
2. http://finance.yahoo.com/**etf**
3. http://money.cnn.com/pf/funds/**etf**/
4. http://www.sec.gov/answers/etf.htm
5. The ETF Book, Richard A. Ferri, CFA, November, 2007 expected release, John Wiley & Sons
6. Swan Financial Planning, private conversation with Dylan Ross
7. www.**etf**.com/