MAY 5, 2006

SPECIAL REPORT

Frontiers of Investing>>

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By Marc Hogan

ETFs: Sliced, Diced, and Razor-Thin

These exchange-traded funds are super-specialized and promise new opportunities. But are they right for you?

There are new exchange-traded funds in town. The Barclays' iShares Silver Trust (SLV) tracks a hot commodity, while the First Trust Advisors IPOX-100 Index Fund (FPX) is a c... IPOs. The latest ETFs tap previously untouched niches and make exotic investment plays available to ordinary investors (see BW Online, 3/27/06, "Funds to Cover Every Angl... ...zz up portfolios, most investors should think twice before buying.

ETFs, baskets of securities that trade throughout the day like stocks, are no longer a low-cost way to get exposure to broad indexes. Assets in these funds swelled to $321.3 billi... , up from $151 billion at the end of 2003, according to the Investment Company Institute (ICI), th... increasi... simplicity and diversification, the trend in ETFs has been a move toward greater sophistication...

WIN BIG, LOSE BIG. Two sector-specific ETFs have been among the year's top performers. P... romoting... beaten the Standard & Poor's 500 index by 36.81% this year through Apr. 30. PowerShares W... xpense r... or ETFs. "If you're right, you will make a lot of money," ETFGuide.com publisher Ron DeLegge s...

With memories of the ill-fated late-1990s explosion of Internet funds still fresh, some analysts ... t more e... e, more narrowly focused funds don't do a very good job of serving shareholders' interests," says... mutual ... brokerage commission charge each time investors make trades, so they don't make sense if y...

Meanwhile, fund managers are serving even thinner slices of pie. State Street Global Advisors, the second-largest ETF shop behind Barclays Global Advisors, recently released ... on individual industries: SPDR Biotech (XBI), SPDR Homebuilders (XHB), and SPDR Semicondu... g down ... says Paul Mazzilli, director of ETF research at Morgan Stanley.

Fund companies aren't stopping there. In February, a new joint venture called Ferghana-Wells... ved inves... ETFs would each track an index concentrated on a different subsector of the health care indus... ETFs fo...

Ferghana-Wellspring is a joint venture between biotech-focused investment bank Ferghana Partners and Wellspring Partners, a financial-services entrepreneurial group.

'FAT CENTER.' The Ferghana-Wellspring approach offers investors increased precision, says Bill Kridel, executive chairman and founder of Ferghana Partners. Rather than investing in giants like Amgen (**AMGN**), Genzyme (**GENZ**), Merck (**MRK**), and Pfizer (**PFE**), the DAISies would focus on "the f[illegible] and growth," Kridel says. "This means you can slice and dice as an investor very finely," he says.

ETFs allowing ordinary investors to tap exciting, up-and-coming technologies aren't completely new. Launched late last year, the PowerShares Lux Nanotech Portfolio (**PXN**) invests in nanotechnology shares like Biosante Pharmaceuticals (**BPA**) and Veeco Instruments (**VECO**) (see BW Online, [illegible] **[illegible]st in Nanotech"**). The $113 million fund has beaten the S&P 500 index by 11.5% this year through Apr. 30.

At the same time, other funds are finding a niche investing in the newest public companies. Kicked off on Apr. 13, the First Trust Advisors IPOX-100 Index Fund (**FPX**) aims to reflect the market for U.S. initial public offerings, in the wake of closely-watched IPOs by companies like Chipotle Mexican [illegible] [illegible]nut seller Tim Hortons (**THI**).

YOUR STYLE. The fund invests in the 100 largest IPOs by market cap, buying the new stock on [illegible]e seventh day after the IPO and selling it on its 1,000th trading day. The fund follows less than a year after Van Kampen's more narrowly focused IPOX-30 Index Portfolio, which is a unit investment [illegible]t, not an ETF.

Then there are ETFs that concentrate on styles. Rockville (Md.)-based Rydex Investments on Mar. 7 unveiled six Pure Style ETFs, which home in on either growth or value among small-, mid-, and large-cap stocks. The funds track indexes that screen out stocks with both value and growth statistics, which may increase volatility.

ETFs have also picked up on the commodities craze. On Apr. 28, Barclays Global Investments [illegible] ETF focusing exclusively on silver. Barclays' iShares Silver Trust finished its first day of trading up 7% at $138.12, with a volume of 2.342 million shares. Its 0.5% price tag is higher than [illegible] expense ratio for both its existing gold ETF, iShares Comex Gold Trust (**IAU**), and rival State Street's streetTracks Gold (**GLD**). Still, some analysts, among them PIMCO Chief Investment Officer Bill Gross, warn against buying metals now that prices have already soared.

NOW WITH LEVERAGE. For investors seeking a more general commodities fund, Deutsche Bank's (**DB**) DB Commodity Index Tracking Fund (**DBC**) opened in February. It's the first ETF to invest in a basket of futures on crude oil, heating oil, gold, aluminum, corn, and wheat. But it costs a steep 1.3%. Another ETF investing in crude futures, Victoria Bay Asset Management's U.S. Oil Fund (**USO**), opened Apr. 10. It has an expense ratio of 0.5%.

The biggest new wrinkle for ETFs could be the use of leverage, or more sophisticated derivatives, options, and debt securities commonly used by hedge funds. ETFs using leverage are expected to gain SEC approval this year, according to a report released in April by Tiburon (Calif.) financial services consultancy Tiburon Strategic Advisors.

For several years, Bethesda, Md.-based ProFunds has been awaiting the regulatory go-ahead for both long- and short-leveraged ETFs. The ETFs would likely carry lower expense ratios than ProFunds' corresponding traditional mutual funds. ProFunds fueled speculation about the funds late last year when the company hired former State Street ETF innovator Gus Fleites as chief investment officer. A ProFunds spokesperson says the company cannot comment on the funds during their registration period.

CHOOSE CAREFULLY. Finally, industry watchers say ETFs may soon cross into the final frontier: active management. All ETFs currently track indexes, but the SEC could approve actively managed ETFs as early as this year, according to the Tiburon report. "It's not will they be coming, it's when," says Tom Lydon, president of financial advisory firm Global Trends Investments. Still, questions remain about how such ETFs would address transparency, among other concerns.

Investors have plenty of ETFs to choose from. The number of ETFs on the market soared to 212 as of March, up from 119 at the end of 2003, according to the ICI. While more are in the pipeline, some experts think many investors should avoid ones that are highly specialized and cost more than the average index fund. Says Morningstar's Culloton: "Most people can live a long and happy life and be successful investors without a lot of these very nichey funds."

Edited by Karyn McCormack

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