ETFS 101, Part 4 - **INDEXES**

In our "101 Series" this year, we've discussed features that have contributed to the explosive growth of Exchange-Traded Funds (ETFs) over the past ten years (e.g., intra-day trading, low expenses and tax efficiency). We've also discussed how to choose an ETF and how to begin the process of building a portfolio of ETFs. This month we turn to indexes.

As a reminder, constructing an ETF portfolio is no different than doing the same utilizing individual stocks or open-end mutual funds. You have to first establish your investment goals (e.g., income or growth); know your investment timeline (e.g., short or long); and consider your risk tolerance (e.g., conservative, moderate or aggressive).

The investment process of most ETFs is to track an index; as a result, they are considered to be "passive" in their investment approach (as opposed to "active"). However, don't assume that ETF investing means the same thing as index investing. An ETF is simply a certain type of structure for a mutual fund. It is, in my opinion, a superior structure for tax efficiency and trading. If this were a vehicle, we would say the "ETF auto" had a better chassis than the "traditional fund auto." But the ETF could be used for active investment management as well as passive, index-tracking.

A big reason that most ETFs are passive in their approach is due to regulations about transparency. ETFs must be transparent, reporting their holdings every day. This is no problem if you are merely tracking an index because everyone already knows how the index is constructed and what it is comprised of. But if you are an active manager, you may not want to reveal this sort of detail on a daily basis having traders try and front-run your strategies. Still, there are a few actively-managed ETFs and more may emerge as transparency regulations get tinkered with in the future.

Most ETFs track an index and you can easily find ETFs with low expenses that track the well-known, major indexes such as:

*U.S. Large Companies - S&P 500, Russell 1000

*U.S. Smaller Companies - S&P 600, Russell 2000

*U.S. Total Market - S&P 1500, Wilshire 5000, Russell 3000

*Foreign Developed Markets - MSCI EAFE

*Foreign Emerging Markets - MSCI Emerging Market

*U.S. Bond Market - Barclays Aggregate Bond Index

For most investors, sticking with long-established indexes such as the above is a sensible approach. However, many of today's indexes are very different.

When indexes were first developed, they were simply a way to describe the market, to give us some idea of how the general investment market performed over some period of time. The S&P 500 had 500 companies in the index that were an adequate representation of the large public companies in the U.S. The Russell 2000 was an index of 2,000 smaller companies and reflected the performance of the small U.S. public companies.

These indexes explained the market, but were not investment vehicles. This changed when some open-end mutual funds started investing exactly like the index did, closely tracking the performance of the index. These "index funds" had lower expenses than traditional actively-managed funds because they didn't have to pay for the cost of a real person to make decisions.

While many ETFs track these traditional indexes, there are a great number of ETF indexes that were not created just to "describe" the market, but instead were specifically created to implement a particular investment strategy, and this is a signficiant difference. It makes today's ETF world the "wild west" of index investing. It is exciting and ever-changing and offers tremendous opportunities, choices and approaches to portfolio construction. However it also introduces new risks and traps for the unwary investor and we will discuss more about these next month.

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