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ETFs: The Next Evolution

By: Dennis Duffy

Truly innovative, transformative ideas in **investment** management appear only once every few decades. In the 1970s, indexing **investing** was such an innovation. Although it was first met with skepticism, derision, and very little **investor** interest, indexing is now widely accepted as the way to achieve low-cost beta exposure to the broad stock and bond markets.

Fast-forward to the 1990s when an innovative offshoot of indexing was created: the exchange traded fund or ETF. The first of these **investment** hybrids was the Standard & Poor's Depository Receipt (SPDR). Based on the S&P 500, SPDRs began trading on the American Stock Exchange in 1993. The new vehicle offered the inherent advantages of indexing (low costs, broad diversification, and tax efficiency), along with the continuous pricing and trading flexibility of an individual stock. It, too, did not gain immediate acceptance in the marketplace.

But three key factors have helped to bring ETFs to prominence.

Performance

First, nothing sells like performance. The extraordinary absolute and relative performance of large-capitalization stocks in the mid-1990s and, in particular, technology stocks during the latter part of the decade gave a slow, but steady, boost to sales of SPDRs and QQQs, an ETF based on the tech-laden Nasdaq 100.

More recently, the markets have turned in favour of non-U.S. stocks, and the cash flow to international equity ETFs has moved in lockstep. Today, the best-selling ETFs track the MSCI EAFE Index and MSCI Emerging Markets Index.

The introduction of a slew of ETF products and subsequent aggressive promotion of them also has played a role in their popularity. Today, there are more than 600 ETFs, accounting for more than \$595 billion in assets, and they run the gamut from broad market stock and bond ETFs to specialty funds such as 'green' ETFs or 'wound care' ETFs.

Finally, ETFs rightfully hold appeal for a wide range of investors including pension funds.

ETFs provide an efficient, diversified way to gain exposure to various segments of the market or implement a 'core/satellite' approach. Thus, trust officers, portfolio managers, and investment advisers can use them as a simple, effective asset allocation tool.

With the large number of available ETFs, investors can use an ETF based on an encompassing market benchmark for a predominant portion of the portfolio and then over- or under-weight by style, market capitalization, sector, country, or asset class,

ETFs also offer a convenient parking place for assets that are in transition. For instance, when a pension or endowment fund changes investment managers, the trustees frequently liquidate the assets before a new manager is identified. While this process is underway, an ETF enables the assets to be fully invested in the stock market, rather than in short-term reserves or out of the financial markets entirely. Conventional index funds are typically reluctant to serve in this transition role, largely because of the transaction costs engendered by the movement of considerable sums in and out of the fund.

Equitizing Cash

Institutions seeking an efficient way to invest frictional cash and gain broad exposure to the market may consider a broad-based ETF. A fund manager, for example, may find it preferable to use new cash in the portfolio to buy an ETF that closely approximates the fund's benchmark. By doing so, the manager gains exposure to the market in an efficient manner, eliminating the potential for 'cash drag' on the portfolio and subsequent under-performance. Futures contracts are oftentimes used for this purpose, but ETFs can be purchased usually for smaller sums and they track many sectors for which there may be no suitable or liquid futures contract.

Finally, ETFs are a popular vehicle for hedge funds, broker/dealers, and banks employing various hedging and arbitraging strategies. ETFs are ready vehicles to make speculative bets on a market's returns or the returns of a particular segment of the market – either by taking a pure long position or a pure short position. One example is a hedge fund or arbitrageur who uses an ETF to hedge against another bet. In this scenario, a hedge fund may go long on a specific stock or market segment while, at the same time, shorting an ETF. This strategy reduces or eliminates market risk and enables the arbitrageur to take bets relative to the market. ■

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