ETF Investor's Burning Questions

Scott Burns, CFA,
Director of ETF Analysis
Editor, *Morningstar ETFInvestor*

ETFs are one of the fastest growing areas in the investing eco-system. As with any product undergoing such tremendous growth, the questions are multiplying at a rate almost as fast as providers can launch new ETF products. While new investors in ETFs will always have many of the same basic questions, the ever increasing complexity of ETF offerings often leave even experienced investors scratching their heads.

Sitting at the nexus of where products meet advisors, the Morningstar ETF Research team is in the unique position to field questions first hand from financial advisors. We address these issues in our commentary—especially through Morningstar's *ETFInvestor* newsletter. This monthly publication is the ETF Research team's "journal of record" and we consistently provide thought provoking and industry shaping features. Often times, the topics we cover are the result of the open communication that we enjoy with our subscribers. They ask and we answer.

Invariably, every year a few questions come to dominate the ETF investing world. In 2008, ETN credit risk was at the top of everyone's worry list. In 2009, the headline makers were leveraged and inverse ETFs and commodity-futures tracking products. Just as we provided insightful and timely analysis on these issues, we've scanned the landscape for 2010 and collected three of the questions that most commonly come up from advisors so that you can minimize any adverse investing experiences.

Taxes

It is no surprise that in the first half of the year the nuances of ETF tax treatment continue to trip up advisors. ETFs in general are very tax-efficient vehicles due to the ability to create and redeem shares, saving the investor from the taxman until he or she chooses to sell the fund. However, that tax-efficiency doesn't carry over to ETFs that hold securities that aren't very tax efficient themselves.

The general rule of thumb we use is that as far as the IRS is concerned the ETF is a look through vehicle. That means that if the fund holds physical precious metals (such as SPDR Gold GLD) gains on any sale of the fund will be taxed as a collectible (ordinary income rates, capped at 28%) just like if you held the gold. Funds that hold futures contracts and other financial instruments such as most commodity-futures tracking funds, leveraged ETFs and inverse ETFs will be taxed as the underlying futures would be tracked. That's a not so tax-efficient 60%/40% split between long-term and short-term gains, regardless of how long you hold the fund. On top of that, you need to mark your gains or losses in these funds to market at the end of the year and pay taxes on that.

Those are the biggest areas that still trip up advisors, but the message as always is "know what you own" followed by "and know how it will be taxed."

Liquidity

One of the truly hot-button questions among ETF users is "how liquid does an ETF need to be in order for me to buy it?" The fact that ETFs trade on the exchange and can be transacted throughout the day is one of the great features of these products. However, with that flexibility comes the need to understand the mechanics of securities trading—no different than you would for a stock or bond.

An ETF that doesn't have much liquidity is much like a low-float stock or a small-cap stock. You would never want to put a market order out for those types of securities because the order book is so thin that the bid-ask spread on the fund could pop as much as 500 basis points on you as your order gets filled. Rather, we recommend that you use limit orders for all but the most liquid of ETFs. Since many advisors are purchasing ETFs across all their clients accounts in model portfolios, the size of their trades can add up to some very large trades. In that case, the best practice is to work with a liquidity specialist either at your execution platform or with the ETF provider.

You can buy a less-than-liquid ETF and still get good execution—you just need to be strategic in your trading policy.

Tracking Error

ETF tracking error has been in the news quite bit a lately. So much so that I even authored a rebuttal to the claim that fixed-income ETFs were broken in an article titled "Our Take on the Bond ETF Dilemma." The contention by many is that bond ETFs through a combination of true tracking error (the variance of the net asset value of the fund from the index return) and premium and discount expansion were failing to meet their investment objectives.

My take is that it is the bond indexes that are flawed and that the ETFs represent the true market prices of the bonds in their portfolio. The indexes on the other hand use a series of statistical estimates to "price" bonds in their respective portfolios. I don't know about you, but the security that trades millions of dollars a day is giving us better information than any statistical estimate could.

Many nay-sayers of ETFs point out that indexed bond mutual funds do a better job of tracking and exhibit lower volatility than ETFs. My counter to that is that those folks are kidding themselves. The bond funds use the same crooked measuring stick in statistical estimates to smooth their returns, ignoring the reality that bond ETFs demonstrate everyday. If ignoring reality helps those folks sleep at night, then that is their choice. Unfortunately, as anyone who was a financial advisor during the market crash of 2008 will tell you: that ignorance is only bliss for so long. M