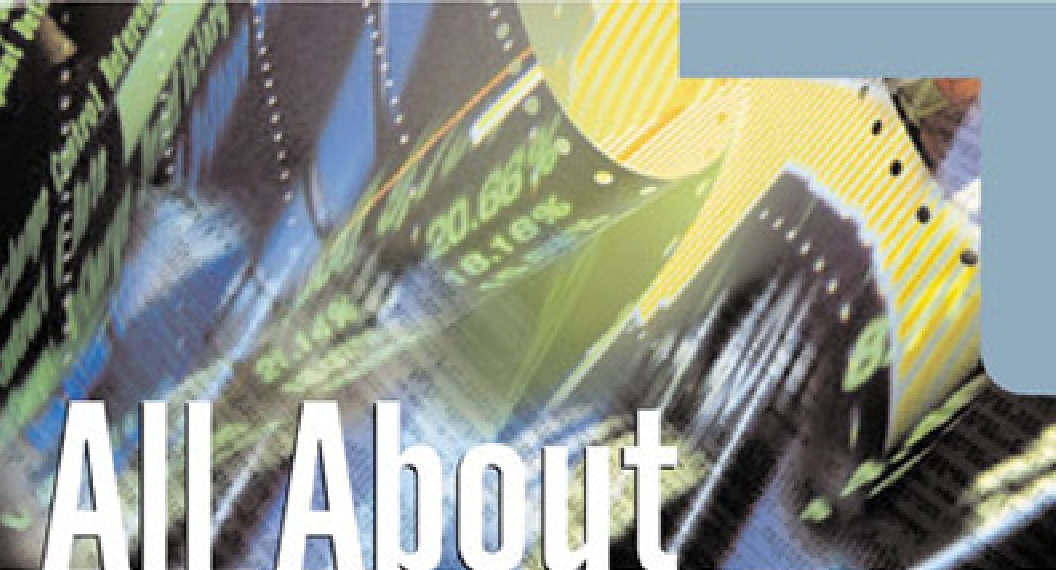

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Everything You Need to Know About Exchange-Traded Funds, *Including*:

- The differences between traditional mutual funds and exchange-traded funds
- The basic rules of types of ETF's
- How to build core assets using ETFs

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This book is dedicated with thanks and love to my wife
Carolyn Younglove Richards

CONTENTS

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CHAPTER 1

What Are ETFs?

June's father was as certain as he'd ever been that the fledgling technology company he talked about so excitedly would become a huge success. Every penny he had in the world he dumped into the stock.

Oh, he had plans. A second home on the Gulf, near Sarasota, Florida. A Caddy out front. A sleep-in boat, parked in the canal out back. He had it all down—what he was going to do with the money when that little company became a big success.

But just three years later, all those plans floated out the window when the company went down the tubes into bankruptcy. At least her father hadn't mortgaged his little house in Detroit. There he would remain for the rest of his life. No Cadillac. No boat. Not much going for him, frankly. It was sad.

June had a pretty good job. She'd accumulated some money. No way was she going to rely on just a single enterprise. But she did have the feeling that America as a whole would continue to thrive. More than 100 million people, some of them fabulously inventive, working and creating. If only there were some way she could buy into that wholesome economy—a single stock that would capture that marvelous productivity. She found it. An exchange-traded fund.

She could buy it through a brokerage firm just as easily as her father had acquired that dumb venture. Even easier, in fact. Instead of talking with a real-live broker, she chose to acquire the exchange-traded fund online. For a commission of only $8.00, she could buy into the whole of the U.S. economy.

The investment seemed so insignificant, but it tracked 3000 U.S. companies. Three thousand, including big ones and a whole lot of little ones. Unless some disaster knocked everyone to kingdom come, June knew that those businesses couldn't all fail. As the United States goes, her one little investment would go. She didn't intend to sell, but if she had to, the stock could be sold just as easily as it was acquired. How did they come up with such an investment?

In 1993, a remarkable new financial vehicle, called an exchange-traded fund, came into being. This one didn't track 3000 stocks; that came later. But it did track 500, which is a lot. It opened up new vistas for traders and investors alike. Each exchange-traded fund (ETF) can be bought and sold as readily as shares of IBM stock, yet each represents an entire aggregation of companies.

The growth of equity exchange-traded funds all over the world has been extraordinary. As of this writing in December 2001, they number 199, plus 17 quasi-ETFs. They trade in the United States, numerous European exchanges, South Africa, Israel, Singapore, Hong Kong, Japan, and Australia. Other ETFs are being prepared for Indonesia, Thailand, and Turkey, not to mention the United States. The values of all exchange-traded funds so far total $103 billion. During the week prior to Thanksgiving, 2001, the most popular exchange-traded fund, the Nasdaq 100 Fund, traded an average of $3.3 billion per day. During the same week, the original ETF, called "Spiders," traded $2.8 billion daily.

Some exchange-traded funds track the U.S. stock market in its entirety. Others track foreign markets or individual industries. But all can be traded quickly and easily, as if they were single stocks.

If you're an experienced investor, you may have discovered that trading—at least rapid trading—is a marvelously efficient way to lose money. If you're a novice investor, plan, right from the start, on doing the job right. Use exchange-traded funds, by all means. But use them for their convenience, simplicity, and their ability to defer capital gains taxes. Do not trade ETFs. Be a long-term investor.

HAVING A LOT LATER ON

The goal of financial planning and investing is to maximize how much you'll have when you need the money. Since you're thinking about investing now, presumably some of your money doesn't need to be spent at this time. We're talking about having a lot later on.

Oh sure, the investments you select and the rates of return are important. But they're not the most important aspect of investing. The essential ingredient is to invest as much as possible now. You're continually faced with trade-offs between the present and the future. If you think hard, any number of things might come to your mind, for example, that you'd like to buy. A three-month trip to the Andes for example. If you're under the control of a foot fetish, 1000 pairs of shoes wouldn't be half enough. But the more you spend now, the less you'll have later to educate children or provide a long and fulfilling retirement. To illustrate how to have a lot later on, let's say you're a lousy saver and a good investor. You put aside $50 a month. The money appreciates at 12 percent a year for 25 years. The ending value is $93,900.

Alternatively, assume you're a good saver and a lousy investor. You set aside $200 a month. But the money appreciates at only 6 percent a year for 25 years (not 12 percent). The ending value is a respectable $138,600. We quadrupled the amount saved and halved the rate of return. The final result is considerably more than $93,900.

Being a good saver is harder than being a good investor. In Chapter 11, I suggest investments you need to review only every 13 months. But why not be a good saver and a good investor too? You set aside $200 a month. The money appreciates at 12 percent a year for 25 years. You end up with $375,700. Now we're really getting somewhere.

Shoot for at least 10 percent. I'm going to show you how to accomplish this—or something like 10 percent—using mostly exchange-traded funds and without your having to watch the darn things every other minute. Since 1946, U.S. stocks have appreciated at a little more than 12 percent a year. During this time, the United States went through thick and thin.

Just equal the market, and you'll come out fine. But remember this: The rate at which the money grows is less important than the rate at which you set money aside. The key is to start now. The sooner, the better. We've already seen that if you invest $200 a month at 12 percent a year for 25 years, you end up with $375,700. Let's assume instead that the starting time is a year from now. You begin then, in 12 months, to invest $200 a month at 12 percent a year, this time for 24 years. The ending value is $331,200.

You cut down the investment time by 1 year out of 25. That's a 4-percent reduction in the number of years. But the ending value falls by a whopping 12 percent ($331,200 is 12 percent less than $375,700). The one lousy year missed at the beginning has a disproportionate effect. You reduce the number of years by 4 percent but end up with 12 percent less.

Instead of missing a year of savings at the beginning, this time you miss a year of savings at the end. You start now, setting aside $200 a month. The funds grow at 12 percent a year for 24 years, resulting in $331,200. You then knock off the investing, but the money already invested continues growing for one more year at 12 percent. The ending value is $370,900.

When you put in $200 a month for the entire 25 years, the ending value is $375,700. When you discontinue investing during the final year and the money continues to appreciate at the same 12-percent rate, the ending value is $370,900.

A missed year at the beginning causes the final balance to decline by 12 percent. A missed year at the end causes the final balance to decline by only 1.3 percent. You might call this the magic of compounding. There are two ingredients: time and the rate of appreciation. Most people concentrate on the rate of appreciation and forget about the time. This is understandable. We live in the now, one moment at a time. Oh sure, we know that things change. But our thoughts and feelings at any one moment have far more meaning and impact than what came before or what will come in the future. Therefore, we forget about the importance of time.

In your investment life, I don't want you to forget about time. I want you to shoot for an attainable rate of appreciation, and I want you to achieve this over as long a time as you can, starting as soon as you can.

CREDIT CARDS

Let's say you're paying 19-percent interest on credit cards. Instead of paying off the cards as rapidly as possible, you're wondering whether you should instead place some of your money into investments.

Let's assume that the last dollar you earn in salary is federally taxed at 27 percent. Interest or dividends earned from your investments are taxed at 27 percent also, piling on top of your salary. But if you acquire an investment and hold it for at least a year and a day, any profit is taxed at a maximum of only 20 percent, regardless of how high a tax bracket your salary carries you.

We'll forget about dividends for now and assume you earn nothing on your investments except capital gains taxed at 20 percent. If you want to invest before the credit cards are paid off, you want the returns to at least equal the 19 percent you're paying on the credit cards. To end up with 19 percent appreciation after tax, the investment must grow at 23.75 percent, pretax. This rate of return, reduced by 20-percent capital gains tax, equals 19 percent.

At 23.75 percent, you're at nearly twice the 12-percent rate I want you to shoot for. But even 23.75 percent isn't enough. Unless you can earn *more* than 19 percent after tax, why bother with diverting the money from the credit cards to invest at all? No, you'd have to shoot for something like 30 percent a year, every year. After all, the 19 percent is charged to you consistently. You'd have to earn 30 percent consistently.

Believe me, you won't. Nobody consistently invests money at 30 percent—nobody. Until the high interest debt on your credit cards is repaid, forget about investing. The best way for you to save is to get rid of that debt as soon as you can.

THE HOUSE

Exchange-traded funds are remarkably sophisticated investment vehicles. You'll get the feel for them as we go along. But any kind of complete description can't be attempted until we nail down a number of other things. We're going to visit a four-story house. In the basement is finance, which lies at the foundation of any investment program. You probably don't spend much time in the basement of your house, and we won't spend much time with finance either. Then, in successive floors, come the following:

- Stocks and bonds
- Indexes
- Mutual funds
- Index funds
- In the penthouse, exchange-traded funds

THE BASEMENT: FINANCE

The entire world of investments arises because the people who make the goods we use have to keep eating. But the goods they make must be designed, manufactured, sold, shipped, and paid for. There's a delay, often a long delay, before the revenues come in. If new technology is involved and the goods are newly developed, payment doesn't arrive until years after the job is first undertaken. If you're one of the extraordinary Silicon Valley people who are exploring new ways of manipulating electrons and photons of light, the payoff probably won't arrive for a good long time. Meanwhile, you and the people who work for you want a building to work in. You want to turn the lights on when you're working late. You have to develop ways of bringing your product to the public's attention. (With so much claiming the public's attention, this takes money, too.) To obtain the funds for these and many other purposes, either you have to borrow money from people who have some to spare or you have to offer them partial ownership of your business. To the members of the public who lend you money, you provide bonds (IOUs). To those who become partial owners, you give stock in your corporation.

Even companies that have been around for a while offer additional bonds or stock when they need more financing. Let's say that, 100 years ago, General Electric (founded by the remarkable Thomas Edison) sold stock to the public to finance the development and sale of electric motors. In current parlance, this is called an initial public offering, or IPO. Those primitive motors no longer exist, except in museums, and the investors who bought the original General Electric stock are dead. But the stock isn't dead. The shares continue to be passed around from investor to investor today.

Let's say that General Electric later needed to finance the building of factories to make refrigerators. It sold new stock to the public (called a secondary offering). Some of those investors are dead, too. But that additional stock, combined with the original GE stock, continues to be passed from one investor to another. If you buy General Electric stock today, you're not doing so because of GE's past. You don't care which of the company's shares you're buying; they're all the same anyway. You're buying a small portion of ownership because of what you expect the company to accomplish in the future.

So much for finance. That's it for the basement. Now let's walk up to the first floor.

THE FIRST FLOOR: STOCKS

Stocks represent shares of ownership of corporations. Here are aspects of stocks that pertain to exchange-traded funds.

Dividends: The profits you enjoy from stocks come from two sources. (Pssst, if you buy and sell too much, there won't be any profits.) Some companies pay out a portion of their earnings to shareholders in the form of dividends. The dividends are cash in hand, usually paid every quarter. You can spend them, if you like, but they're part of your investment package. If you can arrange it, reinvest the dividends back into one or more of your investments. Dividends are taxed to the recipient at high rates, as if they were salaries.

The other portion of your profit stems from buying the stock low and selling high. This is called appreciation. If you've held the stock for at least a year and a day, the tax on such a long-term capital gain is capped at only 20 percent maximum. Note that I said at least a year *and a day*. If you buy a stock on April 1 and sell it a year later on April 1, sorry, that's a short-term profit, taxable at your highest tax rate, as if the money were earned in salary. Maybe this is the IRS's idea of an April Fool's joke. In any month, the joke's on you. You must hold for at least a year and a day. To generate long-term gains, you'd have to sell on April 2 or later.

If your top tax bracket on ordinary income is only 15 percent, rather than 28 percent, the tax rate on long-term capital gains is reduced to 10 percent.

More good news. The tax reduction act of 2001 provides that if you hold an investment for five years (and a day), the long-term capital gains rate is only 18 percent, not 20 percent. And if your top tax on ordinary income is only 15 percent, the capital gains tax on securities held for at least five years is reduced to 9 percent. These are no small matters. I want you to hold exchange-traded funds indefinitely. Not only are the tax rates lower, you also give yourself the opportunity to gain appreciation on money you didn't pay out in taxes. Yes, you'll probably have to pay taxes eventually, but because of the favorable compounding effect, you end up reducing your taxes overall.

The portion of earnings that is paid out to shareholders as dividends is not deductible to the corporation. But the portion of earnings that is reinvested by the corporation in its own growth is indeed deductible to the corporation. Companies don't like to pay taxes any more than anyone else. They do like to reinvest for growth. Therefore, U.S. corporations are generally paying a relatively small portion of their earnings in dividends and reinvesting a relatively large portion of earnings into the company's growth. More rapid growth makes the stock price rise faster, which enables the shareholders to enjoy the low tax rates of long-term capital gains. By suppressing dividends and expanding the reinvestment of earnings, corporations reduce their taxes and enable shareholders to cut theirs as well. Dividend yields (the annual dividend per share divided by the price per share) have gone down, sure, but this doesn't mean that you're the loser. More of your total return should stem from price appreciation, taxed at lower rates. Corporations lower their taxes, and you lower yours. Everyone wins except the IRS.

There's a little problem, however. Dividends are pretty much cash in hand. Appreciation, on the other hand, is indefinite. In the long-term, say, 10 years, prices almost always go up. But in the next year or two, who knows? A lot of people think they know what's going to happen to stock prices in the next year or two. But they don't, not consistently. I mean *any* year or two, you understand, not just the two years after you happen to read this book. Relying more on appreciation and less on dividends does save taxes, but it requires more patience.

Splits: When a corporation increases its earnings rapidly, the price of its stock usually rises. But when the price rises too high, investors tend to shy away. How high is too high varies from one stock to another. IBM usually favors its stock price remaining above 100. Others consider 60 to be too high. To bring the price down to where investors feel comfortable buying, corporations arrange for stock splits.

Let's say you own 200 shares of XYZ, and the current price is $60 a share. The company undertakes a 3-for-2 stock split. For every two shares you owned before, the company wants you to own three shares. Having owned 200 shares before, you now hold 300. The price was $60 before; now it's $40. The stock split does not change the value of your holding. Three hundred shares at $40 ($1200) have exactly the same value as two hundred shares at $60 (also $1200). The sole purpose of stock splits is to bring the price down to where investors feel more comfortable buying it. If IBM had never arranged any stock splits, each share would cost millions of dollars a share. Hardly anyone could afford to buy shares