Mimosa Investment Management

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Exchange Traded Funds

This year marks the 20th anniversary of exchange traded funds (ETFs). They were designed to be index mutual funds that traded like stocks. The original fund was the SPDR or Spider, and was designed to track the performance of the S&P 500. Now ETFs have become all the rage in investing for some individuals. Many investors in traditional mutual funds are dumping them in favor of ETFs. Let's review the characteristics of ETFs a little more closely.

Mutual funds vs ETFs

Mutual funds have historically provided investors a relatively low cost way to invest smaller amounts and achieve the diversification necessary for responsible investing. Traditional funds calculate the value of all their investments at the end of the day and divide by the number of shares outstanding to get the net asset value. All buy and sell transactions are then done at the closing net asset value. Twenty years ago, big institutional investors said that they needed the flexibility to buy and sell certain market indicies during the day rather than having to wait until after the close. Authorized participants were the large broker dealers who actually funded the initial shares of the ETFs. Individual investors purchased the shares when they were traded on the open market. They usually paid a commission on the trade, just like buying a stock or bond.

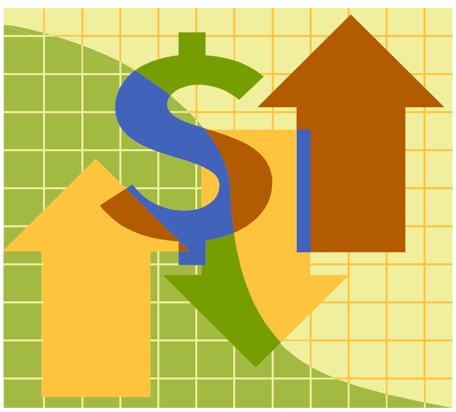
ETF Index vs Actively Managed funds

The original ETFs were index funds designed to have low expense ratios, be tax efficient, and trade like stocks. They were required to track the performance of some index and did not have a discretionary investing component until 2008, when the US Securities and Exchange Commission authorized the creation of actively managed ETFs. Just like actively managed mutual funds, the manager has discretion to buy and sell investments of his or her choice and can therefore charge higher management fees for, hopefully, superior performance. Over the past 5 years, many traditional mutual fund investors have shifted at least some funds to ETFs.

There are now a large number of ETFs including the original index ETFs, stock, bond, commodity, and currency funds. Some ETFs now have leverage, which means they are more sensitive to market movements and can be quite volatile.

Costs

While the traditional mutual fund trades at net asset value, the ETF trades on the open market during the day. This means that during times of high demand, the investor will likely pay a premium above net asset value. Conversely, during times when many investors are selling a fund, they may receive less than net asset value for their shares. When this premium or discount is coupled with transaction costs and expense ratios within the funds, particularly discretionary funds, the cost of owning ETFs can be substantial.



Final Thoughts

We are constantly reviewing the investment landscape for appropriate investments for our clients. While ETFs may have a role for smaller individual investors, we have not felt compelled to include them for our clients. We can achieve the appropriate diversification for our clients by buying individual stocks of multinational companies and ADRs of foreign firms. We would be most likely to consider adding ETFs as an investment in some remote corner of the world that appears particularly attractive to us where no appropriate individual stock or bond is available.