



While you were sleeping...
Rapid change means more choice in indexing

In his bestselling book, *The World is Flat*, Thomas Friedman repeatedly uses the phrase “while you were sleeping...” to preface his description of rapid, fundamental changes in technology, communications, and business models that have deeply transformed the global economy. A similar tidal wave of growth and change is surging through the indexing industry – faster than most individuals can absorb. This is good news. Because change means choice.

What’s new?

We know an investment category has achieved critical mass when its acronym becomes part of the mainstream vernacular. That’s the case with ETFs – exchange traded funds. In only a few years, the ETF has matured from an interesting new idea to an investment mainstay. In 2007 alone, ETF assets ballooned 44% to \$608 billion.

Investors can now choose among 629 ETFs, up from 359 a year ago. The vast majority of ETFs are index instruments, allowing easy, liquid access to a remarkable array of asset classes – by geography, industry, style and capitalization. We can expect the portfolio building blocks available to indexers to continue to proliferate as 19 ETF suppliers vie for market share. (Barclays’ iShares, State Street Global Advisors, and Vanguard rule the roost thus far, with a combined 87% market share.)

Quality first and always

Of course it’s quality, not quantity, that’s most important. Fortunately, much of the expansion of the ETF marketplace is favorable for investors. Recent additions to the ETF universe include:

- The first two municipal bond ETFs: TFI and MUB
- The first international bond ETF: BWX
- Many flavors of treasuries – short, intermediate, long, laddered (PLW), and inflation protected (TIP)
- Private equity ETFs: PSP (domestic) and PFP (international)
- A hedge fund index from Goldman Sachs: (Bloomberg: ARTIUSD, institutional pre-cursor version)

This last item is particularly interesting as it offers access for individual investors where they have rarely been welcomed. As Heather Bell of indexuniverse.com wrote in October, “You soon may be able to access the returns of the hedge fund universe without having to make a massive investment and attest to your assets – and, believe



it or not, the proposed vehicle is an index fund. GS has filed with the SEC for the Goldman Sachs Absolute Return Tracker Index designed to mimic the returns and performance characteristics of hedge funds.”

Interestingly, the Goldman Sachs product does not include the normal 20% hedge fund performance fee, giving the product a 20% advantage over the standard hedge fund industry product. Note also that GS is one of the largest hedge fund managers at \$29 billion, yet here is an index product of their own creation, with real appeal for individuals. Kudos to them for embracing innovation and opening the hedge market to more investors. Now you can use active hedge funds *and* a hedge fund index. According to Bell, other, similar products are in the works. For instance, IndexIQ is working on a hedge index instrument.

These are important developments. Among many other consequences, two attractive investment goals are now achievable in Q1 2008 that weren't possible in Q4 2007:

- A sophisticated standalone bond portfolio comprised completely of ETFs
- A liquid, no minimum investment plug-and-play hedge fund proxy

More positive trends

Beyond choice, there's more good news from the index front, most of it happening quietly while we sleep:

- Costs are dropping, led by Vanguard. The lowest cost ETFs are now in the 7 basis point range, as close to friction-free long term investing as one can practically hope to achieve.
- Tax efficiency continues. With infrequent trading, ETFs are generating minimal capital gains. In fact, 143 of the 147 iShares funds reported no capital gains for 2007.
- Liquidity flows. Professionals, especially short-sellers, are leading the way in ETFs, promoting price efficiency and liquidity. Short interest now comprises 16% of all outstanding ETF volume, according to SSGA.

The usual cautions

The proliferation of ETF possibilities invokes an inescapable investing mantra: just because you *can* buy it doesn't mean that you *should*. Some bad ideas are just as bad when executed via ETFs as with any other investment vehicle. For instance, we cannot recommend any actively managed ETFs due to tax inefficiency and high cost structures. For investors desiring active management, we'd recommend hiring an active manager rather than utilizing ETFs.

Likewise, we would steer away from short funds. We see no value in these instruments, as simply shorting an ETF is more effective and less expensive than buying a fund of short positions.

And some ETFs, in our view, just don't make sense. The new so-called timber index, with the symbol CUT, holds stakes in lumber companies, but also in companies that make paper and furniture – net users, not producers, of forest products. If CUT



doesn't cut it for you, maybe WSI from FocusShares is worth a look. Or maybe not. This unusual index includes only the stocks of Wal-Mart suppliers. Again, just because it's available doesn't make it a smart choice.

Many ETFs deliver strongly on their potential, with accurate representation of their asset classes, tax efficiency and low costs; some do not. Due diligence is just as important in ETFs as in any other area of investing.

What hasn't changed

The tide of new options in ETFs and indexing is exciting. But that excitement must not distract from the fundamentals of investing for individuals. Most importantly, individuals should hold diversified portfolios, with careful and purposeful asset allocation across all sectors, styles and geographies. Purchasing ETFs is the last step in this process – only after the exacting process of optimizing allocations is done.

Portfolio timing

By the same token, the easy liquidity of ETFs can tempt investors to use them to time the markets – jumping in and out of sectors to capitalize on their uneven movements. We never advocate market timing, with ETFs or anything else. We believe in “portfolio timing” – creating a diverse, reasoned portfolio that is ready for anything, one that does not rely on making changes to meet objectives, and one that logically connects risk and return. (See our recent article, *Investment Fitness*.)

The OCM advantage – At Osbon Capital Management, we aggressively seek the latest and best methods to index, with the goal of increasing after-tax return with reduced risk. ETFs are central components of all client accounts.

Conclusion

While we've been sleeping, exchange traded funds have transformed the investment marketplace in many ways. We encourage all investors to make the most of available ETFs:

- Index some or all of your portfolio – stocks, bonds, and alternative investments.
- Test tax efficiency in this political year. As tax rates may rise, tax efficiency may become even more valuable.
- Challenge costs. Pay only for what you need and pocket the rest; ask for proof of added value.
- Connect risk and return. Distribute assets to rationalize the relationship between potential return and potential risk.



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