Feedback? investing@fortunemail.com

Better than mutual funds?

Cheaper and more efficient than their older siblings, exchange-traded funds are winning plenty of converts. by Bethany McLean

Back in 1997, Stephen Doyle, who founded Montgomery Asset Management and built it into a $12 billion firm, helped sell a majority stake to Commerzbank. Then he mostly retired—until, that is, a former partner of his named Jim Concidine came to him with an idea for creating a new money management firm. It was an idea Doyle found so compelling that he decided to go back to work: Forget stocks, bonds, and mutual funds. Instead, invest using only exchange-traded funds.

Main Management, which Doyle and Concidine founded with others including Dick Fredericks, a financial services analyst and banker and former ambassador to Switzerland, is not alone in its obsession with ETFs. Assets in exchange-traded funds—baskets of securities that track the

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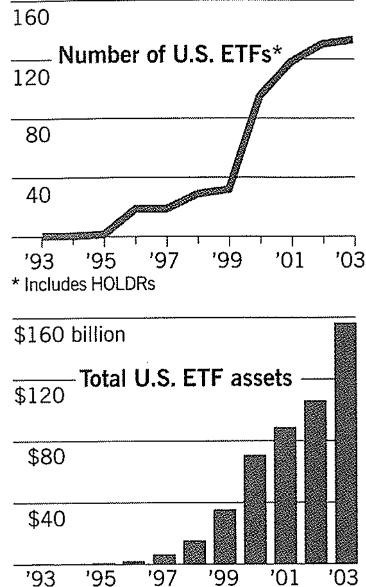
performance of an underlying index but trade like stocks—have grown from almost nothing five years ago to over $150 billion at the end of 2003, according to Morgan Stanley. While the market is still dominated by the two biggest ETFs (so-called Spiders, which track the S&P 500, and the Cubes, or QQQ, which track the Nasdaq 100), there are now 133 ETFs listed in the U.S., giving investors a complete tool kit for investing everywhere from Latin America to Germany and in everything from health care to the 50 highest-dividend-yielding stocks. "It's just the beginning for ETFs," says J. Parsons, a managing director at Barclays Global Investors.



Most of the existing ETFs were created by Barclays, which launched its first ETF back in 1996 and now has 84 different products in what it calls its iShares family (see www.ishares.com). Last year iShares' assets grew 71%, to $58 billion; Parsons hopes that Barclays will soon have the same cachet as Fidelity and Vanguard.

But the behemoths of the fund industry aren't standing on the sidelines. In 2001, Vanguard launched its first version of an ETF, which tracks its total stock market index (trading symbol: VTI); the firm is planning to roll out another 20 so-called VIPERs in the next few months. Last fall Fidelity launched an ETF that tracks the Nasdaq composite.

The appeal of these alternative funds is straightforward, especially given the drumbeat of scandalous news out of the mutual fund industry. ETFs are available to all investors at market prices throughout the day, unlike mutual funds, which price once a day at the close. (Or at least they price that way for most of us.) Mutual funds reveal their holdings only periodically, but ETFs are completely transparent, and there's no risk of style drift. And while the lion's share of ETF trading volume comes from institutions and hedge funds looking for a quick way to, say, short the semiconductor sector, ETFs are structured in such a way that timing by some investors doesn't take money out of the pockets of others. No wonder that financial planners describe ETFs as "cleaner" than mutual funds.

There is also a philosophical reason for investing with ETFs—one that is important to Main Management. While Main itself isn't for most of us—the minimum investment is $1 million—it's worth hearing why Doyle describes ETFs as a "beautiful, elegant, simple solution."

Despite Doyle's success at Montgomery, he was frustrated. The spectacular returns of the early years soon turned mediocre, a situation that hard work and smart people seemed unable to reverse. It's a problem that plagues the fund industry: Over many periods a majority of active managers fail to outperform their benchmark indexes. Concidine, who spent most of the past decade managing a wealthy family's billions, had similar gripes about performance. In search of a solution, he began to use ETFs.

Concidine soon came to the conclusion that ETFs fix two prime causes of underperformance: fees and taxes. The expense ratio on U.S. equity ETFs averages 29 basis points, vs. an average expense ratio of more than 150 basis points for actively managed U.S. mutual funds, and an average of 75 basis points for the average index mutual fund, says Morgan Stanley. Mutual funds' high expense levels are especially infuriating given that many managers basically track an index. As Doyle says, "I have nothing against closet indexing, but I do have something against the cost of the closet." (One caveat: Like stocks, ETFs are purchased through brokers, meaning that you pay commissions. If you're investing a small amount every month, the com-

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M&A

The next frontier: TV takeovers

If 2003 was the year investors rediscovered beaten-down shares, 2004 is shaping up to be the year aggressive companies gobble up their healthy but smaller rivals. (Witness J.P. Morgan's buyout of Bank One and the ongoing auction for AT&T Wireless.) That makes stocks in consolidating industries like cable and satellite ripe for buyout-related gains. With the dealmaking momentum driving prices higher, UBS cable-industry analyst Aryeh Bourkoff says, "It's going to be a good year for valuations."

At the top of Bourkoff's takeover list is **EchoStar (DISH, $36),** the sole remaining independent satellite-television company now that Rupert Murdoch's News Corp. has swallowed competitor DirecTV. EchoStar's ten million customers are enticing to phone companies, which could use additional services to offer as their traditional revenues slip away. The likeliest bidder: SBC Communications, already an EchoStar partner and investor.

Cable-industry consolidation is a sure bet in 2004, now that potential buyers like Time Warner, FORTUNE's parent, have shrunk heavy debt loads. One juicy target is **Cablevision Systems (CVC, $27),** which has a lucrative presence in the New York area but a relatively puny market value of about $8 billion. Smith Barney's Niraj Gupta sees a buyout value for Cablevision of anywhere from $36 to $42. That's the kind of programming that would draw high ratings from the cable company's investors. —**Adam Lashinsky**

On top of the heap

The five exchange-traded funds with the most money under management.

ETF (trading symbol)	**Assets** in billions	**What you get**
S&P 500 SPDR (SPY)	$36.05	The oldest ETF, it tracks the S&P 500.
Nasdaq-100 index (QQQ)	$20.08	Heavily traded Cubes are a play on big tech.
iShares S&P 500 (IVV)	$6.31	Barclays's answer to the S&P 500 SPDR.
DIAMONDS (DIA)	$5.54	Shares track the Dow Jones industrial average.
S&P 400 MidCap SPDR (MDY)	$5.30	A popular vehicle to bet on smaller companies.

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missions will eat up the cost savings.)

Exchange-traded funds are also highly tax efficient. If mutual fund managers face redemptions, they may have to sell stocks to raise cash. ETFs, though, are essentially created in individual units, so selling on the part of one investor doesn't trigger capital gains for another. And ETFs track indexes, meaning that their turnover is usually relatively low.

At the core of Main's argument is the belief that stock picking is a doomed endeavor. Look at Enron vs. the iShares Dow Jones U.S. Energy (IYE) sector ETF. From August 2001 to August 2002, Enron lost everything. The ETF sank some 20%. Today Enron is still pretty much worthless, while the energy sector has hit fresh highs. And Fredericks thinks the risks of owning individual securities will only increase. He says that analysts are still often guilty of group-think and that, thanks to the increased use of derivatives and complex financial structures, companies are fast becoming unanalyzable. "Who understands Freddie Mac?" he asks.

So Main "looks for the haystack, not the needle," as Fredericks put it. It identifies out-of-favor sectors, and then, when everyone else has jumped in, it sells. It's the opposite of momentum investing. In its first full calendar year, Main outperformed the S&P 500 by 300 basis points.

Other advisors, like Ross Levin of Minneapolis-based Accredited Investors, use ETFs as part of their tool kit. Levin likes Japan, so he bought an ETF called EWJ, which tracks Japan's largest public companies as a cheap way to get diversified exposure to that market. He also uses ETFs to hedge existing portfolios. If a client walks in his door with a huge Exxon position, Levin can short an energy ETF in order to offset some of the risk without triggering taxes by selling Exxon outright. "We're almost like kids in a candy store," he says about the expansion of ETFs.

So is the mutual fund industry quaking? Not exactly. In fact, mutual funds themselves increasingly use ETFs to quickly invest excess cash. Vanguard, for its part, is adamant that ETFs are not competition for its existing funds. CIO Gus Sauter says VIPERs are just a way of reaching customers who use a broker instead of dealing directly with Vanguard. He adds that for some investors—small dollar-cost averagers as well as big guns who can get a price break by committing $250,000 or more—regular index funds are cheaper.

Of course, Vanguard, with its low costs and lack of scandals (to date), has less to worry about than other funds. It's nice to know that if the industry doesn't shape up on its own, there's a challenger that may force it to do so.