ETF Onslaught Only Beginning

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9/22/2006 12:22 PM EDT
URL: http://www.thestreet.com/p/funds/etf/10310383.html

Earlier this summer, Jim Cramer wrote that he thought the market was saturated with exchange-traded funds. If you're under the same impression, let me warn you: you ain't seen nothing yet.

There are only about 250 ETFs on the market. According to the Investment Company Institute, there are more than 8,600 mutual funds (not to mention over 6,000 unit investment trusts). Given those figures, does new ETF issuance really sound so excessive?

The creation of new ETFs seems to be picking up steam, and the reason is that they are the future of this industry. And they're particularly problematic for traditional, open-ended mutual funds.

As things currently stand, ETFs are solely index-based. Since indices are constantly repriced throughout the day, this allows for the intraday trading of ETFs, which is what makes them so popular.

As you may know, actively managed mutual funds are only priced once the market is closed. Technologically, however, there's no reason that needs to remain the case; actively managed funds could easily be valued throughout the day just like an index and its corresponding ETF. It's only a matter of time before this becomes a reality, which means ETFs of actively managed portfolios are almost certainly in our future.

Not convinced? Consider this: Three months ago, Profunds, which along with Rydex Funds is known for mutual funds that are leveraged and/or negatively correlated to popular indices, launched the first leveraged ETFs.

Because these ETFs were exact replicas of several of its existing open-end mutual funds, these filings showed that Profunds is willing to potentially cannibalize sales in its existing open-end funds.

Why would Profunds make such a decision? Simple: It sees where the future lies.
Just think, why would investors buy a fund vehicle that prices only once a day when they could get the exact same portfolio that's liquid any time the market is open?

If you're already tired of ETFs, sorry -- you're not even out of the first inning of this ballgame.

The Stealth Approach

One of the proposed ETFs Cramer dismissed in his July article, the **Claymore/Sabrient Stealth ETF** (STH) , just began trading Thursday. (Disclosure: I serve as the portfolio advisor on multiple unit investment trust products for Claymore, so go ahead and assume I'm favorably predisposed toward this Chicago-based mutual fund firm.)

I have no relationship with Claymore's partner on this product, Sabrient Systems, but I'm familiar with its studies.

This is a highly-regarded quantitative research firm in Santa Barbara, Calif., that does some really interesting work. The Stealth ETF will track Sabrient's already existing index of the same name, which is meant to give investors access to underfollowed companies.

A number of academic studies have found that stocks bought when they have no analyst coverage have generally performed better than stocks that were followed, something that came to be known as the neglected stock effect.

The presumed cause is that once such stocks are "discovered" by Wall Street, this drives prices dramatically higher, rewarding shareholders who got in ahead of the crowd.

Cramer called the idea for an ETF based on this theory stupid, but I would argue that if investors aren't going to gain access to such companies through a vehicle like this, how else are they supposed to find them?

I believe this is suitable to make up part of an investor's small-cap exposure.

To be fair, Cramer's take was more nuanced: He said, "The idea of picking undercovered companies and buying them makes no sense at all. The idea of buying *good* undercovered companies makes sense."

It might please him to know that the neglected-stock angle is merely used to define the universe of stocks eligible for the index.

Sabrient then employs proprietary analysis methods to identify the companies within that universe that exhibit superior growth potential on a risk-adjusted basis.

In other words, they're taking Cramer's advice and looking for good stocks that also happen to be uncovered by Wall Street. I'm betting this ETF would get his OK after all.

Sector Funds

Cramer also knocked sector funds in the same July article. Again, I have to disagree.

Sector funds (or similar unit investment trusts, which provide static portfolios for a finite period of time) are used all the time for a very specific reason: they allow advisors to give clients sector exposure without having to be experts on all stocks in the group themselves.

Should a broker be A) sorting through the biotech sector in search of that one winning stock, or B) helping investors gain such exposure through a related sector fund?

I don't think there is a right answer to that question, but sector funds are of use to the thousands of financial consultants who believe B is the right choice.

Over the last decade, for example, regional bank portfolios were a great way to gain exposure to the broad trend of industry consolidation.

And in recent years, commodity mutual funds provided average investors good exposure to a sector that might have otherwise been difficult to access.

Sector funds and ETFs -- embrace them!

At the time of publication, Hanlon held none of the securities mentioned, although positions may change at any time. Chip Hanlon focuses on nondollar investments. He is currently the president of Delta Global Advisors. Under no circumstances does the information in this column represent a recommendation to buy or sell stocks. Investing in foreign markets involves unique risks including, but not limited to, currency fluctuation and political risk. In addition, international investing is typically more expensive for U.S. investors than buying shares listed on a U.S. exchange. Hanlon appreciates your feedback; click here to send him an email.