Funds: ETFs get more popular and more complex

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By Linda Stern

WASHINGTON, Feb 28 (Reuters) - Exchange-traded funds may look like traditional mutual funds, but they aren't. And investors are showing signs that they appreciate the difference.

With only about 3 percent of the assets of traditional funds, ETFs are still dwarfed by them. And the total number of ETFs is just above 150, compared with a universe of more than 8,000 traditional funds.

But ETFs are coming on strong.

In January, for the first time ever, exchange-traded stock funds pulled in more new money than those traditional funds with which they compete, according to research firm Lipper Inc., a unit of Reuters Group Plc. Lipper said investors pulled some $2.8 billion out of traditional stock funds in January, while they invested between $3 billion and $4 billion in comparable ETFs.

"You can see that ETF activity is significant," says Robert Adler, president of AMG Data Services, which monitors fund flows. He pointed out ETFs are seeing greater trading activity when money is moving out of a sector, and not just in. In the week ended Feb. 23, for example, so much money was pulled out of small-cap ETFs that it made the whole fund category suffer outflows, even though money was actually going into traditional funds at the same time.

In fact, this trading activity points to one of the key differences between mutual funds and exchange-traded funds. Like traditional funds, ETFs are pooled investments. But they trade on stock exchanges, so folks who want to buy and sell quickly can jump in and out when they see prices they like.

Traditional mutual funds, by comparison, are priced once a day, after the market closes, and people must buy and sell their shares before they know what the price they will get.

In the wake of the mutual fund scandal - which revealed that some favored investors were swooping in and out of funds aimed at buy-and-hold investors - many traditional funds carry redemption fees that discourage rapid trading.

So ETFs are good for market timers, and they have other key differences that make them preferable in other situations.

They are all based on indexes and not actively managed, so theoretically they have lower expenses. Someone wanting to invest a large chunk of a retirement plan distribution or an inheritance could put it into Vanguard's total market ETF (VTI.A: Quote, Profile, Research) (VTI.N: Quote, Profile, Research) , pay a mere 0.14 percent in expenses every year, and let it alone. **Continued ...**

1 | 2 Next

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(Page 2 of 2)

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But the very growth of the ETF industry provides mixed blessings for investors -- and certainly complicates a market that had been easy to grasp.

On the positive side, there are more varieties of ETF available all the time. That's good for choice, but it also starts to dilute the benefits of indexing.

The more narrowly the new ETFs slice their indexes, the more they start to look like actively managed funds.

The iShares KLD Select Social Index Fund (KLD.N: Quote, Profile, Research) , whose index weeds out companies by a variety of social criteria, started up a month ago. The PowerShares WilderHill Clean Energy Portfolio, which represents an index of environmentally conscious energy companies, is set to start trading this week.

PowerShares Capital Management, in Chicago, is about to unleash several funds based on "indexes" that are computer generated to include companies with better earnings prospects. That's about as close to an actively managed fund as you can get.

With those new wrinkles, some ETFs may be less great than others. Fees will grow, and the slices represented by some ETFs will be pretty narrow. That might be good for investors who enjoy playing the market and trying to figure out which sectors are better to jump in and out of, but they shouldn't assume that an ETF is necessarily cheaper than a traditional fund.

Traditional funds remain the better option for stolid, long-term investors who feed their retirement funds $25 or so every week. Investors do have to pay brokerage fees whenever they buy or sell an ETF, so they don't make great choices for those smaller amounts.

ETFs are fun, a little bit more transparent than traditional funds, and easy to buy and forget. It's no wonder their popularity has surged, but as ETFs get more complex, they become no easier to select than traditional funds.

Think of them as another tool, but not the only one that should be in your box.

Previous 1 | 2

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