

Strategies for exchange-traded funds

InsiderQ&A



Lydon

Financial adviser **Tom Lydon** is an evangelist for exchange-traded funds, essentially mutual funds that trade like stocks. A single ETF can cover the broad market, such as the Standard & Poor's 500 index, or thin slices of it, such as the timber industry. He is editor of ETFtrends.com and recently co-authored "iMoney," a book that highlights ETF strategies.

Why should investors add ETFs to their portfolios?

If I can't beat the market, why not buy the market? You can do that with exchange-traded funds, and expense ratios for ETFs can be 10 to 20 percent of what actively managed funds' are. It's a great way to buy representation in basically any asset class — from domestic to foreign to sectors

— and in areas where average investors couldn't really get into before, such as commodities and currencies. They are also tax-efficient.

Are ETFs more suited for taxable accounts versus tax-deferred, retirement accounts?

When you look at taxable accounts, part of the reason why most actively managed mutual funds don't outperform their benchmark are the huge (taxable) distributions that have been kicked off over time. ETFs are more tax-efficient.

As far as 401(k) plans, ETFs are not really available there. But as individual investors get more information, there's going to be more pressure on the 401(k) providers to offer other fair and reasonable choices that truly represent the markets

(through ETFs). I would suspect in the next 12 months, we'd hear a lot more about this.

Should investors care about an ETF's size?

I suggest looking for ETFs that have at least \$100 million in assets. Another key point is that if you're going into ETFs that represent certain thinly sliced areas, or ones that have their markets closed while ours are open, put in limit orders (to buy up to a specific price) and understand what the current bid/ask spread is. If you put in a market order, sometimes you can get swept up in a lack of volume and pay a premium.

How'd you get to the \$100 million minimum?

When you look at the 600-plus ETFs,

there are about 200 or so that are above that level. It gives you enough to choose from. That doesn't mean that an ETF with \$50 million in assets isn't liquid. Most of the underlying stocks in these indexes are very liquid themselves.

You talk about the "buffet effect" in the book, where investors have so much choice that they may buy something they might not ordinarily.

There are so many options out there. Just because someone comes out with a Singapore ETF doesn't mean everyone has to own it.

What will be the next big thing in ETFs?

Actively managed ETFs. They finally hit the marketplace. There was a lot

of beating of the drums. They're here, they've arrived. But they're really seeds that will be planted for the future. Most individuals and advisers will look at these, and it's going to be at least a year, probably closer to two or three years, before people really dive in.

You talk about Vanguard founder Jack Bogle in your book. He has said ETFs may encourage investors to trade too often.

He has been such a great pioneer for the average investor and for indexing. Unfortunately, I think he needs to give the average investor a bit more credit. If an investor is going to be silly about the way they invest or do something irresponsible, it's not the ETF that's the bullet in the gun that shoots them in the foot.