By Lisa Cohen

True Innovation or Mere Fashion?

Is the ETF a product for every portfolio? Or is it destined to follow the arc of the closed-ended fund: interesting and useful, but for the few?

Welcome Readers

This month we're introducing The Fund House, a new column that intends to examine the conventional wisdom on financial product trends with an eye to separating hype from reality. Every other month, we'll examine a current topic of interest to the industry and solicit financial advisors' thoughts on the trend. But, we need your help. We're asking for feedback from skilled, experienced financial advisors because they have a wealth of perspective and insight to share with other advisors and industry leaders who also read these pages. This column creates an opportunity for advisors to "talk back," as it were, to the industry at large. If you'd like to offer opinions or story ideas, or to participate on a panel composed of Registered Rep. *subscribers, please email* Registered Rep. *editor David Geracioti at dgeracioti@prismb2b.com.*

Whenever a fund company introduces a new product, it is invariably heralded as the biggest thing since night baseball. Financial advisors are told that the great bulk of their clients have had this serious, unmet investment need. And, the wholesalers have been trained to tell reps that the new product will tackle that pesky problem.

There are all kinds of interesting products that pop up to address various investing needs. Having spent my career researching and developing new financial products for fund companies, I can assure you that the ideal mass market product is a rare event. Seldom does the industry come up with a magic bullet that can be used, cookie-cutter like, on the untold masses of retail investors.

Seems obvious, right? But think about closed-end funds. Back in the early 1990s, a few hundred of these funds rolled out with great fanfare and were accompanied by stories in the press about how important they would be. Assets reached $150 billion by 1995. (During that time, one now-defunct personal finance magazine even launched a column—"The NAVigator"—dedicated to covering the hot new funds.) Today, closed-end fund assets are under $300 billion, despite another spate of offerings over the past couple of years. ("The NAVigator" column faded away in the mid-1990s, even before the magazine did.) Closed-end funds are designed to—and, broadly speaking, do—deliver on various important investing objectives. For example, they are useful in portfolio diversification—for some investors, anyway.

And now the words "exchange-traded funds" are on everyone's lips. But, the long list of new ETFs launched in 2006 makes one wonder: Will all of these new funds really find a large audience? With Morningstar now tracking more than 300 ETFs, the manufacturing side of the business clearly wants to eat while dinner is being served. (When Wall Street has success selling its latest idea, everyone seems to race a me-too product to market.) ETF assets stood at $350 billion at the end of the third quarter, according to the Investment Company Institute. This is impressive for a category that didn't exist 10 or so years ago. But, to put that growth in perspective, this number is dwarfed by the total assets in equity mutual funds, which top $5.4 trillion, says the ICI. By comparison, State Street's flagship S&P 500 ETF, the SPDR, has assets of more than $65 billion.

The question is not whether or not ETFs make sense. They certainly do, for at least some portion of a portfolio. Who can argue with lower fees and intraday trading of key indices? Further, they allow the average retail advisor to pursue more efficient (and complex) investment strategies (core and explore, comes to mind). What is less certain at this point is whether individual investors and the advisors who work with them will jump on the ETF bandwagon in a massive way. The complexity of many of the newer ETF offerings suggests that only the most sophisticated retail investors will actually be able make good use of them on their own. (Question: How many individual investors realize that ETFs sometimes can trade at slight premiums or discounts to NAV?)

The Next Big Thing?

It all comes down to the financial advisor. Since most mutual funds are bought and sold on the advice of a financial intermediary, ETF makers must win the advisor over to achieve any kind of scale. So, will ETFs appeal to FAs?

And if they do, which funds will FAs prefer? Is it even possible for some of the newer entrants—single commod-

ity ETFs, currency ETFs and leveraged ETFs—to either gather meaningful assets or to deliver on the original premise of the ETF—that is, exposure to a specific asset class with low fees and ease of trading? I predict it is likely that we'll begin to see the same type of stratification within the ETF market that we're currently seeing in the mutual fund market: The top two or three funds in any given category soak up most of the cash while the more esoteric products drift for awhile, useful for a select few, before being closed.

Naturally, many investment-management firms research new product ideas to test how to position them and see how they might be received. Despite sophisticated market research and focus groups, it is often just too hard to tell which new product will be a hit and which will be a dud. Timing, too, can be a challenge. Not only do you need to launch a product at the optimal point for that strategy, but you must also be there with advisors, explaining the product and winning them over to the concept that this new vehicle fills an unmet need (or does the same thing as vehicle X, but better and more cheaply).

Before a product manufacturer can even meet an advisor, usually there is a long and involved vetting period where an internal research team will play the role of gatekeeper. Every firm has one, and they are responsible for determining if a manager's portfolio strategy adds value, if it does so with a good risk/return profile, if the fees and expenses are fair and if the investment process is scaleable and repeatable by the portfolio-management staff, among many other things. (Oh, and will there be demand for the manager or the strategy?) The gatekeepers must investigate the dozens of products launched each month to identify those that add alpha, replicate an index and, in general, give their firm's advisors an edge, a way to differentiate themselves.

Despite all of this analysis, how, when and why the market decides to embrace a new product idea can be a bit of a mystery. In the first half of 2006, nearly 90 new ETFs and index funds were introduced, according to researcher Strategic Insight. Fund sponsors include all the biggies, such as Barclays, State Street, as well as some niche-oriented firms, like Rydex and ProFunds, and newcomers, like Wisdom Tree.

> To achieve scale, ETF providers will **ultimately** need financial advisors to embrace this new product package. The question is will they?

Core and Explore

From the perspective of a manufacturer, betting on products that package market exposure seems like a logical product strategy, particularly in light of the generally acknowledged low-return environment in which we find ourselves. Besides, there is compelling research that demonstrates the beauty behind passive strategies. In his 1973 book *A Random Walk Down Wall Street*, Princeton University professor Burton Malkiel turned Wall Street upside down, showing how efficient major equity markets are and that you were better off indexing and going home. Which is why many professional investors use core-and-explore strategies, in which you track the market (beta) for your core and add alpha by hunting in less-efficient realms. A core portfolio built on low-fee ETFs and index funds will, of course, find broad appeal among advisors.

The big bet ETF manufacturers are making suggests that advisors must be doing just that. But they aren't, not yet, anyway. Despite consistent flows to index funds and the excitement over ETFs, as of June 30,

Index Funds & ETFs

Assets in index funds and ETFs continue to grow.

As a % of equity fund assets:	13%
As a % of monthly equity fund new sales:	10%
As a % of individual investors' share of equity fund assets:	less than 5%

Source: Strategic Insight

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96 percent of individual investors' equity fund assets were held in mutual funds, leaving less than 4 percent of individual investors' equity assets in ETFs.

So are the fund manufacturers wrong, or are they just early to the game? Are they successful innovators or fashion victims? ETFs are growing fast and do have a place in the world,

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especially the uncomplicated index-based funds. But, perhaps, some of the more esoteric sector ETFs will go the way of B shares—packaged and launched in an innovative way only to fall out of favor when their time (or cycle) had passed. Or maybe they are more like lifecycle funds, some of which were launched in the early days of the 401(k) business and languished for a decade or so before taking off over the past two years (albeit boosted with much slicker packaging).

The biggest risk to ETFs, we posit, are ETFs themselves. Continued product proliferation without clear differentiation among competitors is not helpful to advisors or investors. What benefits the market most is a reasonable number of well-defined, well-articulated products that do a good job serving investors.