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The most useful tool in the box
ETFs are cheaper and more flexible than mutual funds

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Global exchange-traded funds (ETFs) are catching on with retail and institutional investors and should be viewed as an essential tool for both active and passive managers, a Wall Street strategist says.

At a recent talk to the Toronto Society of Financial Analysts in Toronto, Morgan Stanley's ETF strategist, Deborah Fuhr, reported worldwide ETF assets had surged to US$248-billion by the end of September. The number of ETFs trading on 28 stock exchanges around the world has reached 318, with another 45 set to launch.

When Fuhr started as an ETF analyst in 1996, there were only 21 ETFs and US$5.2-billion invested in them. Morgan Stanley is not itself an ETF manufacturer, so Fuhr is considered an objective authority on the subject.

As the name suggests, ETFs are index-tracking funds which trade like common stocks. They are bought and sold through brokers and investors can go long or short on various industries or geographical regions.

It's true that equity mutual funds also let investors target sectors or regions but they can't go short, and they have higher costs.

As Patrick McKeough says in the current issue of his newsletter, Canadian Wealth Advisor, "index funds and ETFs do show better long-run performance than about two thirds of actively managed mutual funds with long-term track records."

Two firms dominate the ETF market globally: Barclays Global Investors (BGI) has 121 ETFs and 40% of the market (including 12 from its Canadian division). Second is State Street , with 38 ETFs and 27% market share, according to Fuhr.

Other major players include Nomura Asset Management, Credit Suisse, the Bank of New York, UBS Global Asset Management and -- in Canada -- TD Asset Management.

The two most popular ETFs are SPDRs (tracking the S&P 500) and the Nasdaq 100 Trust, or QQQs. Those two ETFs alone account for a third of all U.S. ETF assets and a quarter of ETF trading volume every day.

Part of the growth of the industry has been fuelled by U.S. index fund giant Vanguard Group. Vanguard first made its mark with low-cost index mutual funds but its VIPERS

ETFs now have US$4.4-billion invested, giving Vanguard 2.4% of the market for U.S.-listed ETFs.

Among a flurry of new global ETFs are several serving China, Europe and even one in Iceland. Also set to launch are two gold bullion ETFs to trade on U.S. exchanges: State Street's Equity Gold Trust and iShares Comex Gold Trust. There is already a gold stocks ETF (iGold) trading on the TSX.

One of Fuhr's handouts was a Morgan Stanley paper recommending investors boost exposure to Europe. "Europe has at last stopped underperforming the U.S. market," it said, listing five reasons why European equities are poised to outperform.

Valuation is a major one: Europe is at an "extraordinary" 33% price-based multiple discount to the U.S. and European earnings are rapidly playing catch up with the U.S. earnings recovery. Also, Europe is less sensitive to changes in oil prices and interest rates. Morgan Stanley is particularly bullish on the MSCI Turkey index as Turkey attempts to join the European Union.

While there is every kind of exotic ETF under the sun for traders, the average long-only retail investor who wants to buy and hold will likely be better off with a broadly diversified global ETF.

One way of doing this is to use global ETFs like streetTRACKS DJ Global Titans (with 50 stocks and an MER of 0.54%) or iShares S&P Global 100 (with 100 stocks and an MER of 0.4%). But both of these are at least half invested in U.S.-based multinationals. These are global titans, to be sure, but depending on your view of the future of the U.S. dollar and current valuations, you could consider EAFE (Europe, Australia, Far East) and emerging markets ETFs. iShares already serve these markets and Vanguard has announced plans for similar products.

Year-to-date returns to Sept. 30, 2004 show the iShares MSCI Austria ETF is the top so far this year, with a nine-month return of 33.8%. That's followed by three energy or oil-based ETFs which have returned between 28% and 32%. Other top sector ETFs include 19% for the Internet HOLDR, and the wireless HOLDR at 23.4%.