

## Thought for the Week: Monday, August 23<sup>th</sup>, 2010

### Not all ETFs are Created Equal

This week we discuss some of the **common pitfalls lurking out there for the unwary Exchange Traded Fund purchaser**. As a result of their efficiency and simplicity, ETFs have gained increased popularity with investors of all shapes and sizes. Since their U.S. introduction in 1993, they have grown to rival Mutual Funds with respect to the amount of money being invested in them on a daily basis. Correspondingly, the number and variety of ETFs available has expanded rapidly to chase demand. Such expansion can create problems.

- **ETFs are powerful investment tools**; however, like all power tools they should be used with care and experience.
- **DIAS utilizes ETFs to quickly and cost-effectively allocate capital to a wide variety of asset classes, regions and markets**. They form the core of most of our portfolios.

However, not all ETFs are created equal. Prior to making an investment in an ETF, **here are a few of the issues we research**. We would suggest any ETF purchaser do the likewise.

#### ETF Contango

Is Contango a dance or a disease? It's actually **a disease that regularly affects Commodity ETFs** making them behave irrationally! It's a disease that can infect the portfolio of an inexperienced investor.

The chart below shows the price of Oil (white line) and the price of USO, an ETF which aims to track the price of Oil (green line). USO closely tracked the price of Oil until 2009 when the price of Oil started to recover from its bottom. Unfortunately for those invested in USO, its price didn't recover to the same degree. For those who bought USO as way to track the price of Oil, this discrepancy was somewhat disappointing. **Oil recovered by approximately 40% while an investment in USO hardly moved.**



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**USO became “Contangoed” in 2009 – the performance of USO clearly didn’t match that of Oil.**

Contango is a phenomenon which can occur when the forward price of a commodity is greater than its current, or Spot, price.

**The USO ETF contains forward contracts to buy Oil which mature every month.** Therefore, as the price of Oil rises and falls, the price of the forward contracts rise and fall. As a result, you get a single security that follows the performance of Oil.

However, **every month, the ETF sells these forward contracts before they expire** (it does this because it doesn’t want to buy and take delivery of the physical Oil). It then replaces last month’s contracts by buying the following month’s contracts. **If the price of Oil is rising, the price of the new contracts will be higher than the price of the old contracts.** The ETFs will have replaced cheaper contracts with more expensive contracts, thereby creating a loss.

When you sell something at a lower price than you buy it back, you make a loss. **In this way the ETF makes a loss, even though the underlying commodity is rising in value.**

**Check historical charts for Contango potential before buying commodity ETFs.**

Other Common Potential Pitfalls include:

**LIQUIDITY: All ETFs are easy to buy, but some are hard to sell!**

As ETFs proliferate, some attract significant capital while other are not be so lucky. The ETF marketplace is competitive. There are **over 2,200 ETFs currently available; however, less than 100 ETFs account for approximately 60% of the total invested assets.**

**If an ETF fails to attract interest from buyers (thinly traded or lacking in volume) it may be very difficult to sell.** This will generally cause the sale price to be lower than that quoted or what you would expect from following the asset class the ETF represents.

Check the daily and monthly volume prior to purchasing any ETF, **especially those ETFs that cover narrow sectors of a market or asset class.**

**CONCENTRATION RISK: Check under the Hood!**

Prior to buying an ETF, **research the investments it holds.** If a high percentage of the fund’s assets are held in just a few companies or investments, you may be exposed to greater or different risks to the ones you imagined when buying.

For example, imagine you track Healthcare by buying a Healthcare ETF with 15% of its assets in a single company stock and 45% of its holdings in three ‘Big Pharma’ company stocks. If any one, or all, of these companies suffer from a specific event that does not affect the rest of the industry, you will lose money faster than the general market you were tracking. **You will have made the right sector decision, but picked the wrong security.**

**In our opinion, ETFs are highly efficient and effective investment tools, particularly when compared to Mutual Funds. However, just like every rule, there are exceptions out there waiting for the unaware and inexperienced.**