Exchange-Traded Funds (ETFs)

April 14, 2000

The Future of Indexing and More

■ A new product in the fund world, or a recreation of an old product, is the Exchange-Traded Fund (ETF). Currently, ETFs are passively managed portfolios modeled after an index. ETFs provide investors with a vehicle that closely tracks the performance of an index while providing the ability to trade in and out of the fund on an intraday basis.

■ With the advent of WEBs, SPDRs and DIAMONDs, we are now seeing the next generation of ETFs that are coming to market in the near future. The newest ETFs will not only provide investors with access to most of the popular indices, but offer them a group of handpicked securities bundled into a single issue with intraday liquidity. Like the existing ETFs, the newest funds will be traded on the American Stock Exchange (AMEX).

■ Unlike closed-end funds, ETFs are anticipated to have a broader appeal to institutional investors, since they have the ability to increase or decrease positions through a creation and redemption feature.

■ Barclays Global Investors, the current manager of the World Equity Benchmark Shares (WEBs), anticipates a launch of numerous ETFs, and other companies will follow, including Nuveen, currently a significant player in municipal closed-end funds, and State Street.

■ Much smaller discounts and premiums. Transparency throughout the trading day in pricing and the ability to obtain new shares or redeem outstanding shares at each day’s closing NAV are the keys to having the exchange-traded concept work successfully. If the securities needed to create or redeem shares are known and can be freely purchased in the open market, and if there is a disparity between the fund price and the underlying value of the securities, the advantage will be recognized and the disparity will narrow.

■ We believe that the ETF is an important product and a strong indicator of the future direction of the fund industry in general. We do not anticipate a major impact for most of the existing closed-end funds. Some funds may be candidates for conversion, although most will not.
What Is an Exchange-Traded Fund?

A new product in the fund world, or a recreation of an old product, is the Exchange-Traded Fund (ETF). ETFs are generally passively managed portfolios modeled after an index. ETFs provide investors with a vehicle that closely tracks the performance of an index while providing the ability to trade in and out of the fund on an intraday basis. ETFs are not registered as closed-end funds; rather, they are more analogous to open-end funds because of the creation and redemption feature and the stock price values that closely track the underlying net asset values. We will discuss their differences below.

Types of Exchange-Traded Funds include the following:

WEBs

World Equity Benchmark Shares (WEBs), listed on the AMEX, offer investors access to 17 foreign markets, and Barclays has filed for more WEBs to be listed. WEBs were modeled after S&P Depository Receipts (SPDRs), which track the S&P 500. WEBs are best classified as open-end funds that trade and track the Morgan Stanley Capital International (MSCI) indices.

WEBs—World Equity Benchmark Shares

- Australia
- Austria
- Belgium
- Canada
- France
- Germany
- Hong Kong
- Italy
- Japan
- Malaysia
- Mexico
- Netherlands
- Singapore
- Spain
- Sweden
- Switzerland
- United Kingdom

DIAMONDs (DIA)

The Diamonds product is a unit investment trust. It has been designed to closely track the price and yield performance of the Dow Jones Industrial Average (DJIA). The portfolio holds all of the DJIA stocks. The Trust (sponsored by PDR Services, a wholly owned subsidiary of the American Stock Exchange) issues and redeems Diamonds units only in multiples of 50,000 called “Creation Units” in exchange for DJIA stocks and cash. Individual Diamond units trade on the AMEX. As of March 2000, the trustee has agreed to reduce the trustee fees from 0.146% to 0.096% of average daily net assets. Underlying securities may be dropped or added as the DJIA drops or adds securities to the index. The trust is a unit investment trust registered under the 1940 Act and isn’t a managed fund. The (net assets) market capitalization for Diamonds is about $2.0 billion.
Like Diamonds, other broad-based index ETFs include the following:

- Diamonds (DIA)
- Nasdaq-100 Index Tracking Stock (QQQ)
- MidCap SPDRs (MDY)
- SPDRs (SPY)

**SPDRs (SPY)**

The SPDRs were the first ETFs to be put on the market, in 1993. The SPDRs product is a unit investment trust. Spiders, also known as S&P Depository Receipts, are units of beneficial interest in the trust. The trust holds a proportional amount of substantially all of the common stocks in the Standard & Poor's 500 Index. Investment results generally correspond to the price and yield performance of the S&P Index. The minimum number of SPDRs that may be created or redeemed at any one time is 50,000, which aggregation is referred to as a "Creation Unit." The underlying securities may be dropped or added as the S&P 500 drops or adds securities to the index. The market capitalization for Spiders is about $17.3 billion.

**Select Sector SPDR Funds**

In addition to the original Spiders, new ETFs have been created to represent subsectors of the S&P 500, including the following:

- Basic Industries Select Sector SPDR Fund (XLB)
- Consumer Services Select Sector SPDR Fund (XLV)
- Consumer Staples Select Sector SPDR Fund (XLP)
- Cyclical/Transportation Select Sector SPDR Fund (XLY)
- Energy Select Sector SPDR Fund (XLE)
- Financial Select Sector SPDR Fund (XLF)
- Industrial Select Sector SPDR Fund (XLI)
- Technology Select Sector SPDR Fund (XLK)
- Utilities Select Sector SPDR Fund (XLU)

**Merrill Lynch’s HOLDRs**

HOLDRs Trust issues depositary receipts that represent an undivided beneficial ownership in common stock of a group of several companies within a specified industry. HOLDRs are created and redeemed in round-lots of 100. The trust is not a registered investment company under the Investment Company Act of 1940, and investors should read a HOLDRs prospectus to understand the difference. Unlike other ETFs that add or drop securities from their trusts as their underlying index changes members, no new company will be added to the group of underlying securities in HOLDRs trusts. Underlying securities in HOLDRs are predetermined when the trust is originally created, and therefore, underlying securities can only be removed from the trust as a result of mergers, acquisitions, or other occurrences that lead to the termination of the common shares of a company. HOLDRs have only nominal expenses, usually lower than other basket or fund products.
Currently, there are eight HOLDRs, including the following sectors:

- Pharmaceutical (PPH)
- Telecommunications (TTH)
- Internet Infrastructure (IIH)
- Internet Architecture (IAH)
- Internet Business-to-Business (BHH)
- Broadband (BDH)
- Internet Business-to-Consumer (HHH)
- Biotechnology (BBH)

**How Are ETFs Traded?**

With the exception of HOLDRs, ETFs are considered open-end investment companies that can be either bought like a stock or created by the ETF’s distributor. While the ETFs are clearly not closed-end funds, they are able to trade intraday; when purchasing shares on the secondary market, investors pay a standard commission just as if they were buying common stock. Unlike a closed-end fund, ETFs can also be redeemed, or issued directly by the distributor in “Creation Units”; this is done to prevent the fund from trading at a premium or a discount. There are relatively small creation and redemption fees when traded in “Creation Unit” size.

Because the current generation of ETFs are generally index funds and are managed passively, they tend to have a low fee structure and should closely track the performance of the index they are following. For example, WEBs charge 84 basis points for expenses, which was recently reduced compared to the average expenses for a closed-end country fund, which is 113 basis points.

**The Launch**

Until now, the starting point for a typical ETF has been somewhat different than that of a typical initial public offering (IPO). There is often no concentrated marketing effort to raise capital, unlike a closed-end fund. Additional capital can always be added to the fund. This also means reduced expenses, since typically there have not been broker incentives for selling the product other than normal commissions and wrap fees.

The majority of investors buy and sell shares in the secondary market and do not create or redeem shares. The creation and redemption of ETF shares is a major difference from closed-end funds. “Creation Units” are created through a Payment-in-Kind (PIK) method. This is normally the method for large holders or institutions. Generally, PIK involves depositing or receiving securities to the trust. PIK is actually more tax-efficient since the fund would not have to realize any gains or losses if it had to sell securities. There are costs associated with the creation and redemption of shares; most smaller transactions will be done in the open market.

**Much Smaller Discounts and Premiums**

Transparency is the key to having the exchange-traded concept work. If the underlying securities are known and can be freely purchased in the open market and there is a disparity between the fund price and the underlying value of the securities, the advantage will be recognized and the disparity will narrow. But transparency is paramount.
Since the fund shares can be redeemed in “Creation Unit blocks,” a disparity in price between the underlying value and the stock price allows arbitrageurs to purchase the fund at a discount and then choose to redeem shares, thus eliminating the disparity.

**Recent Activity**

Some of the most noteworthy events include Barclays’ plan to launch many ETFs in the very near future. Barclays filed 26 domestic funds and 11 international funds with the Securities and Exchange Commission (SEC) in December 1999. The funds will be fashioned after notable indices and hybrids of indices, which include the Dow Jones, Russell and S&P indices, to name a few. Barclays anticipates that it will be the first to market, but there will surely be others to follow—one notable name is Nuveen. Barclays already has experience with these types of funds, since it has been managing the WEBs since 1996. Its new funds will initially be domestically oriented. State Street has also filed for additional ETFs.

Nuveen has hired Gary Gastineau to head up its Structured Investments unit. Mr. Gastineau was formerly a product development specialist for the American Stock Exchange. Gastineau will be establishing index-type and eventually actively managed exchange-traded products for Nuveen. Actively managed ETFs are still in a conceptual stage, but if successful, they will be a new angle on ETFs.

We can surely expect that other fund companies will be waiting to jump into this market, given that the many issues that face closed-end funds will not have an impact on these products.

**What Do We Think?**

We have restrained optimism regarding these new funds. When WEBs were first issued in 1996, they had only $79 million in assets. Four years later, they have $2.0 billion in net assets, and while they have gained interest, it did take some time. With many possible new entrants who will be issuing ETFs, these funds may be somewhat smaller than the larger existing funds. Despite their potentially small size, we believe that these new ETFs represent a trend of growing importance in the fund industry.

**Will Existing Closed-End Funds Convert to ETFs?**

1. We believe that this notion is somewhat premature because we first need to determine if this concept will work on an actively managed portfolio versus a passively managed index fund. Nuveen has no such plans, however, for actively managed ETFs before 2001.

2. Once it is determined that an actively managed portfolio ETF can work structurally with the transparency of the underlying securities, you then have to get past the resistance by fund management. Since fund companies have a definable income source from closed-end funds, they can be a stable cash cow. Some concerns do exist. For example, if there was a proliferation of ETFs, would the assets disappear over time? If the fund was in a poor-performing asset class, assets could leave rapidly and never return.
3. Many closed-end fund portfolios utilize leverage and invest in illiquid securities, including private placements, where it would be difficult or impossible to deliver the underlying securities and be able to arbitrage those securities.

4. Payments-in-kind allow for the avoidance of capital gains distributions by passing along appreciated securities to shareholders that redeem “Creation Units.” We believe this represents an advantage over many existing funds that generate a tax burden to existing shareholders when the fund needs to raise cash by selling securities for redemption purposes.

5. Transparency: One of the major difficulties in analyzing a closed-end fund is that fund companies are only required to report what is in a portfolio twice a year, so to know what is in a portfolio at all times is virtually impossible. For the ETF concept to work there needs to be a higher level of transparency and on a more frequent basis.

While we believe that the Exchange-Traded Fund is an important product and a strong indicator of the future for funds in general, we do not anticipate a major impact for most of the existing closed-end funds. Some funds may be a candidate for conversion; most will not.
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