

WESTOVER CAPITAL ADVISORS, LLC

ASSET MANAGEMENT & INVESTMENT COUNSEL

H. MURRAY SAWYER, JR., ESQ.

H. M. SAWYER, III, CFA

Direct Dial
(302) 427-6988

1220 N. MARKET STREET
SUITE 800

Direct Dial
(302) 427-8080

HMS@WestoverCapital.com

WILMINGTON, DELAWARE 19801-2555

Chip@WestoverCapital.com

(302) 427-9600 Voice
(302) 427-8900 Fax
www.WestoverCapital.com

Welcome to the Brave New World of ETFs

The novel *Brave New World* by Aldous Huxley was a life-changing book for many. In 1999, Modern Library ranked it fifth on its list of the 100 best English language novels of the 20th century.

Published in 1932, this dark, satiric novel looked at a future society negatively changed by giving the state control over new and powerful technologies. One such technological "improvement" was the creation of complex entertainment machines which generated harmless yet mindless leisure and high levels of consumption amongst the populace. The novel's characters use a drug, soma, pervasively. It clouds actual reality, substituting hallucinations of happiness instead.

If some investors are not careful, that same dream world might happen to them if they listen to the ads for this so-called "new" investment product, this soma called "exchange traded funds," or "ETFs" for short.

This essay will bring you a short history of ETFs, identify where they can be useful, contrast them with mutual funds, but end with a warning to be wary of ETF overindulgence.

Like a mutual fund, an ETF holds a basket of something. It can be the 30 stocks found in the Dow Jones industrial index, many hundreds of US Treasury inflation protected bonds (or TIPS), or the stocks of an index which tracks the Morgan Stanley EAFE international index.

One of the troubles is that today the number of ETFs has exploded. First launched in 1993, there are now more than 3,500 ETFs vying for the attention of the retail investor. That's seven times the number of stocks which comprise the S&P 500, for example.

Today the size of our US deficit for this fiscal year and the amount of dollars invested in ETFs are almost the same: \$1.5 trillion for the deficit, \$1.4 trillion for the ETF market.

As their number has exponentially grown, so too has the chance for their misuse by the unsophisticated. Originally designed as index trackers, the more esoteric ETF products of today look, for example, at returning two or three times the daily inverse return of the various equity indices. That may be fine for a professional trader, but not for your average Joe Six Pack Investor.

John Bogle, the famed Vanguard founder and protector of the common man investor, has warned that ETFs should be likened to a shotgun: great when you're out hunting, but also "excellent for suicide." And as Wall Street tries to develop and market yet more and more ETF flavors-of-the-day, their chances for doing mischief to the retail investor increases.

Like Barry Bonds' body on steroids, ETFs have exploded on the investment scene in the last two years. The stock market started its recovery in March 2009. Then, the S&P 500 index hit its low, around 636. Today it has doubled, trading in the 1300 range. Over that same period, the *Wall Street Journal* reports that \$57 billion have been pumped into the ETF market. And at the same time mutual funds have

seen withdrawals of \$66 billion.

ETFs are attractive relative to mutual funds for three reasons. First, they price like stocks, minute-by-minute during the course of the day. Mutual funds set their price once, at the end of the day. Second, like the purchase or sale of a stock holding, you can control the tax consequences of buying and selling most ETFs, whereas you can't do that with mutual funds. And third, and perhaps most important, the expenses associated with managing an ETF are much less than that of a typical mutual fund, perhaps on the order of two or more times less expensive.

But this capacity to trade ETFs at any second may invite casual and unnecessary trading to the harm of the do-it-yourself investor. Without doubt, ETFs have made it possible for the professional traders to move their large cruise ship positions in a snap of a finger which is good for the hedge fund client but that very strength on the professional level is a potential hindrance to the retail Joe.

As the *WSJ* reported on April 18th, Don Phillips, president of fund research at Morningstar, captured the two sides to this new investment product quite succinctly. Phillips said, "ETFs linked together two basic instincts. One was this trend toward lower costs and passive investments -- generally healthy behaviors. On the other hand, what they have tapped into is the human love of gambling -- the need for action and trading."

At Westover we think stock picking is one of our core strengths. We use ETFs, but on a limited basis, to fill in the interstices of a diversified portfolio where the selection of individual stocks is too problematic. Like in the emerging market small cap space. Or we'll also employ bond ETFs if we know we'll need to raise cash and we don't want to return to the opaque world of selling individual bonds, where bid and ask spreads can be unduly wide and non-rational.

So in conclusion, buyer beware. If you're an individual investor, make sure you know what the particular ETF is designed to do and use it for that purpose only. Or better yet, leave their use to the professionals who know that in this brave new ETF world, that soma is a drug that can do harm as well as good.

LISTEN TO THE MUSIC

The Doobie Brothers are coming to the Grand in Wilmington April 21. I'm going for nostalgia's sake but my wife Randy has begged off, stating that its not fun watching "old men pretending they're not." I have to admit it: she has a point.

Nevertheless your quiz is, without internet assistance, to put these four Doobie Brothers songs in correct chronological order:

Blackwater
Long Train Running
Listen to the Music
What a Fool Believes

A gift certificate to the restaurant of your choice in the amount of \$100 awaits the winner. Good luck. Maybe I'll see you at the Grand.