What Can Go Wrong With ETFs

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Not every innovation works as advertised, and exchange-traded funds are no exception. Some ETF defects are minor, but others can damage your investment results if you don't take steps to avoid them.

ETFs trade like stocks and can behave like them, too. The fact that you can buy and sell ETFs just like stocks is advertised as one of their great benefits. But as the May 6 flash crash demonstrated, it can also be a serious disadvantage. On that tumultuous day, the share prices of many ETFs dropped to pennies in a matter of minutes even though their underlying assets were worth far more. Of the securities hardest hit by the mayhem, about 70% were ETFs. The exchanges later nullified trades executed at prices that were 60% or more below pre-crash levels. The best protection against future crashes is to use limit orders (see How to Buy and Sell an ETF).

ETFs can miss the mark. Most ETFs are designed to track a market measure, such as Standard & Poor's 500-stock index. But even without the extraordinary circumstances of May 6, some ETFs fail to track their benchmarks as closely as they should. For example, iShares MSCI Emerging Markets Index (symbol EEM) is designed to follow the MSCI Emerging Markets index. Over the past year through May 31, the ETF gained 16.4%, but the index rose 22.7%. One reason for tracking errors is that funds charge expenses (0.72% annually in this case) while indexes don't. But the way an ETF goes about trying to match its benchmark can also lead to unexpected results. While the emerging-markets index holds more than 850 stocks, the iShares ETF owns only 600, ignoring shares of some of the smaller companies. When small-company stocks in emerging markets rallied in the past year, iShares investors missed part of the gains.

ETF trading involves extra costs beyond commissions. Exchanges require buyers and sellers. When there is not enough of either, the gap grows between the price buyers are willing to pay for shares of an ETF and the price sellers are asking. This is called the bid-ask spread, and it costs you every time you trade. The spread for widely held ETFs, such as Vanguard Total Stock Market (VTI), is usually a mere penny. But spreads for newly issued or thinly traded ETFs -- Market Vectors Vietnam (VNM) is one example -- can be a nickel or more. In general, you should pass up ETFs with wide spreads. If you must own one, use limit orders when you buy and sell.

Share prices may be below or above an ETF's net asset value. This situation is common for closed-end funds, the older cousins of ETFs. Most widely traded ETFs don't have this problem because trading specialists
swap shares for the fund's underlying assets to get rid of discounts and reverse the process to eliminate premiums. But ETFs that are thinly traded or wildly popular can deviate from their NAVs. Don't buy an ETF for a premium to NAV or sell one at a discount. You can get real-time NAVs on AOL, Yahoo and some other Web sites by adding ".iv" to an ETF's symbol.

**Beware leveraged ETFs.** These ETFs attempt to double or triple the returns of their benchmarks for a single day. But leverage can lead to unexpected results for funds held over periods longer than a day. Suppose the S&P 500 climbs 10% on Monday, then drops 10% on Tuesday. A $100 investment in an S&P 500 ETF at the market's open on Monday jumps to $110 by the end of the day, then sinks to $99 by the end of Tuesday. You're out 1% over two days. But if you buy a double-leveraged ETF, you have more than doubled your loss. That value of your holding jumps to $120 on Monday, then tanks to $96 by the Tuesday close. Extend this kind of volatility over a long period and you can lose money even if the index goes up. You don't need that kind of trouble.

(For information on finding the right ETF, see [How To Evaluate ETFs](http://www.kiplinger.com/magazine/archives/what-can-go-wrong-with-etfs.html).)