



5 minutes with Mark

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THE CASE FOR EXCHANGE TRADED FUNDS

The business principle of understanding and controlling expenses and taxes applies to your portfolio, as well.

Why pay mutual fund managers higher fees and incur extra taxes when Exchange Traded Funds (ETFs) are available at a fraction of the cost? Why, indeed? And that explains why ETFs are gaining tremendous attention.

Fairly new to the marketplace, ETFs are like mutual funds in that they both own large pools of well-diversified investments within specific sectors, such as large-cap, mid-cap, etc. The main difference is in the investment approach, and the resulting internal fees and distribution of tax liabilities. For the most part, ETFs are indexed investments focusing on a particular range of stocks, and taking a buy and hold approach. Trading is minimal, so internal fees are few, and therefore there's little year-end tax activity other than dividends.

As the data in the first chart shows, there's a significant difference in expenses depending on the investment model utilized, active vs. passively managed funds (indexed funds and ETFs). When you factor in taxes – and a true comparison must consider all costs – the difference can be even greater.

Certainly, if an active manager beats the markets by more than the cost difference after taxes, there's a positive net return as compared to the indexed fund or ETF.

This leads to the question: "How many managers outperform the market?" Our second chart shows that from 1994 to 2004, 87% of large-cap funds *underperformed* the indexed return before taxes, and 97% fell short after taxes.

U.S. large-cap is typically the dominant portion of an equity portfolio. So why not realize significant savings through the cost and tax efficiencies of a large-cap ETF vs. an actively managed large-cap mutual fund, when both make virtually the same investments? Just as important, of the 3% of large-caps that outperformed the market, rarely did the same fund do so consistently.

EXPENSES: Mutual Funds vs. ETFs		
Avg. Active Large Value Fund	Avg. Index Fund	ETFs (S&P 500 Value)
1.43%	.85%	.18%

PERFORMANCE: % of Active Large-Cap Value Managers UNDERPERFORMING the Index (from 12/31/94 thru 12/31/04)	
Before Tax	After Tax
87%	97%

Bottom line: I know everyone reading this message, and I don't think any would approve a business expenditure on something with a 3% likelihood of meeting your expectations.

Shouldn't this thinking apply to your portfolio, as well?

PROWELL FINANCIAL MANAGEMENT

211 Pumpkin Hill Road ■ Glenmoore, PA 19343
Phone 610.942.9042 ■ Fax 610.942.3129 ■ mark@prowell-financial.com