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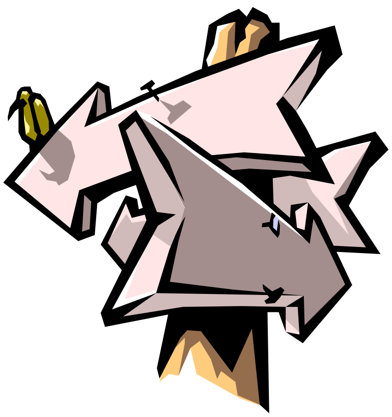

A New Choice In The Basket

Exchange-traded funds offer a lower-cost alternative to traditional mutual funds while giving skeptical investors peace of mind.

Dirty dealings at many of the nation's biggest mutual fund companies are turning a spotlight - or at least a flashlight - on an up-and-coming alternative to traditional mutual funds.

Exchange-traded funds offer most of the benefits of traditional funds at a much lower cost. As a plus, they are structured so nobody can sneak in a late trade that benefits some shareholders at the expense of others.

If you've heard of exchange-traded funds, it's probably been by one of the catchy nicknames derived from their ticker symbols. Spiders (SPY), Diamonds (DIA) and Cubes (QQQ) are three of the most popular.

ETFs, as they are known, look a lot like traditional mutual funds. Investors who buy shares get a small piece of a portfolio of securities. The big difference is that ETF shares are bought and sold on a stock exchange the same as shares of IBM or Outback Steakhouse. Traditional funds are bought and sold through the fund company using the closing price at the end of the day.

Although ETFs have been around for a decade, the number of offerings has exploded in the past few years. More than 100 ETFs are now on the market tracking U.S. and foreign stock indexes. About a dozen more track bond indexes and one is in the works that will own gold.

But ETFs haven't exactly taken the investment world by storm. Most investors are in the dark about how the funds work and why anyone might want to own one.

Although they recently have attracted more attention, ETFs still hold only about $130-billion in investor assets, compared with the $7-trillion socked away in traditional mutual funds.

"Institutional investors are way ahead of individual investors in realizing the benefits," said Dan Dolan, chief of Standard & Poor's Corp.'s Sector SPDRS (pronounced Spiders), a group of ETFs that specialize in stock market sectors such as energy and financial services. "Investment products are still sold, not bought. The challenge with ETFs is that the intermediary has a hard time making money."

ETFs have none of the sales charges known as front- and back-end loads, the redemption fees that drag on for years or the marketing fees that have made traditional funds so lucrative for fund companies and the brokers who sell their wares.

The average stock ETF has an annual expense charge of 0.35 percent, while the average traditional stock fund has an expense charge of 1.57 percent. The "Spider" that tracks the Standard & Poor's 500 Index has an expense ratio of just 0.12 percent, beating even the famously cheap Vanguard 500 Index Fund.

As a result, ETFs are a better deal than traditional funds for many investors. The major exception is investors who make frequent transactions, such as retirement savers accumulating a few shares each payday. Paying a commission for every small purchase doesn't make sense. Commissions also are a drawback for small investors who frequently sell shares to take tax losses or to rebalance their holdings.

ETFs appeal both to active traders, who use them to jump in and out of technology stocks, and to buy-and-hold investors.

The fastest-growing group of ETF shareholders is made up of investors who pay a financial adviser an annual fee to manage their money. Advisers who are taking 1 or 2 percent a year as a fee are more inclined to put low-cost funds in their clients' accounts than those who make their living off commissions. ETF fees are so low that the investor can come out ahead even after paying the financial adviser's fee.

"ETFs have really helped us as investment managers," said New Port Richey financial planner Steve Athanassie of Trademark Capital Management. "We've all become more sensitive to fees the last three years."

He said ETFs have replaced most of the traditional stock funds in his clients' portfolios.

"With three ETFs, you can own virtually every stock in the world," said Tampa financial planner Sameer Shah of Shah & Associates. The three: the Vanguard Total Stock Market VIPER (VTI), iShares MSCI EAFE Index Fund (EFA) and iShares MSCI Emerging Markets Fund (EEM), for those who want exposure to developing countries.

"If you have a self-directed brokerage account, then ETFs are great," Shah said. "Or if you want to keep a relationship with a broker, you can buy these and you're going to be better off than you are with the mutual funds that the wire houses put you in."

ETFs try to match the performance of an index, not to beat it. That means some actively managed funds will always do better, but ETFs should outperform most mutual funds over the long run.

"The public isn't aware of how bad mutual fund performance really is," said Larry Swedroe, a St. Louis author whose books champion passive investments such as index funds and ETFs. "Tens of billions of dollars are being flushed down the toilet needlessly by investors. They're making everybody else rich."

Investors may not know much about ETFs, but once they learn about them, they like the concept, financial advisers who recommend them say.

"We just explain that it's like an index mutual fund, only it can be traded as a stock, and they like that flexibility," said Palm Harbor financial planner Kirk Kinder at the Financial Guidance Group. "We still have a lot of actively managed funds, but I'm moving away from them. I think that 10 years from now, ETFs' track record will be much better than actively managed funds."