

# ETFs: The Transparency Factor

Don Freeman  
August 28, 2010

It is no coincidence that so-called Exchange-Traded Funds or ETFs date back to 1993 just as the Internet era was beginning to create new levels of transparency that Wall Street had to follow. After all, even the smallest retail investor no longer needed to rely on what their broker was telling them or what was written in a prospectus or annual report as they could simply log on to the Internet and find out just about any information they wanted to know. In other words as retail investors like you and I became more educated and sophisticated, we began to demand investment products that were more transparent.

## Why Traditional Mutual Funds Lack Transparency

By their very nature, actively managed mutual funds often lack transparency. And while such funds must file quarterly and annual reports to the SEC or other relevant regulatory agencies, it is important to remember that these reports are only a snapshot in time. In fact, some fund managers will even “window dress” their portfolios at the end of a reporting period to ensure that it appears that their mutual fund was holding all of the hottest investments for the entire reporting period.

Moreover, managers of actively managed mutual funds are often free to change their entire investment strategy or investment mandate at any given time. Hence, the manager of a so-called growth fund may start buying value stocks as these stocks begin to rise or vice-versa. In other words, ordinary retail investors like you and I really have no idea what investments or investment risks our fund managers are exposing us to beyond specific reporting dates.

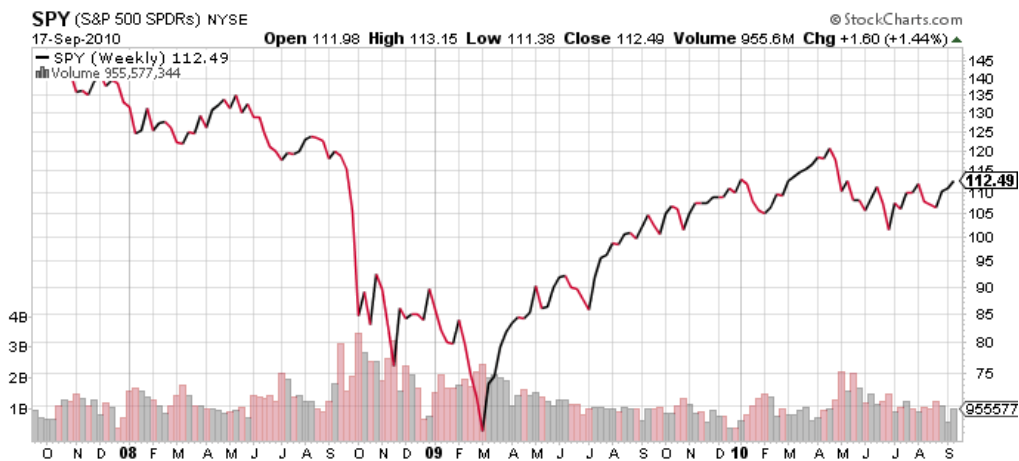


**Figure 1 SPY - SPDR S&P 500 Sectors / Top Ten Holdings (September 2010)**

## Why ETFs are Transparent

In contrast and by their very nature of being funds that tend to replicate indices, ETFs are much more transparent investments than traditional mutual funds. Take the case of the SPDR S&P 500 ETF (NYSEArca: SPY) issued by State Street (one of the first ETFs ever created) which attempts to replicate the performance of the S&P 500 index. To view the current holdings and sector allocation of the fund, an investor can simply visit the website of [ETFdb](http://ETFdb.com) (or any number of other websites) to see its latest holdings. Figure 1 shows the sector breakdown and top ten stocks that comprise the SPY Exchange-Traded Fund.

As an index fund, investors know that the SPDR S&P 500 ETF must replicate the S&P 500 Index's performance. However and unlike actively managed mutual funds, ETFs do not sell or redeem their individual shares at net asset value (NAV). Instead, a financial institution will purchase and redeem ETF shares directly from the ETF through the use of so-called "creation units" or "creation baskets". These consist of a list of securities and the number of shares that an institutional investor must deliver to an ETF in order to replicate a particular index. Hence, the SPDR S&P 500 ETF will likely contain each and every stock that makes up the S&P 500 in the same proportion that they exist in that particular index.



SPY - SPDR S&P 500 (Weekly Chart)

## Conclusion

When looking at the big picture, the transparent nature of ETFs can offer retail investors a greater measure of safety and more peace of mind than investments in actively managed mutual funds. However, investors must still remember that individual ETFs each have their own unique risk and reward profiles and one ETF may not be as transparent as another ETF. Hence, be sure to consult a qualified financial advisor who can advise you how to select the right ETF investments that will both fit into your current investment portfolio and match your particular investment needs.

*Don Freeman is President of Freeman Capital Management LLC, a US registered investment advisory firm in Phuket, Thailand. Don divides his time between Southeast Asia where he studies emerging market economies and conducts workshops to educate expatriates about investing in ETFs and other types of investments; and Portland Oregon where he continues to advise his US based clients.*

[freemancapital@gmail.com](mailto:freemancapital@gmail.com) Phuket, Thailand 089 907-5795