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SHORTING OUT
**Fast-Money Crowd Embraces ETFs,
 Adding Risk for Individual Investors**

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Exchange-traded funds are a simple way for small investors to take a stake in broad market segments like China or precious metals. Brokers often tout them as an affordable alternative to traditional mutual funds.

But buyer beware: The funds also are heavily used by the fast-money crowd such as hedge funds and big Wall Street traders. Combined with the effects of a 24-hour market and the unusual inner workings of ETFs, that trading can distort prices on days such as Feb. 27 and March 13 when the market swooned. Some investors who sold amid the turmoil got significantly less for their ETF shares than the underlying assets were worth.

- **The Situation:** On days of volatile trading, the share price of an ETF can wander away from the price of the assets it's supposedly tracking.
- **The Background:** Exchange-traded funds track markets like index funds, but allow more trading strategies.
- **The Cost:** ETF investors who sell during turmoil can get significantly less than the assets are worth.


Mutual funds known as index funds and ETFs both generally attempt to track the performance of broad indexes such as the S&P 500 in the U.S. (Some track narrower slices of the market: See [related article](#)¹.) Decades ago, an investor seeking to match those indexes would have had to purchase shares in each of the companies separately. Today, they can own shares in an index fund or an ETF.

An ETF has some advantages: Unlike index funds, whose prices are set once a day, an ETF can be traded during the day. As with regular shares, traders can buy options on an ETF or borrow ETF shares and sell them in a bet that they will fall in price.

Thanks to these features, ETFs have turned into a powerful tool for Wall Street pros. On many days, two of the three most actively traded issues on the New York Stock Exchange and other U.S. markets aren't regular stocks, they're ETFs. The largest ETF manager, Barclays Global Investors, estimates that 80% of trading in its funds is carried out by big investors like hedge funds, investment pools that cater to the wealthy. Even Vanguard Group -- the mutual-fund giant that built its reputation by serving individual investors -- has started marketing its own ETFs directly to hedge funds.

The waves caused by these traders emerged starkly on Feb. 27. First, stock prices tumbled in China. U.S. markets, opening after China closed, picked up on the trend and also fell sharply. This

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succession of events caused uncertainty about the proper price for U.S.-traded ETFs that track Asian markets. "The bottom line is, nobody knows where Taiwan is going to open" the next day, says Michael Crinieri, head of ETF trading at **Goldman Sachs Group Inc.**

One ETF managed by Barclays Global Investors that tracks the Chinese stock market closed the U.S. day on Feb. 27 down 9.9% even though the index it was tracking had fallen just 2.1% during Chinese trading hours. That index fell another 3.1% the next day in China. Although ETFs are often advertised as an easy way for investors to jump in and out of the market, those who sold during the U.S. day would have lost far more than the actual index they thought they were mirroring.

To be sure, there's a flip side: Those who bought during the U.S. day got a bargain price. Still, the basic problem remains. ETF prices came unglued from the stocks and markets they are designed to track.

The problem can occur even without time-zone complications -- perhaps because of a frenzy among those trading the ETFs, or because the prices of the underlying assets aren't as up-to-date as ETF prices. On Feb. 27, the share price for a precious-metals fund offered by Powershares Capital Management, ended the day 3.3% below the actual value of the fund's holdings.

ETFs have taken off in the past five years during a period of relative calm in global markets. Their popularity has soared among individual investors, and some are starting to show up in 401(k) retirement plans.

Industry executives argue ETFs are a good idea on the whole because they provide traders large and small with strategies previously unavailable to them. The added flexibility could help the market adjust more quickly in stressful times and mitigate another 1987-style crash, proponents say.

Patrick O'Connor, head of portfolio management for Barclays' iShares line of ETFs, says it's pointless to expect an ETF to precisely track an overseas market that isn't trading because of a time-zone difference. An ETF delivers its real value during seesawing markets, he says, by serving as a "price discovery vehicle" -- a way to discover the best collective guess of investors about where those markets will move the next day.

If the guess turns out to be wrong, that's the way it goes, says Mr. O'Connor. "We all wish we could have a crystal ball," he says. So long as markets calm down, any big discrepancies are quickly cleared away in a day or two.

On Feb. 27, ETFs continued trading normally during the market's gyrations and their prices swung to reflect the ebb and flow of investor sentiment, Mr. O'Connor notes. "I understand how investors can be confused" by temporary price disparities, he says, but "ETFs and iShares worked exactly as designed."

That's news to Scot Stark, a financial planner in Freeland, Md., who frequently uses ETFs for clients. He says he sold shares in the China iShares ETF for six of his 35 clients on Feb. 27.

The ETF had gone up more than 50% since he bought it for them in late June, and by 2 p.m. that day Mr. Stark was ready to exit. "That day was the day we happened to eliminate our position," says Mr. Stark. But "we hadn't noticed differences nor had we been informed of any pricing

discrepancies," he says. "It is actually very surprising."

The extent of the price distortions in February was also a surprise to Dan Culloton, a Morningstar Inc. analyst who follows ETFs. It should be "a wakeup call to investors," he says.

"So far in the great ETF boom, what largely has been talked about is their flexibility, efficiency and ability to track their market," he says. But on volatile days in the market, he now believes, investors need to be extremely careful about using ETFs for short-term trading, regardless of the sales pitch.

There are about 430 ETFs in the U.S., holding about \$430 billion in assets. While that's tiny compared to roughly 8,100 traditional mutual funds, which hold some \$10.5 trillion in assets, ETF assets are growing much more quickly.

Many of the newest ETFs are targeted mainly at professional investors. Vanguard is famous as a pioneer of the S&P 500 index fund, which is popular among mom-and-pop investors. But Vanguard now offers ETFs as well, and last year started marketing them directly to hedge funds.

Vanguard executive Martha Papariello says the company is trying to expand to new audiences. While an index fund may be good for individual investors, ETFs are useful for sophisticated investors using fast-trading strategies "that nobody would have looked to traditional index funds to meet," she says.

Unlike ETFs, traditional mutual funds can't be sold short, the strategy of selling borrowed shares in hopes of profiting by buying them back later at a lower price. Also, most mutual-fund companies penalize rapid trading.

By shorting an ETF, traders can easily make big bets against a market sector such as energy or biotechnology companies or an entire foreign market, from Germany to Malaysia.

A mutual fund is priced just once a day based on the value of the underlying holdings. The Vanguard index fund tracking the S&P 500, for example, is priced in late afternoon New York time and reflects the closing prices of the 500 stocks in the index. All buy and sell orders from the previous 24 hours are settled at that daily price.

By contrast, an ETF's share price is determined by buyers and sellers in the market and may diverge from the value of the fund's holdings.

When an investor puts in an order to buy or sell an ETF through a broker, the money doesn't go directly to the fund company. Small orders are typically carried out through a stock exchange. Large trades go to traders called market makers, who are authorized to create or redeem shares of the fund from scratch in the market. That's an unusual power: Market makers in regular stocks can't create or eliminate a share of, say, General Electric, but they can if it's a share of an ETF.

Powerful players such as big brokerages on Wall Street try to profit from pricing gaps. Goldman Sachs has a team of five traders -- sitting amid the bustle of Goldman's massive trading room, 50 stories above New York Harbor -- who specialize in taking advantage of discrepancies as they quote prices to clients. If Goldman creates ETF shares to sell to a big hedge fund, it will attempt to sell the shares at a slight markup to the price at which it thinks it can purchase the underlying assets.

It can't go too far, of course. As Goldman's Mr. Crinieri notes, other market makers would step in to offer a better deal. Any big spread is likely to be narrowed quickly amid the bustle of buying and selling. The exception: when markets are fast-moving and volatile. Then it can be hard for market participants to immediately grasp what the "correct" price is.

Feb. 27 was one of those exceptional days when trading was heavy and ETFs got considerably out of whack with their underlying assets. Between 2 p.m. and 4 p.m., more shares of the iShares emerging-markets fund changed hands than usually trade in an entire day. Driving the activity was "really short-term traders like hedge funds," says veteran fund manager Mark Mobius of **Franklin Templeton Investments**.

A hefty portion of the activity was short-selling. On the China iShares fund, the equivalent of three months of typical short-selling activity was compressed into one day.

Staffers at Matthews Asian Funds, a mutual-fund company in San Francisco, say they were glued to their computers by the drama in the China iShares fund. Usually, the fund's managers focus on the long term, not hour-by-hour movements, says Matthews fund manager Mark Headley. "We're not into the trading minutiae" unless "we see something this big," he says, calling ETFs a "global phenomenon."

By the end of the day, ETF traders were betting that stock prices would take another big hit when overseas markets reopened. The iShares emerging-markets fund lost 8.1% even though index it tracks had fallen only 3.1% in its most recent close.

As a result, an investor selling \$10,000 of the Barclay's iShares emerging-markets ETF would have received \$500 less than if the fund had tracked its index directly. The value of the underlying portfolio, updated to reflect movements for those shares traded during U.S. daytime hours, would also have been \$360 greater than the investor received for his ETF. Conversely, investors buying the ETF at the right moment would have picked up a bargain.

There were disparities even for ETFs consisting exclusively of U.S.-traded stocks. The Russell 2000 Index of small-company shares fell 3.75% that day, but the iShares Russell 2000 Index ETF that tracks the index fell 4.7%, in large part because like other ETFs it trades for 15 minutes longer than regular stocks. Funds tracking gold and oil similarly diverged from their indexes.

In all that day, 89 of the 421 ETFs tracked by Morningstar fell short of their portfolio value by more than 1%. (Plus or minus 0.5% is generally considered normal.) And 60 of those fell short by more than 2%.

The iShares Malaysia ETF -- one of the most actively traded ETFs, despite the relatively small market -- closed 5.98% below its value on Feb. 27. The iShares ETFs tracking countries like Singapore, Hong Kong, South Korea, and Taiwan all closed 5% to 6% below their portfolio values.

Ultimately, it turned out that the big traders were wrong. While overseas markets continued to lose ground, it wasn't the expected bloodbath reflected in ETF pricing.

Traders were so far off on the Barclays iShares China fund that even though the underlying index fell 3.1% on Feb. 28, the price of the China iShares ETF actually rose 4.3% in U.S. trading that day as traders reversed their overly pessimistic pricing. It was the same story for the emerging-

markets iShares, where the index fell but the fund gained 2.5%.

Significant ETF price discrepancies also occurred last Tuesday, when the Dow dropped 243 points, or almost 2%. That day, 45 ETFs closed at 1% or more above their portfolio values. An additional seven closed below by more than 0.5%.

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