

Exchange Traded Funds (ETF's)

We have often been asked how to trade an index without spread betting and our answer is normally the same, try ETF's. Exchange Traded funds have been around for quite some time now, but the demand for more specific categories has meant a whole host of new funds are being made available.

For new and old investors, the futures market can be quite scary at times. Some of the lot sizes for futures are a bit rich for many, let alone the perceived risk. Now if you're not too sure what the futures market is and after reading Kevin's article on page 16, are still not sure that this is something for you, well there is good news here and more on the way.

If you wanted to take advantage of the rising demand for gold, the previous alternatives were limited for many investors. Of course you could spread bet, but that is not for everyone, nor is taking delivery of the metal which does not allow you to buy and sell within seconds rather than days. (That said it is always good to own some gold coins for the long term).

Everyone understands the principle of buying or selling a share, so what better than being able to buy and sell gold, silver and oil and even a currency pairing in exactly the same way and from the same account? The good news is that you can already do this with some of the items listed and it will not long before a further group will be offered.

HOW THEY WORK

An ETF is basically an index fund that is traded on the stock market. Most funds contain a basket of the asset class (such as stocks) which represent the underlying index. For example the first ever ETF that was released, SPY, tracks the S&P 500 thus contains shares of the stocks listed within the index.

There are a number of different ways of how ETFs are managed, there are Grantor Trusts which mirrored an index when originally created but does not attempt to track it move for move. HOLDERS follow this discipline. There are Management Investment Company's. which tracks the index closely, although uses a sampling technique rather than buying each of the constituents, these include iShares and sector SPDRs. Then there is a straight forward Index fund that mirrors as closely as possible the index by purchasing all the stocks in the index on a

weighted basis and will maintain a close price rating to that index.

If you want to check out how well an EFT correlates to a particular index, you just need to look at the R squared figure, which ranges between 0.00 and 1.00, with 1.00 being perfect correlation and 0.00 being no correlation.

The costs associated with ETFs are relatively small and are laid out clearly. The good thing from an investor's point of view is that they do not pay these directly, they just buy and sell the fund as they would a stock meaning the only direct costs are brokerage fees.

THE RANGE

There are currently over 200 different ETFs to choose from. You can see a list on sites such as Yahoo or on the TC2005 charting package.

The range includes the main US indices and all sub indices. Individual country selected index funds, sector funds (you can trade the Consumer Staples fund (VDC) or energy fund (VDE) etc.)

Of particular interest are the newer editions sold as Gold (GLD) which trades at one tenth of the price of gold, the Euro Currency (FXE) which is effectively the euro/dollar pairing and the DB Commodity Index Tracking Fund, DBC, which contains a basket of commodities.

Recently released is a Crude oil fund (USO) and Barclays Global are expected to be launching a silver index fund.

TRADING THEM

You can trade in and out of any of these ETFs using a normal stock brokerage account. There is no minimum amount to buy, so you could buy just 5 shares for example.

As with any investment we would suggest you should manage the amount of money you use in any one of these funds. This is particularly important for the more specialized funds such as gold or crude oil where there is still a high amount of risk and volatility for short term players.

Education

At last it is becoming possible to trade commodities, currencies, bonds and stocks all through one account. Now this is not due to a broker offering the service, but due to ETF's becoming available that specialise in these asset classes.

It is essential that good money management is implemented with these newer commodity and currency ETFs as some can be pretty volatile.

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