

Are ETFs tax-friendly?
Take another look.

FEEES, TAXES, AND ETFS

By Robert N. Gordon

EXCHANGE-TRADED FUNDS (ETFs) ARE ON A ROLL, EVEN TO A POINT WHERE they are now being created on some arcane asset classes. But beware: As the portfolio becomes less standard, the costs to trade ETFs escalate. And from a tax perspective, there may be some better choices.

ETF investors should be aware of these funds' extra and sometimes hidden costs—bid/ask spreads and substantial discrepancies between the ETF and the index it purports to track. All of these costs could be avoided by investing instead in a no-load, low-expense, open-end indexed mutual fund.

Like stocks, ETFs have a spread between the bid and ask price. Recent research covering more than 300 ETFs calculated the average bid-ask spread to be 0.38 percent of the ask price. For the SPDRs (Standard & Poor's Depository Receipts), one of the best known and widely traded ETFs, the spread averaged only 0.01 percent of the ask price. But don't think that's how they all trade. For example, with both the UBS-ETF DJ Germany Titans 30 and the UNICO I-Tracker MSCI Europe, the spread was more than 9 percent.

We anticipate that wider spreads will persist in the foreign markets and in indices with less liquid securities. In countries where markets are closed when U.S. markets are open, large spreads will probably continue because the market makers can't efficiently lay off their risks. If actively managed ETFs get off the ground, we predict spreads will be substantial because dealers will not know what securities are in these funds.

In addition to spreads, ETF investing also involves standard brokerage commissions. For those investing a set amount monthly, a no-load open-end mutual fund—where spreads and commissions are nonexistent—may be more efficient than an ETF.

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ETFs also have tracking errors—positive or negative—stemming from inaccurate replication of the benchmark. Often these discrepancies are miniscule, but that is not always the case. (See "My-So-Called Index"

in the June 2006 *Wealth Manager*, p. 68.)

If you are using ETFs as client trading vehicles, we believe index options may be a better choice. Index options have no tracking error, no management fees, no distributions—and a distinct tax advantage. Trading in broad-based index options does entail commissions and bid/ask spreads just like trading in ETFs, but all gains or losses on listed index options are taxed at 23 percent while OTC index options are taxed at "normal" rates.

Of course, all options have a maturity date and thus, a day when you are forced to realize your profits. Although index options have no fees or distributions, ETFs and mutual funds can be held until death, when the step-up in basis forgives all capital gains taxes.

Deciding whether an investor should use ETFs, index mutual funds, listed index options or OTC index options seems to come down to the investor's time horizon. Traders should use listed options, while no-load index funds or OTC options might be better for longer-term investors.

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COSTS OF DOING BUSINESS

	Exchange-traded funds	Open end index funds	Listed index options	Unlisted index options
Management fee	Yes	Yes	No	No
Tracking error	Yes	Yes	No	No
Commissions on purchase/sale	Yes	No	Yes	Yes
ST gains taxed @	35%	35%	23%	35%
LT gains taxed @	15%	15%	23%	15%
Marked to market at year end	No	No	Yes	No
Distribution of gains	Yes	Yes	No	No
Possible Mispricing	Yes	No	Yes	Yes
Trades intra day	Yes	No	Yes	Yes
Taxable dividends	Yes	Yes	No	No