FOR FINANCIAL SERVICE EXECUTIVES, CLIENTS, AND FRIENDS OF DUBICK & ASSOCIATES

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Perspectives

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- It's been said that men invest to grow their money, and women invest to preserve theirs. What other differences are there between men's and women's views of money, and why should you care? —page 3
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ETFs: The Next Big Thing

The Motley Fool has dubbed them the latest "it" equity, and that's probably as good a title as any for Exchange Traded Funds (ETFs). ETFs – fixed baskets of securities that trade like stocks – now account for nearly one-third of all passive investing, according to Financial Research Corporation. In 2004 alone, Barclays Global Investors, the industry leader, took in nearly $45 billion dollars – an amount exceeded only by American Funds and Vanguard Groups. The Investment Company Institute reported that as of September 2005, assets in ETFs had reached nearly $260 billion.

Although introduced 10 years earlier, it was not until the mutual fund scandals of 2003 that investors started turning to ETFs, attracted to the product's pricing and transparency. Although mutual funds, with over $8 trillion in assets, dwarf ETFs, the industry has responded to the upstart. Over the last year E*TRADE, Fidelity and Vanguard have all cut fees on index funds.

ETFs are similar to indexed mutual funds, with a few important differences. First, unlike funds which are priced once a day, ETFs trade all day on stock markets. Second, while mutual funds have investment minimums, there are no minimum investment requirements for ETFs. Third, the fees on ETFs tend to be lower. According to Morningstar, ETFs charge an average fee of 0.42% annually, while index funds charge 0.77% on average. Fourth, ETFs are usually more tax efficient than funds because they generate fewer capital gains. Since investors who want to liquidate shares in an ETF simply sell them to other investors, the ETF does not need to sell shares to meet redemptions. Generally, ETF shares are sold only to reflect changes in their underlying indices.

Mutual funds, on the other hand, are more economical when it comes to dollar cost averaging and rebalancing, since investors must pay for each ETF trade. Mutual funds also offer free reinvestment of dividends.

Fueling the Growth of ETFs

Several factors beyond investor enthusiasm, are behind the expansion of ETFs. Hedge funds have found ETFs attractive because they are marginable, can be shorted, and can be purchased through a prime broker.

ETF options, whose average daily volumes now outpace that of index option contracts, are an increasingly popular vehicle to hedge positions. One reason for their popularity is the way ETF option contracts settle. While index options are "cash settled" (when exercised, the investor gets cash), with ETF options – like stocks – investors physically receive the underlying securities. This means that in addition to taking a profit when they exercise the option, they have the choice of keeping the underlying index and generating additional profit if the index rises.

The push Barclays has put behind their iShares has also spurred the sale of ETFs – the firm provides advisors with every tip and tool possible to facilitate their efforts. At a recent conference on

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The Hype and More on Hedge Funds

Over the last ten years, the hedge fund business has grown from slightly more than $50 billion to over $1 trillion. In 2004 alone $139 billion flowed in, and Celent Communications recently estimated that global hedge fund assets will increase at an average annual rate of 16.5% over the next five years, doubling to over $2 trillion by 2009. Financial Marketing Perspectives spoke with ***Joyce E. Heinzerling,*** *General Counsel and Chief Compliance Officer of Archery Capital LLC, an equity long/short fund of funds manager, about the institutionalization of the industry.*

FMP: What has fueled the growth of hedge funds?

Joyce: There are a couple of factors. First, the collapse of the equity markets in 2001 and 2002 sent investors rushing into hedge funds. Then there was pressure on institutional investors, particularly in the pension market, to hit target returns in lackluster markets. Ownership has become more widely distributed. Once the province of the affluent, participation by high net worth clients has declined from 81% of all hedge fund dollars ten years ago to 44% today, while participation by pension funds has grown from 1% to 9% and funds of funds from 6% to 24%.

FMP: The growth has been accompanied by some problems, right?

Joyce: Right. People threw money at hedge funds with blind trust in the late 90's. Then in 1998 we watched Long-Term Capital implode, which necessitated a $3.6 billion bailout facilitated by the Federal Reserve and several large commercial banks and brokerage firms.

In September of 2003, the SEC issued a report entitled "Implications of the Growth of Hedge Funds." In it they cited a number of concerns, including the lack of regulatory oversight, inconsistent valuations of illiquid securities and conflicts of interest. Over a five-year period – 1999-2004 – the SEC brought 51 cases against hedge fund advisers who, it asserted, defrauded investors of more than $1.1 billion.

FMP: But now hedge funds have to register. Isn't it helping the situation?

Joyce: It doesn't seem to have made much difference – the fraud at Bayou was committed by registered advisers. Also, managers of mutual funds have always had to register, and we still had a market timing crisis. And conflicts of interest have to be addressed. Bayou cleared its own trades and traded with affiliates.

FMP: Is oversight coming from anywhere else?

Joyce: Not really. Some institutions don't have the right people for due diligence. If banks had performed proper credit and risk analyses, they might have limited their exposure to Long-Term Capital. Also, there's too much dependence on statistical models, and too many models are based on assumptions that investment returns are well-behaved and provide stationary distributions – i.e., if a portfolio sitting at position X has Y probability of making money, then the obvious answer is to leverage it and make more money. Additionally, style risk is a big factor, as style will be a significant determinant in what a manager does on the margins when presented with an opportunity or a fat risk.

> "In the last two hedge fund blow-ups, there were lots of red flags. Investors in the KL Group might have noticed that the principals had little experience trading but posted 40 to 50% returns."

FMP: So what's the answer?

Joyce: First of all, managers need to separate the trading and risk management functions. In most cases, the same people are responsible for both.

Second, investors need to do background checks on hedge fund managers – and then use that information. In promotional material for the Bayou funds, Sam Israel told investors he was the head trader at Omega Advisors, a hedge fund run by Leon Cooperman, for four years; however, Mr. Israel had only worked as an order taker, and only for 18 months. In a recent Wall Street Journal article, an investigative consultant said that when he finds hedge fund managers have padded their résumés or failed to disclose jobs that went bad, more than half of his clients go ahead with the investment because of the time and money already spent in the portfolio due diligence.

Third, they need tighter controls over the movement of cash. Lastly, they need to tackle the problem of valuation. Prime brokers should play a role here, since they can be the first line of defense against valuation mispricings.

In the last two hedge fund blow-ups, there were lots of red flags. Investors in the KL Group might have noticed that the principals had little experience trading but posted 40 to 50% returns. They might have been concerned that the principals operated out of an obscenely expensive office, drove flashy sports cars and partied most of the time. If none of that raised a red flag, they might have noticed that the funds were not audited. While these signs may have been harder to read at the Bayou Group, both funds lacked the most basic controls – independent auditors and procedures for affiliated brokers.

FMP: So the democratization of hedge funds could be a boondoggle and not a boon for average investors?

Joyce: Perhaps for the unsophisticated, but the problem is not just at the retail level. In May 2005, a conference was held for institutional money managers from places like General Motors and Harvard University who collectively oversee $350 billion in pension, endowment and foundation money. When surveyed anonymously, 44% didn't think their boards were capable of meeting their fiduciary duty to monitor hedge fund investments. Many acknowledged that they "more or less backed into having a hedging strategy," yet nearly half reported that they expected to boost their hedge fund holdings to more than 20% of assets within five years. It is obvious that due diligence will be the key to successful hedge fund investing.

Five Truths About Women and Money

A friend who hosts a radio show recently asked me to participate in a program about women, men and money. I was glad she asked since despite all of the information available, many financial services firms still don't seem to recognize the financial differences between the sexes. For example:

- Women live, on average, seven years longer then men.
- The average woman earns 75¢ for every $1 a man earns.
- The typical woman spends 11.5 years away from her job versus 1 year for men. (Usually that time is spent raising children or taking care of elderly parents.)
- As a result of lower pay and less years working, the median pension for women is half that for men

Yet most literature on investing for retirement doesn't factor in these differences. Perhaps more important, firms and advisors don't realize how differently women and men think about money.

FIVE TRUTHS ABOUT WOMEN AND MONEY

1 Because womens' lives are more integrated than men's, they are more likely to behave the same in all situations. In other words, a woman is likely to handle her money the same way she handles her life. Advisors who take the time to learn about a woman's life will have a big head start on what kind of investor she will be.

2 Women are less secure than men about their ability to earn money. Even Oprah has admitted to fears that she will end up a bag lady. When helping women invest, remember that while the numbers may add up to financial independence, feeling financially secure is more than simple math.

3 While men ask "What can I make?," women are more likely to ask "What can I lose?" More concerned about making a mistake than men, women are often more comfortable starting small. If the potential is there, an investment of time in a small account could pay off over the long term.

4 Women are more brand-loyal than men. The reason small accounts can pay off is that woman are more likely to come back to – or stay with – an advisor or firm that helps them. While men are out looking for the next big idea, women are staying with the person they trust.

5 While men view life as a competition and money as the way to keep score, women view life as a journey and money as the means to an end. This difference makes it likely that portfolio performance will be more important to men than women. This is not to say performance is not important to women, just that other things are, too.

I know – and I'm sure you do, too – many women whose attitudes totally contradict this list. In fact, you probably know men who fit the profile better. The point is simply for firms and advisors to think more broadly about their businesses. Consider whether your collateral and website reflect the economic realities – and potential thinking – of women. During a review or a sales call are you addressing the topics and issues that are likely to be of concern to female clients and prospects? One way to start is by conducting a gender audit. Another is to obtain feedback from female clients and prospects about the way you present your services and products. As you approach new projects, expand your thinking to include a woman's point of view.

This month Dubick & Associates celebrates its eighth anniversary. Many thanks to all of you who have been friends, clients, sources of inspiration – or all of the above. A special thank you to Gerri Leder, who created this newsletter and was kind enough to cede it to me.

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Mutual Fund Ownership – Province of Middle Class

Over the last few years affluent investors have flocked to separate accounts, hedge funds, and other alternative investments. It's not surprising then, that the annual Investment Company Institute (ICI) fund ownership study found mutual funds have become largely a middle-class investment. About half of all U.S. households owning funds have incomes between $25,000 and $74,999, according to the report.

The number of households owning mutual funds has remained steady over the past three years at about 54 million, or 47.5% of all U.S. households. While ownership of funds outside of retirement plans exceeds ownership inside plans, the difference is not great – 38.9 million households versus 35.6 million.

Although mutual funds are suitable for every age, given the range of investment objectives, ownership tends to be concentrated among investors in their prime saving and investing years – two thirds of the households owning funds in 2005 are headed by individuals 35-64 years old.

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ETFs sponsored by Barclays, advisors talked about the reasons they have incorporated ETFs into their practices. A Morgan Stanley broker said his group, with $1 billion in assets under management, had moved to an all-ETF model. "ETFs are scaleable, that's the key," he said. "We have better meetings and a higher percentage of closings."

The Outlook for ETFs: Sector ETFs, 401(k) Plans, and More

A ruling by a federal court judge in Manhattan this September is expected to spark even more activity – the court ruled that the International Securities Exchange (ISE) does not need a license to trade options on ETFs. This ruling paves the way for each of the six major options exchanges to begin trading options on ETFs without licensing fees. Despite plans to appeal by Dow Jones and others, the ISE moved forward with the launch of an option on Dow Diamonds, an ETF that tracks the DJIA.

The recent expansion of sector ETFs to sub-sectors, which allows advisors and institutions to more precisely manage their market exposure, is also likely to promote growth. In October 2005, PowerShares introduced eight more ETFs targeting such industries as utilities, oil and gas, and insurance.

Several firms like online broker ShareBuilder Securities and Banneker Capital Management are now offering ETF-based 401(k) platforms. The lower fees attached to ETFs make them attractive, and firms are using technology to lower the cost of trading.

It is also expected that more fixed income ETFs will be rolled out, and that actively managed ETFs will be available in the foreseeable future. Creating actively managed ETFs, however, has been a challenge. Traditional ETFs are highly transparent to keep the price in line with underlying securities; however, active managers do not want to disclose their portfolio activity, since doing so would allow other managers to see their strategy. Last year the SEC sought comments on actively traded ETFs, and there are currently several filings, but no word yet on a release date.

ETF Acronyms and Brand Names

Some ETFs are better known by their fund names, and others by the names of their fund families. Here are the best known from each side:

FUNDS

Spiders The Standard & Poor's Depository Receipt (SPDR, or Spider) tracks the S&P 500 index of large capitalization stocks. The first ETF, launched in 1993, it is still the single most popular ETF.

Cubes It tracks the NASDAQ 100 Index, a market-capitalization weighted index of the 100 largest non-financial companies traded on the NASDAQ. The nickname "Cubes" comes from the fund's QQQ ticker symbol.

Diamonds This ETF tracks the Dow Jones Industrial Average, a price-weighted basket of 30 very large capitalization stocks selected by the editors of The Wall Street Journal.

VIPERs Both a fund and a fund family name, VIPERS are offered by Vanguard. Each VIPER is a separate share class in one of Vanguard's existing conventional mutual funds, not a stand-alone entity like other ETFs. After Barclay's iShares, this is the second largest ETF fund family.

FUND FAMILIES

iShares Managed by Barclays Global Investors, funds range from the iShares S&P 500 Index to more focused sector funds like the iShares Goldman Sachs Technology Index Fund. Although not the first on the market, iShares launched in 1996, are the largest and probably most well-known ETF family.

PowerShares PowerShares track a market index that changes over time based on a predefined set of rules. By tilting the index composition toward undervalued stocks and away from overvalued ones, the fund attempts to beat the market. This product is for investors who like the ETF concept, but not passive investing.

Rydex Unlike typical S&P 500 ETFs, which are weighted by market capitalization, the Rydex S&P Equal Weight ETF invests in each of the stocks in the S&P 500 equally. A second fund – the Rydex Russell Top 50 ETF – is a traditional cap-weighted ETF.

Fidelity ONEQ This fund, which mirrors the NASDAQ Composite Index of 3000+ stocks that trade on NASDAQ, is Fidelity's first foray into the world of ETFs.

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