As ETFs grow, more take narrow focus

Your Money
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Funds that trade like stocks are hotter than hot.

Assets of exchange-traded funds, or ETFs, have increased 52 percent, to $335 billion, in the past 12 months, according to the Investment Company Institute. They've more than doubled in size in the last 2 1/2 years.

Although overshadowed by the more than $9 trillion in mutual fund assets, ETFs continue to attract investor money away from the mutual fund treasure trove.

There are more than 230 ETFs, which were introduced 13 years ago with SPDRs, based on the Standard & Poor's 500 index. That remains the largest ETF in terms of assets and one of the most actively traded.

You can trade ETFs, which often hold baskets of stocks similar to mutual funds, any time during market hours. They have no minimum investment other than buying a single share, and there are no penalties for redeeming them, although investors do have to pay trading fees. Annual fees often are lower than similar mutual funds.

But as with any investment, what you don't know can hurt you. No one should consider ETFs without first understanding them.

A significant shift is under way, with new ETFs diverging from the original concept of replicating broad market indexes and providing diversification. Instead, they're emphasizing narrow industries, single countries or commodities.

Oil, gold, medical devices, aerospace, insurance, home construction and biotech are typical of these specialized ETFs.

This year, the Securities and Exchange Commission is likely to decide whether to approve ETFs with derivatives, options and debt securities, as well as actively managed ETFs that abandon the indexes altogether.

Although a narrower focus can mean more risk, a look at some of the hottest 2006 ETFs indicates

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specialization is king:

-- PowerShares WilderHill Clean Energy, a socially responsible fund that tracks an index of businesses using technologies that promote cleaner energy and conservation, has been this year's top-performing ETF, with a 31percent gain.

-- Internet Infrastructure HOLDRs, a fund that owns shares of a group of software, business services and telecommunications firms involved in the Internet industry, is up 23percent.

-- IShares FTSE/Xinhua China 25 Index, a highly concentrated index of 25 large Chinese companies whose shares trade on the Hong Kong Stock Exchange, is up 21 percent.

-- Oil Services HOLDRs,investing in a group of well-known energy services firms in drilling and well-site services, is up 21 percent.

"Growth in ETFs is coming from investors who want to play focused areas rather than hold for the long term," said Ronald DeLegge, publisher and editor of ETFguide.com in San Diego. "ETFs have already confirmed themselves as a critical and actively traded part of the investment landscape, though most investors are scared of new things and are only beginning to learn about them."

There is a lot to like about ETFs.

Because they're usually based on indexes, there is less trading, and that reduces costs. They are tax efficient, with fewer capital gains distributions because they don't have to sell underlying securities to meet redemptions. They allow sophisticated investors to move quickly to seize opportunities or invest in commodities without a commodities broker.

"No one should gravitate to ETFs just because they're a hot product, since they're simply a tool to help reach a goal and are not a strategy," said Dodd Kittsley, director of ETF research for State Street Global Advisors in Boston, which introduced SPDRs and manages 59 ETFs worldwide. "The investor should first speak to a financial adviser or investment professional to devise an asset-allocation strategy, then see where ETFs might fit in to implement that strategy."

There are concerns about ETFs that investors also must keep in mind.

Every time you buy or sell a share in an ETF, you must pay a brokerage fee. That can make them too expensive if you hope to invest in small increments on a regular basis by using dollar-cost averaging or automatic deposit.

Due to the structure of ETFs, it's possible you could wind up buying at a premium to the portfolio's actual value and selling at a discount. That possibility will increase in thinly traded ETFs or during gyrating market periods. Another consideration is that in low-volume markets, it might take a while to match an ETF seller with a buyer.

"I wouldn't really say ETFs are inappropriate for any particular type of investor, but any that are narrow market baskets focused on sectors, commodities or currencies will tend to move very

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sharply in both directions," said Don Cassidy, senior research analyst with Lipper Inc. in Denver. "That's a problem for people who are not disciplined or good as market timers, just as it would be if they invested in sector mutual funds."

Cassidy warned about investing in "me too" ETFs, because the first ETF in a specific investment category, such as gold, small-caps or real estate investment trusts, tends to grab the lion's share of assets and daily trading volume. That means those ETFs that follow it are generally less liquid and don't follow their underlying portfolio values as efficiently as the initial fund does.

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