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Exchange Traded Funds (ETFs) vs. Exchange Traded Notes (ETNs)

ETFs, or Exchange Traded Funds, burst on the investment scene about a decade ago and have exploded in popularity with both institutional and taxable clients. However, now there is a new kid on the block called the Exchange Traded Note (ETNs), which shares some characteristics with its ETF counterpart, but also has some important differences.

An ETF is an investment designed to track an underlying basket of stocks. Most track broad, well-known indexes such as the S&P 500, but newer ETFs are tracking everything from high yield bonds to commodities to nuclear energy. ETFs often charge lower fees than mutual funds and trade during the day like a stock. Because of the way ETFs shares are created and redeemed, investors are not subject to capital gains payouts when other investors decide to sell their shares, as is the case with mutual funds.

ETNs, like ETFs, trade instantaneously throughout the day, typically track an underlying index, and carry competitive management fees. However, ETNs differ from ETFs and mutual funds in the way they are constructed. ETNs are actually debt securities – senior, unsecured, unsubordinated debt securities issued by Barclays Bank PLC of London, creator of the popular iShares ETFs (although new ETNs are coming to market issued by other investment companies, not just Barclays). These 30-year notes are designed to pay at maturity (or sale) the value of a notional amount invested in the index the note is designed to track. However, unlike many ETFs, there are no taxable distributions to the investor during the holding period. Capital gains tax is due only upon sale, according to your holding period. Thus, ETNs offer a very tax efficient alternative to both ETFs and mutual funds.

When deciding if you should add either an ETF or ETN to your portfolio, a few items to note: First, the decision should depend on your current asset allocation and investment strategy. Many ETFs and ETNs target specific sectors of the market as well as track broad indexes, and most are passively managed; their goal is to perform in-line with their respective index with low tracking error. In addition, investors must pay trading commissions to buy and sell these investments, making frequent transactions and dollar-cost averaging strategies very cost inefficient methods for the smaller investor trading with smaller dollar amounts.

ETNs, because of their debt-like structure, can provide better tax efficiency, but investors must understand the potential credit risk of the investment company offering the notes. ETFs have no such stipulation. In general, most ETFs and ETNs offer a low-cost, tax efficient and passive alternative to traditional mutual funds, both active and passive, and merit consideration in most portfolios.