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AN UPDATE ON THE EXCHANGE TRADED FUND WORLD

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Since I last wrote about exchange traded funds (ETFs), they have only increased in popularity and number. There are now hundreds from which to choose. As a reminder, these are publicly-traded unmanaged mutual funds, generally with very low fees. At Baltimore Capital Management, we have started to manage dedicated ETF portfolios as a way to diversify smaller accounts. The investment results have been excellent.

In some ways, ETF accounts are thematic by definition. If, for example, an investor likes Brazil as an economic play, there are multiple ETFs that can give the investor exposure to that country. While some may keep the analytical work that simple, we prefer to actually look at what individual securities that are in the ETF portfolios.

One of the benefits of these products has been a new ease of entry into sectors or asset classes that were challenging for individual investors to access in the past. The easiest example is gold. Prior to the availability of the gold ETF, buying the metal was challenging. Not only are the mark-ups on gold coins and bullion high, but in the past an investor would then need a safe place to store the metal. The gold ETF eliminates the problem by allowing a simple purchase of the fund, with the knowledge that there is gold in a bank vault to back it. Similarly, investing in silver is also now possible through an ETF.



Many other commodities now have ETFs, but some warrant a more careful investigation by the prudent investor. For example, while the gold and silver ETFs are backed by the actual commodity, the oil and natural gas ETF's use financial futures to try and replicate the commodity moves. While these funds do track the commodity for short time periods, they have failed miserably over the longer term in matching the commodity's performance.

There are other ETFs that in my view are flawed products. Most of the ETFs that promise to do twice or three times what a market does on the upside or downside also come up short as long-term plays. While they work over a few days, their dependence on futures and derivatives do not make them appropriate for longer-term investing. In fact, they typically don't work effectively for much more than a week.

On the positive side, international ETFs have made it easier to access foreign markets. While American Depositary Receipts have provided access to larger foreign companies by listing their shares on the New York Stock Exchange (NYSE), the ETFs provide broader access to foreign markets. For example, there are two Peruvian companies listed on the NYSE, but the Peruvian ETF includes dozens of companies.

ETFs also provide a practical venue for fixed-income investors. With their low fees and myriad of choices, one can match just about any fixed income goal, be it short-term, long-term, international, or junk bonds. Other sectors like real estate can also be accessed via ETFs.

In summary, the ETF world has opened doors to many asset classes and strategies that in the past were much harder to implement. While ease of access is terrific, doing one's homework is as important as ever.

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