ETFs for the Long Run

What They Are, How They Work, and Simple Strategies for Successful Long-Term Investing

LAWRENCE CARREL

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John Wiley & Sons, Inc.

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To Theo and Jackson for their inspiration and to Judy and Jerry for making an investment in me.

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Preface

The exchange-traded fund, better known as an ETF, is the mutual fund for the twenty-first century. Like mutual funds, ETFs hold a diversified portfolio of stocks, bonds, or some other asset class. Yet, their structure is different enough that almost every ETF is less expensive, more tax-efficient, more transparent, and more flexible than any comparable mutual fund. That means more money for you. And in the end, isn't that what investing is all about, having more money in your pocket?

There are other books on the market that explain exchange-traded funds. But most of them are for a professional audience of investment advisors and institutional portfolio managers. This book is for everyone else, anyone who is in charge of his or her personal or household finances. So, if you are an individual investor, whether a buy-and-hold investor in stocks, bonds, mutual funds, commodities or currencies, or even a day trader, this book is for you.

You need to prepare for retirement. You might need to save for your child's education. You might just want to grow capital to buy some other big expenditure, such as a house, a boat, or a vacation. Whether you're the kind of person who likes to manage his or her own finances or who just wants to understand what your investment advisor is talking about, this book is for you. I will explain, in easy-to-understand language, why you should be investing in ETFs over almost any other investment vehicle. I promise not to use any mathematical formulas.

Investing and increasing your assets is difficult. It means having to choose from a multitude of choices and decide which will be a winner. It's taking a risk on the unknown and then waiting. Basically, it's predicting the future, and that's hard to do well. Wall Street investment advisors tell you this is a very complex process, and thus individual investors need their services to navigate these difficult waters. But it doesn't have to be that way. It can be very simple if you follow a systematic approach. One way to simplify your investing life is to buy ETFs.

Let's face it, if you wanted to spend hours each day researching the price/earnings ratio and the return on investment of public companies, you would have gone for a career on Wall Street. Whether you do or don't work on Wall Street, I'm assuming that reading financial statements in your free time sounds like about as much fun as getting a foot amputated.

Even if you like picking stocks, unforeseen circumstances burn the best stock pickers. You can be right in forecasting an industry's rise, but you could own the one company in that industry that was posting a loss or suffering from a scandal. By owning a fund, you could own the entire industry; making one company's troubles just a small stain on your profits.

For this reason, mutual funds have flourished.

Mutual fund investors know that funds are great investment vehicles. Buying mutual funds is much easier than buying individual stocks. You get a professional manager to do the hard work for you. Plus, they offer diversification with a low minimum investment.

With more than 8,000 mutual funds on the market, you can buy a portfolio to suit any strategy. A single fund can hold as few as 20 underlying securities or thousands.

It's a wonderful concept. You don't have to pay attention to the financial news. You don't have to spend time doing scads of research on a wide range of stocks and industries. You just have to pick a few funds, then save the money to put into them. The fund manager takes care of all the rest. He researches stocks, decides what to own, and then buys and sells in order to maximize profits. You don't have to get your foot amputated.

Consequently, mutual funds are the premier savings device for Americans. According to the Investment Company Institute, the mutual fund industry's trade group, 44 percent of all U.S. households own mutual funds or a similar investment device. For nearly 70 years, mutual funds have served the needs of individual investors. For the most part individual investors have been served well, but not always.

High fees are a huge offense mutual funds commit against their own shareholders. In investments, high fees can mean the difference between earning an annual profit or a loss. And the more fees decrease the size of your investment, the longer you will need to save. So, if you found an investment very similar to a mutual fund for a much lower price, would you buy it? Of course you would.

ETFs are that product.

ETFs offer everything a mutual fund does, and usually cost less to own. With the flexibility to trade during the hours of the stock market, and daily portfolio transparency, an alternate title for this book could have been *Mutual Funds Are Good; ETFs Are Just Better*.

If you're one of those hedge fund investors who believe that you get what you pay for, then ETFs are not for you. Unregulated hedge funds offer the potential for huge profits for people who can make a minimum investment in the millions of dollars and stomach massive amounts of risk. With no transparency, the hedge fund investor has no idea what he owns and it can often take weeks or months to get his money out. You need to be rich to invest in hedge funds because there is a much greater risk of their blowing up.

Most investors can neither manage the minimum investment nor stomach the risk of a hedge fund. ETFs are the opposite of hedge funds. These highly regulated funds are much safer than hedge funds. They are open to anyone, very liquid, highly transparent, much cheaper to own, and filled with the potential to beat hedge fund returns with much less risk. And if that is what you're looking for in an investment, then this book is for you.

This isn't to say ETFs have no risk. Like hedge funds and mutual funds, ETFs are as risky as the assets they hold. So an ETF tracking the broad market benchmark, the S&P 500 Index, would be much less risky than an ETF with just companies from the biotechnology industry. The ETF tracking the S&P 500 would have the same amount of risk as a mutual fund tracking the same index, while a biotech ETF would be just as risky as any biotech sector mutual fund. Meanwhile, an ETF holding bonds would typically have less risk than a mutual fund owning equities, and vice versa.

I became a financial journalist in 1995 at the start of what became known as the Information Age. During that time I reported on the rise of the Internet economy, the inflating of the stock market's dot-com bubble, and its subsequent popping. I wrote and edited stories about Wall Street investment banks bringing to the stock market companies with no profits, no sales, and sometimes no products. As the Wall Street community hyped the growth potential of every new stock, mutual fund companies launched new funds filled with these hot stocks and sold them to investors just as the market was peaking.

After the stock market crashed in 2000, I reported on the rash of scandals left in its wake, how companies named Enron, WorldCom, Adelphia, and Tyco defrauded their shareholders. Soon after that I reported on the scandal in which many mutual funds let market timers, hedge funds, and speculators get an unfair advantage to maximize profits over the funds' own shareholders. Recently, I've reported on the subprime mortgage crisis and how some of the brightest minds on Wall Street got ensnared by their own creative schemes for making money off of unsuspecting homeowners.

Reporting these stories left me with the impression that Wall Street is an extremely hostile environment for the small investor. I'm a naturally skeptical person, and these experiences only heightened that sensibility. As I moved into writing about personal finance, I became a different kind of investigative journalist. My job was to cut through the hype and figure out if investments and financial products were a good deal for the individual investor.

In general, there's not much on Wall Street that I get effusive about. However, I like revolutionary ideas, especially when they help the man on the street. So the fact that I became a fan of ETFs soon after I started writing about them isn't to be taken lightly. I immediately liked that they offered a low-cost alternative for mutual fund investors. And unlike most things on Wall Street, the more I learned about ETFs, the more I liked them.

As the ETF industry expanded, it broke down some of the walls Wall Street had built between institutional investors and the little guy. Suddenly individuals found doors opened to investment ideas, assets, and pricing levels that had previously only been available to large institutional investors, such as hedge funds, endowments, and pension funds. Small investors now had a choice. Instead of getting fleeced, they could buy an ETF and get the same advantages as the big boys.

This book tells the story about how ETFs were invented and how they are built, and explains in detail how they can offer investors so many benefits. In the end, it tells you how to build your own ETF portfolio. I've come away from this project believing ETFs are one of the best, if not *the* best, investment vehicle available to the small investor. I hope you find this book helpful and catch my enthusiasm for ETFs.

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CHAPTER 1

ETFs—The Newfangled Mutual Funds

Diamonds and Spiders and Cubes, oh my.

Upon reading such things in the financial press, individual investors familiar with stocks and bonds can't be blamed for wondering if some weird menagerie was let loose upon Wall Street. When names like iShares and PowerShares float by in articles and ads, investors may think that typical shares of company stock have undergone some strange mutation into bigger and better shares. And, in a manner of speaking, they would be right.

All of these are brand names for an investment vehicle known as the exchange-traded fund (ETF), one of the hottest products on Wall Street. At the end of 2006, there were 359 exchange-traded funds. In 2007, 270 new ETFs were launched, increasing the industry by 75 percent for a year-end total of 629. Over that same time, the industry's assets under management surged 44 percent to $608.4 billion.

Despite their phenomenal growth and the fact that ETFs have been on the market for 15 years, many investors still are not aware of them. Ask the average person on the street what an ETF is and you will get answers such as the electronic transfer of funds, an enriched text format for computer documents, or the president's energy task force.

While these terms all share the same initials, you can be sure that whenever someone you know is excited about ETFs, they're talking about exchange-traded funds. A simple way to understand the acronym is to recall that it refers to newfangled mutual *funds* that *trade* on a stock *exchange*.

Much like any other industry, such as automobiles or laundry detergent, Wall Street needs to come out with new and improved products to continue attracting clients and investments. Not all new products are improvements: for example, New Coke, Coca-Cola's reformulation of its flagship product in the 1980s, was one of the biggest marketing failures in history. ETFs are Wall Street's new and improved *mutual funds*. They could even be called the mutual fund for the twenty-first century. Both are vehicles that offer individual investors the ability to own a *liquid*, *diversified portfolio* for a minimal investment. But the differences between them are vast enough to make them very different products. Individuals need to consider how they will be investing before choosing which product to buy.

How ETFs Stack Up against Mutual Funds

ETFs combine many features of a mutual fund into a tradable stock, making the claim "new and improved" much more than a marketing ploy. The top six benefits that exchange-traded funds offer over mutual funds:

1. greater flexibility
2. lower fees
3. increased tax efficiency
4. greater transparency
5. ability to invest in more asset classes
6. ability to create more precise tactical investment strategies

Of course, new and improved implies that mutual funds, like last year's cars, are now relegated to the investing world's back lot or are no longer worthy of our attention. That's not always the case: With more than $12 trillion in more than 21,000 different products at the end of 2007, mutual funds won't be leaving Wall Street anytime soon.

Neither will ETFs. First issued 15 years ago, ETFs aren't some fly-by-night products that will soon become last year's model. The flexibility to be bought and sold during the trading session helped the product gain an enthusiastic following among institutional investors, such as the managers of hedge fund managers and other portfolios. In contrast, during the product's early days, buy-and-hold investors found little imperative to buy ETFs when they could purchase mutual funds that followed the same indexes.

Yet, over the past five years, this financial innovation has developed in such a way that makes it unique on Wall Street. In addition to its flexibility and low costs, the ETF can track asset classes besides stocks and bonds—such as commodities and currencies—in a simple and easy format. This has gained ETFs wider recognition among retail investors, and they have become a staple in the portfolios of many individuals. However, despite growing interest in this area of the investment world, the workings and benefits of ETFs remain a mystery to many.

Perhaps you have heard about ETFs while researching other investments, or from a friend or investment adviser who recommends that you look into them. This book aims to help the individual investor understand the benefits of ETFs and how he or she can best use them in his or her personal portfolio.

Greater Flexibility

The biggest improvement and most important benefit that ETFs offer over mutual funds is the ability to be traded on a stock exchange. This is a huge advantage. Trading offers greater flexibility by allowing individual investors to buy and sell when they choose, as opposed to the once-a-day option offered by mutual funds. Because they trade on a stock exchange for the entire market session, the price of an ETF fluctuates all day long. This may seem like more of an advantage to *day traders* and *institutional investors*, who are most likely to hold funds less than one day, but in fact this flexibility is a great benefit for buy-and-hold investors. The ETF investor can pinpoint the exact price at which he or she wants to buy or sell their investment.

That's not the case with mutual funds. Mutual funds can only be bought or sold from the fund company once a day—after the 4 P.M. market close—at one price, the *net asset value,* or NAV. The NAV is basically the average price of all the shares in the fund, but it isn't calculated until after all the stocks have closed for the day. This leaves mutual fund investors at a distinct disadvantage. Investors must decide during a trading session to buy or sell a fund without knowing what the price will be.

For example, say the stock market receives a very negative economic report at 10:00 A.M. Most likely the market would begin a drastic move lower. Now compare the different experiences on that same hypothetical day of an ETF investor and a mutual fund shareholder, who each have portfolios of $100,000. Both investors are tuned into the financial news, so both become aware of the report at the same time. The news provides the catalyst for a major market sell-off that by the end of the day will send the Standard & Poor's 500 index 2 percent lower.

At 10:05 A.M., the mutual fund investor calls his fund company and says he wants to sell all the shares in his fund. The company tells him that they will be sold at the NAV calculated after the trading session ends. So, even though the mutual fund investor tried to get out quickly by calling his fund company early in the day, it doesn't matter. The fund calculates the sale price after 4 P.M. By that time, the market has already fallen, and the NAV is calculated with all the lowered stock prices. The likelihood is that the fund sells the investor's shares at the lowest price of the day.

Meanwhile, the ETF investor calls his stockbroker at 10:05 A.M. and tells the broker to sell all his shares. Because the ETF trades all day long, the broker makes a market order to sell the shares immediately. Even though the market falls 2 percent by the end of the day, the ETF investor gets out before most of the damage occurs, locking in a price near the high of the day. With our hypothetical portfolios, the ETF investor walks away with nearly $2,000 more than the mutual fund investor. The same scenario would also apply in an up market. The ETF investor buys early in the rally and profits from the day's rise. Meanwhile the mutual fund investor may see the rally, but cannot enter during the trading session. Instead, his share price is determined after the market rallied. Essentially, he buys near the top.

This ability to catch the beginning of a market move rather than only its conclusion gives investors greater profit potential. This flexibility also allows ETFs to be bought or sold with a *market*, *limit,* or *stop-loss order,* or on *margin*. Many ETFs also offer tradable *put* and *call options*. Another option not available to mutual fund shareholders is the ability to sell short. An investor can sell short an ETF or stock in anticipation of a downward move in the shares. The investor borrows the shares from a broker, then sells the shares first with the hope of closing the transaction by buying them back later at a lower price.

Greater flexibility gives the investor both more control over the purchase and sale price of the investment and an opportunity to take advantage of market moves.

Lower Fees

ETFs are essentially *index funds*. Index funds track a particular market by holding a basket of the exact same securities as the index, or an extremely close approximation.

The first ETF, the Standard & Poor's Depositary Receipt (better known as the *SPDR,* or Spider) began trading in 1993. It tracked the S&P 500, the very vanilla, U.S. large-cap stock index. Subsequent ETFs followed other major market indexes, such as *DIAmonds*, which follows the Dow Jones Industrial Average, and the PowerShares *Triple Qs* or *Cubes (Qubes)*, which track the NASDAQ 100 Index. At the end of 2007, all ETFs were required to follow an index.

Because these baskets of stocks follow indexes, they are *passively managed* with infrequent asset turnover. Like index mutual funds, this results in extremely low annual *expense ratios*; in addition, the fees for ETFs are often lower than even those for the corresponding index funds. For instance, the Vanguard 500 Index fund, the largest and oldest index fund available to retail investors, tracks the S&P 500 Index. It has one of the lowest annual fees among mutual funds: only 0.18 percent of assets. Compare that with two ETFs, the Spider and Barclay's iShares S&P 500 Index, which charge a minuscule expense ratio of 0.08 percent and 0.09 percent, respectively. These are half Vanguard's fee. And Vanguard's tiny fee is the exception among mutual funds. Most mutual funds charge management fees of more than 1 percent, and some are as high as 5 percent. Currently, no ETF charges more than 1 percent. Fees are one of the biggest wealth destroyers for investors, so small fees add up to significant savings over time.

"Why is it so difficult to capture the market's returns? Because the market returns we read about ignore the costs of investing," says John Bogle, the founder and former chairman of the Vanguard Group, and the creator of the Vanguard 500 fund. "In the search for the Holy Grail of superior returns, real-life investors incur heavy costs—fund management fees, operating costs, brokerage commissions, sales loads, transaction costs, fees to advisers, out-of-pocket charges, and so on. Performance comes and goes, but costs roll on forever."[1]

More Tax Efficient

The third major benefit that ETFs hold over mutual funds is greater tax efficiency, primarily by delaying taxes on capital gains. Whenever a mutual fund, even an index fund, sells a security, it is a taxable event. All profits are capital gains. Profits earned by mutual funds, pass through the fund to the individual shareholders. And when a shareholder earns capital gains, he or she must pay *capital gains taxes*. Even if index-fund investors hold their funds for decades, every year they must pay taxes on the capital gains that the funds incur during the previous 12 months.

Capital gains taxes can be especially onerous when many investors pull their money out of a fund, as occurred in the wake of the stock market's dot-com crash in 2000. As investors pulled their money out, mutual funds were forced to sell their underlying assets in order to cash out these investors. To add insult to injury, the investors who chose to stay in the funds took a double hit. Not only had their investments fallen in price, but as the other investors left, the ones who stayed were stuck with paying the capital gains taxes from all the stock the fund needed to sell.

Meanwhile, because ETF investors own shares in their own personal accounts, rather than investing in a fund's pool of assets, their investment isn't connected to any other shareholder. ETF investors therefore only pay capital gains taxes when they sell *their* shares. Delaying the payment of taxes can make a significant difference in overall returns. When an investor isn't forced to pay out part of their principle in taxes every year, that means there is more principle to grow. In addition, the buy-and-hold investor who doesn't sell his ETF until after retirement may find himself in a lower tax bracket.

These three benefits—flexibility, lower fees, and greater tax efficiency—are what you will hear about from anyone advising you to look at ETFs for an investment, whether they are an industry insider, investment adviser, or even a financial journalist. But there are three other benefits ETFs offer that add to their luster.

Greater Transparency

Transparency means that at any specific moment, investors have the ability to see the price and holdings of the ETF.

Because they are index funds, it's reasonably easy to determine what stocks are included in an ETF or index mutual fund: simply look at the index. Of course, sometimes ETFs and index funds don't hold every single stock in the index. How far an index mutual fund veers away from the index is not apparent, but with ETFs you always know what stocks are held.

Due to its unique structure, the ETF must make available every day a list of all the securities that make up the fund, so that new shares can be created.

Mutual funds have a measure of transparency, but even that is a bit dubious. The portfolios of mutual funds are not transparent on a daily basis. Every six months the mutual fund is required to send to its shareholders a list of its holdings. This means shareholders see what's in the fund only twice a year, and even then, the report is suspect. Funds are given 60 days to deliver this list to shareholders. Because mutual funds are allowed to buy and sell securities every day, the portfolio documented at the end of the six-month period is often not the same as the one actually held 60 days later.

The transparency of the ETF's portfolio during the trading session gives the investor the ability to see the ETF's share price in real time. As mentioned above, the ability to see the share prices gives the investor greater control over the purchase and sale of the investment.

Precise Allocations

Transparency allows investors to create precise *strategic asset allocations* and *tactical investment strategies*. While all mutual funds have an investment strategy they must follow, it's not uncommon for a fund manager to sometimes stray from the strategy. This can happen for a variety of reasons. If the investment strategy is out of favor, the manager might want to hold some stocks on the rise in order to boost his returns.

Transparency allows the investor to see exactly what his holdings are on a daily basis. This is important because a group of mutual funds with different investment objectives may actually hold the same or very similar securities. Thus, with mutual funds the investor could inadvertently be overweight in areas of the market that are not advantageous to the portfolio.

For example, you own a large stock mutual fund and a small stock technology fund. However, small stocks aren't doing well, so the mutual fund manager buys some large tech stocks that are doing well. However, this could cause the investor's portfolio to have a greater weighting in large tech stocks than he wanted. Because fund managers have a lot of leeway and their portfolios are typically hidden from view, the investor is at a disadvantage.

Most ETFs track an index. This is an advantage because it restricts what the ETF can hold. By knowing exactly what each ETF holds, the investor can make very precise *asset allocations* for his or her portfolio. The investor can fine-tune the portfolio to hold the exact amount of large stocks, small stocks, and international stocks he or she wants, without overlap or overweightings.

Investment in Alternative Asset Classes

Finally, ETFs offer another big benefit for individual investors—the ability to buy *alternative asset classes* as easily as stocks. This benefit doesn't easily roll off the tongue of the person advocating ETFs, but it may be the biggest boon to individual investors since the creation of the original ETF.

In the past, commodity and currency markets were difficult for individual investors to enter. But as the world economy changes, these asset classes have taken on greater significance. To not have the opportunity to take advantage of these asset classes is a severe disadvantage to small investors. But companies using the ETF structure have given the investor the ability to participate in these markets with the same ease and minimal investment as the ETF itself.

With increased demand for gold, oil, and other commodities, as well as foreign currencies, investors have more tools with which to create more diversified portfolios.

One Caveat

For all the laudatory benefits of ETFs, in some cases mutual funds may actually be preferred. ETFs have one big drawback: the price of admission. Because they trade like stocks, they can only be bought or sold through a stockbroker, who, of course, charges a commission. Even with a discount broker, these transaction costs can eat into principle, making ETFs prohibitively expensive for adherents of *dollar-cost averaging*, one of the mainstay strategies for *long-term investing*.

While mutual funds sold through brokers carry commissions, known as loads, savvy investors know to stay clear of those and invest in no-load funds. With no-loads, every investment dollar lands in the fund and not in a broker's pocket, maximizing the investment. And no-loads don't charge a fee to sell. So dollar-cost averaging remains the index funds' ace in the hole.

Summary

ETFs aren't only for the big boys anymore. They offer buy-and-hold investors many benefits over regular index mutual funds.

This book is written for the average buy-and-hold investor: the man or woman who takes care of their individual or family's investments. It will make the case for why ETFs are the mutual funds for the twenty-first century, and the best investment vehicles currently available for individual investors. The theme of the book is that mutual funds are good, but ETFs are even better.

The following chapters will help the individual investor understand mutual funds and ETFs from the bottom up. Even if you don't create your own portfolio, investors need a clear understanding of what they are buying and why. Chapter 3, "The Evolution of the ETF," will explain the similarities between ETFs and mutual funds and describe the benefits they both provide over buying single-company stocks. Chapter 4, "Index Fund-amentals," will advocate for indexing as an investment strategy, by explaining the advantages of investing in indexes over actively managed portfolios. This will lead to Chapter 5, "Fee Bitten," a deeper examination of how fees hurt returns and why investors should always look for the lowest cost alternative. Once you have seen the effect that fees have on profits, the book will examine the nuts and bolts of mutual funds and ETFs. Chapter 6, "The Better Mousetrap," shows how the ETF achieves its greater efficiencies. Finally, Chapter 8, "The ETFs That Aren't ETFs," will examine the new exchange-traded vehicles that are similar to ETFs, and highlight the important differences between them. In the end you should have a greater understanding of these kinds of investments, both their benefits and their costs. The book will then explain how to build your own ETF portfolio, from the mechanics of trading to designing asset allocation strategies.

Sometimes, the most important factor in understanding something is to gain insight into how something came about and what contributed to its current form. Your journey starts with the history of the ETF, who the industry leaders are, and how they got there. Chapter 2, "ETF History Lesson," will cover the ETF industry's first ten years. Chapter 7, "The New Indexers," will examine the main drivers of the industry's incredible growth since 2003. The book ends with an analysis of the main issues that will affect the industry in the future.

CHAPTER 2

ETF History Lesson

How a New Type of Fund Was Born

The history of the exchange-traded fund begins with the stock market crash of 1987.

On October 19, 1987, better known as Black Monday, the Dow Jones Industrial Average plummeted 508 points, or 22.61 percent, to 1,738.74. With a loss of $500 billion in assets, it was the largest one-day crash in U.S. stock market history.

> *While Black Monday was the biggest stock market crash in the U.S., it was only the second largest one-day percentage drop in the Dow Jones Industrial Average. Nor did that occur in the Stock Market Crash of 1929. That crash started Black Thursday, October 28, 1929, with the Dow tumbling 12.82%. The next day it sank 11.73%. Together, that two-day drop decimated 23.1% of the Dow's value. The Dow's largest percentage decline actually occurred Saturday, December 12, 1914, when it plunged 24.39%. That day the stock market opened for the first time since the outbreak of World War I, five months earlier.*[1]

There are competing theories about why the U.S. market crashed. I won't go into those. Whatever the catalyst was, the result was the same: Once investors heard that the market was falling, they panicked. Everyone wanted to sell simultaneously. This triggered the program trading: computerized signals programmed by arbitrageurs to create sell orders at certain prices in the market. The program trading flooded the market with more sell orders, exacerbating an already bad decline. Prices plummeted. The plunge spread, causing stock markets around the world to collapse.

"It's really the first time that Johnny Retail realized that when he sells his mutual fund he doesn't get out until the end of the day," said Bob Tull, a member of the team that created the first international ETFs.[2]

Up until that moment, retail investors didn't comprehend that the fund's price, the net asset value (NAV), is calculated on the close. On the day of the 1987 crash, everyone who tried to sell their funds thought they would get out when they called the broker. Only later did they realize that they got the price at the end of the day, after all the stocks had fallen. The funds structure locked the retail investor ("Johnny Retail") into the worst price of the day.

While everyone lost money in the crash, retail investors ate the biggest losses. The institutional investors—pension funds, insurance companies, university endowments, and any other large investors—got out intraday. But most small investors were in mutual funds, many within a 401(k) plan. Unable to access their money until after the damage had been done, they suffered the most. None of this should have surprised anyone: Wall Street hadn't been created for the investor. It was created for the banks to make a profit from other people's money.

The story of the ETF is one of competition, redemption, and comeuppance. It's about how the American Stock Exchange, suffering a long, slow, debilitating decline in business, reversed what many considered a terminal situation by devising the small investor's revenge for the '87 Crash. It's the story of how a financial invention put "Johnny Retail" on the same level playing field with the institutional investors. It not only gave the retail fund investors the freedom to trade when they wanted, but also charged the same low fees the institutions paid to buy and sell large baskets of stock. Finally, it's a tale of how Wall Street ignored the product because it didn't pay enough to sell it. In spite of that, the ETF became one of the market's hottest products because it benefited the small investor.

Four months after the crash, the Securities and Exchange Commission (SEC) issued a report analyzing the market's fall. The SEC euphemistically called the crash "The October 1987 Market Break." In the February 1988 report, the SEC raised the question: What would have happened if there was a market-basket instrument that could have absorbed the shock to the individual securities underlying the Standard & Poor's 500 Index (S&P 500)? The SEC added that if an exchange did propose a market-basket instrument based on the S&P 500, it would receive a quick approval.

Nathan Most, the senior vice president for new product development at the American Stock Exchange (Amex), viewed this as an invitation to design a market-basket security. Over the previous decade, Most had been creating products for the Amex to trade. During most of the 1980s, the Amex had been losing market share in equities to heavy competition. Most's team focused on creating customized securities called *derivatives*, especially options. Futures and options are derivatives because their value is based on the value of an underlying asset without actually owning that asset. Futures are a promise to buy or sell a specific commodity or security at a specific price on a predetermined date. Options are the right to buy or sell an investment at a certain date for a preset price. These products sliced and diced the underlying assets, and repackaged them in a way that changed the investment's risk-and-return profile. In the end, it was a way of transferring the underlying risk elsewhere. There were some successes, but many ideas ran afoul of the regulators and were short-lived. But now the regulators at the SEC were requesting new market baskets; it seemed like a gift to the Amex.

"We began work on it the next day," said Steven Bloom.[3]

At the time, Bloom was the Amex's vice president of new product development and Most's right-hand man. With a Harvard Ph.D. in economics, Bloom came to the Amex in 1985 to learn from Most. He was only 26 years old. By 1992 *Worth* magazine named Bloom one of Wall Street's rocket scientists, a group of bright young derivative makers who fed investment banks a steady diet of synthetic securities to trade. It didn't hurt that he worked for a man whom *Worth* called one of Wall Street's original financial wizards.[4]

A Short History of the Amex

Originally called the Curb Exchange, the American Stock Exchange began as an outdoor market around the same time as the New York Stock Exchange (NYSE). The NYSE traces its beginning to the signing of the Buttonwood Agreement in May 1792. Underneath a buttonwood tree on Wall Street, 24 prominent brokers and firms agreed to trade securities for a commission, giving preference to one another over other brokers. The five securities traded were three government bonds and two bank stocks.

Historian Stuart Bruchey describes how the meeting "organized a broker's guild, whose major function was to exclude nonmembers and maintain rates while minimizing competition."[5] With the price of membership too high for most small dealers, "the exchange was virtually restricted to the wealthy members of the city's financial establishment."[6]

The Buttonwood Agreement brokers soon moved indoors to a local coffeehouse. By 1817, the group became the New York Stock & Exchange Board, also known as the Big Board, a forerunner of the New York Stock Exchange. Meanwhile, the brokers who couldn't afford to join the Big Board, for financial or other reasons, continued to trade in the open air just down the street. They became known as the curbstone brokers, because they traded at the "Curb" market.

With high standards for listing and trading, and an emphasis on respectability, the conservative NYSE shied away from new industries. Thus, the Curb earned its niche by functioning as the "proving ground for new securities."[7] Many of the stocks that proved themselves eventually graduated to the NYSE. Therefore, the Curb needed to constantly replenish its listings.

As the market for everything not traded on the Big Board, the Curb became known as the place for small and midsized companies and for entrepreneurial innovation. With the NYSE's narrow view of what constituted a respectable industry, the Curb by the late 1800s was the main market for the most exciting companies in the United States. Most of the mining and petroleum companies in America started trading on the Curb. So did a growing group of manufacturers, who would later become known as the industrials.

It wasn't until the founding of the New York Curb Market in 1911 that the curbstone group became an organized exchange. The Curb was no longer simply a place, but an actual organization with a constitution. Yet the traders still traded outdoors, in all kinds of weather, on the corner of Broad Street and Exchange Place. It was characterized as the "Broad Street Jungle" because telephone clerks hung out of the windows of the surrounding office buildings giving buy or sell hand signals to the brokers on the street. "To make it easier for a clerk to pick out his broker in the milling crowd below, each broker wore some distinctive article of clothing—a colorful jacket or an unusual hat," writes historian Stuart Bruchey.[8]

In 1921, the market finally moved inside to 113 Greenwich Street, five blocks away from the NYSE. By the end of the 1920s, the newly named New York Curb Exchange had become the second-largest exchange in the United States. The building expanded to 86 Trinity Place, its current address, in the 1930s. In 1953, the market changed its name to the American Stock Exchange.

But by 1987, the Amex was the nation's third-largest stock exchange—a distant third, too. It had lost a significant amount of market share to an electronic market, the National Association of Securities Dealers Automated Quotations system, better known as the NASDAQ. The NASDAQ was privately owned by the National Association of Securities Dealers, or NASD, a self-regulating organization responsible for the operation and regulation of the NASDAQ and over-the-counter markets.

The NASDAQ, which owns and operates the NASDAQ Stock Market, went public in 2002. It trades under the ticker NDAQ. In July 2007, NASD, which had created and continued to regulate the NASDAQ, and the New York Stock Exchange's regulation, enforcement, and arbitration operations merged to become the Financial Industry Regulatory Authority, or FINRA. When it commenced operations, FINRA was the largest nongovernmental regulatory organization for the U.S. securities industry.[9]

When Black Monday occurred, the NASDAQ was eating the Amex's lunch in terms of equity listings. It was beginning to make the Amex look