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## The Trouble With ETFs

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Here we go again. Wall Street takes a good product, the exchange-traded fund, and in pursuit of profits creates multiple permutations. There are now nearly 450 ETFs, 75 of which were launched this year. In their rush to market, providers are creating flawed funds. Instead of mimicking the performance of an index, plenty are missing the mark, often falling short.

New research from Morgan Stanley ([MS](#)) shows significant "tracking error" in a number of these funds. That's the difference between the ETF's return and that of the index it's supposed to replicate. It works like this: The total return for the Dow Jones Transportation Average was 9.81% last year, while the ETF that tracked it gained only 8.92%. After accounting for expenses the tracking error was 0.41 percentage points. In short, investors aren't getting all they expect.

### PROBLEMS OVERSEAS

Funds that track the big indexes like the Standard & Poor's 500 rarely go far astray, according to Morgan Stanley. That's because they own widely held stocks that are easy to trade. The misfires happen when ETFs try to match more esoteric indexes, like the High Growth Rate Dividend Achievers Index ([DAH](#)). These niche indexes may have big stakes in fewer stocks or hold small companies that are harder to trade. "With all of the new and innovative indexes, there are questions whether these things can be faithfully replicated," says Dan Culloton, a senior analyst at Morningstar Inc. ([MORN](#)).

Foreign ETFs often veer off the track, too. The iShares S&P Latin America 40 Index Fund ([ILF](#)) missed its benchmark by 1.23 percentage points last year. That's because the fund can't always buy all the locally listed shares it needs in Mexico, Brazil, Argentina, and Chile. "There's an acceptable level of tracking error, depending on the particular market," says Christine Hudacko, a spokeswoman for Barclays Global Investors ([BCS](#)), the largest ETF provider with \$270 billion in 128 portfolios.

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These errors don't always work against the investor. In some cases ETFs outperformed by a wide margin. PowerShares WilderHill Clean Energy beat its bogey by nearly three percentage points. Investors might be pleased, but that's not indexing. "The job of an ETF manager is to manage vs. the index," says Paul Mazzilli, director of exchange-traded fund research at Morgan Stanley. "The only source of error should be the fees."

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