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Is Your ETF Heading for the Great Investment Burial Ground?

By Sheryl Nance-Nash
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With nearly 900 exchange-traded funds holding more than $780 billion in assets, surely life in the ETF arena is a matter of survival of the fittest. Evolution in the world of ETFs has led to the birth of an array of niche products, some of which have inevitably proven too narrow for their own good. A product that fails to gain that elusive broad appeal can end up with too few investors, too few assets and eventually, too little interest to sustain itself.

In May, Rydex/SGI eliminated 12 of its inverse and leveraged ETFs. According to Morningstar (MORN), 25 ETFs closed through June 28 of this year, a much slower pace than last year, when 46 had already been put out to pasture by that time.

So, what can kill an ETF? The primary sign a fund will close is lack of sustainable purchasing volume. Providers make their money by creating new units of their ETFs, explains David Levy, portfolio manager at Kenjol Capital Management: No demand equals no profitability.

A tell-tale sign of this slack demand is when an ETF has very low daily trading volume. "Keep an eye on funds with average daily volume of less than $100,000. If an ETF has average daily volume of 0 to a few hundred shares (which would probably be less than $50,000 in daily volume), this is a red flag," says Levy. "I would avoid these ETFs altogether, especially if there is a comparable ETF with another provider," he adds. To get a clear idea of the patterns, look at volume over the last 30 to 60 days, he suggests.

The $20 Million Threshold

Historically, ETFs have also closed when they failed to gather assets.

"If an ETF stays below, say $20 million for years on end, it's likely that the ETF is costing the management firm more to run than it brings in with revenues," explains Michael Iachini, director, investment manager research, Charles Schwab Investment Advisory (SCHW)."If your ETF has more than two years of history and less than $20 million in assets, it's a candidate for closure."

Trouble is, more than 170 ETFs have less than $10 million in market value, and while some are new, some have been around long enough that they should have gained more assets.

"There is no clear metrics on what makes an ETF scalable to an issuer, but using about $20 million [in assets under management] as a minimum threshold, you still have a group of about 300 ETFs which could be in jeopardy," says Dan Weiskopf, principal, Global ETF Strategies, Forefront Advisory. "Of course, there have been ETFs which have been closed with greater assets than $20 million, so this would simply be a quick screen."

Kevin Mahn, managing director and chief investment officer at Hennion & Walsh, says if an ETF has been trading for more than six months and has less than $10 million in assets, a relatively low daily trading volume or both, he would think twice before placing significant client assets into it for fear that the ETF might soon close its doors.

How Important Is This ETF to its Issuer?

Then too, ETFs in certain asset classes are essentially land grabs. "If two ETFs, similar in scope, launch around the same time, the most enduring is typically the fund that gathers the most assets in the shortest period of time," adds Weiskopf. "Subsequent fund launches in the same asset class tend to suffer from being late to the party and therefore have a greater chance of failing."

Ask who's your daddy: A big gun or a little gun? "The larger firms will be better able to keep small ETFs around to support an overall product offering. An investor should review how important the ETF is to the issuer," says Weiskopf of Global ETF Strategies.

Another sign of an ETFs health can be found in the proxy material sent to investors. A few ETFs have been forced to close as a result of a change in control of their management agreement. For example, Claymore closed the Delta Global Shipper ETF as a result of this issue and later reissued a similar ETF a few months later, says Weiskopf.

Sometimes it just comes down to bad timing. A company may have launched a narrowly focused fund such as a copper ETF shortly before a negative cycle begins, which prevents it from raising the minimum amount of assets to thrive.

Also, ETFs that have very narrow missions may have limited interest and as a result, may have poor liquidity. A small asset base will have fewer trades resulting in large spreads in the bid vs. ask prices. "The way to avoid these funds is to monitor the volume, spreads, and market movements over a month -- to study one ETF against others with similar holdings before you buy," says Rose Greene, a certified financial planner with Rose Greene Financial Services.

Choose Your Moment to Get Out

What should you do if you're pretty sure a funeral is pending for an ETF you're invested in? You have a couple of options. Monitor the price, and sell when the timing is right, suggests Marilyn Plum, a certified financial planner with Ballou Plum Wealth Advisors. Don't wait for the ETF to liquidate, she adds. That may occur at an unfavorable market time, and when it liquidates, you'll be cashed out with the resulting gains or losses.

Know too, that even though the fund may liquidate at a loss, gains from the prior period may be included in the 1099, adds Greene.

Unless the ETF fulfills a unique need in your portfolio that you can't meet with any other investment, you should consider selling your shares and reinvesting the proceeds in another vehicle that will meet your investment needs, says Iachini.

You don't have to make any sudden moves. Usually, when an ETF announces it will close, it will continue to trade for another three to four weeks. During that time you can buy or sell shares as you typically would. On the day that the ETF closes, all trading stops.

The provider then has a period of time -- usually about two weeks -- to sell the underlying securities within the ETF. The proceeds are distributed to the owners of record and those owners get the value of the securities as of the day they were sold, not on the last day the ETF traded. This means those left holding shares in an ETF when it closes take the chance that the underlying securities could go down or up in value in the meantime.

The seemingly endless frenzy of ETF launches continues, with each new offering more exotic than the last -- but remember: Only the strong survive.