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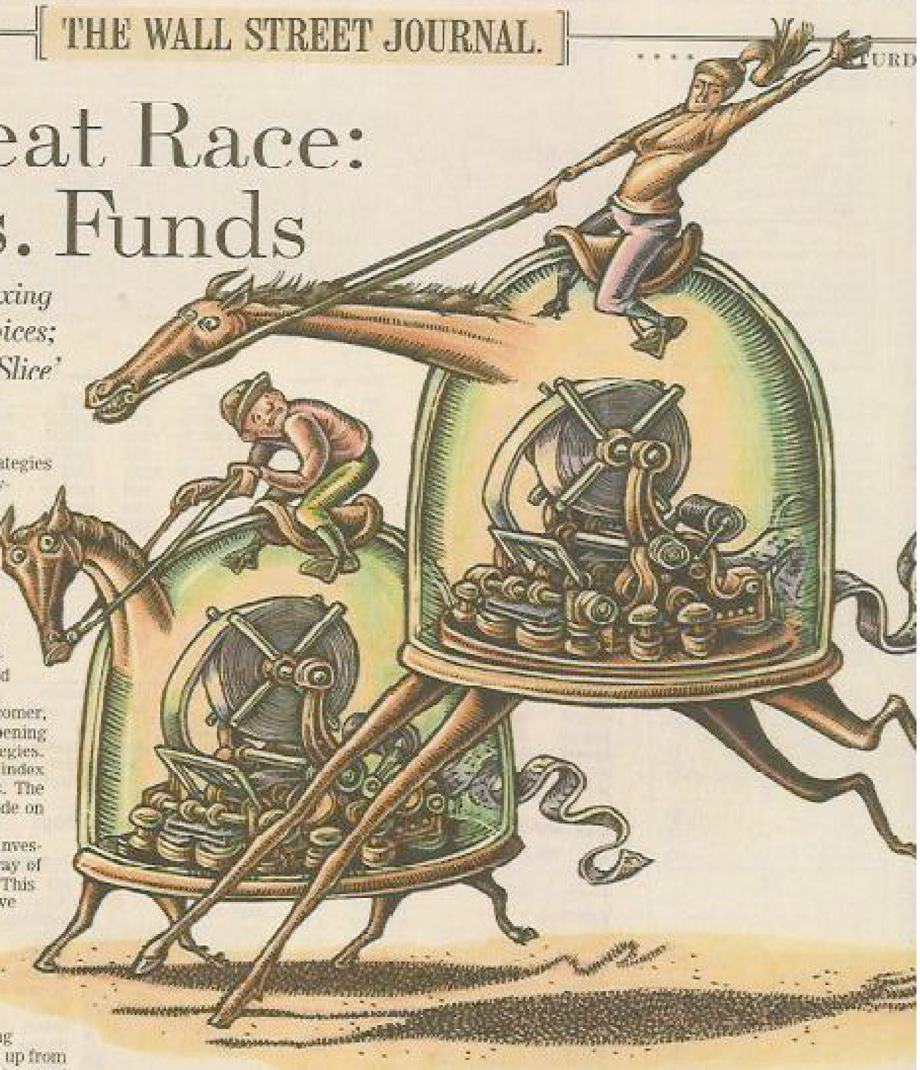
The Great Race: ETFs vs. Funds

New Opportunities for Indexing Complicate Investors' Choices; Picking the Right Market 'Slice'

By Eleanor Laise



ONE OF THE SIMPLEST strategies for socking away savings—buying into an "index" fund that simply tries to match the performance of, say, the S&P 500—is getting trickier.

Currently nearly 10% of all long-term mutual-fund assets are in index funds, and little wonder: Not only are the fees low, but the indexes they track usually have long, reassuring performance records—something investors find comforting.

But in the past few years a racy newcomer, exchange-traded funds, have started opening up significant new investment strategies. While ETFs behave much like traditional index mutual funds, they have key differences. The main one: Unlike mutual funds, they trade on an exchange, just like a stock.

As a result of the boom, mom-and-pop investors are gaining access to a growing array of different exchange-traded index funds. This year alone, more than 30 new ETFs have been launched, tracking everything from clean-energy stocks to the nanotechnology industry.

According to Boston-based Financial Research Corp., ETFs now account for nearly one-third of all assets devoted to so-called passive investing (a term for investments like index funds), up from 9% in 2000. In less than three years, the total number of ETFs has jumped nearly 70%, to 185, while the number of index funds has remained relatively flat. ETFs have even started popping up in 401(k) plans.

A key driver in the popularity of ETFs is the failure by many mutual-fund managers to beat the market for extended periods of time, even as they collect big management fees. Instead, many advisers have turned to a strategy of lower-cost index funds, and increasingly, ETFs.

ETF's rising attractiveness also stems from the mutual-fund trading scandals of recent years. Traditional mutual funds are priced only once a day, after the market closes—and some rapid-fire traders used strategies designed to profit from the fact that prices could get out-of-date. Because ETFs are priced like stocks, meaning they trade

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