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Five ETFs That Strategists Say Should Be Avoided

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Most ETFs fulfill the promise of low cost and all-day trade. But some are so rife with flaws, they should be handled with great care or avoided altogether. We asked several ETF strategists to tell us which they think are the worst ETFs and why.

• **Ron Rowland, founder, All Star Investor and Capital Cities Asset Management, Austin, Texas.**

Alerian MLP ETF (AMLP): Ever since Congress created the Investment Company Act of 1940, the investing public has come to associate mutual funds, and now ETFs, as investment vehicles that are "pass-through" structures from an income tax standpoint. In other words, investors believe that funds themselves do not incur or pay any taxes. Any and all tax obligations are "passed through" to the shareholders. AMLP changed that.

There are more than 1,100 ETFs and ETNs listed for trading in the U.S. today. Of those, AMLP is the only one structured as a C-corporation. Because it is the first of its kind, investors are not aware of the outrageous expenses that come with this structure.

As a C-corp, it has to pay 35% federal income tax on all capital gains (price appreciation) as well as various state tax liabilities. This burden is of course ultimately borne by the shareholders.

Since AMLP does not know who or how many shareholders it will have when its tax bill becomes due, it must accrue this on a daily basis. AMLP accomplishes this by reducing the daily price change by 37.5%, leaving

Naming their pet peeves among ETFs are, clockwise from left: Ron Rowland of All Star Investor, Michael Johnston of ETF Database, Matt Hougan of ETF... [View Enlarged Image](#)
shareholders with the other 62.5%.

According to data from AMLP's website, since its launch on Aug. 25, 2010, through the end of 2010, AMLP shareholders only received 65% of the total return generated by the underlying benchmark index (8.7% vs. 13.5%). That is the equivalent of a 35% expense ratio.

The 35% entity-level tax obligation is before and in addition to the shareholder's tax obligations. If you bought AMLP in a taxable account when it was launched and sold on Dec. 31, you now owe taxes on your 8.7% return. Depending on your tax rate, this might reduce your return by another 20% to 40% of the remainder. It's essentially the compounding of taxes, or double taxation.

AMLP likes to counter this argument, saying that their distributions are tax-deferred. However, tax-deferred is not the same as tax-free, and having the fund pay 35% corporate taxes seems to defeat the whole purpose. MLPs are one of the most tax-efficient vehicles available to investors. However, AMLP is the least tax-efficient ETF that I'm aware of.

I don't claim to be a tax specialist, but no one has indicated that my analysis is incorrect. Investors should consult their own tax adviser about their particular situation.

• **Michael Johnston, senior ETF analyst, ETF Database, Chicago.**

RBS U.S. Large Cap Trendpilot ETN (TRND): Trend following has become a very popular investment strategy, so a trend-following exchange traded product seems like it might be a big hit. The RBS U.S. Large Cap Trendpilot ETN is a relatively simple product. When the S&P 500 is above its 200-day moving average, investors get exposure to equities. When the S&P 500 dips below its 200-day, exposure is shifted to

low-risk Treasuries.

But TRND is full of faults, and just doesn't make much sense for investors. For starters, the fees charged by this product are just plain ridiculous. When the strategy is invested in the S&P 500, expenses accrue at an annual rate of 1.0%. That's almost 17 times the fees charged by the **Vanguard S&P 500 ETF (VOO)**. When invested in Treasuries, expenses accrue at 0.50%, or 41 basis points more than **PIMCO 1-3 Year U.S. Treasury Index ETF (TUZ)**. There's nothing proprietary or complex about the underlying strategy, so going the do-it-yourself route could save you quite a bit in fees.

Then there's the potential "strategy lag" that results from TRND's methodology. Most investors implementing a trend-following strategy shift exposure as soon as a specified price point (such as the 200-day moving average) is crossed. But TRND implements a bastardized version of trend following; in order to shift into equity exposure, the S&P 500 must be above its moving average for five consecutive trading days. Conversely, it takes five straight days below to get into cash. That puts TRND behind the trend-following curve, potentially leaving some money on the table.

To top it off, TRND is a debt security issued by a financial institution that not long ago needed a \$75 billion bailout just to stay afloat. Not exactly a recipe for investing success.

• **Sam Subramanian, editor of AlphaProfit Investment Newsletter, Sugar Land, Texas.**

United States Natural Gas (UNG): UNG invests in near-month natural gas futures contracts. As each month draws to a close, UNG rolls its position forward by selling the near-month position and buying a contract further from expiration. This helps the fund avoid taking physical delivery of natural gas.

When prices of the longer-dated futures contracts exceed the price of the front-month contract — i.e., an upward sloping forward price curve, also called contango — the fund loses money each time it rolls its position.

UNG currently has two strikes against it. One is the oversupply of natural gas. The other is the price structure of the forward curve.

Weak industrial demand, coupled with excess supplies resulting from investments made in recent years, has caused inventories of natural gas to swell. The U. S. Energy Information Administration states that working gas in storage tallied 2,959 billion cubic feet as of Jan. 7, 2011. As such, gas inventories are 161 bcf above their five-year average of 2,798 bcf.

Looking at the price structure, natural gas for February delivery is currently changing hands at \$4.42 per MMBtu. The prices for delivery further out are higher. Prices for deliveries three months, six months and one year out are \$4.47, \$4.62, and \$5.19, respectively. In other words, the natural gas forward price curve is in contango, a situation that is detrimental to the performance of UNG.

If one expects economic recovery to gain further traction in 2011, it is reasonable to assume that industrial demand for natural gas will pick up and enable the price of natural gas to increase in 2011.

A better way to profit from the rise in price of natural gas is through natural gas stocks, either via direct ownership of stocks of natural gas producers or natural gas ETFs such as First Trust ISE-Revere Natural Gas (**FCG**) or such natural gas mutual funds as Fidelity's Select Natural Gas .

The negative roll yield that will result from natural gas' contango price structure will be a drag on the performance of UNG. UNG should be avoided at least until the natural gas price structure takes on a downward slope, i.e., backwardation, and the positive roll yield will become a tail wind.

• **Matt Hougan, president of ETF Analytics, San Francisco.**

iPath S&P 500 VIX Short-Term Futures ETN (VXX) and **iPath S&P 500 VIX Mid-Term Futures ETN (VXZ)**: It is tempting to play volatility here. The CBOE Volatility Index (VIX) is trading at its lowest level since before Lehman Bros.' collapse, and products like VXX and VXZ look cheap. Don't be seduced. These products actually track volatility futures, not the VIX itself, and that little difference makes all the difference in the world.

You know how the United States Oil (**USO**) has trailed spot oil prices for the past year because of contango? The same situation exists in volatility, except it's 10 times worse. VXX lost about 70% of its value in the past year. Given the current shape of the volatility roll curve, it is set to continue its triumphant march towards zero in 2011. Could it spike in the interim? Of course it could, big time. But for long-term investors, VXX is a miss.