WHAT DID YOU DO IN THE ETF WAR, DADDY?

A battle royal is shaping up in the world of exchange-traded funds. The big winner: investors who are seeing fees plummet.

Gus Sauter, Vanguard Group's chief investment officer. REUTERS/TIM SHAFFER

BY AARON PRESSMAN
BOSTON, DEC 3

Gus Sauter, Vanguard Group's chief investment officer, vividly recalls the first time he proposed exchange-traded funds to his boss.

"That's the dumbest idea you've ever had," then-CEO Jack Brennan told him after a five minute discussion back in 1998.

Sauter persisted. Eventually he convinced Brennan that these newfangled ETFs -- index-tracking funds that trade in real time at ever-changing prices on a stock exchange -- were a natural fit for Vanguard, the largest manager of traditional mutual funds that mirror various indices.

Today, Sauter's "dumb" idea has grown to about $135 billion of Vanguard's $1.5 trillion of assets under management. And after years of trailing in the race to attract new money from ETF investors, the fund giant is poised to take the top spot this year. In the first 10 months of 2010, Vanguard grabbed

USURPING THE THRONE: Vanguard Group's CEO Bill McNabb in the board room at the Vanguard Headquarters in Valley Forge, Pennsylvania, December 2, 2010. **REUTERS/TIM SHAFFER**

$31 billion versus $18 billion for iShares, now owned by New York money manager BlackRock Inc and the market leader for much of the past decade.

iShares is still the firm to beat in total U.S. ETF assets under management, with roughly $413 billion -- more than three times Vanguard's total. But iShares has seen new money invested in ETFs slip for three years running, while Vanguard's has doubled over that same period. According to data from Lipper, a unit of Thomson Reuters, iShares could end the year at half its 2007 inflow level.

"Today, we don't care if you're in an ETF or a traditional mutual fund," current Vanguard CEO, Bill McNabb, explained in an interview at the firm's Valley Forge, Pennsylvania headquarters. "ETFs will become almost by default a bigger and bigger part of what we do."

The success of Vanguard's ETFs starts with the basic appeal of the products generally, McNabb noted. Expense ratios are among the lowest available. And because big investors sometimes redeem shares in return for the underlying stocks, painful year-end capital gains payouts are rare.

"THERE'S A PRICE WAR ON AND IT'S GOING TO BE JUST LIKE OTHER COMMODITIES, LIKE AIRLINES OR STEEL OR CORN."

NEW KING OF THE HILL

The de-throning of iShares would have seemed all but impossible just a few years ago. Until recently, the firm had dominated sales charts, issuing hit funds like clockwork. In 2005, it garnered $42.3 billion of the entire ETF industry's $52 billion of net inflow. Two years later, riding a wave of freshly introduced fixed income funds, iShares peaked with a record $52.3 billion of new money from ETF investors.

The changing of the guard is likely to bring at least one major benefit to investors: lower prices. "You can think of Vanguard as the Walmart of retail investing," said Charles Sizemore, who runs Dallas money manager Sizemore Capital Management. "The company's relentless obsession with keeping fees cut to the bone will force competitors to do the same."

And Vanguard is not the only one pushing lower cost ETFs. State Street Corp, which runs the oldest and largest single ETF, the $81 billion S&P 500 SPDR, has undercut fees with some new products. Several giants of the mutual fund world have also awakened to the ETF market, adding to the pricing pressures. Charles Schwab and Pacific Investment Management, home of bond manager legend Bill Gross, undercut iShares fees on some recent offerings.

As the ETF market matures and the largest providers duplicate more of one another's most popular funds, fees are likely to drop more, according to Scott Burns, Morningstar's director of ETF research. "There's a price war on and it's going to be just like other commodities, like airlines or steel or corn," Burns said.

None of this is especially good news for BlackRock, one of the world's biggest asset managers, which paid $13.5 billion for iShares parent, Barclays Global Investors, in a deal that closed last December.

BlackRock's shares have flagged this year, declining 31 percent so far, in part due to concerns about the future of its ETF business. Goldman Sachs downgraded the stock to "neutral" from "conviction buy" in October, citing the heightened price competition in ETFs.

Laurence Fink, BlackRock's CEO, sounded a bit defensive on the firm's third quarter call with analysts a few weeks later. "It's much more complex than the simplicity of just fees," Fink said. "I'm not terribly worried about it. I think the next two years it's going to be all about innovation," he added later in the call.

Few would dispute that point.

If the last decade was marked by the dominance of iShares, the next is shaping up as a battle royal among the industry's biggest players for a piece of a market that is fast nearing $1 trillion -- more than 10 percent of the total long-term mutual fund market and growing.

INEVITABLE WAR

THAT EXCHANGE-TRADED funds have become one of the fastest growing and competitive segments of the investing world in less than 10 years must come as a shock to all but the most rabid true believers.

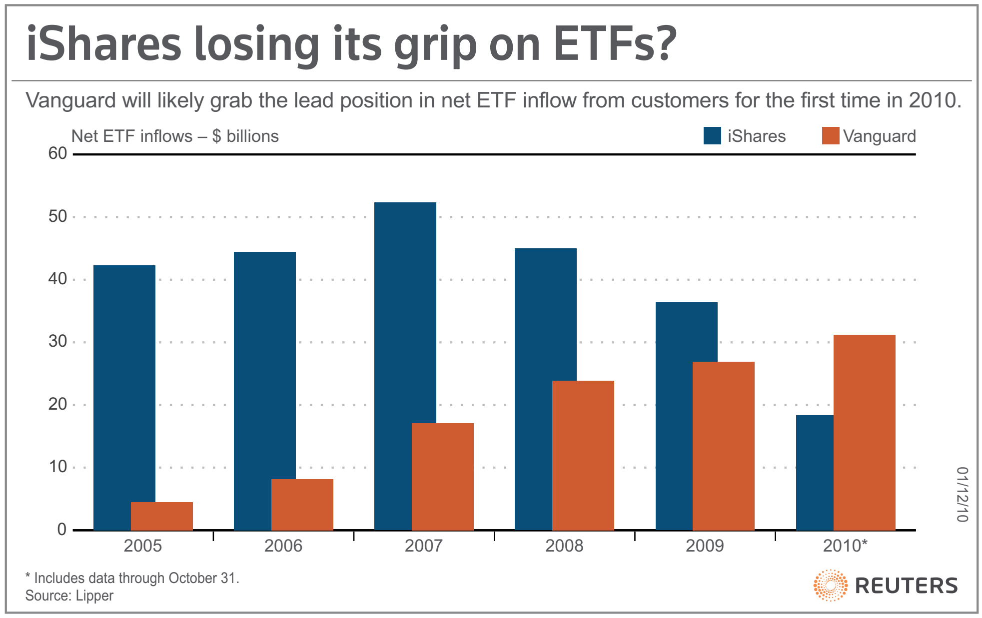
The first ETF was dreamed up in the late 1980s by Nathan Most, a former coconut oil futures trader spending the twilight of his career helping the American Stock Exchange think up new products.

It took six years to get Most's idea approved by regulators, but the S&P 500 Depository Receipts, dubbed "Spiders" based on the initials SPDR, quickly caught on. To this day, the original Spiders remain the largest single ETF whether measured by total assets or daily trading volume.

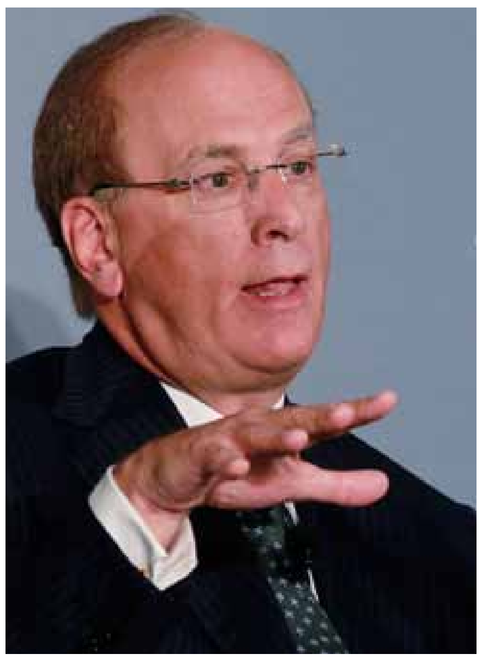
Not much happened right away. But since the first batch of iShares funds debuted in May, 2000, the industry has grown almost 20 times in size -- and this has happened during the so-called lost decade, when the stock market made virtually no gains at all.

This year, ETFs are dominating sales of many of the top fund categories. Vanguard's emerging market ETF has pulled in almost $19 billion through the end of October, more than any other fund in its sector and the second most of any kind of fund after Bill Gross's Total Return Fund, according to Lipper data. State Street's SPDR Gold Fund captured $7 billion, the most of any commodity fund and sixth best overall.

In a sign of the growing preference for passive over active management, investors have been adding to equity ETFs this year while pulling money from their mutual fund counterparts. Stock ETFs gained $54 billion in net new money through the end



Reuters graphic/Stephen Culp

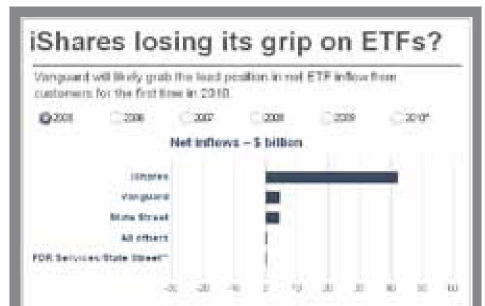


ON THE DEFENSIVE: Laurence Fink, chairman and chief executive officer of BlackRock, speaks at the Reuters Insider "The New Wall Street" Newsmaker in New York May 26, 2010. REUTERS/BRENDAN MCDERMID

of October, compared with net outflows of $30 billion year-to-date for stock mutual funds, according to data from the Investment Company Institute.

Through ETFs, even individual investors are accessing an array of markets that were previously out of reach or too expensive, including emerging market bonds, non-U.S. dividend stocks or precious metals like platinum and palladium.

Financial advisers appreciate the ability to craft investment plans with targeted holdings in various ETFs, which lately have



Click for interactive with more on ETF inflows http://r.reuters.com/daf97q

ranged into niches like companies mining rare earth minerals.

The industry has encountered a few growing pains of late. More ETF prices were hit during the May 6 "flash crash" than those of ordinary stocks, prompting new SEC trading rules. Regulators also had to crack down on marketing of some leveraged ETFs last year. And some commodity-oriented funds have not performed as expected.

None of which has slowed the popularity of ETFs much. Investors poured $85 billion into ETFs through the end of October.

BATTLE LINES

AGAINST THAT BACKDROP, the Vanguard-iShares battle has taken center stage. The two are index fund pioneers. Jack Bogle created Vanguard in 1975 to bring index funds to the masses. iShares grew out of Wells Fargo's former investment arm that opened the first index fund for institutional investors in 1973.

But the conflict was a long time coming. After competing weakly for years, Vanguard only made ETFs a top priority as McNabb took

UP NEXT? A man walks past a Charles Schwab Investment branch in Washington January 19, 2010. **REUTERS/JIM YOUNG**

over as CEO in 2008. Total staff dedicated to ETFs has hit 300 from about 50 five years ago, McNabb said. And after some lean years for new funds, Vanguard has introduced 17 so far this year.

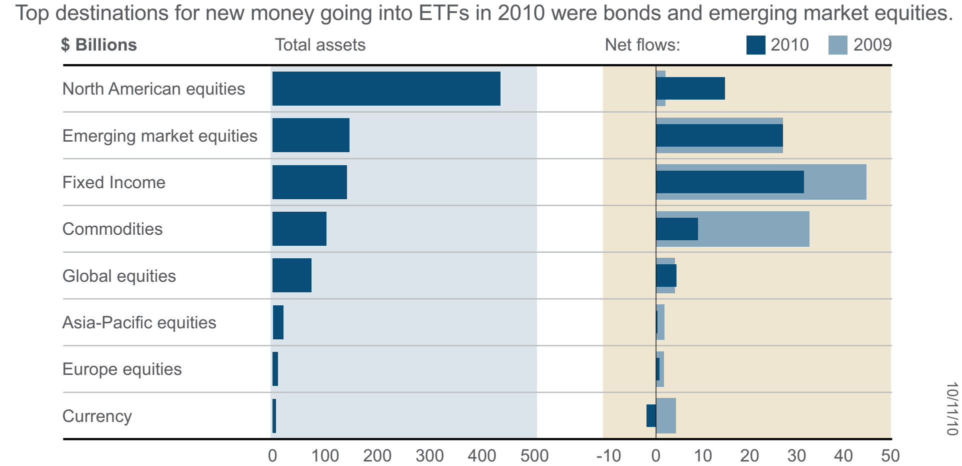
As for iShares, one of its largest and most popular funds, the $47 billion MSCI Emerging Markets index Fund, lagged its benchmark by almost seven percentage points in 2009. Vanguard had no such tracking error issue with its now $41 billion emerging market ETF, which used to be half the size of the iShares fund and also happens to charge a 63 percent lower management fee.

With investors pouring into all manner of emerging market funds, the iShares ETF has garnered only a net $4.4 billion through the end of October, compared with the Vanguard fund's net inflow of $18.7 billion, according to data from Lipper.

After years of largely ignoring Vanguard offerings, top financial advisers and brokers now applaud the enhanced service and expansion of Vanguard's line-up. Over the summer, the firm outpolled iShares for the first time in an annual survey of ETF customer loyalty among financial advisers conducted by Cogent Research.

ETF investors seek diversification

Top destinations for new money going into ETFs in 2010 were bonds and emerging market equities.



NOTE: Leveraged and inverse funds not included. * Data through October 31, 2010.
Source: BlackRock Inc.

REUTERS

Reuters graphic/Stephen Culp

"In many cases, we've found they offer the most efficient way to get the exposures we're looking for," said Jeff Layman, chief investment officer at BKD Wealth Advisors in Springfield, Missouri.

BKD recently switched clients from a large iShares world equity fund to a competing product from Vanguard that offered broader market coverage and lower fees. "We're pretty interested in keeping costs low," Layman said.

Adviser Milo Benningfield in San Francisco said he has been steadily phasing out iShares funds as Vanguard has broadened its line-up. "When Vanguard offered only a handful of ETFs, I was happy to hold iShares products longer-term," Benningfield said. "But then

"BY NO MEANS SHOULD YOU BE PUTTING A NAIL IN THE BLACKROCK ISHARES COFFIN."

they had some tracking error and were less tax efficient than I'd hoped."

Like much of the firm's success over the years, Vanguard's ascent in ETFs has been slow and steady, but it has been helped by stumbles at iShares. Since the BlackRock deal was announced last June, iShares has suffered from an exodus of talent, some inconsistent fund performances and generally higher fees than competing products.

At the same time, critical exclusive licensing deals with investment index providers like McGraw Hill's Standard & Poor's and Russell Investments expired, opening the door to more copycat funds with lower fees.

Vanguard rolled out nine ETFs tracking bread and butter S&P indexes like the S&P 500, Mid-cap 400 and Small-Cap 600 in September, for example. Seven Russell-based Vanguard ETFs arrived a few weeks later.

The copycats are intended for the giant brokerage and wealth management firms that issue research recommendations around one or another particular set of indexes. "We were hearing it from the front lines at Merrill Lynch and other big broker/dealers," said Rick Genoni, who heads Vanguard's ETF product management group.

SHARE AND SHARE ALIKE

NO ONE EXPECTS iShares to fade away. The firm has tripled its new fund launches this year and slashed its fee to 25 basis points from 40 on its gold fund, a red hot category for investors worried about the Fed's controversial stimulus plans or further potential global debt calamities.

State Street's much larger gold ETF, which charges 40 basis points, still leads in inflows for the year but at least one major investor seems to have noticed the fee cut. George Soros's Soros Fund Management sold about 550,000 shares of State Street's gold fund in the third quarter and bought 5 million shares of iShares' fund, which trades at 1/10 the price of its competitor. Soros's firm declined to comment.

"By no means should you be putting a nail in the Blackrock iShares coffin," said financial adviser Gary Gordon, president of Pacific Park Financial in Orange County, California. "It'd be like counting out Coca-Cola because Pepsico is claiming market share."

For its part, BlackRock says it is ready for the competition, which ultimately could

ALL THAT GLITTERS: An employee holds gold during processing at the PT Antam Tbk. precious metal refinery in Jakarta January 15, 2009. **REUTERS/ BEAWIHARTA**

benefit the entire ETF market. "Sure, we want to beat the heck out of our competitors," said Noel Archard, who oversees product strategy, research and development for iShares. "On the other hand, the more people doing it right, the better it is overall."

There will continue to be plenty of business for iShares, he added. "How many SUVs are there?" asked Archard. "It's about brand affinity. Ultimately, the market will decide."

And he disputes that investors are shifting allegiance just because of expense ratio differences. "Vanguard, Schwab, they say look at the low expense ratio," Archard, who worked on Vanguard's ETF effort until 2006, said. "What about spreads, commissions, trading support? What is the total cost of ownership?"

In many cases, iShares funds have more trading volume per day and trade at tighter bid/ask spreads than competitors, Archard said.

The firm also argued that third-party market trackers like Lipper and Morningstar have undercounted iShares net inflow this year. By its own count, investors added a net $25 billion to its exchange-traded funds through the end of October, more than the $18 billion figure calculated by Lipper and Morningstar.

The talent drain is nothing new for iShares either, executives at the firm noted. In 2006 alone, State Street recruited Anthony Rochte from iShares to head its ETF sales and Bruce Lavine left to help found an independent ETF shop called WisdomTree that now oversees about $9 billion.

FATHERLESS

ANOTHER CHALLENGE for iShares is the departure of the firm's father figure, chairman Lee Kranefuss. After the BlackRock acquisition, he retired in April.

"He is a sharp, sharp dude," Morningstar's Burns said. "For any company to lose somebody that's clearly that intelligent and had that much invested in the success of the product has got to be difficult."

A former business consultant with an entrepreneurial bent, Kranefuss joined Barclays Global Investors in 1997 to develop a strategy aimed at retail investors. Acquiring a mutual fund firm seemed too expensive at the time and Kranefuss eventually hit upon a tiny line of international ETFs which Barclays ran in conjunction with Morgan Stanley.

Sensing the potential to upend the fund business with a lower cost alternative, Kranefuss turned to Nathan Most, who developed the very first ETF in 1993, as a consultant and gave him an office at iShares.

To hone the iShares ETF approach, Kranefuss spent long hours discussing potential problems with Most, a former commodity trader and product development guru at the American Stock Exchange who died in 2004.

Most batted down all of Kranefuss's nightmare scenarios. "He'd say if it was so simple for something to go wrong with this structure as you think, it would have failed already," Kranefuss recalled.

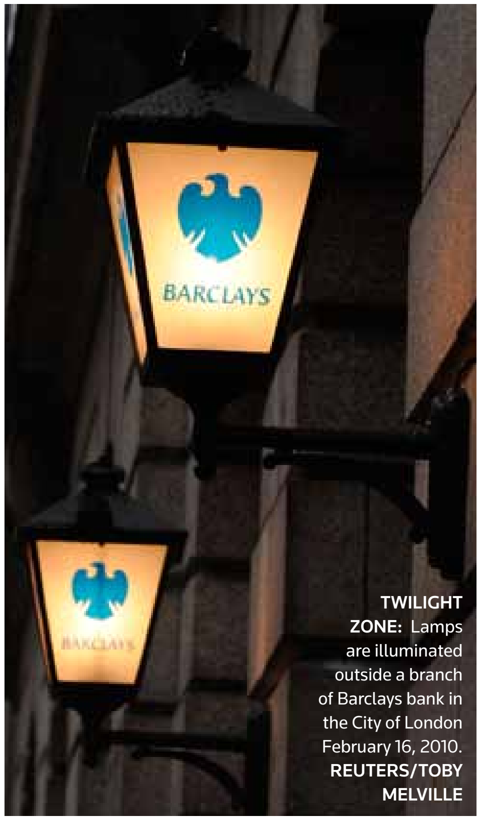
Getting dozens of new ETFs through the SEC's registration process took months longer than expected, leaving Kranefuss with an office full of salespeople with nothing to sell. Competitors were amused. "We kept hearing they were going to be closed down any minute," recalled Noel Archard, who worked at Vanguard at the time.

Yet when the first 45 iShares funds launched in May 2000, they too quickly caught on, garnering over $2 billion by the summer. In three years, iShares ETF assets surpassed State Street and hit $200 billion after five years.

At Vanguard, executives were initially concerned about the impact ETFs might have on their highly successful indexed mutual fund business. The original ETF and still the largest, State Street's S&P 500 tracking SPDR, was used mainly by rapid traders and hedge funds to implement arbitrage strategies.

Still, CIO Sauter saw a major synergy between mutual funds and related ETFs. He had witnessed first-hand the harm wreaked on mutual funds when too many investors asked for their money back at the same time, as happened after Russia's debt default in 1998.

Fund managers had to sell securities at the worst possible time to raise cash to return to the fleeing customers. The ETF structure, which allowed investors to dump their shares in the secondary market without requiring a fund's managers to sell securities, would relieve that pressure, he believed.



TWILIGHT ZONE: Lamps are illuminated outside a branch of Barclays bank in the City of London February 16, 2010. **REUTERS/TOBY MELVILLE**

When then-CEO Brennan finally approved Sauter's plan to create a class of ETF shares for some of Vanguard's existing index mutual funds in 2001, he required that the ETFs trade under a separate brand, VIPERS, in case something went wrong.

It took some years for ETFs to gain traction inside Vanguard. "We went sideways for a while," Sauter said, noting the firm had collected less than $20 billion of ETF assets in its first few years.

In 2006, Noel Archard jumped from Vanguard, where he headed institutional ETF sales, to Barclays' iShares. The move seemed to confirm market chatter that Vanguard was not truly dedicated to succeeding with ETFs.

Instead, Vanguard doubled down. The VIPERs brand was abandoned and the firm moved to expand its line in fixed income and real estate. With new training programs for advisers and a website overhaul, the renewed sales push worked. Net inflow into Vanguard ETFs shot up from $8.1 billion in 2006 to $26.9 billion in 2009.

BEYOND VANGUARD

THE BLACKROCK ACQUISITION of iShares also coincided with a surge of competition in the ETF arena. Several major money managers that had been ignoring the market, primarily Charles Schwab and Pacific Investment Management or PIMCO, decided to create their own ETF families. And iShares' two main existing competitors, Vanguard and State Street, turned up the pressure with dozens of new funds and lower fees.

More competition is expected in 2011 when the first ETFs arrive from Tacoma, Washington-based Russell, which already manages about $150 billion alongside its popular family of indexes like the Russell 1000 of large cap stocks and Russell 2000 of small caps. It has filed with the Securities and Exchange Commission to start with a slate of 33 funds.

Russell set up its new ETF operation just blocks away from iShares home base in San Francisco's financial district. It's not just the location that is similar. The new unit is run by James Polisson and Andrew Arenberg, two iShares veterans, and other colleagues from their former team.

With its funds still in registration at the SEC, however, Russell declined to comment on its ETF plans.

Schwab also raided the iShares talent pool to staff its ETF operation which opened its first funds a year ago and has over $2 billion in 11 funds so far. The firm kicked off its entry last November with the first offer to let customers trade its ETFs commission free. Brokerage competitors TD Ameritrade and Fidelity Investments have since followed suit with similar free trading offers.

Schwab will expand the line-up next year, aiming at "big slices" not "little niches," Peter Crawford, senior vice president at the firm said. "We want this to grow big -- we're not aiming for a hit rate of 50 percent."

No one is calling that a dumb idea.

COVER PHOTO: Gus Sauter, Vanguard Group's chief investment officer sits for a portrait near the board room at the Vanguard Headquarters in Valley Forge, Pennsylvania, December 2, 2010. **REUTERS/TIM SHAFFER**

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