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Exchange Traded Notes (ETNs) as an Alternative to Exchange Traded Funds (ETFs)

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In my August 6th 2010 commentary I presented a diversified ETF portfolio asset allocation construct which included: U.S. Stocks, Foreign Stocks, Fixed Income, Real Estate, and Tactical Asset Allocation segments. Exchange Traded Notes (ETNs) are an alternative to Exchange Traded Funds (ETFs) in that ETNs also traded daily on stock exchanges and track the performance of an underlying index (less fees). One difference, however, is that ETNs are subject to the risk of default, particularly during economic downturns. This hazard may overshadow the benefits that ETNs provide such as lower taxes and lack of tracking error. And while ETNs are linked to the return of the benchmark index, as debt securities, ETNs don't actually own issues they are tracking. ETNs, therefore, differ from ETFs in the following ways:

1. ETNs are unsecured debt where investors lend money to the provider in exchange for the commitment to provide a return tied to an index. ETFs, on the other hand, hold stocks or other securities in trust with a custodian.

2. ETNs follow closely the underlying index with no tracking error, while ETFs may not always follow the indexes. So while the ETN provider commits to paying the index return, ETFs may diverge from the indexes they track due to constraints in managing the underlying basket of securities.

3. ETNs are defined as prepaid contracts and investors pay taxes on capital gains received that the time of sale, whereas, ETFs and mutual funds distribute taxable income and short term capital gains annually. Given the low turnover on most ETFs, however, this may not be a significant advantage.

4. ETNs may be the only option for investors who want exposure to a given market segment or asset, such as commodity futures. For example, iPath DJ-UBS Coffee Tracking Sub Index ETN (JO) is widely traded and has gained 17% year to date and 24% over the past 12 months.

As a new product ETNs have a very short history, but have been growing very rapidly because they provide efficient access to segments of the market that would otherwise be difficult for retail investors to reach. However, given that ETFs are exposed to market risk, while ETNs face both counterparty and market risk, there probably has to be a compelling tax advantage for ETNs to entice unfettered investment enthusiasm.