ETF:

➡ *from page 1*

liquidity problems. Not every industry should have its own index, she said.

"Beyond the moral implications, it's not a very good investable universe," Edmondson said.

Trading Window Always Open

ETFs can track specific commodities, currencies or real estate markets. They can be leveraged. They can use hedge fund-like strategies or follow the basic S&P 500 index.

And unlike mutual funds, ETFs can be traded at any time, not just at the end of the day.

Edmondson said another appeal is lower regulatory requirements, which make it much cheaper to set up an ETF than a mutual fund. It could be the difference between $100,000 and $1 million, which makes it a more appealing way to tool around with novel ideas, such as an index devoted to wearables.

While ETFs have been around for more than 20 years, they've grown in popularity relatively recently. There were 629 ETFs in 2007 with net assets of about $608 billion, according to the **Investment Company Institute**. By 2014, there were 1,411 funds with about $2 trillion.

"The barriers to entry are much lower for ETFs," Edmondson said. "Because the risks are lower, it's easier to experiment."

EQM creates its indexes and then licenses them for a fee to ETF issuers who handle the actual sale of the products to investors and their advisors. Its online retail ETF is launching later this month through **Amplify Investments**, while its wearables fund will be issued in May from **Exchange Traded Concepts LLC**.

Dependable Dividends

Reality Shares Inc., another San Diego-based firm involved in ETFs, is both index creator and issuer. CEO **Eric Ervin**, a former wealth manager at **Morgan Stanley**, founded the company in 2012 in an effort to replicate a strategy used by his clients.

While the stock market often has down years, there have only been three years in the past four decades when the overall dividends issued by the S&P 500 declined, according to Ervin. Stock prices are affected in part by investor sentiment, but dividend growth is a more objective reflection of a company's performance, he said.

"You can't fake a dividend," Ervin said. "It's a window into the health of a business They don't care if there's a bomb that goes off somewhere and the stock market goes down 20 percent."

Jamie Scott Lytle

Jane Edmondson's firm, EQM Indexes LLC, designs exchange-traded funds, also known as ETFs.

The problem was that most investors can only get dividends by buying the stocks Ervin was trying to avoid. But using derivatives futures, Ervin was able to strip away the underlying stock volatility and create an ETF that only tracked the growth in dividends among S&P 500 companies. The strategy is usually reserved for institutional investors and high net worth individuals.

Because the ETF, called Divy, doesn't hold stocks, it won't have double-digit returns in a booming market. But Ervin said investors usually use the fund as an alternative to other fixed-income investments.

"It's definitely not a return enhancer," Ervin said. "It's more like a risk reducer."

Divy launched in late 2014 and currently has net assets of about $36 million. Ervin launched three new ETFs earlier this year, each with about $3 million in assets, that use the firm's analytics to pick companies most likely to grow their dividends. Those funds hold stock in those companies, with some betting against stocks most likely to cut dividends.

Regulatory Concerns

While ETFs have proven popular with investors, they've been at the center of some serious market volatility. In August, some ETFs dropped more than 30 percent in just a few minutes as their trading prices fell below the supposed value of their underlying assets. Critics said some more complicated ETFs had a transparency problem, though ETF issuers countered that the 80-year-old laws governing the markets were ill suited to the more modern ETFs.

The **Securities and Exchange Commission** has said ETFs will be one of its main focuses in advisor audits, called exams, this year.

"It seems fairly certain that the explosive growth of ETFs in recent years poses a challenge that isn't going away, and may well become even more acute as new ETFs enter the market," SEC Commissioner **Luis Aguilar** said in October.

Ervin remains a staunch supporter of ETFs, though he admitted the recent controversy had left some investors with a negative impression that no amount of marketing could undo. "They just blanket the industry because of some headline they read in August," he said.

While regulators are likely more concerned with highly complex and potentially illiquid ETFs, Edmondson said even more straightforward funds tracking specific industries have seen a tightening of practices in the wake of August's crash. As she aims to roll out a new index each quarter, Edmondson said the stricter scrutiny and the increasingly crowded marketplace will make it harder to stand out.

"ETFs based on disruptive industries are low-hanging fruit," she said. "The challenge is to continue to innovate."