



## VIPERs Provide Lowest-Cost International ETF Alternative

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For ETF investors seeking international equity exposure, the preferred solution has been to purchase two broadly diversified ETFs sponsored by Barclays – the iShares MSCI EAFE Index Fund (symbol: EFA) and the iShares MSCI Emerging Markets Index Fund (symbol: EEM). These funds have been extremely popular in large part because with just two securities, an investor can gain exposure to over 90% of the equity market capitalization outside of the U.S. Moreover, the expense ratios of EFA and EEM, at 0.35% and 0.75%, respectively, are attractive relative to actively managed international mutual funds, whose expense ratios average 1.77% (source: Morningstar, July 2005).

Investors have shown a clear preference for the broad-based international stock exposure that EFA and EEM provide, versus more targeted bets on country-specific or regional ETFs. As of August 4, 2005, the \$24 billion of assets invested in EFA and EEM exceeded the \$18 billion invested in the other 46 international ETFs combined. Given the huge success of EFA and EEM, as well as heightened investor interest in international diversification, it was just a matter of time before competition emerged.

Although they have only been on the market since March 2005, Vanguard's foreign stock VIPERs (Vanguard's brand name for its exchange-traded fund line-up) are capable of mounting a challenge to Barclays' dominance in the international ETF arena. Vanguard's funds – the European VIPERs (symbol: VGK), the Pacific VIPERs (symbol: VPL) and the Emerging Markets VIPERs (symbol: VWO), present formidable competition to the iShares EAFE and Emerging Markets products, primarily due to their significantly lower expense ratios. As shown in the following table, the VIPERs products carry expense ratios that are roughly half those of their iShares counterparts – something that should be near and dear to any ETF investor's heart.

### Broad-Based International ETFs

Asset Class	Index/Fund	Symbol	Expense Ratio
Int'l Developed Markets	iShares MSCI EAFE	EFA	0.35%
Int'l Developed Markets	Vanguard European VIPERs	VGK	0.18%
Int'l Developed Markets	Vanguard Pacific VIPERs	VPL	0.18%
Int'l Emerging Markets	iShares MSCI Emerging Markets	EEM	0.75%
Int'l Emerging Markets	Vanguard Emerging Markets VIPERs	VWO	0.30%

Assuming an international equity portfolio that is weighted 80% in developed markets and 20% in emerging markets, an investor would save \$226 per year in fund expenses for every \$100,000 invested in the VIPERs products versus their iShares counterparts. For shorter-term positions, the expense ratio advantage of the VIPERs is offset by their wider bid/ask spreads, which should shrink as trading volumes in the products increase.

Despite this expense ratio advantage, investors do not appear – based on recent asset flows – to be expressing a preference for the VIPERs products, let alone converting assets from the iShares ETFs. For example, since their launch on March 4, the VIPERs European Fund and the VIPERs Pacific Fund have garnered assets of \$141 million and \$93 million, respectively – not a trivial sum, but one that pales in comparison to the \$3.2 billion that flowed into the iShares EAFE Fund in the first half of 2005.

Part of the reason that the VIPERs international ETFs have not attracted more assets may be due to some basic confusion with respect to the construction of the MSCI EAFE Index. (The EAFE index, which stands for Europe, Australasia, Far East, is the premier international equity benchmark and can be thought of as overseas equivalent of the S&P 500 for developed – as opposed to emerging – markets.) The EAFE is sub-divided by MSCI into two constituent indexes – the MSCI Europe Index and the MSCI Pacific Index. The MSCI Europe Index consists of 16 European countries and accounts for 74% of the EAFE Index. The MSCI Pacific Index includes five countries in the Pacific region – Japan, Australia, Hong Kong, Singapore and New Zealand – and accounts for 26% of the EAFE Index.

Taken together, the securities that compose the MSCI Pacific and Europe Indexes are identical to the securities that compose the EAFE index. While Barclays' EFA product tracks the entire EAFE index, Vanguard's VGK and VPL products track the two components that make up the EAFE. An investor using the VIPERs who wants to replicate the performance of the EAFE would simply purchase VGK and VPL in the proportions that mirror the respective weights of the MSCI Europe and Pacific Indexes in the EAFE Index. Alternatively, an investor wanting to overweight one region versus the other can easily do so with the VIPERs products.

It certainly does not help Vanguard's cause to have Morningstar, the most popular source for independent fund research, question the usefulness of the VIPERs Pacific Fund and its underlying MSCI Pacific Index. In its analysis of the fund, Morningstar seems to fail to grasp MSCI's index construction methodology and the distinction MSCI makes between developed and emerging markets. According to a recent Morningstar report, the fund "omits large swaths of the Pacific region...don't look here for firms from the big Pacific markets of Taiwan and Korea." Morningstar goes on to say "It is hard to figure out why an investor would want to own this fund."

Regrettably, Morningstar treats the VIPERs Pacific Fund as a not-very-useful regional fund, overlooking how it fits neatly into a three-part indexed international equity solution, consisting of VGK, VPL and VWO, that provides investors with the lowest-cost foreign stock exposure available in the market today.

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