New index products focusing on individual countries are open-end funds but trade on the stock exchanges like closed-end funds.

A New Route Overseas: Country Indexing With WEBS & CountryBaskets

By Albert J. Fredman

Global investing has experienced a huge surge in popularity over the past decade. And more focused single-country and regional portfolios are gaining popularity with individuals seeking to fine-tune their international exposure.

A big step forward for global investors occurred in March when exchange-traded single-country index funds debuted on both the American and New York stock exchanges. Investors who employ a "top down" approach to global investing can have access to nearly 20 different stock markets.

Technically, these products are open-end funds even though they trade on stock exchanges like closed-end funds. In fact, they are the first shares of open-end funds to trade on an exchange. There are no front-end loads or deferred sales charges; rather, you pay the usual brokerage fee to buy or sell shares. Like closed-end funds, the index products have both a share price and a net asset value, but they are designed to trade very close to net asset value, so there should be no significant discounts or premiums.

The portfolios don't try to "beat" the market, but instead mimic the performance of their respective benchmark indexes. They provide assurance that your return will not significantly lag that of the index due to bad decisions made by a portfolio manager. In addition, international index funds have special cost advantages compared to conventional open- and closed-end international funds, where management fees and trading costs can be high.

By holding just one of these exchange-traded open-end funds, you can own a significant chunk of a country's total market capitalization, much as you would use an S&P 500 index fund to hitch up with U.S. equities. The single-country index fund is a new concept; Vanguard offers several international index funds, but they target groups of countries rather than individual nations.

The two index products are WEBS (World Equity Benchmark Shares) and CountryBaskets. WEBS were developed by Morgan Stanley and trade on the American Stock Exchange. CountryBaskets are Deutsche Morgan Grenfell/C.J. Lawrence's product and trade on the New York Stock Exchange.

As index funds, WEBS track the Morgan Stanley Capital International indexes for their 17 nations. CountryBaskets follow the Financial Times/Standard & Poor's actuaries world indexes for their nine countries. Table 1 lists the stock markets and trading symbols for the individual portfolios in each group. The "round lot" is the usual 100 shares.

You can get real-time share-price quotes on WEBS and CountryBaskets throughout the day. Trading takes place in the Canadian market during the hours the U.S. market is open and on the Mexican Bolsa for a good part of that time. There are also smaller amounts of overlap for some of the other markets. When the respective foreign markets are closed, the prices of WEBS and CountryBaskets will fluctuate with movements in currency exchange rates and shifts in investor sentiment. Indicated net asset values of the individual portfolios are recalculated throughout the day during market hours. Official net asset values are published at the day's end.

WEBS and CountryBaskets are very similar but a few subtle distinctions exist. For instance, CountryBaskets are designed to track their respective benchmarks via "index replication," or owning all the stocks in the index. Conversely, WEBS are based on a sampling or "portfolio optimization" technique, which means that an individual WEB will generally own fewer stocks than the total contained in the benchmark. In general, a WEB is expected to hold about 60% of the total capitalization of the index.

All indexes are capitalization (or market-value) weighted, similar to the S&P 500, and include all major companies in their respective markets.

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Table 1.
Directory of Exchange-Traded Single-Country Index Funds

WEBS (ASE)				CountryBaskets (NYSE)	
Nation	Trading Symbol	Nation	Trading Symbol	Nation	Trading Symbol
Australia	EWA	Malaysia	EWM	Australia	GXA
Austria	EWO	Mexico	EWW	France	GXF
Belgium	EWK	Netherlands	EWN	Germany	GXG
Canada	EWC	Singapore	EWS	Hong Kong	GXH
France	EWQ	Spain	EWP	Italy	GXI
Germany	EWG	Sweden	EWD	Japan	GXJ
Hong Kong	EWH	Switzerland	EWL	South Africa	GXR
Italy	EWI	United Kingdom	EWU	United Kingdom	GXK
Japan	EWJ			United States	GXU

closer alignment with the index weightings. No dividend reinvestment plan is available at this time, although this feature could be offered in the future.

Creation Units

Large in-kind investments and redemptions can be made by a group of major global banks and securities firms through creation dealers. In-kind investments and redemptions are not nearly as common as the daily inflows and outflows of cash experienced by regular open-end funds. Most investors simply buy and sell shares through their brokers as they would with any stock. Nevertheless, a general understanding of this process is important, since the feature represents a major difference between exchange-traded index funds and ordinary closed-end funds.

Table 2 shows the market capitalizations for each of the countries that WEBS include and their respective weightings in Morgan Stanley Capital International's well-known EAFE index (Europe, Australia, and Far East), which consists of the world's developed markets outside the Americas.

Fifteen of the 17 countries that WEBS cover comprise more than 97% of the EAFE index. The five EAFE index countries for which there are no WEBS—Denmark, Finland, Ireland, Norway, and New Zealand—amounted to less than 3% of the EAFE at this writing.

CountryBaskets include a U.S. portfolio that consists of 639 companies, including those in the S&P 500. WEBS do not include a U.S. portfolio, but the American Stock Exchange offers "spiders" or Standard & Poor's depositary receipts (SPDRs), which are similar conceptually to the newer products. Both an S&P 500 and an S&P 400 MidCap SPDR are available. The former, which was introduced in 1993, has proven quite popular and now has $1.4 billion in net assets. Technically, SPDRs are exchange-traded unit investment trusts because they have mandatory maturity dates, whereas WEBS and CountryBaskets do not. This distinction is of no practical significance for investors, however, because the maturity dates for the SPDRs occur more than 100 years in the future.

Once a year, WEBS and CountryBaskets make cash distributions of net investment income and realized net capital gains (the U.S. CountryBasket makes quarterly distributions). Realized capital gains distributions could occur if the portfolio is rebalanced to bring it in

Table 2.
Market Capitalization Data for WEBS*

Country	Market Capitalization ($ billions)	EAFE Weighting (%)
Australia	271	2.70
Austria	33	0.43
Belgium	104	1.16
Canada	371	n/a
France	565	6.52
Germany	577	6.98
Hong Kong	310	3.31
Italy	242	2.68
Japan	3,825	38.70
Malaysia	261	2.48
Mexico	111	n/a
Netherlands	322	4.18
Singapore	152	1.75
Spain	159	1.89
Sweden	184	2.13
Switzerland	416	5.90
United Kingdom	1,371	16.68

** Market capitalizations as of 7/19/96; EAFE weightings as of 7/24/96.*
Source: Morgan Stanley Capital International

Basically, WEBS or CountryBaskets are directly issued or redeemed by their distributors in "creation units." A basket of stocks corresponding exactly to those in the index in composition and weighting is deposited (to create new units) or received (as a redemption package). The size of these creation units vary by country. For WEBS, they range from 40,000 shares for Belgium to 600,000 shares for Japan. At recent prices, the value of one creation unit for Japan was nearly $9 million.

Why would these big players be motivated to create new units of the fund or exchange positions for underlying stocks? Simply the potential to earn arbitrage profits. Those with the most efficient overseas operations have the highest profit potential. If, say, the Australia WEB were trading a point below its net asset value, an institution may choose to redeem and take its basket of stocks while simultaneously purchasing an equivalent WEB position on the exchange, locking in a profit that's virtually risk-free. Another reason to create new units would be if an institution seeks to make a very large

investment in a particular portfolio.

The big investors are active in derivatives markets and routinely buy and sell baskets of stocks that match equity indexes. New units can be created and existing ones redeemed during the day as arbitrage opportunities arise.

Net Assets and Expenses

Table 3 contains the net assets and expense ratios for each individual portfolio. The Japanese WEB, the largest of all, has net assets of $103.1 million. A number of the country portfolios are still rather small, with assets less than $10 million. Expense ratios for individual portfolios vary based upon factors such as their size. The expense ratios for both CountryBaskets and WEBS include 12b-1 distribution fees of 0.25%.

Expenses for the passive portfolios are considerably lower than the average for actively managed international funds. For example, the average expense ratio for the 17 WEBS is 0.87%, compared with Morningstar averages of 1.82% and 1.85% for closed-end and open-end international equity funds, respectively.

Of course, the expenses of the WEBS and CountryBaskets are not at rock-bottom levels as those of Vanguard's international index funds or the S&P 500 SPDRs. The Vanguard International Equity Index—Europe and Pacific portfolios both have expense ratios of 0.35%, whereas the Vanguard International Equity Index—Emerging Markets has a 0.60% expense ratio. The S&P 500 SPDRs have a 0.19% expense ratio, which is far lower than the expenses on the WEBS and CountryBaskets because the SPDR is much larger in size ($1.4 billion in assets) and it holds domestic equities. (Incidentally, the $25 billion Vanguard 500 portfolio has a 0.20% expense ratio.) Of all the new index products, the U.S. CountryBasket has the lowest expense ratio at 0.69%.

Index funds are managed to minimize "tracking error," or the extent to which a fund's returns deviate from those of its benchmark. This means that the portfolio must be rebalanced from time to time to account for index additions and deletions and other factors. In general, index funds underperform their benchmarks slightly due to their expenses—the higher the expenses, the greater the differential.

Volume and Liquidity

Table 4 provides the average daily trading volumes in both series. The Japanese WEB, which has averaged 105,593 shares at this writing, has even had several days where it traded more than a million shares. Conversely, a number of others trade in low volume. Note that the volume figures for WEBS and CountryBaskets are not strictly comparable because the latter trade at prices that are generally two (or more) times higher than those of a corresponding WEB so lower volume would be expected, all else being equal.

Investors in any exchange-traded stock or fund need to be concerned about liquidity. A stock that's liquid to one individual can be illiquid to another. It essentially depends on the size of your order. A relatively large order to buy (or sell) a fund that trades, say, 5,000 shares or less per day can push the price up (or down). It's important to be volume conscious when placing orders of more than several hundred shares because of the potential for adverse price impacts. By placing a limit order to buy or sell at your price or better, you know in advance what price you will pay or receive if the order is filled. But if the fund is relatively illiquid, only a part (or none) of your order may be filled. If you really want a fund, you need to be patient as it could take

Table 3.
Assets and Expense Ratios of Exchange-Traded Single-Country Index Funds

WEBS (ASE)						CountryBaskets (NYSE)		
Nation	Net Assets* ($ mil.)	Expense Ratio** (%)	Nation	Net Assets* ($mil.)	Expense Ratio** (%)	Nation	Net Assets* ($ mil.)	Expense Ratio** (%)
Australia	12.2	0.87	Malaysia	5.6	0.89	Australia	12.3	0.79
Austria	13.6	0.87	Mexico	5.8	1.02	France	41.6	0.81
Belgium	1.8	0.87	Netherlands	11.6	0.87	Germany	21.3	0.78
Canada	13.8	0.84	Singapore	8.4	0.87	Hong Kong	29.3	1.06
France	22.9	0.87	Spain	4.2	0.87	Italy	32.0	0.83
Germany	28.5	0.87	Sweden	4.4	0.87	Japan	72.2	0.81
Hong Kong	7.8	0.89	Switzerland	6.1	0.87	South Africa	16.0	0.96
Italy	35.2	0.86	United Kingdom	15.7	0.84	United Kingdom	12.6	0.80
Japan	103.1	0.83				United States	16.0	0.69

** As of August 30, 1996*
***After fee waiver*
Source: WEBS and CountryBaskets prospectuses and telephone representatives.

awhile to complete your order.

The bid-asked spreads (the difference between the price at which you can buy shares and the price at which you can sell shares) may vary by country, but generally represent a smaller percentage of the bid price on more active funds. The actively traded Japanese WEB typically trades at a spread of $^{1}/_{16}$. The highly active S&P 500 SPDRs trade at spreads of $^{1}/_{16}$ or $^{1}/_{32}$, depending on market conditions. You can also check the "size" in the quote to determine how many shares are being bid for and offered. For example, if a portfolio is quoted "15 to $15^{1}/_{8}$, 20 by 35," you would know that 2,000 shares are being bid for at 15 and 3,500 are offered at $15^{1}/_{8}$. The size changes throughout the day; the greater the size, the higher the liquidity.

Comparing to Closed-End Funds

Noteworthy differences between the new products and closed-end single-country funds exist. WEBS and CountryBaskets have the following distinguishing features:

• ***No IPOs to inflict losses upon new investors.*** Closed-end funds are launched with an initial public offering, or IPO. Typically, the shares are offered at a premium of 7% or so to net asset value, but they often slip to a discount several months later, inflicting losses on purchasers who are often unaware of this risk. (This point may not be that significant now because the single-country closed-end fund market is highly populated and probably won't experience that much growth in numbers.) WEBS and CountryBaskets are created more as an open-end fund, which starts small and grows with demand as additional capital is invested in new creation units.

• ***No discounts and premiums.*** Closed-end country funds sometimes trade at outrageously high premiums of 30% or 40% to net asset value or markdowns as great as 20% or 25% from net asset value as investor sentiment shifts from greed to fear, or vice versa. However, the index funds' mechanism for in-kind investments and redemptions should prevent a discrepancy between price and net asset value of more than, say, 3%. Thus, their market prices should be less volatile than those of closed-end funds, other things being equal.

• ***Greater liquidity.*** In general, the index series are more liquid than closed-end funds of the same country. The latter experience fluctuating premiums and discounts because they don't provide a mechanism for continuous creation and redemption of shares. The liquidity of WEBS and CountryBaskets basically mirrors the liquidity of their respective markets.

• ***Each portfolio is passive.*** CountryBaskets and WEBS normally remain fully invested and don't try to time the market or hedge currency risk. This results in lower management costs, greatly reduced transaction expenses and greater tax efficiency.

• ***They are relatively tax efficient.*** Because they follow a buy-and-hold policy, the index products distribute little, if any, realized capital gains, on which taxes must be paid if the investment is held in your taxable account. There can be significant tax consequences when a closed-end fund makes a sizable capital gains distribution in a good year. Conversely, with most index products, a large portion of the capital gains are deferred until you sell your shares.

• ***No rights offerings.*** Because their structure prevents shareholders from contributing new money to the portfolio, many closed-end funds have resorted to rights offerings where existing shareholders pony up additional cash for new shares. However, rights offerings are often difficult for shareholders to understand and have generated criticism.

• ***Considerably less focus on emerging nations.*** Unlike closed-end funds, WEBS and CountryBaskets focus primarily on developed markets.

• ***Large companies predominate.*** Because the index products are capitalization-weighted, it follows that large companies comprise the lion's share of each portfolio. That's not necessarily true for single-country closed-end funds, which may choose to mix more smaller companies into their portfolios. In fact, Emerging Germany, New Germany, and Japan OTC Equity—all closed-end funds—focus primarily on smaller firms. Fidelity and Warburg Pincus offer open-end funds that target smaller Japanese companies.

Like closed-end funds, CountryBaskets and WEBS avoid the problem of ill-timed inflows and outflows of cash. Conventional open-end funds can be adversely affected by new investments

Table 4.
Average Daily Trading Volume of Single-Country Index Funds*

WEBS (ASE)				CountryBaskets (NYSE)	
Nation	Volume (Shares)	Nation	Volume (Shares)	Nation	Volume (Shares)
Australia	14,998	Malaysia	13,096	Australia	5,726
Austria	6,751	Mexico	12,799	France	5,633
Belgium	1,297	Netherlands	4,324	Germany	3,895
Canada	2,961	Singapore	12,015	Hong Kong	9,067
France	7,634	Spain	2,819	Italy	7,245
Germany	12,995	Sweden	3,621	Japan	10,963
Hong Kong	10,870	Switzerland	9,098	South Africa	3,725
Italy	33,509	United Kingdom	11,828	United Kingdom	2,884
Japan	105,593			United States	10,968

** From March inception through August 30, 1996.*
Source: American Stock Exchange and Deutsche Morgan Grenfell

or withdrawals at inopportune times. In a bear market, for instance, an open-end fund can get hammered by wholesale redemptions. That's the reason garden variety mutual funds rarely invest in illiquid developing markets.

The index products provide obvious competition for country funds. They can be traded at varying prices throughout the day, bought on margin and sold short by those so inclined. Like SPDRs, WEBS and CountryBaskets are both exempted from the "tick" rules of their respective exchanges, placing them among a relatively small number of exchange-traded securities for which short sales on a down-tick are permissible. (Because of the considerable risk, margin trading and short-selling are not recommended.) Dividends and net realized capital gains from the portfolio are distributed in U.S. dollars. Because they increase the pool of competing single-country products, the introduction of WEBS and CountryBaskets has already led to larger discounts (or smaller premiums) on certain closed-end funds. This offers new investors greater value.

Closed-end funds still have unique advantages, however. A good-performing single-country fund at a big markdown can offer special value, especially if that fund is run by a celebrity manager, such as emerging markets guru J. Mark Mobius. In addition, if the discount is compelling enough, it may still be attractive to bargain hunters who are speculatively inclined even though its manager is unknown. Finally, closed-end funds offer a potpourri of choices for those wishing exposure to emerging markets such as Argentina, India, Indonesia, Pakistan, Russia, Thailand, and Turkey.

Investment Considerations

With nearly 60% of the world's total stock market value outside the United States, there are plenty of opportunities for global investors. Exchange-traded index funds are an important new vehicle for individuals seeking more focused international diversification.

With their fluctuating prices, all exchange-traded funds have an advantage over conventional mutual funds, which only offer a single price for the day. In addition, you can place limit orders in an attempt to lock in your price. With prices often seesawing up and down, the ability to nail down a target price with a limit order is a major advantage both the index funds and closed-end funds have over regular mutual funds. For example, if a fund is trading at $10\frac{1}{8}$ bid to $10\frac{1}{4}$ asked, you could place a limit order to try to buy at $10\frac{1}{8}$, rather than accepting the offering price.

Like single-country closed- and open-end funds, the new index products can be dicey and must be used with care. They can be highly volatile and should only be used for a small part of your portfolio, if you use them at all. They are certainly safer than purchasing a closed-end fund at a premium that could evaporate or turn to a discount. Above all, avoid committing a large portion of your assets to a single country. It's important to diversify among countries and geographical regions. Single-country products have greatest appeal for those with large portfolios who want to fine-tune their country exposure.

Of course, a fund that just mimics an index is not for everyone. A skilled manager who knows the country well can take advantage of inefficiencies, minimizing or avoiding exposure to undesirable sectors or companies and overweighting areas where particularly good value exists. In fact, some promising companies might not even be included in the index. On the other hand, there is plenty of evidence indicating that most managers of actively managed funds underperform their market benchmarks. It's particularly hard to beat the market if a fund is saddled with high operating and transaction costs. Finally, the tax efficiency of index funds should be important to those using taxable accounts.

Concluding Comments

WEBS and CountryBaskets are worthwhile new products that should appeal mainly to more sophisticated international investors with fairly large portfolios. They are competing with closed-end funds focusing on the major and second-tier developed stock markets.

The index products appear to be working well, given their short history. I expect they will grow in assets with increased demand and large institutional buyers will force the creation of new units. This has certainly occurred with the Amex-traded S&P 500 SPDRs since their 1993 introduction. As the portfolios become larger, their shares will trade more actively and, consequently, they will offer investors greater liquidity. The Japanese WEB has already been quite successful in this regard.

For further information and literature, including a prospectus, call 1-800-810-WEBS(9327) for the WEBS hotline and 1-888-8CB-INFO(822-4636) to contact CountryBaskets. A statement of additional information can also be obtained if you are looking for even more details than the prospectus provides.

Information can also be obtained through a computer at the following Internet Web sites: http://www.websontheweb.com and http://www.countrybaskets.com.