

Analyzing exchange-traded funds

Examine expenses and performance before investing in these low-cost index portfolios.

It would be tempting to call exchange-traded funds the flavor of the month on Wall Street. But the portfolios, which look like index mutual funds and trade like stocks, should really be called the investment world's flavor of the decade.

In 2006 alone, the number of ETFs available in this country increased by 75 percent, and the assets held in them by more than 40 percent. At the end of December, there were nearly 360 ETFs with total assets of more than \$422 billion, and some experts see that growing to \$2 trillion by the end of 2010.

An ETF is a portfolio of securities, much like a mutual fund, that tracks a particular index. Unlike mutual funds, ETFs trade on stock exchanges. Because of its structure, an ETF usually has a lower annual cost of doing business than a comparable mutual fund. But since you must go through a broker to buy one, commissions on buying and selling ETFs can reduce or eliminate their cost advantage.

Should you jump on the ETF bandwagon? Possibly, if you're looking to build a low-cost, broadly diversified portfolio or if you're interested in taking a gamble on narrow, volatile portions of the market.

SLICING AND DICING

The first wave of ETFs replicated broad market benchmarks like the Standard & Poor's 500 Index and the MSCI EAFE (Europe, Australasia, and Far East) Index. But as the industry grew, so did the menu of offerings. Many of the newer ETFs are based on indexes that didn't even exist a few years ago. And instead of a broad section of the investment world, they follow a narrow slice, like individual commodities or foreign currencies. And some find even smaller niches. For example, the recently launched PowerShares Buyback Achievers Portfolio (PKW) tracks companies that buy back their shares, and



the Claymore/Ocean Tomo Patent ETF (OTP) buys stocks of companies based on the value of the patents they hold.

"It's important to just take a step back and look at all these new and innovative products," says Dan Culloton, editor of Morningstar ETF 150, an annual guide published by the Chicago-based research firm. Culloton suggests that investors ask themselves if they really need an ETF that focuses on nanotechnology or on a single country's stocks. Although he advises people not to dismiss specialty ETFs out of hand, "a certain amount of healthy skepticism is warranted."

Some financial advisers prefer using actively managed funds to indexing when investing in certain market sectors. Louis Kokernak, of Haven Financial Advisors in Austin, Texas, says that if he wants to give a client's portfolio a style bias, for example, a value bias on the international front, he'll use mutual funds. He uses an actively managed mutual fund to target foreign small-cap value stocks.

Broad-based indexes are weighted for capitalization, so that stocks with a greater market value count for more. ETF sponsors are now developing portfolios based on "custom" indexes, which can be weighted by fundamental factors. For example, the WisdomTree Total Dividend fund (DTD) tracks that company's Dividend Index, which was launched in June 2006 and includes 1,472 dividend-paying U.S. stocks weighted by proportionate share of the aggregate cash dividends each component

company is projected to pay in the coming year. In other words, stocks that pay more have greater weighting in the index.

Sponsors of the custom-index ETFs say they should perform better than traditional indexes, but these new products haven't been

around long enough to have a track record, and expenses for those ETFs are generally higher. Also, specialty ETFs often have more difficulty closely following their underlying benchmarks, what investment pros call "tracking error."

PERFORMANCE ISSUES

According to a recent study by Morgan Stanley, the average ETF based on a U.S. major-market index underperformed its benchmark by 29 basis points in 2006, while those following U.S. industries or sectors trailed by an average of 61 basis points. ETFs based on custom indexes typically lagged by 85 points. (One hundred basis points equal 1 percentage point.)

The cost of operating the ETF, changes in the underlying index, and even federal regulations can cause tracking error. The Investment Company Act of 1940 requires a diversified fund to have no more than 25 percent of its assets in a single security. So the iShares Dow Jones U.S. Telecommunications Sector Index Fund (IYZ) has 24.0 percent of its assets in AT&T, while that single stock accounts for 46.8 percent of the underlying index. Last year, AT&T stock soared, but because of limitations imposed by the regulation, IYZ trailed its benchmark by almost 450 basis points.

Of course, ETFs that emulate a narrow slice of the market are often more volatile than those following a broad index. From 1999 through 2006, the S&P 500's best calendar-year total return was 28.7 percent in 2003; its worst was in 2002, with a

decline of 22.1 percent. In contrast, the best calendar year for the Technology Select Sector SPDR Fund (XLK), an ETF that tracks the 18.65 percent of the S&P 500 index in the tech sector, was 1999, when it gained 66.01 percent; its worst was 2000, when it plunged 42.2 percent. But heightened volatility is not unique to ETFs; it also can be a problem in mutual funds that follow a small piece of the market.

BUILDING AN INDEX PORTFOLIO

If you want to put together a diversified portfolio using indexes, Morningstar's Culloton suggests that you own core positions in broad benchmarks covering U.S. stocks, foreign stocks, and fixed-income securities. The exact percentage you should hold in each category depends on your risk tolerance and the time horizon of your investments. You can find asset-allocation calculators at many fund-company Web sites to help you determine the ideal mix for your portfolio.

Keep in mind that many market indexes overlap. All 30 stocks in the Dow Jones Industrial Average are also in the S&P 500. In turn, the 500 stocks in the S&P Index are represented in the Dow Jones Total Market Index and in the MSCI U.S. Broad Market Index. In general, you want your core holdings to be as broadly based as possible to give you exposure to all segments of the market.

With broad-based index investments available as both traditional no-load

mutual funds and as ETFs, how should you pick the proper "wrapper" for your core positions? The answer comes down to which form has the lowest total cost for the way you invest. Broad-based ETFs generally have low expense ratios, though some traditional index mutual funds can be just as cheap to hold. For example, Morningstar data show that the iShares S&P 500 ETF (IVV) has an expense ratio of 0.10 percent, while the E-Trade S&P 500 Index (ETSPX) and Fidelity Spartan 500 Index Investor (FSMKX), which are both traditional index mutual funds, have annual expenses of 0.09 percent and 0.10 percent, respectively.

Ongoing expenses are only part of the story. There's also the cost of commissions, which can add up quickly even if you use a discount broker. The costs generally make ETFs unsuitable if you buy the same dollar amount of an investment each month or quarter, or if you plan to cash out part of your portfolio periodically during retirement. In those cases, you're better off in no-load index mutual funds.

On the other hand, if you're an active stock trader and you use a low-cost online broker, you might prefer ETFs to mutual funds since you'd be able to take advantage of sophisticated trading techniques, like issuing stop-loss orders that instruct your broker to sell shares automatically when prices fall to a predetermined level. And ETFs tend to be more tax-efficient than mutual funds, so they can be an appropriate

choice for investments outside of a tax-deferred retirement plan.

ETF STRATEGIES

Here are some ways you can use ETFs in your portfolio of stocks or mutual funds:

Invest in undervalued industries or sectors. Let's say you think that energy stocks, down from their peak last year, will soar in the future. You can establish a position in an ETF that tracks that part of the stock market to increase your exposure to the energy sector above and beyond what you already hold through a broad index.

Give your index portfolio a style preference. If you own the common index funds, you're invested in a blend of value and growth stocks. In general, value stocks are those considered undervalued, while growth stocks are companies with earnings that are growing faster than average. An ETF can help you accentuate which of the two styles you favor.

Take a tax loss on a stock and still hold a position in the sector. Assume that you own shares of Advanced Micro Devices (AMD), a computer chip maker whose stock has dropped. You could sell the shares to create a tax loss, but the IRS "wash sale" rules prohibit you from taking that loss if you acquire "substantially identical" securities within 30 days before or after the sale. But you can take your tax loss, keep a tech investment, and not run afoul of the IRS by buying an ETF that tracks a domestic, large-cap tech index.

Invest in a sector where the best-managed funds are closed to new investors. Sometimes a top-notch fund in a given asset class or market sector stops taking in new money because the sponsor decides that the portfolio has become too big to pick stocks efficiently. An ETF that follows the asset class or sector doesn't have that problem, since the portfolio simply tries to replicate the index. ETFs give you the opportunity to invest where you want when managed funds are not available.

If you do use ETFs in your portfolio, be sure to watch your total costs, and pay attention to index overlap. You can find more information on ETF expenses and major holdings at Morningstar.com and at ETFConnect.com. \$

Free isn't always free

Some brokers are now offering free online trading, which can make ETFs cheaper to buy and sell. But watch out for attached strings.

► Zecco.com will let you make up to 10 trades a day (up to 40 per month) without commission, but if you have more than one account you can only get the freebies on one. IRAs are charged a \$30 annual fee.

► Bank of America's brokerage will let you have up to 30 commission-free trades a month, but you have to keep \$25,000 in deposit accounts with the bank to qualify.

► Wells Fargo offers 100 free trades a year, but you have to sign up for the bank's PMA Package, which includes a checking account. In addition, you must have a total of \$25,000 in all Wells Fargo accounts, including brokerage accounts, to avoid trading commissions. Credit-card and other loan balances count toward that minimum, making this a costly option for some people. The PMA Package has a \$25 monthly fee if your balance falls below \$25,000.

In each case, if you make more trades than are allowed under the rules of the account, commission fees apply.