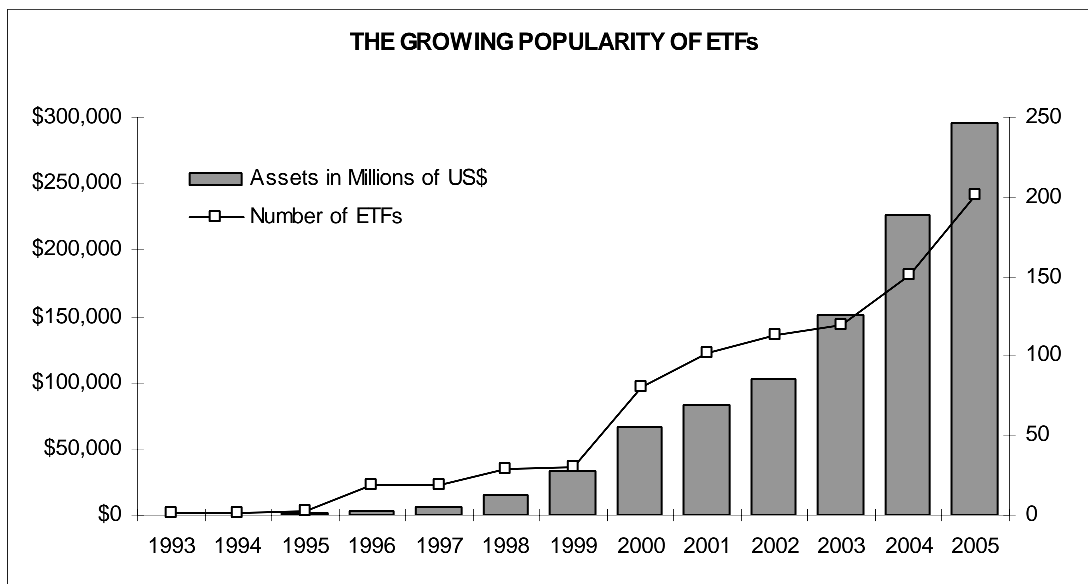
Tools of the Trade: A Look at Exchange Traded Funds

By Claire Fletcher

If a workman is only as good as his tools, then every smart investor should be using the coolest trading tool in the box: Exchange Traded Funds (ETFs). Managing a portfolio of exchange traded funds is a great way to build a diversified portfolio with exposure to equities around the globe. In this article we define ETFs, highlight their advantages, and discuss how they can be used to add diversification to an investment portfolio.

ETFs are a type of financial instrument whose unique characteristics have caught the eye of many an investor, helping ETFs explode in popularity and emerge as one of the most multi-purpose investment vehicles available. The graph shows the rapid growth in ETF assets and the number of available ETFs since their inception in 1993.



Source: ICI and Strategic Insight, 2005

Think of an Exchange Traded Fund as a mutual fund that trades like a stock. Just like an index fund, an ETF represents a basket of stocks that reflect an index such as the S&P 500. An ETF, however, isn't a traditional mutual fund; it trades just like any other company on a stock exchange.

Because ETFs are traded on stock exchanges, they can be bought and sold at any time during the day for the same commission that you'd pay on any regular trade. Unlike a mutual fund that has its net asset value (NAV) calculated at the end of each trading day, investors can adjust ETF positions at intraday market prices, without redemption fees or short-term restrictions.

These baskets of securities can minimize the hazards associated with owning individual equities since each ETF inherently provides diversification across an entire index. ETFs cover virtually every segment of the equity markets, several segments of the U.S. bond market and a growing number of commodities, providing an easy and convenient way to adjust the investment mix of a core portfolio.

As an additional benefit to individual investors, there are no sales loads or investment minimums required to purchase an ETF. Since ETFs have the same holdings as those you would find in an

index, they tend to have significantly lower expense ratios than actively managed funds. Expense ratio is the percent of assets consumed by fees annually.

For example, Barclays Global Investors (IVV) and State Street Global Advisors (SPY) offer ETFs tracking the S&P 500 with expense ratios of 9 and 12 basis points, respectively, compared with 18 for the industry-leading Vanguard Index 500 fund (VFINX). You also bear lower administrative fees because most ETFs are bought and sold on secondary markets.

The expenses associated with traditional mutual funds can have a significant impact on returns for investors. Each basis point improvement in performance or reduction in expenses can save the average investor hundreds of dollars over time.

Moreover, historical results demonstrate that buying the major market benchmark index will actually outperform the majority of active mutual fund managers. By owning ETFs, investors have the transparency, immediacy and flexibility to employ their own trading strategies and enhance total returns while maintaining an adequate level of diversification.

For example, if you believe that prospects are good for oil & gas companies, you can purchase an ETF representing the energy sector without having to determine which individuals stocks are likely to be that group's winners and losers. Bad news can easily sink a stock but the sector ETF gives you more stability by spreading out risk. This strategy is referred to as sector investing.

Sector investing is about the potential to profit from being in the right place at the right time. That often means overweighting a portfolio towards a "hot" sector or actively rotating assets among sectors. While these kinds of sector strategies may enhance returns, sector funds can also help to reduce volatility by adding a layer of diversification as sectors and industries may not move in tandem with the broad market or even other sectors.

Risk-averse investors are advised to choose at least six sectors and to ensure that they are not heavily correlated. Including too many sectors may simply mean replicating broad market exposure. Correlation between sectors is important, because picking just a few sectors that move in sync with one another will deliver either very good or very bad results.

For instance, historically, the energy sector has had a low correlation with the technology sector. While the technology sector is inherently risky and not for the faint-hearted, investors can help smooth out technology fund returns by adding an energy ETF to the portfolio e.g. Energy Sector SPDR (XLE) to provide a hedge against a tech market decline.

Most of the same-sector ETFs have a high correlation so investors should avoid being overweight by selecting only one fund from each sector based on factors such as expenses, liquidity and performance. Try to avoid ETFs that have very high weightings since being overly concentrated in just a handful of stocks weakens their diversification advantage.

Diversifying beyond the traditional asset classes of stocks and bonds is another way to dampen a portfolio's risk. ETFs can be solid building blocks in an asset allocation program because they provide broad exposure to market segments. Asset allocation strategies consider investor goals, time horizons and risk tolerances in the construction of suitable portfolios.

If you wanted more protection from inflation, for example, you could add an ETF that invests in natural-resources stocks e.g. iShares Goldman Sachs Natural Resources Index (IGE) or in Treasury Inflation-Protected Securities, government bonds whose payments rise with inflation e.g. iShares Lehman TIPS Bond (TIP).

You can also gain an extra measure of protection by buying ETFs that specialize in areas that may be quite volatile on their own but that can actually dampen a portfolio's swings because of

their negative correlation to the broad market e.g. iShares COMEX Gold Trust (IAU) and iShares MSCI Emerging Markets Index (EEM).

The combination of instant diversification, low cost and the flexibility that ETFs offer makes these instruments one of the most useful innovations and attractive pieces of financial engineering to date. Through a single, cost-effective transaction, you can obtain diversified equity exposure that tracks the performance of a specific index, industry, geographic region or investment style.

Investors have used actively managed sector funds for many years to target market segments but expenses for such specialty funds have tended to be high. The low cost of ETFs is part of what makes these newer funds so appealing to institutional and individual investors alike. The ready availability of ETFs covering domestic and international equities, fixed-income, real estate and commodities now makes an all-ETF portfolio a real possibility.

Remember. ETFs decrease the company risk associated with buying individual stocks, but sector fund investing can still be highly volatile because the funds focus on a single industry. This volatility should be reduced by using a combination of low-correlating ETFs and rebalancing your portfolio at least annually.

The best ETFs strategy for small, beginning, busy investors is to buy a broad-based fund such as the S&P 500 Index (SPY) and hang onto it forever. Buy and hold is boring, but it's effective in the long run.

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