Title:
ETFs Unplugged

Word Count:
848

Summary:
Is your financial advisor missing a critical piece to the ETF?

Exchange-traded funds (ETFs) are great investment tools but most have a flaw that investors and advisors usually miss. Let’s take a look under the hood and introduce some new and innovative ETF products.

Essentially, ETFs are nothing more than an index fund that trades like a stock. Because of their simplicity, flexibility, low cost and tax efficiency they are growing fast. Last year the Barclays iShares fa...

Keywords:
etf, ishares, investment newsletter, investor newsletter

Article Body:
Is your financial advisor missing a critical piece to the ETF?

Exchange-traded funds (ETFs) are great investment tools but most have a flaw that investors and advisors usually miss. Let’s take a look under the hood and introduce some new and innovative ETF products.

Essentially, ETFs are nothing more than an index fund that trades like a stock. Because of their simplicity, flexibility, low cost and tax efficiency they are growing fast. Last year the Barclays iShares family of ETFs brought in more new money than the Fidelity mutual fund machine.

Diversification

Unfortunately, many investors and advisors are building portfolios of ETFs without looking inside the box and seeing where the money is going. One of the chief goals of a portfolio is diversification and many ETFs are not very diversified. This is because the companies in the ETF are weighted by size – specifically by the market value of its outstanding stock. This can result in an unwise concentration of risk and uneven performance.

The index fund community’s preoccupation with market cap weighting may have a strong theoretical basis but to me it is contrary to common sense. To be blunt, I pay very little attention to it while building global portfolios for clients.

Most investors would agree that just because a company is bigger doesn’t mean that it is a better investment. Let’s look at the most well known index – the S&P 500 index. Many investors think that investing in the S&P 500 means that their money is being divided equally between 500 companies. This is far from the truth. Because the companies are weighted by size, 22% of your investment is going to the ten largest companies in the index and 60% of your investment is going to the largest 50 companies in the index.

Unequal Weighting, Unequal Returns

This is why I have been advising clients to invest in the Rydex S&P 500 equal-weight ETF (RSP) which weights each company in the index equally. In 2003 the equal weight S&P 500 ETF beat the S&P index by 11%, in 2004 it beat the index by 5% and year-to-date it is up slightly while the S&P index is down.

In my book, “The New Global Advisor”, I ask readers a provocative question. If you wanted exposure to the dynamic biotechnology industry, would you prefer to primarily invest in a few large well know biotech companies or would you prefer to spread your investment over thirty biotech companies? If you’re the former, you might invest in the iShares Nasdaq Biotechnology ETF (IBB) whereby 25% of your investment would go to three companies. For those that prefer broader exposure including some small cap companies, I have discovered a new family of ETFs called Powershares.

The new and innovative Powershares family of ETFs essentially creates its own indexes based on rules-based quantitative analysis that they refer to as “intelligent indexes.” This seems to me to be more useful than blindly following market cap weighted indexes. There are two Powershares that I particularly like at this point.

Two I Like

The first is the biotech Powershare (PBE) that contains 30 biotech companies. If its holdings were weighted by market cap, two companies would account for more than 60% of its holdings. Instead your exposure is spread among 30 different companies with no company accounting for more than 5% of the total. 30% of your exposure is to large cap companies, 26% is to mid-cap companies and 43% is to small cap companies.

The biotech Powershare is an aggressive position so don’t get carried away. I think it is a smart play on the tremendous opportunities for capital appreciation in the biotech industry which is showing some momentum after trading sideways since early 2004. The annual fee is only 0.60%.

The other Powershare that I like is the International Dividend Achievers Powershare (PID) that contains 42 ADRs traded on U.S. exchanges. I am usually not a big fan of ADRs since they usually trade at a premium to the underlying security but they do offer some comfort to investors since they meet U.S. reporting requirements and can be easily purchased on U.S. exchanges. The ADRs in this Powershare have to pass a stiff test: five fiscal years in a row of increased dividends. Again the top holdings are no more than 5% of the total index and so you get great diversification.

A Better Way to Get Global Diversification

One problem with the most widely used international index, the MSCI Europe, Asia & Far East Index (EAFE) is its concentration in Japan and the United Kingdom which account for almost 50% of the index’s total value. Meanwhile exposure to promising countries such as Ireland and Hong Kong are less than 2%. Last year, this Powershares index beat the MSCI EAFE index by 7% and companies in the ETF averaged a 29% return on equity. The index is re-balanced quarterly and has an annual fee of 0.50%. Right now 67% of the companies in the index are large cap, 20% are mid-cap and 13% are small cap companies.

Getting the right blend of ETFs takes some time and effort. Remember that all ETFs are not equal so choose carefully.