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Investing in Funds: A Monthly Analysis

The All-ETF Portfolio: Pros Reveal the Ins and Outs

BY ROB WHERRY

The trophy sitting atop the fireplace mantel in Ted Feight's office is a constant reminder of the weekend his money-management business changed for good.

It was a Friday afternoon in September 2001, and Mr. Feight was looking for a discreet way to exit a gathering of financial planners at Shanty Creek, a resort area in northern Michigan. He was due to participate in a weight-lifting competition seven hours south in Cleveland. Before leaving, though, he took in one last presentation -- on exchange-traded funds -- and became intrigued. He made a note to follow up and dashed out. The next morning the then-54-year-old bench-pressed 250 pounds to win the 148-pound category for his age group.

While ETFs -- which resemble index-tracking mutual funds, but trade on exchanges throughout the day like stocks -- weren't doing any heavy lifting in the investment world at the time, financial advisers like Mr. Feight were growing more receptive to new ideas. In 2002, with a bear market grinding into its third year, Mr. Feight moved most of his clients' money out of mutual funds and into cash and took a closer look at the products that had piqued his interest a year earlier. In early 2003, he put the cash back into the stock market -- via ETFs.

Today, 95% of the \$20 million or so he manages is in these products, in an increasingly sophisticated lineup that encompasses every investing size and style. "That one presentation became the basis for my current investing philosophy," says Mr. Feight, who runs Creative Financial Design in Lansing, Mich.

Welcome to the era of the all-ETF portfolio, championed by legions of advisers like Mr. Feight. The proliferation of ETFs -- there are now more than

500 -- has made it possible to create a well-diversified portfolio entirely out of these products, say financial professionals such as Michael Jones, chief investment officer at Wachovia Corp.'s Wachovia Securities unit. "We hadn't reached critical mass five years ago," he says.

While ETFs' exploding popularity with do-it-yourself investors has been publicized over the past year, less highlighted has been their popularity among financial planners. With concern growing in some quarters that inexperienced investors can get burned investing in niche ETFs, we polled prominent advisers across the country about their ETF portfolios. What we got in return was a wide array of models, from blended strategies that still use some traditional mutual funds to portfolios that take on more risk by using country-specific ETFs or sector funds.

But first, what is it about these investment vehicles that financial advisers find so appealing?

ETFs aren't immune to the whims of the stock market, but financial advisers say the products can help stem bleeding during down times and juice returns during market rebounds.

In addition to having low costs and tax advantages, ETFs are based on published indexes available in real time, while mutual funds are required to disclose their holdings only four times a year. Advisers know exactly what they are getting with ETFs, so they can use them to precisely flesh out clients' asset-allocation plans. And with so many narrow ETFs now available, they can plug small holes as needed instead of picking a few stocks here and there.

In addition, ETFs help advisers get in and out of aggressive positions. ETFs have no investment minimums and no penalties for brief holding periods, aside from brokers' fees. Advisers can place stop-loss orders, instructing a broker to

sell when an ETF reaches a certain price. And they can make bearish bets, selling borrowed ETF shares in the hopes of replacing them later with shares purchased at a lower price.

Not every ETF investor should follow the leads of the experts we polled, especially if they are saving through 401(k) retirement plans. To build portfolios with minimal transaction costs, investors must buy in large chunks, not piecemeal; it is difficult to invest in small, regular increments without incurring trading fees that can add up. That said, these concepts could pay off for some investors.

State Street Global Advisors' Standard & Poor's Depositary Receipts, or SPDR (pronounced Spider), was the first ETF on the market in 1993 and has been giving investors broad market exposure to 500 of the nation's largest companies ever since. Its international counterpart is Barclays' iShares MSCI EAFE, which invests in 829 companies throughout Europe, Australia and the Far East.

These two funds sit at the center of most ETF-based portfolios, around which many advisers add other ETFs or mutual funds.

As the ETF industry has matured, the SPDR-iShares MSCI EAFE duo has drawn more competition. Rydex S&P Equal Weight ETF assigns the same weighting to every stock in its portfolio, as opposed to the market-value method used by the SPDR. This difference, which helps limit the effect of overvalued stocks, has helped the Rydex product outperform the traditional S&P 500 index by about 2.3 percentage points annually over the past three years through July 31.

Another up-and-comer with financial advisers: PowerShares FTSE RAFI US 1000. It weights companies based on revenue, cash flow and book value,

among other things. It was ahead of the S&P 500 index by 1.6 percentage points from its December 2005 launch through July 31.

Matthew Murphy, president of Murphy Capital Advisors in Buckeye, Ariz., mixes in iShares Dow Jones Select Dividend. This ETF tracks 116 large-capitalization, dividend-paying stocks.

Other financial planners switch between iShares growth- and value-focused ETFs, depending on the forecast for these investment styles, as an additional core holding. Growth stocks are the opposite of diamond-in-the-rough value stocks; they are relatively expensive shares of companies with rapidly expanding earnings.

Still, the SPDR and iShares MSCI EAFE have a firm hold on their perch. In many of the portfolios offered up by our experts, these funds accounted for 60% of the holdings. The SPDR costs 0.09% of assets a year (or \$9 per \$10,000 invested) and the iShares MSCI EAFE 0.35% (\$35 per \$10,000).

XTF Global Asset Management LLC, a seven-year-old New York firm born out of the ETF boom, has researched almost all ETFs and offers ratings free on its Web site.

Its conclusion: An average 40-year-old in an ETF portfolio based on a target retirement date can get away with four core funds: the SPDR, the iShares MSCI EAFE, and -- for exposure to smaller companies -- iShares Russell 2000 and Vanguard Mid Cap ETFs. It suggests devoting about 33% and 28% of assets to the first two, respectively, with a 19% position in the Russell 2000 and a 20% one in the midcap ETF.

Its "aggressive" portfolio adds in a small position in Vanguard REIT Index, along with a tiny fixed-income exposure.

If a client wants a growth portfolio, Dean Harman, a financial planner in The Woodlands, Texas, may follow a model designed by New Frontier Advisors LLC of Boston that is recalibrated every quarter. It favors ETFs from Vanguard Group Inc. focused on, among other things, small and large U.S. stocks, European and Asian economies and emerging markets.

Earlier this year, just over a quarter of the portfolio was in the Vanguard European ETF, with additional international exposure coming from Vanguard Pacific ETF (9%) and Vanguard Emerging Markets ETF (8%), an index of 866 stocks from Brazil, India, Mexico and other countries.

An additional 45% of assets was split between Vanguard's U.S. growth- and

value-oriented offerings, in both large-company stock ETFs and small ones. Sprinkled over these positions was a 5% stake in bond ETFs, along with a 4% position in State Street's DJ Wilshire REIT ETF. The rest was in cash.

A growth portfolio from McGraw-Hill Cos.' Standard & Poor's unit, meanwhile, has 40% of its assets in the SPDR, 18% in the Rydex Equal Weight ETF, and 17% in iShares ETFs from Barclays focused on small and midsize stocks. This model has almost 19% of its assets in bonds and cash. A 6% international exposure comes from the iShares S&P Global 100.

Wachovia got into the ETF game five years ago with portfolios that combined ETFs with individual shares, a strategy still favored by many financial pros. It launched a family of all-ETF portfolios in 2005, which reached \$1 billion in assets more quickly than any other investing product launched by the company.

Over the past two years, the core has moved between the SPDR, an equal-weighted ETF, the MSCI EAFE and the FTSE RAFI. The portfolio has exposure to growth and value stocks, midsize and small stocks, and various sectors and countries through products from every major ETF family.

Wachovia's ETF portfolios are playing two sector themes currently: overweighting oil drillers and service companies versus energy conglomerates, and semiconductors and Internet providers versus hardware and software makers.

ETFs might give up the juicy returns a few hot stocks would provide, but advisers like the added security of not having to pick between Microsoft Corp. or Oracle Corp. "We may be trading a little upside," Mr. Jones says, "but we have lower risk."

ETFs also solve a problem advisers face when buying international stocks. Foreign stocks traded on U.S. exchanges tend to be "megacap companies highly correlated to the U.S. market," Mr. Jones says. International ETFs have a broader reach. "We can get whatever country allocation we want."

John Schloegel, a vice president of Capital Cities Asset Management, in Austin, Texas, is constantly honing his lineup with more aggressive offerings. While the core includes the SPDR and iShares MSCI EAFE, he has juiced his clients' portfolios with Powershares' Golden Dragon Halter USX China Portfolio, iShares MSCI Mexico and WisdomTree Europe SmallCap Dividend ETFs.

Earlier this year, he also was putting money into commodity ETFs and one from WisdomTree Investments that invests in Asian countries other than Japan.

As for Mr. Feight, some of his portfolios include country-specific ETFs like those focused on Austria, Belgium, Germany, Spain and Italy, along with emerging-market plays in Mexico, China and Brazil.

Mr. Feight thinks the rise of ETFs spells bad news for expensive, poorly performing mutual funds. "If I was a bad manager," he says, "I would be quaking in my boots."

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