

# Exchange Traded Funds

*What they are, why they're different, and how you can use them to enhance your investing.*

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## Exchange Traded Funds (ETFs)

- ❑ What is an ETF?
- ❑ How do they differ from mutual funds? Stocks?
- ❑ Classifications of ETFs
- ❑ Comparing similar ETFs – Criteria
- ❑ Creating an ETF Portfolio
- ❑ Q&A



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## What is an ETF?

- ❑ A fund that can be bought or sold on an exchange like a stock
- ❑ Typically passive, tracks an index
  - ❑ e.g., NASDAQ, S&P 500, EAFE
- ❑ Like a mutual fund, but with some distinct differences (mostly advantageous)
- ❑ Available in a broad range of categories



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## ETFs: Comparisons

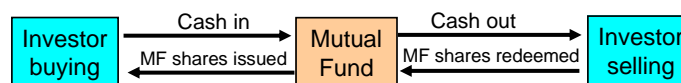
Attribute	ETFs	Mutual funds	Closed-end funds	Stocks
Intraday liquidity	X		X	X
Portfolio transparency	X			X
Diversification	X	X	X	
Fully invested (no cash)	X			X
Buy on margin, short, options	X		X	X
Actively managed	A few	Most (non-index funds)	X	



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## ETFs vs. Mutual Funds: Buy/Sell Mechanism

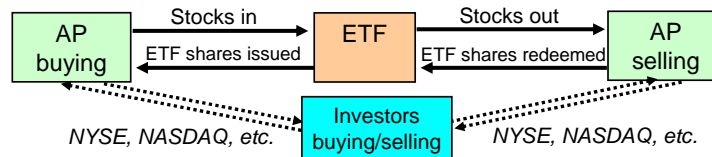
Mutual Funds: Investors Directly Buy and Sell Shares



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## ETFs vs. Mutual Funds: Buy/Sell Mechanism

### ETFs: Authorized Participants (APs) Buy and Sell Share Blocks



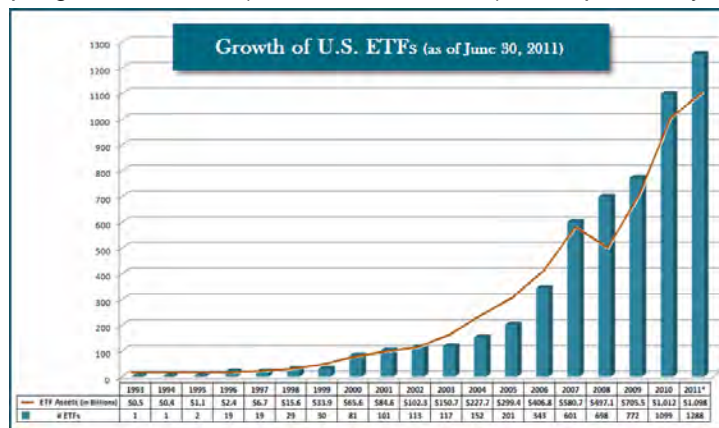
- **Mutual Fund (open ended)** – Shares bought/sold at NAV after market close
- **ETFs** – Shares bought at Bid price, sold at Ask price during market hours
  - AP arbitrage mechanism generally keeps Bid/Ask price spread narrow
  - In-kind redemption process between AP and ETF **triggers no capital gains**
    - Structure is what creates tax efficiency



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## Growth of ETFs

- First ETF in 1993 (SPY = S&P 500 index ETF)
- Rapid growth of ETFs (\$\$ assets, # of funds) in the past five years



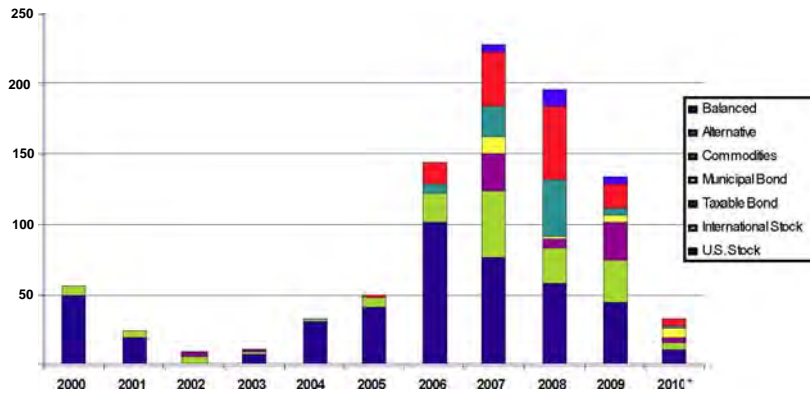
Source: alleft.com



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## New ETF Launches – by Asset Class

New ETFs by Asset Class (through February, 2010)



Source: Morningstar



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## ... and Some Closures



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## Current ETF statistics

- US: 1392 ETFs (24% increase in 1 year)
  - 45 fund sponsors (top 3 have 82% market share)
  - 77 different index providers
  - \$1.151 trillion in total assets (about 1/10<sup>th</sup> of mutual fund assets)
- Breakdown by type:
  - 942 Equity (68%)
  - 188 Fixed Income (14%)
  - 258 Inverse/Leveraged (19%)
  - 134 Commodity (10%)
  - 37 Currency (3%)
  - 34 Real Estate (2.5%)
  - 49 Multi-Asset (3.5%)

(Note: Total >100% because of some overlap between types)

Source: xtf.com (data as of 1-27-2012)



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## ETF Universe: Many Options

HoJo's ETF Emporium: Hundreds of Flavors!



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## Ways to Segment ETFs

- By asset class:
  - Equity
  - Fixed income (bonds)
  - Commodities (physical, futures)
  - Currency
  - Real estate
  - MLPs
  - Volatility (VIX)
- By component weighting:
  - Market cap (e.g., S&P 500)
  - Fundamental weighting (e.g., dividend yield)
  - Equal weighting (e.g., Rydex ETFs)
  - Custom



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## Ways to Segment ETFs (cont'd)

- By indexing approach used:
  - Passive (Russell 2000, Barclay fixed income, etc.)
  - Screened (e.g., growth, value, dividends)
  - Quantitative (e.g., RAFI, AlphaDEX, proprietary)
- By Short or Leveraged:
  - Inverse/short funds (betting against an index decline)
  - Leveraged bull/bear (2x or 3x magnitude of underlying index, either long or short)



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## Segmenting ETFs (cont'd)

- By structure:
  - ETFs (hold assets) vs. ETNs (hold notes)
    - Assets can be stocks, bonds, currencies, debt obligations, or physical assets (e.g., gold)
    - ETNs don't directly hold assets; third party does that
  - Corporate structure:
    - Open-end funds (majority of ETFs)
    - Unit investment trusts
    - Grantor trusts (physical commodities)
    - Senior, unsecured, unsubordinated debt (ETNs)



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## Segmenting ETFs (cont'd)

- By geography
  - US, international (ex-US), regions, single countries
- By industry sectors
  - e.g., telecom, utilities, health care, consumer goods
- For commodities:
  - Single (e.g., cotton, copper, silver)
  - "Basket" - Commodity indices
- By combinations of the above
  - e.g., Japan small-cap, non-US sovereign debt



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## ETF Advantages Over Mutual Funds

- ❑ Lower management fees\*
- ❑ Transparency (daily vs. delayed semi-annual)
- ❑ Tax efficiency (can control gain/loss timing)
  - ❑ No capital gains triggered by ETF redemptions
- ❑ Low minimum purchase price (1 share)
- ❑ Liquidity (intraday trading)

\* Generally true, but varies with ETF



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## Why Fees Are Important

*“If there’s anything in the whole world of mutual funds that you can take to the bank, it’s that expense ratios help you make a better decision. **In every single time period and data point tested, low-cost funds beat high-cost funds.**”*

- Russell Kinnel, Author of Morningstar study comparing the predictive abilities of star ratings and expense ratios (August, 2010)



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## A Comparison of Funds: Fees vs. Return

### Same index, Different returns

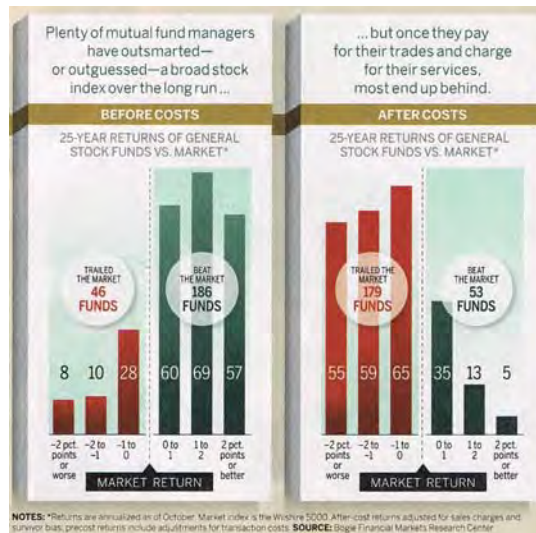
	Symbol	Expense Ratio	Cumulative 5-year Return*
iShares S&P 500 Index Trust ETF	IVV	0.09%	11.5%
Vanguard 500 Index Fund	VFINX	0.18%	11.2%
Dreyfus S&P 500 Index Fund	PEOPX	0.51%	9.3%

\* as of 1-31-2011 (Source: Fidelity Investments)



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## Why Fees Are Important

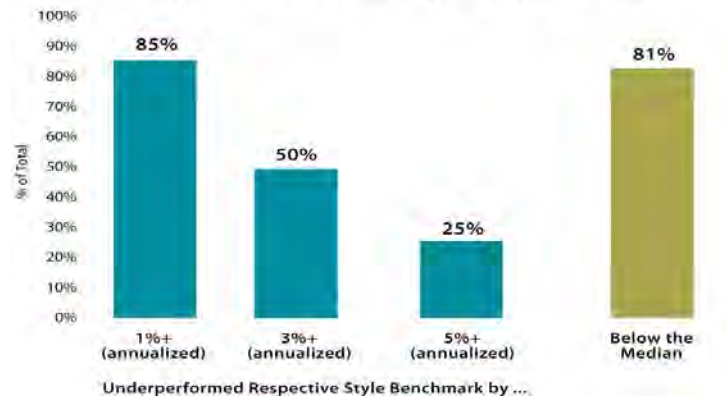


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## Active vs. Passive Funds

### Higher Fees ≠ Guaranteed Better Performance

Percent of high-performing mutual funds that underperformed their style benchmark over any three-year period



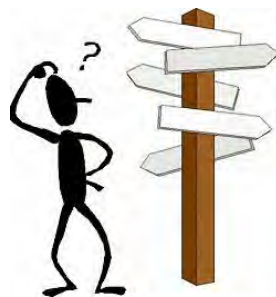
Source: aaii.com, Morningstar



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## Potential Drawbacks of ETFs

- Fees are not always low
- Not all ETFs track their indices well
  - Particularly true for commodity ETNs
- TOO MANY CHOICES!



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## Evaluating ETFs

- Q: How to best compare ETFs?
- A: Look at the key ETF parameters



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## Key ETF Parameters

- **Expense ratio**
- **Weighting scheme (market cap, equal, fundamental)**
- **Dividend yield (%)**
- Efficiency: How well ETF performs vs. its index
- **Base index (including # of securities in ETF)**
  - Tracking error (vs. index)
  - Concentration risk
  - Actual securities held (and % of each)



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## Key ETF Parameters (cont'd)

- Size of fund (\$M), daily trading volume
  - Market impact
  - Bid/Ask ratio
- **Legal structure** (open end, UIT, Grantor trust)
- Premium/discount to NAV
- For bond ETFs:
  - Duration (# years)
  - Credit profile of bonds



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## Where to Find ETF Parameters (xtf.com)

**VWO Vanguard Emerging Markets** (Exchange Traded Fund)

**XTF Rating: 4.9/5**

Price: \$45.54 ↑ 0.11 (0.24%)

Assets: \$42,189,991,651

% of shares traded daily =  $(\$45 \times 16.9M) / \$42,190M = 1.8\%$

Similar ETFs to VWO: EEM, IEMK, XEEM, ADEM, EEM

**Structural Integrity** (ranked in the 90th percentile)

Measure	Value	Rank (%)
Expense Ratio	0.27%	82.20%
Average Bid/Ask Ratio	0.02%	95.80%
Tracking Error	0.75%	37.60%
Concentration Risk	7.17%	67.50%
Market Impact	0.07%	88.40%
Efficiency	1.18 bps	68.90%
Cap Gains Dist	0.00%	100.00%

**Other Parameters:**

- Inception Date: 3/19/2005
- Primary Exchange: NYSE Arca
- Issuer: Vanguard
- Index Provider: MSCI Data
- Expense Ratio: 0.27%
- Geography: Emerging Markets
- Investment Philosophy: Capital Index
- Underlying Index: MSCI Emerging Markets Index
- Index Composition: Cap-Weighted
- Index type (selection method): Capital Index
- Index tracked by ETF: MSCI Emerging Markets Index
- Index weighting method: Cap-Weighted
- Asset Class: Equity
- Capitalization: Broad/Full Cap
- Style: Core or Blend
- Legal structure: Open-End Investment Company
- Dividend Yield: 1.90%
- Annual Yield: 1.90%
- Last Dividend Paid: 0.82, 12/22/2010
- Avg. +/- to NAV: 0.82, 12/22/2010
- Options / Futures Available: Y / Y
- Net Asset Value: \$42,384,752,450
- Premium (Discount): -2.48%

Source: XTF.com



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## ETF Security Weighting

- Market Capitalization
  - Is “growth-biased”:
    - ↑ stock price → ↑ % of index
- Fundamental
  - e.g., Dividend weighted is “value-biased”:
    - ↓ stock price → ↑ Div. % → ↑ % of index
- Equal Weight
  - Unaffected by stock price (i.e., price neutral)
- Custom



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## Not All Indices (or ETFs) Are The Same

- Comparison of similar stock classes among different indices

Annualized Return: July 1997-June 2009

Category	Dow Jones	DJ Wilshire	Morningstar	MSCI	S&P	S&P Pure	Russell
Large Growth	-1.25%	1.18%	-1.74%	-0.22%	1.36%	4.82%	0.73%
Large Blend	1.42%	2.35%	2.78%	0.15%	2.05%	2.05%	2.41%
Large Value	2.74%	3.15%	2.61%	0.28%	2.10%	4.54%	3.30%
Mid-Cap Growth	3.11%	3.14%	1.93%	2.86%	9.45%	9.51%	3.41%
Mid-Cap Blend	4.96%	5.12%	4.82%	3.92%	7.34%	7.34%	5.48%
Mid-Cap Value	5.87%	5.70%	5.54%	6.75%	5.28%	6.08%	5.79%
Small Growth	2.66%	2.75%	0.37%	4.02%	5.01%	6.64%	0.96%
Small Blend	5.02%	4.79%	6.52%	4.19%	5.28%	5.28%	3.41%
Small Value	5.09%	6.11%	6.06%	3.47%	5.35%	6.67%	5.22%
Average	3.29%	3.81%	3.21%	2.82%	4.80%	5.88%	3.41%

Source: Morningstar

- With compounding, small differences have large impacts:
  - 12-year total returns: 3.47%/yr = 50% gain
  - 6.67%/yr = 118% gain



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# Comparing ETFs: An Example

## Two Energy ETFs (XLE, IEO)

Category Filter	XLE REMOVE	IEO REMOVE
Description	Select Sector SPDR-Energy	iShares Dow Jones US Oil & Gas Expl & Prod
XTF Rating	10	7.2
Last Price/Change	\$77.19 +.71	
Expense Ratio	0.20%	0.48%
Market Cap	\$9B	\$556M
Avg. Daily Volume	14,401,210	225,302
Avg. Trade Size	258	359
Annual Yield	1.29%	0.25%
Premium (Discount)	0.04%	0%
Inception Date	10/22/1998	05/05/2006
Exchange	NYSE Arca	NYSE Arca
Issuer	SSGA Funds Management, Inc.	BlackRock, Inc.
Index Provider	Bank Of America Merrill Lynch	Dow Jones & Company
Geography	US	US
Investment Philosophy	Passive Index	Passive Index
Underlying Index	Energy Select Sector Index	Dow Jones US Select Oil Exploration & Production Index
Index Composition	Cap-Weighted	Cap-Weighted
Avg. # of Components	40	59
Legal Structure	Open-End Investment Company	Open-End Investment Company
Options / Futures	Y/Y	Y/Y
Asset Class	Equity	Equity
Capitalization	Large Cap	Broad/Mid Cap
Style	Core or Blend	Core or Blend
Sector	Energy	Energy

Source: XTF.com



# Comparing ETFs (cont'd)

## Top 15 Holdings (%)

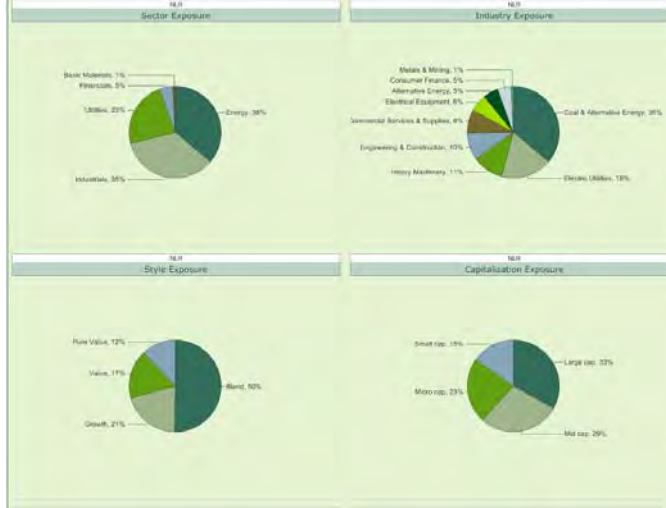
IEO				XLE			
Symbol	Description	Weight	Sort	Symbol	Description	Weight	Sort
OXY	OCCIDENTAL PETROLEUM CORP	15.09%		XOM	EXXON MOBIL CORP	18.07%	
APA	APACHE CORP	8.47%		CVX	CHEVRON CORP	12.82%	
APC	ANADARKO PETROLEUM CORP	7.72%		SLB	SCHLUMBERGER LTD	8.07%	
DEV	DEVON ENERGY CORPORATION	7.29%		COO	CONOCOPHILLIPS	5.20%	
EOG	EOG RESOURCES INC	5.85%		OXY	OCCIDENTAL PETROLEUM CORP	4.48%	
CHK	CHESAPEAKE ENERGY CORP	4.72%		APA	APACHE CORP	3.25%	
VLO	VALERO ENERGY CORP	3.38%		HAL	HALLIBURTON CO	3.15%	
NBL	NOBLE ENERGY INC	3.27%		APC	ANADARKO PETROLEUM CORP	2.80%	
SWN	SOUTHWESTERN ENERGY CO	2.83%		DEV	DEVON ENERGY CORPORATION	2.73%	
CXO	CONCHO RESOURCES INC	2.28%		NOV	NATIONAL OILWELL VARCO INC	2.58%	
XEC	CIMAREX ENERGY CO	2.17%		MRO	MARATHON OIL CORP	2.50%	
DNR	DENBURY RESOURCES INC	2.11%		BHI	BAKER HUGHES INC	2.49%	
PXD	PIONEER NATURAL RESOURCES CO	2.09%		EOG	EOG RESOURCES INC	2.16%	
FXS	NEWFIELD EXPLORATION CO	2.01%		HES	HESS CORP	1.93%	
RRC	RANGE RESOURCES CORP	1.90%		CHK	CHESAPEAKE ENERGY CORP	1.82%	

Source: XTF.com



# Comparing ETFs (cont'd)

- Tools to compare asset mix

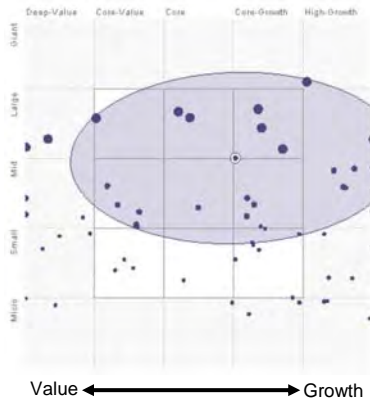


Source: XTF.com

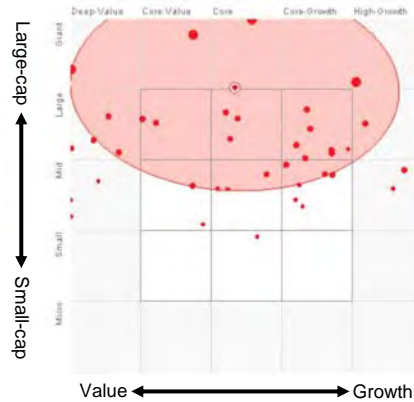


# Comparing ETFs: Morningstar Style Boxes

**iShares DJ US Oil and Gas Exploration (IEO)**



**Energy Select Sector SPDR (XLE)**



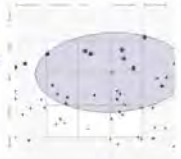
Source: Morningstar Direct



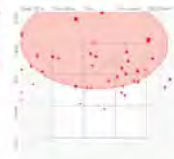


# ETFs: Why Index Composition Matters

iShares  
Oil & Gas  
Exploration &  
Production



Energy  
Select  
Sector  
SPDR



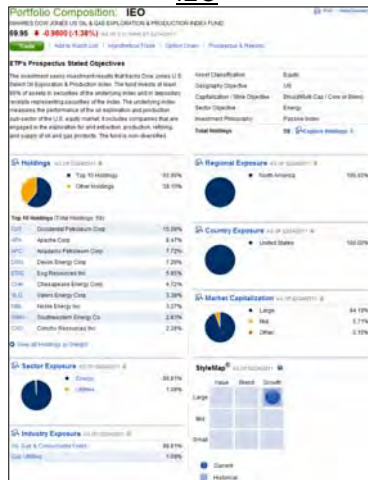
<b>Benchmark Index</b>	Dow Jones U.S. Select Oil Exploration & Production Index	Energy Select Sector Index
<b>Inclusion criteria</b>	Oil & gas extraction companies among top 95% of float-adj. U.S. market cap	Energy stocks in the S&P 500
<b>Weighting Scheme</b>	Market-cap	Market-cap
<b>Turnover Rate</b>	15%	7%
<b># of Stock Holdings</b>	57	40
<b>% Assets in Top-10</b>	58.0%	64.4%
<b>Avg. Mkt Cap (\$Mil)</b>	7,898	40,115
<b>Price / Cash Flows</b>	2.4	3.4

Source: Morningstar Direct

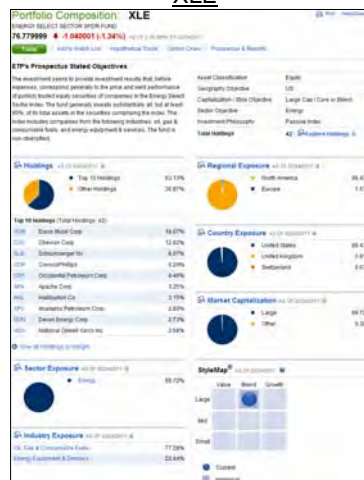


# Comparing ETFs: Composition

IEO



XLE

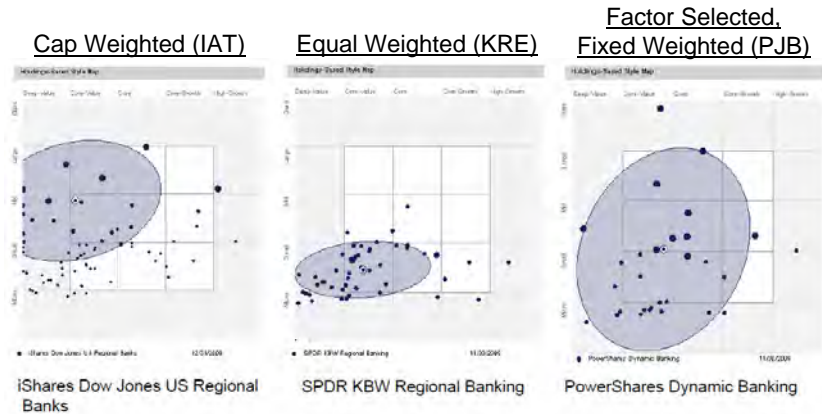


Source: Morningstar, Fidelity Investments



# Comparing ETFs: Banking Industry

## Same Industry, Different Index Strategies



Source: Morningstar Direct



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# Comparing ETFs: Banking Industry

## Same Industry, Different Performance



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## Sources of ETF Data

- Morningstar
  - ETF newsletter
  - Ranking of managed ETF portfolios
- American Association of Individual Investors
- XTF.com
- InvestorUniverse.com
- <http://finance.yahoo.com>
- ETF.com
- ETFtrends.com
- Sites of ETF issuers:
  - <http://statestreetspdrs.com>
  - <https://personal.vanguard.com/us/funds/etf>
  - <http://us.ishares.com/home.htm> (BlackRock)



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## ETF Selection: Dividend ETFs

- Dividend have historically performed better than non-dividend payers

**S&P 500 Total Return by Dividend Policy: Growth of \$100**



Source: Ned Davis Research



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## ETF Selection: Dividend ETFs

- Companies that increase dividends outperform, with less volatility

### S&P 500 Index Component Performance

	Return <sup>2</sup>	Risk <sup>3</sup>
Dividend Growers	8.88%	16.28
Dividend Payers with No Change	6.33%	18.01
Dividend Cutters/Eliminators	0.60%	24.25
Non Dividend Paying Stocks	0.27%	25.98

### Growth of \$100 invested in 1972

	2008 Value <sup>2</sup>
Dividend Growers	\$2,313
Dividend Payers with No Change	\$966
Dividend Cutters/Eliminators	\$125
Non Dividend Paying Stocks	\$110

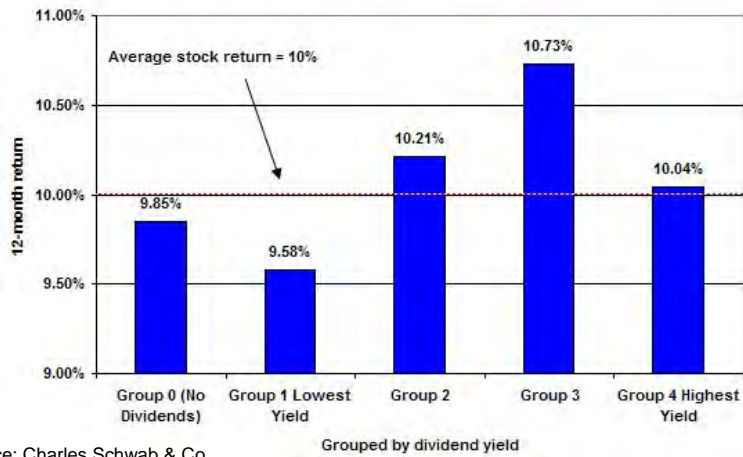
Source: Ned David Research (12-31-08)



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## ETF Selection: Dividend ETFs

### Top 1,500 stocks by market cap: 1990 - 2009



Source: Charles Schwab & Co.



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## ETF Selection: An Example (Dividends)

- ❑ Dividend-focused stocks:
  - ❑ Better current returns than short-term bonds
  - ❑ A variety of ETFs available with different index strategies:

Dividend-Focused ETFs				
Fund	Ticker	Dividend Yield	Expense Ratio	Turnover
iShares Dow Jones U.S. Select Dividend	DVY	3.56%	0.40%	25.00%
PowerShares Dividend Achievers	PFM	1.92%	0.60%	18.00%
PowerShares High Yield Dividend Achievers	PEY	4.16%	0.60%	57.00%
Vanguard Dividend Appreciation	VIG	1.96%	0.23%	20.00%
SPDR S&P Dividend Aristocrats	SDY	3.33%	0.35%	44.00%
WisdomTree Large Cap Dividend	DLN	2.71%	0.28%	17.00%
WisdomTree Total Dividend	DTD	2.83%	0.28%	16.00%

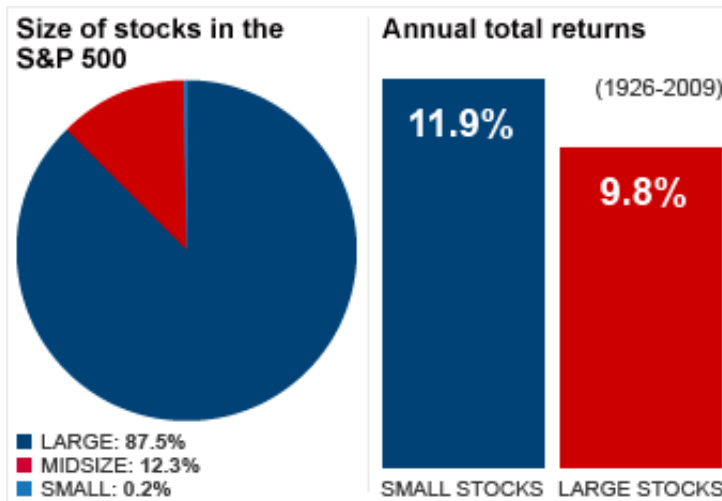
Data from 2010

Source: Yahoo Finance



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## ETF Selection: Market Cap ETFs



SOURCES: IBBOTSON ASSOCIATES; MORNINGSTAR



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## ETF Selection: Market Cap ETFs

	Symbol	Exp. ratio	Yield	XTF Rtg.
<b>Mid-cap:</b>				
iShares S&P MidCap 400	IJH	0.21%	1.19%	8.4
Vanguard Mid-Cap Growth	VOT	0.12%	0.49%	7.7
SPDR S&P MidCap 400	MDY	0.25%	1.00%	8.5
<b>Small/Micro-Cap:</b>				
Vanguard Small Cap Index	VB	0.17%	1.26%	8.6
iShares Russell 2000	IWM	0.26%	1.29%	7.4
First Trust DJ Select Micro	FDM	0.60%	0.74%	5.8
<b>Int'l Small-cap:</b>				
iShares MSCI EAFE SmCap	SCZ	0.40%	3.01%	5.3
WisdomTree Int'l SC Dividend	DLS	0.58%	3.82%	2.6



Source: xtf.com, data as of 1-27-2012

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## Some ETF/ETN “Gotchas”

- ❑ Contango – in ETNs using futures contracts
  - ❑ Commodity, inverse (short), leveraged (2x/3x)
- ❑ Tax treatment
  - ❑ Bonds, derivative-based ETFs, precious metals
- ❑ High bid-ask spreads on some ETFs
  - ❑ Illiquid securities/bonds, foreign small caps
- ❑ Counterparty risk (ETNs)
  - ❑ e.g., Lehman Bros.
- ❑ FEES! (see Morningstar study)
- ❑ Leveraged ETFs: When  $2x \neq 2x$



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## Contango

- Q: What is “Contango”?
  - Mostly a commodity market phenomenon
  - Occurs when:
    - Current futures price > Expected future spot price
  - Because futures eventually converge with spot price:
    - Futures prices fall over time
    - ETFs holding futures in markets in contango ↓ in price
    - ETFs fall short of tracking commodity price gains
  - Some commodity ETNs try to reduce this effect:
    - e.g., USL: 12 months of oil futures spread out evenly by month



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## Contango: Causes ETF to Underperform Market



Source: Bloomberg



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## Tax Issues

- ❑ ETFs are generally tax efficient; in 2010:
  - ❑ iShares: Out of 219 ETFs, only 5 had CG distributions
  - ❑ SPDRs: 9 ETFs out of 96 had CG distributions
  - ❑ Vanguard: 13 ETFs (12 bond, 1 equity) of 64 had CG distributions
  - ❑ ProShares: None of its 99 ETFs paid CG distributions
- ❑ For equity/bond ETFs, only events producing CGs: gains:
  - ❑ Sale by owner of ETF
  - ❑ Changes to underlying index
- ❑ All dividends are taxable in non-qualified accounts



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## Tax Issues

- ❑ Exceptions to tax efficiency:
  - ❑ Some Bond ETFs
  - ❑ Master Limited Partnership (MLP) ETFs
  - ❑ Currency ETNs
  - ❑ Commodity ETNs
  - ❑ Precious metal ETFs (GLD, SLV, etc.)
  - ❑ Leveraged ETNs



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## Tax Issues: Bond ETFs

- Bond ETFs:
  - When underlying bonds are redeemed, ETF must claim a capital gain if value has increased
    - Occurs in declining interest rate environments
  - Callable bonds can also trigger a CG event if called
  - Muni bond interest can trigger AMT
    - Check type of ETF (look for AMT-free funds)



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## Tax Issues: MLPs

- MLP ETFs:
  - Limited partnerships and trusts – Must file Form K-1
  - Structures have shareholder paying taxes, not Trust or LP
  - MLPs do **not** belong in qualified retirement accounts
    - Income is treated as Unrelated Business Taxable Income (UBTI)
    - IRS will tax you if UBTI income is > \$1,000
- MLP ETNs:
  - Simpler tax structure (no K-1s)
  - However, lose “return of capital” tax deferral advantage
  - UBTI issue – IRS still hasn’t issued a ruling on MLP ETNs



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## Tax Issues: Other

- ❑ Currency ETFs:
  - ❑ Typically Grantor Trusts
  - ❑ Any accrued interest, gains upon sale are taxed at income rate
- ❑ Commodity ETNs that purchase futures:
  - ❑ Open futures positions must be “marked to market” at year-end
  - ❑ Can result in capital gains; LT/ST (60%/40%) CG formula applies
- ❑ Gold, silver, platinum ETFs (Grantor Trusts)
  - ❑ Treated as “collectibles” by IRS
  - ❑ LTCG tax rate of 28%, regardless of holding period
- ❑ Leveraged ETNs (2x/3x/inverse)
  - ❑ Hold options and swaps
  - ❑ Any gains or losses taxed at STCG rates, for any holding period



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## Tax Issues: ETNs

- ❑ ETNs are actually a form of debt:
  - ❑ Senior, unsecured, unsubordinated debt security
  - ❑ Always a counterparty risk (e.g., Lehman Bros.)
- ❑ Summary of ETN tax rules:
  - ❑ Holds no real assets; is a promissory note
  - ❑ Taxed only upon sale
  - ❑ Short-term capital gains apply when held < 1 year
  - ❑ Long-term capital gains rates if held > year
  - ❑ Typically no dividends or interest income



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## Take on ETNs

- Pros:
  - Simplicity of tax treatment'
- Cons:
  - Typically very high fees
  - Leveraged and 2x/3x don't track indices well
  - Counterparty risk (with a counterparty that is far more sophisticated regarding derivatives)
- Recommendation: Use them at your discretion, and not for long-term investing



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## Tax Issues

- Tax laws are always changing
  - Major changes coming in 2013
    - L/T Capital Gains (0%/15% → 0%/20%/23.8%)
    - Dividends (0%/15% → ordinary income!)
- Make sure that you understand the tax treatment of your ETF/ETNs:
  - Read fund Prospectus
  - Consult your tax preparer



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## Your Investment Style



Q: Are you a Trader  
or an Investor?



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## Your Investment Style

ETFs can accommodate  
both styles, but our focus  
here is on Investing



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## Building an ETF Portfolio

- ❑ What are your overall investment objectives?
  - ❑ First step of any investment process
  - ❑ Treat as a separate issue from investment vehicles
  - ❑ ETFs are just one means of implementing your strategy



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## Building an ETF Portfolio

- ❑ Numerous approaches for ETF portfolio creation:
  - ❑ Published “models”
  - ❑ Web sites with model portfolios
  - ❑ Subscription services
  - ❑ Asset managers
  - ❑ Target date funds
  - ❑ All-in-1 ETFs
  - ❑ DIY



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## Building an ETF Portfolio: Approaches

- ❑ Published “models” - books
  - ❑ “The Dick Davis Dividend” (Davis, 2008) – 28 model index portfolios
  - ❑ “Yes, You Can Supercharge Your Portfolio” (Stein, DeMuth, 2008)
  - ❑ “The Gone Fishin’ Portfolio” (Green, 2008)
  - ❑ “The ETF Book” (Ferri, 2009)
- ❑ Web sites with model portfolios:
  - ❑ Morningstar
  - ❑ AAll
  - ❑ SeekingAlpha.com
  - ❑ Charles Schwab (ETF Select List)



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## Building an ETF Portfolio: Approaches

- ❑ Subscription services with proprietary models:
  - ❑ [www.7twelveportfolio.com](http://www.7twelveportfolio.com)
  - ❑ ValidFi ([www.validfi.com](http://www.validfi.com))
  - ❑ Agile Investments ([www.agileinvesting.com](http://www.agileinvesting.com))
- ❑ Firms w/ proprietary models that manage assets:
  - ❑ Asset Builder ([www.assetbuilder.com](http://www.assetbuilder.com))
  - ❑ Pinnacle Advisory Group ([www.pinnacleadvisory.com](http://www.pinnacleadvisory.com))
  - ❑ Numerous others



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## Building an ETF Portfolio: Models

- ❑ Target date funds using ETFs:
  - ❑ e.g., FOLIO Investing  
(<https://www.folioinvesting.com/rtg/category.jsp?category=Target%20Date>)
- ❑ All-in-One ETFs:
  - ❑ e.g., Cambria Global Tactical ETF (GTAA)
    - ❑ Fee = 1.42%; new fund (October, 2010)
    - ❑ Is actively managed
    - ❑ Uses SMA formula “triggers” for each segment
      - ❑ Doesn’t work particularly well in “whipsaw” markets



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## Building an ETF Portfolio: DIY

- ❑ Process:
  1. Know your investment goals and style:
    - ❑ Time frame (where you are on retirement “glide path”)
    - ❑ Risk tolerance
    - ❑ Trading frequency (hint: less is more)
    - ❑ Realistic expectations for returns



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## Building an ETF Portfolio: DIY

### ❑ Process:

#### 2. Figure out your asset class mix:

- ❑ No more than 9-12 ETFs needed
  - ❑ Some models use only 3-5 ETFs
- ❑ Adequately diversified? (want assets with low correlations)
- ❑ Qualified (e.g., IRA, 401(k)) or non-qualified account?
  - ❑ Determines which assets belong where
- ❑ Strategic (fixed) or Tactical (dynamic) asset allocations?
  - ❑ For most investors, a Strategic approach is better

- ★ Suggestion: Use published models as a starting point, then customize



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## Building an ETF Portfolio: DIY

### ❑ Process (cont'd):

#### 3. Screen candidate ETFs by asset class:

- ❑ High scores relative to asset class (XTF.com, InvestorUniverse.com, Morningstar, etc.)
- ❑ Low expense ratio (%)
- ❑ % Yield (if that is an objective)
- ❑ Sufficient track record (> 1 year)
- ❑ No tax “gotchas” (or at least understand what they are)
- ❑ Understand underlying index & securities, use of leverage
- ❑ Statistics, if available:‡
  - ❑ Correlation to market ( $R^2$ ) – want a range
  - ❑ Volatility relative to market (Beta,  $\beta$ ) – lower is generally better
  - ❑ Overall volatility (Standard deviation,  $\sigma$ )



‡= Optional for math geeks

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## Building an ETF Portfolio: DIY

### ❑ Process (cont'd):

4. Assemble portfolio w/ % allocations for each ETF
5. Test volatility, projected return, diversification:‡
  - ❑ Morningstar Portfolio Instant X-ray:  
([portfolio.morningstar.com/RtPort/Free/InstantXRayDEntry.aspx](http://portfolio.morningstar.com/RtPort/Free/InstantXRayDEntry.aspx))
  - ❑ Quantext Portfolio Planner ([www.quantext.com](http://www.quantext.com))
  - ❑ G-sphere Portfolio Modeling Tool ([www.mydiversification.com](http://www.mydiversification.com))
  - ❑ Other correlation, mean variance optimization (MVO) tools

‡= Optional for math geeks



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## Building an ETF Portfolio: DIY

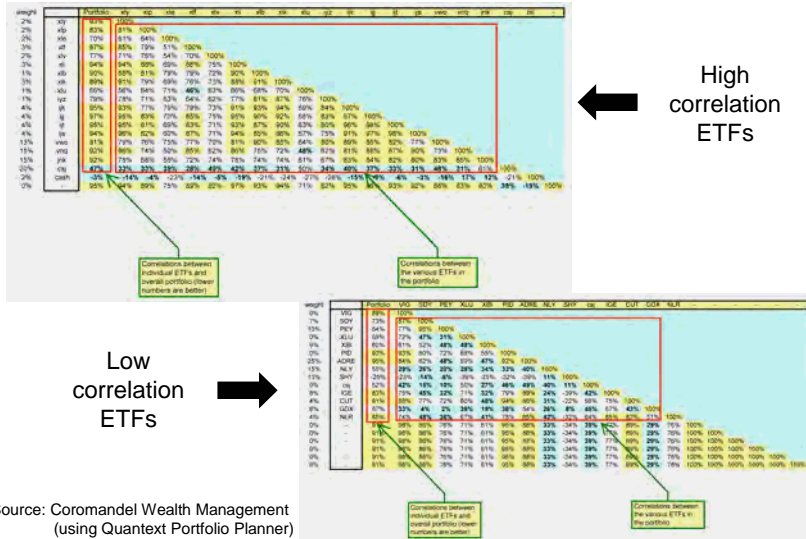
### ❑ Process (cont'd):

6. “Lather, rinse, repeat..”
  - ❑ Iterate ETF mix, percentage allocations to where you are comfortable with:
    - ❑ Volatility (vs. S&P 500)
    - ❑ Projected return (if available)
    - ❑ Adequate diversification among asset classes



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## Building an ETF Portfolio: Correlations



Source: Coromandel Wealth Management (using Quantext Portfolio Planner)



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## Building an ETF Portfolio: DIY

### ❑ Process (cont'd):

#### 7. Ongoing portfolio management:

- ❑ Rebalance %ages - no more than once a year
- ❑ Decide whether you want to be a "market timer"
  - ❑ (We recommend that you don't)
- ❑ Monitor performance periodically (quarterly is fine)
- ❑ Don't be afraid to make some small changes along the way:
  - ❑ New, improved funds come along
  - ❑ Market conditions & valuations change
  - ❑ Your investing strategy may change
  - ❑ If you do make changes:
    - ❑ Go back and revisit Steps 1 through 4



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## Portfolio Construction: Major Hint

- ❑ Getting overly sophisticated about creating the “perfect” ETF portfolio doesn’t really gain you that much.
  - ❑ and if you trade in & out of it, may actually cost you
- ❑ An effective recipe for ETF investing success:
  1. Create a diversified, low fee ETF portfolio with which you’re comfortable.
  2. Add to it regularly
  3. Rebalance it annually.

*That’s it!*



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## Summary

- ❑ ETFs offer investors new investment alternatives:
  - ❑ Tax efficiency, low fees, transparency, liquidity
  - ❑ Broad range of choices, growing monthly
- ❑ Beware of ETF/ETN “Gotchas”:
  - ❑ Tax treatment, creative indexing, high fees, use of derivatives, volatility
- ❑ Do your homework:
  - ❑ Look under the hood (many resources exist)
  - ❑ Compare alternative ETFs
  - ❑ Have a strategy for ETF selection and portfolio creation
- ❑ Take charge of your financial future:

*“No one cares about your money as much as you do.”*

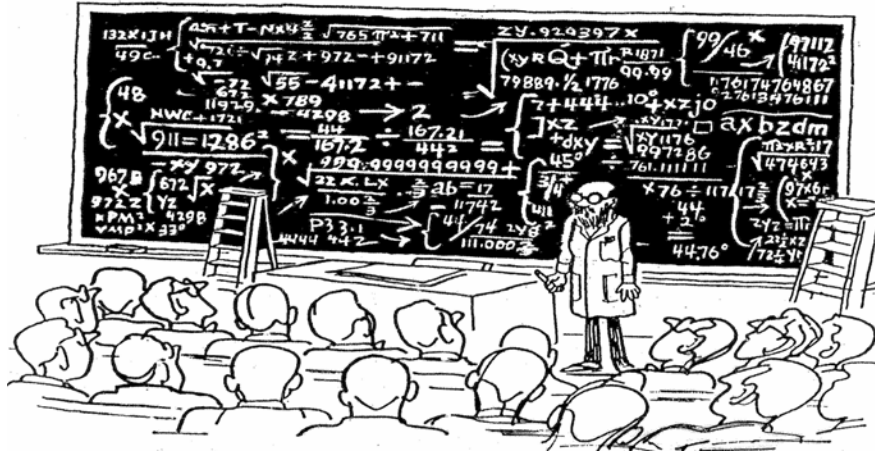
- Andrew Tobias, author of “The Only Investment Guide You’ll Ever Need”



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## Q&A

“Any questions?”



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