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**YOUR MONEY MATTERS**
**The ABCs of ETFs**

*Exchange-traded funds are surging in popularity. Here's what you need to know about them.*

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When Steve Sox and his wife, Terri, decided she was going to be the family's primary breadwinner while he tended to their young daughter, Mr. Sox also assumed another responsibility: managing the family's money.

The 52-year-old Indianapolis resident now spends a few hours a day working on the family's portfolio, the broad outlines of which are almost indistinguishable from those of a typical family financial plan. They have two individual retirement accounts, a college fund for their daughter and a brokerage account.

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The big difference is their portfolio is invested almost entirely in exchange-traded funds, which resemble index-tracking mutual funds but trade just like stocks.


While the first ETF was launched in 1993, ETFs have surged in popularity with investors and financial advisers in recent years. Though still just a sliver compared with the \$8.12 trillion mutual-fund industry, assets held in ETFs rocketed nearly 50% last year. They now stand at about \$240 billion and are expected to hit \$812 billion by 2009, according to Financial Research Corp., Boston. Net new investments in ETFs exceeded those in traditional index funds in four of the past five years. In a further sign of their growing acceptance as an everyday financial tool, ETFs are beginning to appear in some smaller 401(k) plans as well.

What's behind the fascination? Like index funds, ETFs track the performance of a particular index, ranging from the large benchmarks such as the Standard & Poor's Depository Receipt, which mimics the S&P 500-stock index and is known as the "spider," to those following different sectors, geographic regions, countries and styles. There are also six funds tied to bonds and two linked to the price of gold. Providers are in the process of creating more newfangled products -- there are already about 170 ETFs -- tracking silver, oil, the euro and a basket of commodities.

ETFs generally have lower expenses than traditional mutual funds (including index funds), and they trade throughout the day on an exchange, while mutual funds' price are set just once daily. They're also markedly more tax-efficient than mutual funds, and investors know exactly what they're buying because holdings are completely transparent.

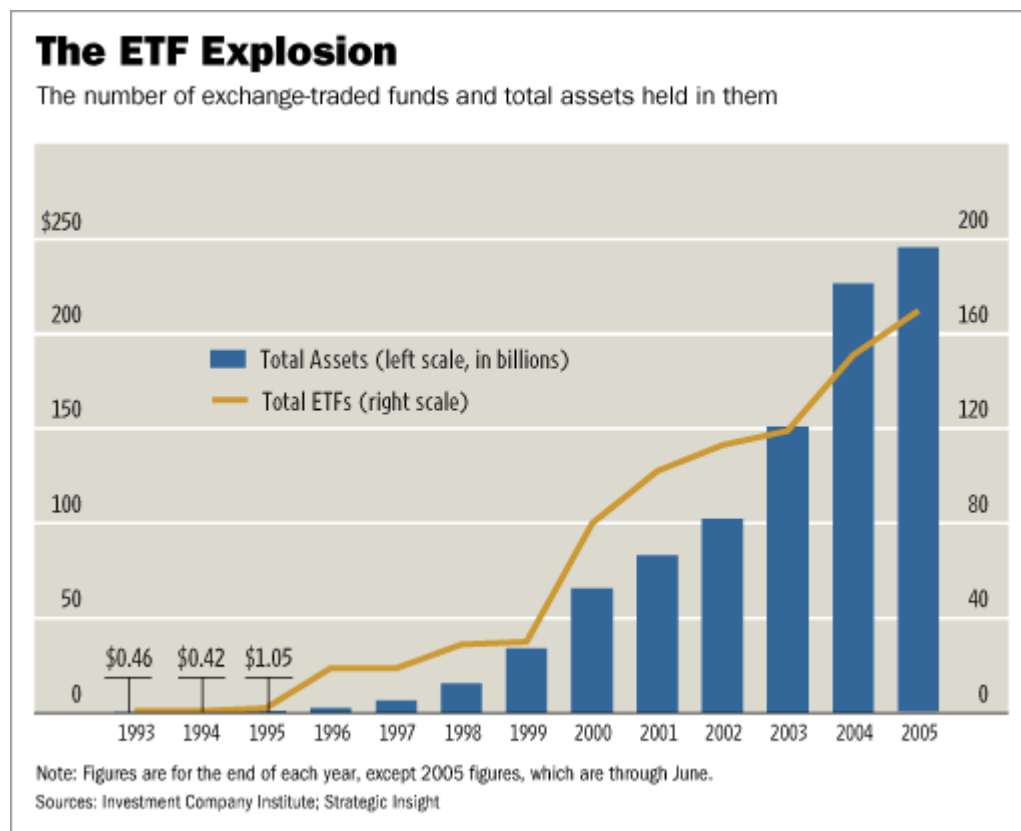
"They're extremely cheap, and you can buy them in any account," says David Jackson, a hedge-fund manager and editor of [ETFInvestor.com](#)<sup>3</sup>, a New York-based Web site for ETF investors and traders.

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The average ETF has an expense ratio of 0.42% of assets annually, compared with an average expense ratio of 0.86% for index funds and 1.41% for actively managed mutual funds, according to Morningstar Inc., a Chicago-based investment research firm. The ETF with the lowest fees: the Vanguard Total Stock Market Vipers (short for Vanguard Index Participation Receipts), from Vanguard Group, Malvern, Pa. This fund promises a return equal to that of a basket of all publicly traded stocks, after its management fee of 0.07% of assets.



One big caveat: Because you pay commissions on transactions, ETFs aren't a good choice if you make small, regular investments. In such cases, the savings on ETFs' management costs can quickly be erased by the trading costs, making mutual funds a better option.

Despite ETFs' growing popularity, many investors still aren't sure how to fit the funds into their financial plans. Building a portfolio of ETFs alone or in combination with other

investments may seem daunting at first, but it can be done, if you're willing to do your homework.

Whether you go it alone or hire an expert, here's a rundown of some basics you'll need to know.

## GETTING STARTED

The first step to managing a portfolio of ETFs is to draw up an asset allocation based on widely used criteria, including your age, financial goals, risk tolerance, time horizon and the amount of the investment. If you're not sure how to do this, the necessary tools exist on a variety of investment Web sites.

Similarly, there are good search tools for locating the right ETFs to implement your plan. For sorting out which ETFs correspond to the different slices of the market you want to invest in, good tools can be found at [Ameritrade.com](http://Ameritrade.com)<sup>4</sup>, the online investment brokerage of **Ameritrade Holding Corp.**, Omaha, Neb., and at [Morningstar.com](http://Morningstar.com)<sup>5</sup>. There are also search tools on the sites of ETF providers like Barclays Global Investors, State Street Global Advisors and Vanguard Group, but, not surprisingly, these promote their own companies' products.

If you can't decide between two similar ETFs, evaluate how the underlying indexes are constructed and what specific stocks or other assets each tracks. Trading volume and the reputation of the issuer are also important, says David Elan, a principal at Windward Investment Management, a Boston-based registered

investment advisory firm.

And don't forget to compare the fees. "One of the biggest -- if not the biggest -- difference makers in long-term returns will be expenses because [similar] indexes track so closely together" in terms of performance, says Dan Culloton, a Morningstar analyst.

Several financial advisers point to the wide variance in cost of ETFs that track real estate: According to Morningstar, the Vanguard REIT Vipers carry an expense ratio of only 0.12%, while the iShares Dow Jones Real Estate ETF is at 0.60%. Nestled in between are the iShares Cohen & Steers Realty Majors at 0.35%, and the streetTracks Wilshire REIT Fund at 0.26%. (iShares are provided by Barclays Global Investors, a San Francisco-based unit of **Barclays PLC** in London. StreetTracks ETFs are marketed by State Street Global Markets, a division of **State Street Corp.**, Boston.)

### **DIVERSIFY -- BUT NOT TOO MUCH**

"If an investor wants to keep things simple and focus on the broadest asset classes, it is possible to construct a portfolio that is very well diversified and easy to manage with just four or five ETFs," says J.D. Steinhilber, founder of [AgileInvesting.com](http://AgileInvesting.com)<sup>6</sup>, a Nashville, Tenn., investment-advisory subscription service that provides advice on managing portfolios with ETFs.

For instance, the following "moderate growth" or "balanced" portfolio might be suitable for an investor looking for capital appreciation with some interest and dividend income, and would carry an overall expense ratio of 0.22% of assets, Mr. Steinhilber says. This portfolio allocates 60% to stock ETFs, 25% to an aggregate bond ETF and 15% to a Treasuries-based ETF, says Mr. Steinhilber. In this example, 40% of the total portfolio might be allocated to the Vanguard Total Stock Market Vipers, 15% to the iShares MSCI EAFE Index Fund (an ETF based on the Morgan Stanley Capital International European Australasian Far East Index) and the rest in the Vanguard Emerging Markets Stock Index Vipers. The bond portion could be invested in the iShares Lehman Aggregate Bond Fund, which attempts to capture the return of the Lehman Brothers Bond Index. The remaining 15% would go in the iShares Lehman 1-3 Year Treasury Bond Fund.

Another moderate-growth portfolio, with more securities, might include a 57% stock allocation, as follows: 25% of the portfolio in the iShares S&P 500 Index Fund, 7% in the iShares S&P MidCap 400 Index Fund, 5% in iShares S&P SmallCap 600 Index Fund, 15% in iShares MSCI EAFE Index Fund, and 5% in the Vanguard Emerging Markets Stock Index Vipers. Of the remainder, 20% could go in iShares Lehman Aggregate Bond Fund, 15% in iShares Lehman 1-3 Year Treasury, and 5% in the Vanguard REIT Vipers. The remaining 3% he would put in streetTracks Gold Shares, the value of which is linked to the price of gold bullion. According to Mr. Steinhilber, this portfolio's total expense ratio is 0.19% of assets.

"The purpose of owning more asset classes is to potentially improve diversification and risk-adjusted returns," he says.

Keep in mind there is a limit to how far you should diversify: The more securities and ETFs in your portfolio, the more potential trading costs you will have. "Once you get beyond the major asset classes, the law of diminishing returns definitely applies," Mr. Steinhilber says.

### **COMBINATION STRATEGIES**

Some money managers who were once proponents of actively managed funds have taken to a more hybrid approach to investing referred to as "core and satellite." In this strategy, the majority, or core, of one's holdings is put in index-tracking ETFs or low-cost index funds, while the portfolio's smaller

positions, or satellites, are invested in higher-cost actively managed funds or other areas that might outperform the market.

"A couple of years ago, we moved to a core-and-satellite design because we believe that equity returns will be modest over the next five to 10 years," says Harold Evensky, a financial planner in Coral Gables, Fla. "We think that controlling expenses and taxes is going to be overwhelmingly important."

Mr. Evensky puts half of his clients' stock allocation in a broad-based market ETF like the iShares Russell 3000 Index Fund ETF. He puts 30% in a mix of domestic value, small-cap and international funds, using both ETFs and traditional index funds. The rest, about 20%, he dedicates to satellites.

"The core is basically buying the American economy, and we want to own it cheap," Mr. Evensky says. "The satellite is where we will take the risk."

### **ALL-IN-ONE, ONLINE PRODUCTS**

If you don't feel like assembling an ETF portfolio yourself, plenty of advisers and a growing number of large brokerage firms are happy to do it -- for a fee. But, again, beware of excessive fees, which could defeat part of the reason for investing in ETFs in the first place.

Online brokerage services are getting into the business of providing ETF portfolios. Amerivest, a portfolio advisory service from Ameritrade Holding, helps investors choose an asset allocation of ETFs, and has waived all trading costs. Amerivest instead charges a flat fee -- 0.50% of assets for portfolios less than \$100,000 and 0.35% for larger accounts, plus the underlying expenses of the fund. Accounts of less than \$20,000 are charged the lesser of \$100 or 2.95% of assets.

The Fidelity ETF Portfolio Builder from Boston-based Fidelity Investments enables people who have Fidelity brokerage accounts to customize and trade a portfolio of ETFs based on one of three "lenses" of the stock market: sectors, market capitalization, or style of investing and market capitalization.

But that, too, comes at a price: If you purchase a portfolio of 10 ETFs at \$19.95 per ETF (Fidelity's standard commission), it could cost \$199.50 just to build the portfolio. There's an initial investment minimum of \$2,000, and you must invest in at least two ETFs. For Fidelity brokerage customers who trade more frequently and have larger accounts, the commissions drop to as low as \$8 a trade.

Online broker ShareBuilder Securities Corp., a unit of ShareBuilder Corp., in Bellevue, Wash., has a service called PortfolioBuilder Plus, which gauges investors' goals, risk tolerance and time horizon through a questionnaire, then suggests one of 15 ETF portfolios. Depending on the amount being invested, the portfolio will include from two to about seven exchange-traded funds, which can be wrapped inside an IRA. The majority of ShareBuilder's customers make automatic investment contributions to their accounts each month, paying \$1 to \$4 per transaction. ShareBuilder says it keeps those costs much lower than its peers by bundling automatic investors' transactions in large block trades.

### **WHEN IS A FEE TOO HIGH?**

At what level should a professional's ETF's fees be considered excessive?

"I don't know what the magic number is, but I would start asking questions when [total fees approach] 1% or higher," says Mr. Culloton of Morningstar. "At that point, once you factor in the expense ratios of the underlying funds, you're approaching the average cost of a traditional actively managed mutual fund. You want to make sure you're getting more advice and service than you can find on your own."

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