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summaries

SIGMA INVESTMENT COUNSELORS

the official newsletter of sigma investment counselors September 2007

The World of ETFs

Over the past few years, exchange traded funds (ETFs) have made a significant impact in the world of investing; attracting an enormous influx of assets, as these products are believed to coalesce the positive attributes of both stocks and mutual funds. Currently there are 545 ETFs offered by U.S. issuers with more than $505 billion dollars in assets under management, representing an approximate 5-fold increase over the past 5 years[1]. In a like fashion, we at Sigma have established, and subsequently built upon significant ETF positions. These holdings commonly serve as either the entire equity allocation within a portfolio, or as supplemental positions meant to fill in the gaps of a more traditional individual equity portfolio.

Each ETF holds a portfolio of securities that is intended to provide investment results that, before fees and expenses, correspond to the price and yield performance of their underlying benchmark index. While ETFs possess instant diversification capabilities very similar to those of mutual funds, they also encompass several stock-like characteristics that make them especially attractive to individual investors and active investment advisors alike. ETFs offer the liquidity and trading versatility of a stock, trading in real time on the major exchanges. In addition, when comparing ETFs to traditional mutual funds, ETFs offer investors complete investment transparency, lower expense ratios, and superior tax efficiency while necessitating no minimum investment amount.

The liquidity that ETFs afford is oftentimes atop the list of their appealing distinctions. While mutual funds may only be bought and sold at daily closing prices after the net asset value has been calculated, ETFs can be traded at any point throughout the market hours, offering the investor the ability to buy into intraday weakness or sell into intraday strength. Moreover, ETFs are traded in exactly the same manner as stocks. For example, an investor may hedge against declining market prices with ETFs by selling short or placing limit orders.

Investors have also been drawn to these vehicles due to the simple fact that holders have the ability to know exactly what they own. ETFs are completely transparent, fully disclosing their holdings daily, whereas mutual funds typically disclose their holdings on a quarterly basis.

Lower expenses can also become a factor when considering an ETF over a comparable mutual fund. ETFs commonly charge anywhere from 7 basis points (generally large cap domestic funds), to 75 basis points (for the more exotic funds) annually, while many mutual funds charge well over 1%. Although ETFs incur commissions upon their purchase and sale, they can ultimately charge much lower fees than mutual funds because they simply buy and hold the stocks that are included in the underlying index. Through this curtailment of trading and turnover, not only is the need to hire fund managers and analysts abated, but the capital gains taxes that mutual fund shares are so often subjected to are all but eliminated for ETFs.

While ETFs have introduced immense improvements into the investment landscape, there are certain aspects of these products that investors often inadvertently overlook, with potential, unintentional consequences. Indexing, an idea that is simplistic in theory, has grown ever the more complex, as seasoned investors have unceasingly looked for the next specialized product. A recent issue of the Morningstar Indexes publication highlights the fact that as the world of indexing has become more in-depth and specialized, the essential diversifying power of ETFs can be dangerously compromised, as investors make decisions based solely on past fund performance and place little or

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no value on proper portfolio diversification. Everyday investors are prompted to jump on board without fully realizing the risk of such investments. Nearly every country, style, sector, commodity, and industry across the financial globe can be owned in a "diversified" manner almost instantly. But it is all too often that the word "diversified" can give investors a false sense of security. One such example may be the HealthShares Infectious Disease ETF, with a mere $3 million in assets. Such opportunities, if misused, can oftentimes lead to disaster for the ill-advised or uneducated investor.

How, then, is such a fate circumvented? Keep it simple. Employ the proven portfolio metrics of diversifying across the entire market. While it may seem counterintuitive, occasionally cutting back your allocation to those positions that have exhibited a sustained run, and reallocating those funds to a position that has underperformed will help protect you from the temptations of greed. Doing so will ensure that your long-term investment plan remains intact and your portfolio stays within the desired ranges that have been set forth for each of its positions.

At this point, you may be wondering why, if an equity portfolio can be fully vested and completely diversified simply through the implementation of a few ETFs, would you pay a manager to oversee such a portfolio? This question has stimulated several internal conversations, and it does beseech a rational explanation.

At the beginning of this year, we embarked upon an internal project to aid us in dynamically optimizing the overall composition of our ETF portfolio as the valuation of its holdings shifted over time. The first step entailed taking our existing ETF portfolio and determining specific weights for each of the funds that would in sum serve as the baseline portfolio from which our dynamic model would deviate. These initial weights were calculated using a mean-variance-optimization model, which helped us create a portfolio we believe employed the most attractive risk/return profile. In other words, we wanted to know, in theory, what balance of our funds would have generated the greatest return through time, while minimizing the ensuing relative risk of the portfolio. From this analysis we were able to gather a baseline portfolio from which to work.

Recently, we began a process of re-weighting each of the ETFs within the portfolio on the basis of their price to earnings (P/E) ratios, relative to historical ranges. In theory, the portfolio weight of those funds that begin to approach the higher end of their historical P/E ranges are ratcheted back, while those funds that begin to approach the lower end of their P/E ranges are given a higher weighting through the implementation of a pre-determined mathematical algorithm.

This tool is not being developed to rebalance simply for the sake of rebalancing at the expense of additional transaction costs. Rather, it is primarily being made available for our portfolio managers to maintain a better understanding of where new monies may be most judiciously invested as well as where cash may be raised for portfolio distributions in an efficient manner. In addition, when the inevitable occurs and one investment class significantly outperforms its peers, this tool will undoubtedly add meaningful value to the rebalancing process.

The world of ETFs will likely continue to grow in popularity throughout the foreseeable future, and as is true with all investments, ETFs possess a certain level of investment risk. However, we at Sigma believe that ETFs, when managed properly, offer a great opportunity for additional contributions to the financial success of our clients.

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