

Exchange-Traded Funds for Asset Allocation

These instruments, which are based on broad market, economic sector, domestic bond and international equity indexes, can be used to create a diversified portfolio.

Despite the bear market, exchange-traded funds (ETFs) continue to be popular, with total assets of about \$91.3 billion at the end of August vs. \$83.0 billion at the end of December 2001. Investors are turning to ETFs, baskets of securities that trade like individual stocks, because they offer diversity and benign tax consequences at a relatively low cost. These attributes make ETFs a reasonable tool for asset allocation, based on an investor's risk tolerance and specific objectives.

The recent addition of four bond index funds from Barclays Global Investors, sponsor of the iShares lineup, has enhanced ETFs as a means of asset allocation. The bond offerings are based on short-, medium- and long-term Lehman Brothers Treasury indexes and a Goldman Sachs corporate bond index. At the opposite end of the risk spectrum, Barclays filed last month with the SEC to offer the first ETF that tracks multiple emerging markets.

In other developments, Barclays plans for the first time to close some iShares ETFs because of lack of investor interest. They are the Dow Jones chemicals and Internet index funds and the fund based on the S&P/TSE 60 index of companies traded on the Toronto Stock Exchange. (An iShares Canada fund remains available.)

"If you're a longer-term buy-and-hold investor, ETFs make sense," says J.D. Steinhilber of AgileInvesting.com, a website that advises on ETF-based portfolios. The table at right with one of Steinhilber's hypothetical asset allocation portfolios illustrates the benefits of diversification, in terms of both risk, as measured by standard deviation, and reward. The expense ratio of 0.22% for this mix of investments is decidedly low cost.

For the S&P 500 index component, Steinhilber prefers the iShares product, which has an expense ratio of 0.09% vs. 0.12% for the older and much larger SPDR fund and 0.18% for the Vanguard 500 index fund.

Of course, the post-bubble market has driven home the imponderables of equity investing. Harold Evensky, a money manager with Evensky, Brown & Katz in Coral Gables, Fla., is revamping his asset allocation models because he believes stock market returns over the next decade will be somewhat lower than the historical norms.

"The extreme amount of individual diversification we've done, so many asset classes and styles, while it still makes sense, is not appropriate in a low-return environment. There's simply too much cost that eats up the value," Evensky says. He is shifting his domestic equity allocation to the Russell 3000 ETF from the iShares S&P 500. "It gives us a broad exposure, and it's extraordinarily cost and tax efficient," he adds. Evensky shuns

sector plays, saying they are "far more gambling than investing."

Steinhilber is also a bit leery of sector funds. "Sector investing can work," he says, "but it's more of an active management approach, trying to pick where we are in the economic cycle." He is now recommending the Dow Jones consumer non-cyclical, energy and health care sector funds. Steinhilber favors the Dow Jones versions over the S&P sector SPDRs because they are more broadly based.

Sam Stovall, chief investment strategist at S&P, currently likes the consumer discretionary, consumer staples, energy and materials sectors.

Steinhilber points out that most of the biggest holdings in sector ETFs are large-cap stocks and that this should be factored into the total allocation to large-cap in the portfolio.

The American Stock Exchange dominates the ETF field, but the New York Stock Exchange trades the iShares S&P Global 100 (IOO) as well as the more popular ETFs traded on the Amex. ♦

ETF MODEL PORTFOLIO

ASSET CLASS	ALLOCATION %	INDEX/SYMBOL	WTD. EXP. RATIO† %	FIVE YEARS 6/30/97 - 6/30/02		SEVEN YEARS 6/30/95 - 6/30/02	
				AVG. ANNUAL RETURN %	ANNUAL STANDARD DEVIATION %	AVG. ANNUAL RETURN %	ANNUAL STANDARD DEVIATION %
Fixed-Income	10	Lehman 1-3 Yr. Treas./SHY	0.02	6.49	1.57	6.35	1.50
Fixed-Income	20	Lehman 7-10 Yr. Treas./IEF	0.03	7.92	5.50	7.24	5.38
Large-Cap	10	S&P 500/IVV	0.01	3.66	17.79	10.66	16.32
Large/Mid-Cap	10	Russell 1000 Value/IWD	0.02	6.53	15.96	12.47	14.59
Mid-Cap	10	S&P MidCap 400/IJH	0.02	12.57	20.74	15.31	18.62
Small-Cap	10	S&P SmallCap 600/IJR	0.02	8.26	21.09	12.50	19.54
Small-Cap	10	Russell 2000 Value/IWN	0.03	9.70	15.73	13.78	14.41
Int'l Equity	15	MSCI EAFE/EFA	0.05	-1.48	16.15	2.47	14.75
Real Estate	5	Dow Jones Div. Real Estate/IYR	0.03	5.93	14.12	11.02	13.11
ETF Portfolio			0.22	6.82	10.16	9.85	9.39
S&P 500 Index				3.66	17.79	10.66	16.32

Source: J.D. Steinhilber of AgileInvesting.com. †Expense ratio adjusted by allocation.