



INVESTING

Get a Good Look Under an ETF's Hood

EXCHANGE-TRADED funds are the current stars of the investment universe, with more than 900 available in the U.S. Before you buy one, you need to look under the hood. "If your due diligence process stops at the name of the fund, you're going to get hurt," says Scott Burns, director of ETF analysis at Morningstar. Here are some key questions to ask.

Will this investment help to diversify my portfolio?

If you are buying an ETF that duplicates what you already own, save your money. Shelley Ferro, a certified financial planner in Metairie, La., says that clients often come to her owning only three funds, and "they're all in the same asset class."

Even if the names are different, you may be buying the same assets. For instance, one ETF may have the Russell 1000 index in its name, while another tracks Standard & Poor's 500-stock index. Both indexes focus on large domestic stocks and move virtually in lock-step, according to a study by CME Group, operator of futures exchanges.

The ETF's Web site will note the stocks that the index follows and the index's class, such as small company or emerging markets. If you already own similar assets, don't buy.

Some overlaps take a little more digging. For example, the biggest stock in Brazil is Petrobras, an oil company. If you own a Brazil ETF and an energy fund, you may be overexposed to energy. "The correlation between Brazil and these energy stocks is incredibly high," says Burns.

How is the index constructed? Most ETFs track an index. The majority of stock indexes are weighted by market capitalization, which is the number of shares multiplied by stock price. A company with larger capitalization will exert more influence on the index's movement than a smaller company.

Some ETFs follow other weighting systems. There are indexes that weight each stock equally. For instance, the Rydex S&P Equal Weight (symbol RSP) tends to underweight the large stocks in the S&P 500 index, while the smaller companies have more weight.

Some ETFs such as WisdomTree Dividend ex-Financials (DTN) weight based on stocks' dividends—the larger a company's dividend, the larger its weight in the index. Meanwhile, RevenueShares Small Cap (RWJ) tracks the same companies that are in the S&P SmallCap 600, but it ranks each company by revenue rather than by market capitalization.

The performance of ETFs that follow the same companies can vary depending on the weighting. For instance, equal-weight ETFs outperform market-cap ETFs when smaller companies do well, but they do worse when large-company stocks rise. Market-cap weighting drove indexes ever higher in the technology bubble. Dividend-weighted indexes were skewed toward financial stocks just before the 2008 meltdown.

For a diversified equity portfolio, your best, and most cost-effective, bet is to have most holdings in a portfolio of domestic and foreign stock ETFs weighted by market capitalization. Hold a small percentage in other weightings for insurance.

How closely will the ETF track the index? There are times when your ETF will perform differently from its benchmark. One reason for tracking errors is that indexes don't charge expenses while funds do. Also, some ETFs do not buy all of the securities in the index.

Before buying, look at the performance of the ETF and its relevant benchmark. If the ETF's performance is way off the mark, hold off.

What is the structure of the investment? Don't confuse exchange-traded funds with bank-issued exchange-traded notes. ETNs provide a return based on an index, usually of commodities. But an ETN doesn't actually hold any assets. Instead it is a promissory note. If the bank defaults, you could lose your investment. "You're basically an unsecured creditor," says Ferro. *

ETNs trade on exchanges like ETFs do. If you aren't certain about the structure of an exchange-traded product, check the sponsor's Web site. Don't buy until you know for sure. **K** —JOSEPH LISANTI