

Diversify your portfolio with Exchange-Traded Funds.

By John J. Lah, CFA

With the drop in the stock market of the past three years, in particular the technology sector, that old bit of wisdom “don’t put all your eggs in one basket” has really hit home for investors. In fact, academic studies over the years have shown that the asset allocation decision accounts for some 90% of the variation in total portfolio returns while only 10% of portfolio performance is affected by investment selection and timing. What this means is that, the correlation between the asset classes you invest in (i.e., stocks, bonds, international stocks, etc.) have a much greater impact on your portfolio than the individual securities that are selected within those groups.

Correlation is a statistical measure that is commonly used in the portfolio management process to determine how closely the assets in the portfolio tend to move together in the same direction. What this means is that, when it comes to portfolio diversification, simply holding many stocks or funds won't reduce your overall portfolio risk. It seems that many investors make the mistake of what I call buying in “bunches”. For instance, buying a bunch of top-performing growth funds, or buying a bunch of blue chip stocks, thinking that even if a few go down, others will continue to perform well. The problem here is that, growth funds or blue chip company stocks are all highly correlated. You've got to focus on holding non-correlated assets — that is, something that has a low or negative correlation. Large institutional investors have understood this concept for quite a long time, and they’ve devoted significant resources in developing a diversified portfolio in their asset allocation strategies.

Until recently, it was difficult and expensive for small investors to create an institutional type of portfolio allocation. However, with the widespread introduction of exchange traded funds (ETF's), from the likes of Barclays Global Investors (iSHARES), and Merrill Lynch (HOLDRS) among others, it is now possible for small investors to easily build a well diversified portfolio just like the big institutions. At last count, there were some 35 domestic stock index funds, 55 sector funds and 28 international funds. With just a single fund purchase, an investor can now buy the whole stock market for instance, by buying the DJ Total Market Index (AMEX: IYY), or create an exposure to the real estate sector by buying the DJ US Real Estate Index (AMEX: IYR). All of these ETF's are No-Load funds that trade just like stocks and provide the opportunity for small investors to create an asset allocation at very low expenses, ranging from 0.09% to 0.99% annually.

Let’s take for example an investor with a moderate tolerance for market fluctuations, that wants to create a diversified portfolio consisting of 50% general domestic equity, 30% fixed income, 5% real estate sector, 5% health care sector, and 10% international stocks.

Keep in mind that every individual’s risk tolerance and return expectation will be different, and there are no one size fits all combination, but for our example, if we create a portfolio allocation using the ETF's it might look something like this:

| Past 24-Months ETF Statistics | Symbol | S&P500 Correlation | Expense Ratio | Allocation | Weighted Expense Ratio |
|-------------------------------------|--------|-----------------------|------------------|------------|---------------------------|
| S&P 500 | IVV | 1.0000 | 0.09% | 20% | 0.0180% |
| NASDAQ 100 | QQQ | 0.8086 | 0.20% | 10% | 0.0200% |
| S&P MidCap 400 | IJH | 0.9080 | 0.20% | 10% | 0.0200% |
| S&P SmallCap 600 | IYY | 0.8603 | 0.20% | 10% | 0.0200% |
| MSCI EAFE Index | EFA | 0.5191 | 0.35% | 10% | 0.0350% |
| DJ Healthcare Index | IYH | 0.5971 | 0.60% | 5% | 0.0300% |
| DJ Real Estate Index | IYR | 0.5230 | 0.60% | 5% | 0.0300% |
| Lehman 1-3yr Treasury ¹ | SHY | -0.3246 | 0.15% | 15% | 0.0225% |
| Lehman 7-10yr Treasury ² | IEF | -0.3068 | 0.15% | 15% | 0.0225% |
| Total Portfolio | | | | | 0.2180% |

¹ Correlation was estimated using Vanguard Short-term Bond Index returns.

² Correlation was estimated using Vanguard Intermediate Bond Index returns.

A sample portfolio like this, will allow for a diverse participation in the markets with a very low portfolio expense ratio of just .218% (plus brokerage commissions), compared to something like .50% to 1.50% for a traditionally managed mutual fund.

When constructing a diversified portfolio, an investor should follow some basic guidelines: (1) determine an investment objective, (2) evaluate the risk tolerance and, (3) diversify among the asset classes that match the risk and return objectives. Now, with the increasing number of exchange traded funds that are available, investors have the ability to easily adjust their portfolio holdings among varying market sectors, or asset classes. Furthermore, these ETF's also provide tax efficient portfolio management because of their low turnover rate, and unlike traditional mutual funds, shareholder redemption activities won't result in capital gains distributions either.

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