

The EZ Approach to ETF Portfolio Building

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As investment products increase in number, complexity and cost, many individuals are plaintively searching for an investment approach guided by two very basic principles:

- Keep it simple, and
- Keep it cheap.

Exchange-traded funds (ETFs) offer a useful starting point for such an approach.

But with over 180 different exchange-traded funds to choose from (see the Guide to Exchange-Traded Funds in this issue), and an infinite number of portfolio combinations, how can you keep it simple?

In fact, building a diversified portfolio of exchange-traded funds is not nearly as complicated as it may at first seem.

The Low-Hassle Approach

Traditional portfolio-building strategies tend to assume that investors all have similar levels of time, effort and knowledge to devote to their portfolios. But, of course, these traits vary tremendously.

In “Your Mutual Fund Portfolio: Choosing the Level of Complexity” (November 2002 *AII Journal*, available at AII.com), John Markese introduced the concept of portfolio-building based on the level of complexity, with portfolios ranging from a basic, bare-minimum portfolio to one that is very complex.



This concept can be easily applied to exchange-traded funds.

Using the Level I and Level II portfolios illustrated in the original article as guidelines, you can build a simple portfolio of exchange-traded funds that requires little maintenance and is low cost.

What constitutes the Level I and Level II portfolios?

Any investment portfolio must follow some investment constants:

- First of all, it must meet your financial goals and match your risk tolerance. Your asset allocation—how much you put into the various asset categories—addresses these financial concerns and is driven by your investor profile.
- Secondly, it must be broadly diversified among major market segments.

With those constants in mind, the simplest approach is to build your entire portfolio around index funds. Index funds are passively managed portfolios, so you do not have to worry about evaluating the skill of a portfolio manager. They also provide automatic diversification—they are, by definition, completely diversified within the market the index covers. Lastly, they are low maintenance investments—you don’t have to monitor their performance against the benchmarks, because they are the benchmarks.

ETFs provide all of the advantages of traditional index mutual funds—including diversification, tax efficiency and low maintenance. They also feature rock-bottom costs, with expense ratios that are even lower than their mutual

fund counterparts. Of course, unlike mutual funds, ETFs trade on an exchange like stocks, so you will have to pay brokerage commissions. But if you stick with a low-cost discounter, and do not trade frequently (you should be invested for the long haul, anyway), you can keep these expenses to a bare minimum.

Leveling the Ground

Table 1 illustrates two basic exchange-traded fund portfolio levels. These should be viewed as a continuum of the simple to the complex and not as separate portfolios—Level I illustrates a realistic minimum, but the holdings can be augmented with Level II holdings.

[Cash holdings are not shown in these portfolios because there are no appropriate ETFs, but they should be a part of any portfolio to maintain liquidity; any short-term, liquid fixed-income investment with absolutely no default risk, such as a money market fund or bank account, can be used for this purpose.]

Level I: The Bare Necessities

Level I contains only three ETFs, but covers substantial investment ground.

The total U.S. stock market index ETF is just that: broad-based, with U.S. common stocks of all capitalization sizes—large-, mid- and small-cap.

While these ETFs hold thousands of stocks, the key is not the number but the weightings. Indexes are capitalization-weighted, meaning that stocks with large capitalizations (number of common stock shares outstanding times the market price per share) tend to dominate a total stock index fund. Holding a total domestic stock index

fund is a bare minimum holding; you may want to augment it with a Level II mid-cap or small-cap fund.

The total domestic market index ETF covers the U.S. markets, but your portfolio needs to be global in scope. Even if the allocation to foreign stocks is small, it does add to overall diversification and risk reduction. The Level I portfolio includes an all-in-one total international stock ETF that covers the primary regional economic zones: Europe, Asia/Pacific, and Latin America. This covers both developed and emerging international economies, but developed economies dominate the index, as does Europe, since capitalization weighting determines exposure and diversification.

The third component in the Level I portfolio is an intermediate-term government bond ETF. Intermediate-term maturities (average maturity of seven to 10 years) capture most of the yield and total return of a long-term bond fund with substantially less fund volatility caused by changing market interest rates. [Note, however, that if your bond holding is in a non-tax-sheltered environment and your tax exposure is significant, you may want to consider an intermediate-term municipal bond mutual fund—at this time, there are no municipal bond ETFs.]

Table 1. Building a Low-Hassle ETF Portfolio: Two Basic Levels

Asset	Level I Portfolio	Level II Portfolio
U.S. Stocks	Total U.S. Stock Market ETF	Large-Cap Stock ETF Extended-Market Stock ETF <i>Or</i> Large-Cap Stock ETF Mid-Cap Stock ETF Small-Cap Stock ETF Micro-Cap ETF
International Stocks	Total International Stock ETF	European Stock ETF Pacific Stock ETF Emerging Markets Stock ETF
Bonds	Interm U.S. Gov't Bond ETF	Short-Term U.S. Gov't Bond ETF Long-Term U.S. Gov't Bond ETF

Beefing Up the Minimum

Level II ratchets up the complexity if you want to be able to control asset allocation and diversification more precisely but still employ the efficiency and simplicity of an index approach.

Level II breaks the total U.S. stock market index into several components: Either a large-cap ETF plus an extended-market ETF (these funds include both mid-cap and small-cap stocks), or a large-cap fund plus a mid-cap ETF, a small-cap ETF and possibly even a micro-cap ETF. By pairing a large-cap fund with ETFs that cover these other market segments, you can fine-tune the ratio of smaller to larger companies to meet your objectives.

Level II should be thought of as an opportunity to mix and match with Level I rather than as an either/or choice. However, making major shifts between growth and value and small and large companies based on a forecast can defeat the original purpose of passive investing.

Similarly, the foreign markets are broken down into a European stock ETF, a Pacific stock ETF and an emerging markets stock ETF, allowing choice in allocation between the more developed markets and the emerging markets of the Pacific Rim and Eastern Europe.

Table 2. ETFs for Level I and II Low-Hassle Portfolios

Total U.S. Stock ETFs iShares Dow Jones U.S. Total Market Index iShares Russell 3000 Index streetTRACKS Total Market Vanguard Total Stock Market VIPERs	Small-Cap Stock ETFs iShares Russell 2000 Index iShares S&P SmallCap 600 Index Vanguard Small-Cap VIPERs
Large-Cap Stock ETFs iShares Russell 1000 Index iShares S&P 500 Index SPDR Trust Series I Vanguard Large-Cap VIPERs	Micro-Cap Stock ETFs iShares Russell Microcap Index
Extended Market ETFs Vanguard Extended Market VIPERs	Total Market International Stock ETFs iShares MSCI-EAFE
Mid-Cap Stock ETFs iShares Russell MidCap Index iShares S&P MidCap 400 MidCap SPDR Trust Vanguard Mid-Cap VIPERs	European, Pacific and Emerging Market ETFs Vanguard European VIPERs Vanguard Pacific VIPERs Vanguard Emerging Market VIPERs
	Interm-Term U.S. Gov't Bond ETF iShares Lehman 7-10 Year Treasury Bond Fund
	Short-Term and Long-Term U.S. Gov't Bond ETFs iShares Lehman 1-3 Year Treasury Bond Fund iShares Lehman 20+ Year Treasury Bond Fund

and sold more frequently in the fund). [For more on the various indexes and their differences, be sure to read next month's Mutual Funds column "Stock Index Funds: More Choice and Complexity," by John Markese.]

The ETFs listed in Table 2 are all based on widely followed indexes that offer the most complete coverage

For the bond holdings, Level II offers a short-term U.S. government bond ETF and a long-term government bond ETF, enabling you to create your own maturity level. A long-term government bond ETF can provide a higher return, although with more volatility; combining it with a more stable, although lower-yielding short-term government bond ETF allows you to control how much extra risk you are willing to take on for added yield.

Populating the Levels

While Table 1 provides a generic outline of your simple exchange-traded fund portfolio, Table 2 lists the ETFs that most closely match the Level I and II holdings.

How did we choose these funds?

Although there are nearly 200 ETFs to choose among, by far the largest number of ETFs either cover specific market sectors (such as financial or energy stocks), or are style specific (for instance, growth or value indexes).

Sector funds concentrate on one industry or a few closely related industries, and as such they are not well diversified. Similarly, style funds focus on stocks with either growth or value characteristics; they also tend to be concentrated in certain industries and not well diversified. Beyond any additional risk, the trick to master is just which sector or style funds to invest in, adding to the complexity of the analysis. Therefore, these ETFs were easily eliminated.

It is also important to select an ETF that covers a suitable index. For example, a number of the broad-based ETFs in our listings are based on "enhanced" indexes. Although the fund itself is passively managed, the index follows a rules-based approach that is semi-actively managed. This defeats the purpose of a simplified index approach—it is higher maintenance (you need to monitor how the index behaves in different market environments), and it can result in higher fund costs (stocks have to be bought

of the Level I and Level II market segments.

Table 2 narrows your choices down considerably. And remember when looking at the list, you only need to pick one fund from each market segment. Index funds, including ETFs, are by nature fully diversified. For example, you do not need to own two different mid-cap ETFs.

Keeping It Simple

Despite the large number of ETFs available, it is possible to quickly narrow down your choices and build a simple, low-cost portfolio of exchange-traded funds.

The approach illustrated here allows you to build a portfolio that requires very little time and energy to manage, is relatively low cost, and yet provides substantial diversification. It can be used with portfolios of any size, from the very modest, to the largest holding millions of dollars (don't we all wish?). ▲