Upgrade Your Portfolio with Exchange-Traded Funds

Profitable ETF Strategies

iMONEY

for Every Investor

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Preface

ETFs for Everyone

Time and research have demonstrated that individual investors like you want to be empowered—and to get there, you are seeking new information, new products, and more powerful tools to aid in your quest. You want control over your portfolio, and you want to know what's actually in it. Thanks to great advances in technology and the increasing globalization of the world economy, today it's easier than ever for you to take investments into your own hands.

Maybe you already know about exchange traded funds (ETFs), but you'd like to know more. Or you know a lot about them, but you haven't quite figured out how to incorporate them into your portfolio. With hundreds of ETFs dotting the financial landscape, becoming ever more specialized and covering some creatively constructed indexes, trying to figure out how they work and how to use them to your best advantage can be a daunting task.

We've taken the time to speak with and e-mail individual investors just like you. We've actively solicited your comments and input on our blog, ETFTrends.com, every step of the way. We asked: How did you discover ETFs? What have your experiences been so far? And how do you use them to your advantage? Your answers helped shape the direction of this book. We also sought expert advice and opinions about ETFs—where they've been and where they're going. We've done extensive research, in an attempt to make this book the one-stop-shop for ETF information. And we hope it will be light and entertaining as well.

ETFs came into existence in the early 1990s, but they didn't really take off until a series of scandals rocked the mutual fund industry. Today they're a formidable challenger to the mutual fund throne. To understand ETFs fully is to know where they came from and how they—and the underlying indexes they track—are created. This is why we've broken it down for you and given you a brief history before we dive in and discuss the nuts and bolts of the industry. We also have special chapters devoted to both buy-and-hold and trading strategies.

It's now more important than ever to ensure that you have a handle on your retirement savings. With lavish pension plans quickly becoming extinct, people can no longer just assume that the government will carry them through. How dire is the situation? During World War II, there were 42 workers paying into Social Security for each person receiving benefits. By 2030, projections are that only two working people will be contributing for each person receiving benefits—and most baby boomers will be retired by then. Ouch. But all is not lost if you firmly resolve to look out for yourself and your money.

Our goal in writing this book is to give you confidence to make wise, educated, and informed choices about the investments you make when it comes to ETFs. We want you to have a solid grasp of how ETFs work. You will be able to put together a portfolio that works best for you, and you'll have the tools to manage your portfolio effectively. Ultimately, we want you to be a successful investor.

—Tom Lydon

A Multipurpose Tool

ETFs are the Swiss Army knives of investments. They can do myriad things for millions, yet provide a single tool that's extremely specialized. Over 20 years and in 5 books on investing, I've yearned for such a tool. Now that ETFs have entered the mainstream, it's finally possible for everyone to start using them to boost their returns and lower their investment costs.

I've long been troubled by high expenses and lack of transparency in annuities, brokerage accounts, mutual funds, and retirement plans. Do you know how much brokers, middlemen, and fund managers are gouging you for investing your money? What about your 401(k) or pension fund? If you don't know, it's probably too much.

I've seen instances of investors being fleeced for more than 3 percent per year in some accounts. I know that doesn't sound like much, but considering that an ETF offers the same range of investment products *and* much more diversification and transparency for as little as .07 percent per year, it should make you mad. It makes *me* mad every time I hear from one of my ripped-off readers.

Enter ETFs, which you can look into with fishbowl transparency, pay rock-bottom fees for, and track on stock exchanges every hour of the day. ETFs that invest in stock indexes offer you the added feature of lowering your tax bill. Because they hold a constant basket of stocks, they almost never generate capital gains taxes. In this sense, they are far more efficient than actively traded mutual funds. And because ETFs are mostly a static pool of securities, you don't have to suffer from managers making bad decisions—which they make consistently—in timing the market.

Why employ a manager or broker to guess on a single hot stock, sector, industry, or country? You don't have to because ETFs enable you to buy entire markets. Of course, even though they are a worthwhile tool to build wealth, they are far from perfect; you need to know how to use them. That way, you'll be able to take charge of your investments and reach all of your financial goals. You'll also achieve what I call a "New Prosperity"—that is, the point at which your investments serve you silently so that you're free to live the life you want.

The core of the iMoney philosophy is that you put *information*—the *i* in *iMoney*—to work to create knowledge. We'll help you avoid powerful yet consistent pitfalls in investing, to use the current information available at ETFTrends.com and other resources, and other investment research to convert your newfound knowledge into wisdom that you'll be able to use the rest of your life. We've taken the best ideas from investment savants such as Jack Bogle, Warren Buffett, Burton Malkiel, and others to help you craft flexible, customized portfolios that work for you over time. Along the way, we've sampled the wisdom of Modern Portfolio Theory, behavioral finance, and Nobel Prize–winning economists to make the learning curve less steep.

Better yet, by employing our iMoney strategies, you won't be able to blame someone else for taking advantage of you. As the old maxim goes, "Only a bad carpenter blames his tools." Read, enjoy, and prosper.

—John F. Wasik

Introduction: A New Investment Strategy

I always said that no one will look out for your money better than you. Nobody cares as much as I do.

—Kentucky investor Donn Soderquist

In the late 1960s, Tom's dad was a stockbroker in Boston and he recalls fondly that his office was on one of the top floors of the Prudential Building, which at the time was the tallest building in the city. When he took me to the office, I was impressed with not just all the machines, ticker tape, and phones, but also the fact that my dad's company literally towered above all of the other companies in the Boston area.

Seeing that sparked an interest in what my dad actually did. He explained that he helped people manage their money, and he taught me a little about companies and stocks. As I learned more, I asked my dad where he invested his money, and he said, "Mutual funds."

Dad liked to read *Barron's* on the weekends, and back in the 1960s, you had to have a copy reserved at your local store. Many Saturdays, we'd take a drive into the next town to pick up the latest issue. In the middle of each magazine were pages of statistical information on individual stocks. One small section on a single page listed the 300 to 400 mutual funds that were available at the time.

Dad explained to me the advantages funds had over stocks (they were diversified) and said that instead of owning individual stocks, you could hold a basket of stocks. Theoretically, if the general market went up, the mutual fund would go up as well. If you bought an individual stock, it wasn't always guaranteed that if the market moved up, the stock would. As time went on and my interest grew, I'd grab Dad's copy of *Barron's* and look to see how his Nicholas Fund was doing.

Over the years, I enjoyed continuing my education about mutual funds as their popularity grew, the number of fund companies grew, and the number of mutual funds grew. After I graduated from college, I interviewed with Fidelity Institutional. One of the main interview questions was, "Can you tell us what a mutual fund is?" Although I had gone to an undergraduate college that's known for its business program, we spent very little time actually learning about investments. If I hadn't spent the time with my dad learning the ins and outs of mutual funds and thumbing through his copy of *Barron's*, I would have surely messed up that interview.

Investors Want More

The growth of the Exchange Traded Funds (ETF) marketplace reminds me of the growth of mutual funds in the late 1960s, 70s and 80s. Investors are still looking for diversified investment options run by qualified individuals who worked at trusted companies with big names.

Over the past few decades, trillions of dollars have flowed into the mutual fund arena, and for the most part, investors have been served well. But today they are looking for more. *You want diversification, and you need to know exactly what managers are buying. And you're more price conscious than ever.*

With today's advances in technology and communication, individual investors and advisors desire a more active role in directing their portfolios. Not all investors feel the need to pay a fund manager to make the decisions for buying and selling for a particular mutual fund. Instead, they tend to appreciate the flexibility of being able to select asset classes, sectors, or global regions in a quick, easy, efficient, and inexpensive way.

Sure, those conventional mutual funds will continue to proliferate. But ETFs are on the verge of hitting a tipping point in the eyes of individual investors and financial advisors as a greater percentage of new money flows into ETFs.

Just a few decades ago, only a few hundred mutual funds existed. But when they really caught on with the general populace, they took off so quickly that they made the Road Runner look pokey. After several years of holding steady in their numbers—a few hundred or so—new funds suddenly began appearing almost daily by the late 1970s. It was as though someone had found a mutual fund dandelion and blew the seeds this way and that. Funds were on fire, and their managers were stars.

Mutual funds covered it all—all asset classes, sectors, and global regions. There were mutual funds covering almost any area a big-thinking investor could dream up—it was simply a matter of putting together a basket of stocks. At the height of it all, it must have been a nightmare for a person who has trouble making decisions, with 11,000 mutual funds to choose from.

Although the number of mutual funds has declined in recent years because of the wounded trust resulting from scandals of the late 1990s and growing investor education about their shortcomings, they still have longevity and name recognition. They're like your favorite slippers—a little beat up, but still cozy and familiar. They won't be going anywhere anytime soon, and, if nothing else, mutual funds have proved the naysayers wrong. They did become big, and they are sticking around.

The mutual fund industry became an unqualified success story, with more than $24 trillion in assets worldwide. It now has a worthy rival.

Enter the ETF, the Younger, Sleeker Cousin of the Mutual Fund

Much like mutual funds during their rapid growth period, ETFs are sprouting up like June corn in an Iowa field. After hitting the market in 1992, ETFs now hold nearly $600 billion in assets in more than 600 funds. Considering that only 32 funds were trading in 1999, representing only $36 billion, their ascent has been dramatic. By comparison, the mutual fund industry, which began in 1924, took 60 years to reach the same asset level that ETFs enjoy today. The exchange traded fund market is expected to grow 33 percent annually until 2010, reaching almost $2 trillion.

Some days several new ETFs come to market. And if there isn't an existing index—say, something for a particular country or currency—ETF providers will go ahead and create an index and build an ETF around it if there's enough interest. Although the first—and, by far, the most popular—ETFs were the traditional ones that track stock indexes, an ever-growing variety of ETFs covers specialized sectors and markets (stocks, currencies, commodities). Chances are, you could find an ETF that seems as though it was tailor made for you. And much like the mutual funds did when they were proliferating, new ETFs are appearing all the time from a combination of factors—chiefly, consumer demand and whatever is the latest, hottest sector.

ETFs are the brash new kid on the block, offering innovation and a stream of fresh ideas. They're turning a decades-old formula on its head, offering greater flexibility, more opportunities for diversification, and the chance for investors to get in on exciting markets that were previously closed to them. Here's what they are and what they do better than mutual funds:

- **They're served up in a basket.** Like mutual funds, ETFs pool various securities—stocks, bonds, commodities, currencies—into one package. Most often these packets are reflected by an index that represents a large group of investments. The Standard & Poor's 500 index represents the 500 largest stocks by market value, for example. This basket is then treated like an individual security and listed on an exchange. Constantly creating and redeeming shares "in-kind," ETFs exchange shares for pools of underlying securities.

- **They make trading easy.** As separate, listed securities, ETFs trade just like stocks. You can buy and sell them through brokers, and they are traded throughout the day. Their prices constantly reflect changes in market prices. They are different from open-ended mutual funds, in which investors buy shares in a pool of securities. Mutual funds are not listed on exchanges. When you purchase shares in an open-ended mutual fund, new shares are created. With ETFs, you buy them the same way you would a stock, using techniques such as shorting (selling in anticipation of a price drop), limit-buys, and stop-loss orders. You can also write options—both calls and puts—against ETFs. You can't do that with mutual funds.
- **You know what you're buying.** ETF managers publish their holdings every day and note any changes. Most portfolios that represent an index rarely change at all. You know what you own at all times. What you see is what you get. That's not possible with an open-end, actively traded mutual fund, which only has to publish quarterly statements and won't fully disclose its trading expenses. As such, ETFs are not subject to the kind of trading abuses that have ravaged mutual funds in the last decade. ETFs are continuously repriced throughout the trading day, so late trading isn't possible. In comparison, the net asset value (NAV) of traditional mutual funds is always a trading day's closing price.
- **Their cost is very low.** Because there's little in the way of trading costs—holdings in index ETFs are rarely sold—management fees are low. Although you'll pay a brokerage commission to buy or sell them (we recommend working with a deep-discount broker), expenses are minimal in ETFs because they are efficient. Considering that the average actively managed stock mutual fund charges you 1.50 percent per year in management expenses, the savings are significant, according to Morningstar, Inc., the Chicago-based financial information company. The average U.S. stock ETF charges .41 percent annually.

- **They're tax friendly.** If an actively managed, open-end mutual fund has a good year, you'll often pay for it in taxable gains outside of a tax-deferred account. Not so in most ETFs, which are largely insulated from the need to sell holdings for shareholder redemptions. Most index ETFs have static portfolios that are passively managed, so they generate gains only if a security needs to be sold because the index keepers have changed the index. So most ETFs don't generate capital gains from buying and selling components; you pay tax only on profits from selling your ETF shares, meaning that you also control the timing of taxable outcomes.
- **They help you diversify and reduce risk.** Because ETFs are broad baskets of securities, they can represent entire markets. Want to buy a fund representing all listed U.S. or foreign stocks? How about sampling most large overseas stocks? Or U.S. bonds? ETFs can do that and more. By giving you exposure to more securities, they lower your portfolio risk. You need never buy another single stock or actively managed mutual fund again. Why gamble far too much money on what you think will be the next Google when you can buy an entire fund full of potential winners from all over the world?

Profit with Prudence, Avoid the Hype

ETFs are the good-looking new kid in school, the one the other students want to get to know a little better. Getting swept up in a lot of hype, though, could be deadly to the money you're investing. ETFs may be a welcome addition to any portfolio, but they are hardly perfect. Unlike no-load mutual funds, you can't buy them directly from the distributor.

You need to purchase them through a broker, preferably a deep-discount house. And it may not make sense to buy them in small increments because you will be dinged with a commission every time you buy or sell. If it costs you more than .50 percent per transaction, buying through a similar index mutual fund might make more sense if the ETF equivalent is available. If you do dollar-cost averaging by buying a small number of shares each month, ETFs may not be the right vehicle for you unless you're in a specialized plan that can buy shares through a trust or retirement plan (see Chapter 12, "iMoney ETF Portfolios"). If you want to generate dividend income from an ETF, make sure your broker pays those directly to you or allows for automatic dividend reinvestment.

Also keep in mind that because ETFs trade during the day, their NAV, or the total value of all securities held in the portfolio, also changes. There may be a slight difference between the NAV and the fund's market value, known as a premium or a discount. There's rarely a very large gap between the two numbers, although you should be aware that it exists.

The low management costs of ETFs also make them a little too appealing, so you might fall prey to the "buffet effect." When something is cheap, we tend to buy more of it, whether we need to or not. We know the temptations of a hot new product that promises unlimited wealth. Can you spell *dot.com*? As streamlined investment vehicles, ETFs strive to do what mutual funds have done, only with more investor-friendly features. Yet you can't fully take advantage of ETFs unless you understand what they are and what they can do. We hope to provide a roadmap to ETFs through our iMoney strategies.

How to Use This Book

The beautiful thing about ETFs is how you can tailor them to your goals and your ability to stomach portfolio risk. Are you a staunchly conservative buy-and-hold investor? We've got several portfolios that could work for you, just as we do for the daredevils among you who prefer lots of trading and a black diamond level of risk.

- If you know all you need to know about the history of ETFs, skip to Chapter 3, "Investing in Domestic Shares: U.S. Stock Index ETFs."
- Just need ideas for building your own portfolio? Chapter 12, "iMoney ETF Portfolios," offers you one-stop shopping.
- Want to take the plunge and explore the new world of commodity or currency investing? Go to Chapters 6, "Gold, Silver, and Oil: Commodity ETFs," and 7, "A Buck Isn't Worth a Dollar: Currency ETFs."
- Just want to build secure retirement portfolios? Sample Chapter 10, "Hedging Your Bets: Long and Short ETFs."
- Don't have a clue about ETFs? If you're just getting started, go to the next chapter. The industry's history is worth exploring, and you'll need to know the foundation of ETF indexing.

Along the way, we've set up some signposts to help you understand our investment philosophy: Understand risk, diversify, and know what you're doing. Our "iMyths" hopefully will dispel some common misconceptions about investing. And because we realize that learning about ETFs can be information overload, we've included "iMoney Strategies" at the end of each chapter to provide a summary and clear guidance.

Although some might argue that we have more than enough things to play with when it comes to ETFs, it's not stopping some companies from creating new tools to enliven the ETF experience. If you choose to play the market and make guesses on its direction, you can use ETFs to place those bets (see Chapters 6 through 9, 11, and 12). We don't recommend it (most people fail miserably at this), but there are often good reasons to short an index, if for no other reason than to give you some downside protection. Of course, you're not limited to profiting with ETFs when the market is doing well. They also make it possible for investors to game the swings in the market and to come out ahead even while the numbers are falling—namely, through short-selling. It's a tricky method of investing that involves borrowing securities when you believe they're going to lose value. Chapter 11, "What Lies Ahead: The Future of ETFs," is for you if you're this kind of investor. Don't worry, we'll explain it in greater detail later!

For those of you continuing on our scheduled tour, grab something to drink and relax as we regale you with a brief history of ETFs.

1

Busted: The Failure of Mutual Funds and Birth of ETFs

ETFTrends.com reader Layne Prebor is quitting his last mutual fund and has decided to take matters into his own hands: "[I] have assumed complete responsibility for my investment decisions."

One day, John Wasik had the honor of playing audiovisual geek for John C. "Jack" Bogle. John remembers ....

I had booked him to keynote a business journalist's conference (the Society of American Business Editors and Writers) in Denver, and his PowerPoint presentation didn't make it to the hotel, so he punted with some old transparencies and an overhead projector. It was Stone Age compared to today's slick presentations, but Bogle delivered it effortlessly in his dead-on, humorous style.

For those of you who don't know Jack Bogle and his amazing career, you're in for a treat. Among other things, Bogle is the Thomas Edison of the stock-index mutual fund. More than 30 years ago, Bogle had this idea that instead of guessing which stocks would do well, he would package them all in one fund: the Vanguard 500. As the chairman of the Valley Forge, Pennsylvania–based fund giant (the only one mutually owned by its customer-investors), he saw that a number of roadblocks got in the way of investors earning market-based returns.

Managers consistently made bad decisions in buying and selling stocks. They bought and sold at the wrong times. They passed their trading costs along to shareholders. Most of them couldn't beat the market averages over time. Even if they had a great year, they were probably lucky and were unlikely to do it again. This was the core of Bogle's research, and his inspired mental lightbulb led to the index fund.

So when Jack finished his incredibly precise and typically devastating critique of actively managed funds, he told John to keep his transparencies. "I felt like Moses had descended from the mountain and he handed *me* the tablets," John says. "It's been nearly half a decade since Bogle gave his presentation, but I still have his transparencies and a clear memory of what he said."

The title of Bogle's talk was "It's an Ill Wind That Blows No Good: How the Mutual Fund Scandals Will Serve Fund Owners." At the time, the acrid smell of the mutual fund late-trading scandals was a lingering stench over some major mutual fund companies (not Vanguard, though). Managers from older, established complexes such as Putnam Investments, which offered the very first mutual fund, allowed hedge fund operators to trade against their portfolios when the market closed. This was a fraud against hapless fund investors who trusted the mutual fund companies to protect and invest their money.

Bogle noted this precipitous fall from grace in his speech and added a few pointed barbs of his own. In many ways, he presaged the rise of ETFs. The trust vacuum needed to be filled. Smart investors were tired of half-truths and portfolios they couldn't see into; they'd had enough. ETFs gathered steam in the wake of the scandals and haven't looked back. Once again, Bogle laid the groundwork:

- **Cost matters!** Bogle studied the relationship between high-cost actively managed stock and index funds. The difference in returns over the 18-year period he studied (1984–2002) was remarkable. The costliest funds posted a 6.8 percent actual return—6.5 percent when you adjust for risk and a paltry 4.3 percent when you subtract taxes. In the same period, low-cost funds turned in a 10.2 percent actual return—10.3 percent risk adjusted and 8.3 percent after taxes. That last number is critical: You could nearly double your return by staying in an index fund that didn't trade. That's the foundation for index ETFs: Eliminate the management and trading costs and errors, and you boost your total return.

- **Timing and selection cream investors over time.** As if the cost argument weren't enough, Bogle found that you paid dearly for managers consistently guessing wrong on which stocks to buy and how they timed their purchases. He looked at one of the greatest periods of stock market growth and discovered that investors were getting nowhere near market returns. In fact, they were getting fleeced. In that period, stocks rose 12.2 percent. When you subtract management costs and the expenses due to bad timing (most investors guess wrong on when to buy and sell), active fund investors received a pathetic 2.6 percent return.
- **Buy high, sell low?** Most investors dive into the market near the top and sell near the bottom. Many active managers do the same. It's a strategy guaranteed to lose money. Bogle's graph showed that $1.5 trillion flowed into stock mutual funds in the first quarter of 2000, which was when the market peaked before it headed south. Was this unusual? No. The mutual fund and brokerage industry relentlessly advertised returns during the dot.com bubble, performance that was unlikely to be repeated and certainly destined to go the other way. Open-ended funds are also cursed by their organizational structure. When fundholders are selling their shares, managers must sell off positions to meet cash redemptions. That means, they, too, are forced to sell at the worst time.

Brain Freeze: We Listen to Bad Vibes

Although Bogle didn't discuss this at the time, we're hardwired to consistently do the wrong thing in investing. Our brains are programmed to be optimistic, misinterpret short-term trends as long-term realities, and see patterns where there's only random noise. We love trends. We love winning when everything seems to be coming up roses. We hate losing and have a hard time owning up to it. Denial then becomes our best friend. These components of our genome consign us to be consistent losers at investing—unless we listen to the rational voices in our brains. As investors, we can do much better. As Jason Zweig says in his book *Your Money and Your Brain,* if you've never yelled, "How could I have been such an idiot?", you're not an investor. There is almost nothing, Zweig says, that makes smart people feel as stupid as investing does.

It's possible to ignore Wall Street and the fund industry as they vie for our hearts, minds, and money every day of the year. What's important is to recognize that there's another way of thinking about investing. Instead of timing the market, forget about timing. Got your eye on a hot new search engine company? Forget about it. Most new businesses go out of business. Think passive. ETFs were born to the role, but their birth came after some rough years in the mutual fund business. Despite this investment wisdom, mutual fund companies barrage us with yesterday's returns, luring in billions when we're most vulnerable to believe the good times will last. (They never do.)

How could you have predicted when these funds would have had their hot years or their failure to repeat those stellar numbers? You couldn't. But you can see how the index investors fared. Although they didn't catch those incredibly stratospheric returns, the downside was mild—they were three times less volatile! Unfortunately, most investors would have been lured in by the returns of the 1998–1999 period, only to be burned in 2000–2001.

Table 1.1 Yesterday's Winners, Tomorrow's Losers: Active Funds' Declines

	1998–1999		2000–2001	
Fund	**Rank**	**Return**	**Rank**	**Return**
Van Wagoner: Emerging Growth	1	105.52	1106	–43.54
Rydex OTC: Investor Shares	2	93.43	1103	–36.31
TCW Galileo: Aggressive Growth	3	92.78	1098	–34.00
RS Investor Shares: Emerging Growth	4	90.19	1055	–26.17
PBHG: Selected Equity	5	84.56	1078	–29.03
Average Fund Return		**76.72**		**–31.52**
S&P 500 Return		**24.75**		**–10.50**

Source: Bogle Financial Research Center

A Brief History of Mutual Fund Folly

Before we introduce our iMoney strategies, a little history is in order. No, we're not going to tell you about the Treaty of Ghent. Let's look at the history of mutual funds for a bit. Outside of your home, your most valuable assets and favorite investments are probably mutual funds and stocks. If you're like most investors, it's where you have most of your money: your 401(k), your IRA, your children's savings accounts, and your long-term savings. It's a long tradition: Mutual funds and stocks have been the investment of choice for the vast majority of Americans for decades. If you work with an investment advisor, financial planner, or brokerage company, they've directed you to them, too. Today more than $10 trillion is invested in mutual funds in the United States alone.

The last decade or so has seen a change in the air. Those warm feelings investors once had toward their mutual funds, in particular, have slowly begun to grow cold, and it shows. The trust once freely given to mutual funds has flown out the window as poor returns and white-collar crime have tarnished their reputations.

A market crash should provide lessons for every investor, although far too many have short memories. In March 2000, the stock bubble popped. By fall 2002, the S&P had declined 46 percent from its peak and the NASDAQ lost a staggering 72 percent of its gain, known as "giving back."

Mutual funds were not immune to the fall. Fund managers can do only so much to avoid having their funds follow the market. They suffered equally, to the surprise of most of their shareholders, who expected their managers to outperform the indexes. They were paying good money for the expertise of these managers, and they didn't seem to be getting it. Stock mutual funds declined *en masse,* and some of the high-profile funds gave back much more than the S&P 500. Even balanced funds, those invested in both stocks and bonds, suffered, to the dismay of investors who selected them as a more conservative investment.

Billions of dollars flowed into aggressive growth and technology funds in the late 1990s as a result of mutual fund companies spending millions advertising and pushing their high-flying funds. Remember those days when you couldn't open a newspaper or magazine without seeing a mutual fund company touting its funds? Those aggressive growth and technology-heavy funds touted glowing track records as if these exorbitant returns would continue forever.

Bubble Mania: Falling to Earth Again

The fund companies weren't dumb—they knew what they were doing during the dot.com bubble. It was a time when everyone and their brother was talking about the stock market. Fund companies were looking to grab their share of the pie, so they spent money on advertising and marketing to investors who were looking for big returns. But there was plenty of blame to go around: Investors plugged their ears and sang "Lalalala" when it came time to talk about balanced funds; they wanted to hear about funds with the biggest and quickest payoff. Because the customer is always right, the fund companies played along and gave it to them.

iMyth: Bigger Is Not Better

For years, mutual funds advertised how much money they managed. Like sheep in a flock, investors piled into name-brand, actively managed funds. People assumed that the more assets a fund scooped up, the better decisions they would make and the lower the costs would be. After all, when you're managing billions of dollars of other people's money, don't you tend to be more cautious and make maximum use of economies of scale and your huge, brilliant research staff? Actually, the opposite appears to be true. Bogle studied the relationship among fund assets, expenses, and returns from 1978 to 2002. Not only did annual fund expenses climb (from .03 percent to .80 percent over the period), but money kept flowing in, even during years of underperformance relative to the S&P 500. Even though the funds he studied couldn't beat the S&P 500 from 1994 to 1997, they pulled in about $400 million per year. These funds weren't even mediocre; that would have been matching the market average. In some years, the funds lagged the market by 10 percentage points. Bigger is not better when it comes to achieving market returns. Fund size has nothing to do with performance. Keep your expenses low and match the market with an index ETF.

Listening to chants from financial analysts that "this time is different," most of the shareholders of the hottest funds came on board in 1998–1999, just in time for the bear market's emergence from hibernation in 2000. The high-profile funds lost altitude quickly. Unfortunately, the fund companies weren't handing out parachutes to shareholders.

As the stock market decline worsened, mutual fund call center phones rang off the hook. Shareholders were holding the line, and they wanted some answers about their deteriorating savings. The mandate came down from mutual fund management: Tell the shareholders that ups and downs are natural for the stock market, and that it's more important not to panic and to adopt a "long-term perspective." That had to be a reassuring thing to hear for someone just a few years from retirement.

Back then, being a phone rep for a fund company must have been like working in the complaint department at White Star Shipping in 1912, the year in which the *Titanic* sunk. The fact is, investors got caught up in the hype of the stock market boom of the 1990s, and fund companies did little to protect investors from what was coming. In fact, many saw an opportunity to capitalize, and they did just that.

After the Bubble Burst: Salt in the Wounds

In early 2003, the bleeding finally stopped. But then the dust settled and reality set in. Millions of investors saw their portfolios cut in half (or more), and they spiraled into a vortex of depression and disappointment. What followed was a psychology student's dream: a living demonstration of coping mechanisms.

Some investors just played ostrich and stuck their heads in the sand. It was easy to play "don't ask, don't tell" and simply ignore the statements from the fund and brokerage companies when they came in the mail. Why not? The fund companies aren't going to call and ask you if you opened your statements this month—especially not if things are heading south.

Some of the most badly burned investors swore off the stock market for good. These investors considered this experience too painful, and today they are settling for low-yielding bonds, CDs, and money market funds, and they aren't looking back. Better safe than sorry. Other investors just faced reality. They opened their statements, calculated their losses, and licked their wounds.

As if loading up on aggressive mutual funds and going through the worst market decline in three decades wasn't enough for shareholders to endure, on September 3, 2003, New York Attorney General Eliot Spitzer kicked off a massive industry-wide probe. He alleged that four prominent fund managers had allowed a hedge fund to trade in and out of mutual funds in ways that benefited the parent companies at the expense of long-term shareholders. In short, the big guys were robbing the little guys.

Bad Performance: The Final Straw

Although some of these funds have made amends and worked hard to restore their relationships with investors, trust is proving difficult to get back. Financial reporters who had been strong supporters of mutual fund investing changed their tone and started to increase their criticism of mutual funds. John was one of them.

It wasn't long before shareholders, too, began to demonstrate their displeasure with certain funds. At the time of the downturn and the scandals, there was an increase in the amount of performance analysis of mutual funds: Were they really as good as people thought? It turns out that the answer was a resounding no.

Studies revealed fewer than 10 percent of active funds outperformed their benchmarks over time. If nine out of ten mutual funds trailed the S&P 500 index over time, you might rightly ask, "Why own a mutual fund?"

Then investor advocates started measuring returns through *asset weighting.* This method looks at performance based on when you actually purchased shares. Most investors bought into funds at the height of their run-ups, then rode them on the way down. They weren't getting the returns the fund companies were advertising.

In the wake of the market decline, the scandals, and the realization that few funds outperformed their benchmarks, the number of mutual funds began to consolidate. Today there are a little more than 8,000 mutual funds, down from a high of 11,000 at the market top in

2000. Each year, 300 to 500 mutual funds are lost because poor-performing funds are being killed off or merged with other funds that have better track records.

You would have thought that the scandals chastened the industry to offer full disclosure on all their portfolios, but that didn't happen. In many cases, the directors of the funds—the stewards representing outside investors—are often the very people running the management company. That has been changing with the addition of independent directors, but plenty of conflicts are still built into the system.

To this day, you still don't know how much managers are costing investors in terms of bad trades or total transaction expenses. These are hidden from view because if they revealed the total impact of these costs, returns would diminish even more.

Once again, Bogle was right. Costs matter big-time because performance suffers. The firms that paid attention to this message have benefited the most. Ninety cents of every new dollar invested in mutual funds today is sent to one of five fund companies: Fidelity, American Funds, Vanguard, Barclays, and Dodge and Cox. None of these five companies was implicated in the mutual fund scandal. Don't get us wrong: There are many great mutual funds out there, although very few of them are actively managed. Index funds, which can be most efficiently packaged in ETFs, make the most sense for the majority of investors.

That begs the question: If actively managed mutual funds aren't meeting their benchmarks and the lack of transparency has been an increasing problem for investors, why not go straight to the source? Why not just buy the index?

Index Investing Writ Large: How ETFs Can Be Employed

ETFs got their start in the United States by tracking some of the largest stock indexes—in particular, the S&P 500, the Dow, and the NASDAQ. Since then, ETFs include everything from the smallest public companies to currencies.

Not only are ETFs sprouting up in the areas mutual funds are already covering, but they're expanding into new ones that were previously unavailable to individual investors, such as foreign currencies and commodities.

Indexes can give you diversified ownership in entire markets in one package, including products that are difficult to invest in outside of futures exchanges. At one time, only the wealthiest of investors could trade in commodities. But ETFs have made it possible for anyone to get in on the game.

Not only can ETFs give you access to investments that mutual funds can't, but they can be solid, long-term investment vehicles—if you follow our iMoney strategy. ETFs offered in 401(k) plans aren't widely available yet, although they are becoming more widely known (see Chapter 12, "iMoney ETF Portfolios"). One forward-thinking fund manager created software enabling him to manage a variety of ETFs in 401(k) plans while keeping costs low and active management to a minimum. We think it's the wave of the future.

iMoney Strategy: Our ETF Analyzer

As long as you are focused on how much risk you can take and have a good idea how to preserve your money for the future, you can ignore the stock market, actively traded mutual funds, and stockbroker and Wall Street recommendations. Pick an ETF that's broadly diversified, offers low costs, and gives you a break on taxes.

How do you gauge the best fund for you? Here are some guidelines for evaluating different ETFs:

1. **How much does it cost?** This answer is found in the fund's *expense ratio,* a percentage of how much a fund manager deducts annually from your assets. Check the ratios of funds you're considering against a benchmark. Also, consider brokerage commissions to buy and sell shares. Here are some industry expense averages compiled by Morningstar (www.morningstar.com), a financial information company:
   - U.S. fixed-income ETFs: .29 percent
   - U.S. stock ETFs: .41 percent
   - International stock ETFs: .52 percent
2. **What's in the portfolio?** The fund manager should give you a complete list of securities, the rate of *turnover* (what percentage of the portfolio is sold off during a year), and the sectors the portfolio represents. A portfolio with 50 stocks or less will be more volatile than one with 500 issues, so keep that in mind when gauging risk. Look for sector weightings, style (growth or value), and composition (percentage of stocks, bonds, cash, and so on).
3. **What's the risk level?** Services and analysts rate risk in a number of ways. One of the most visible is standard deviation, the amount the portfolio's performance varies from the average of its peers. The higher the standard deviation, the more price variation you can expect. Several services, such as Morningstar, offer risk ratings, although it's difficult to provide for some of the newer funds. Also, look at the *beta*, which is how much the fund's return varies from a market benchmark such as the S&P 500. For bond funds, look at the *credit quality,* which rates the bonds within the portfolio. This will give you some idea how likely those securities are to default. The higher the letter ranking, the higher the quality; those rated BB or lower are called "junk" bonds, translating to higher-than-average risk. Another measure is called " duration," which measures how much bond prices will decline if interest rates increase by one percentage point.

4. **What's the risk-adjusted return?** Again, many new funds might not have much history, but you can measure risk-adjusted returns through the *alpha*. This number tells you how well a fund performed when compared to a standard for its class of funds. The higher the alpha, the better. A negative alpha tells you that maybe the fund took too much risk. Another good test is the *Sharpe Ratio*, which measures the performance against a risk-free benchmark. The higher the ratio, the better, of course, with 1.0 being excellent. The ratio tells an investor whether a portfolio's returns are due to wise investing or are a consequence of too much risk.
5. **What is the tracking error?** For a fund to fully represent the index it's intended to track, it must have a high correlation to that index. Funds that perfectly track an index have a tracking value of 100, also known as the highest *R-squared*, a statistic measuring correlation. Generally, funds with R-squareds from 85 to 100 track an index fairly well. Those below have tracking errors and should be avoided.
6. **What is the tax liability?** Few stock ETFs have any tax liability (the amount of capital gains and other taxes generated), but some do. The fund company can give you a breakdown of any taxable distributions. Keep in mind that bond, commodity, and precious metals ETFs have different tax treatments than stock funds. Of course, if you are concerned about taxable gains, you can always place your ETFs within tax-deferred accounts such as individual retirement accounts. Vehicles such as Roth IRAs and Roth 401(k)s allow you to avoid paying any taxes on withdrawals after age 59½. The catch is, you are paying taxes on the money deposited in these accounts.

The next chapter explains the mechanics of indexing and shows you how it works.

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