By Doug Wells

Exchange Traded Funds

Avoid Three Common ETF Investing Mistakes

Since their inception in 1993, ETFs (exchange traded funds) have gained in popularity and are now a common staple in many investor portfolios. In concept, ETFs are quite simple. They are an investment vehicle that trades on an exchange—very similar to stocks. ETFs hold assets such as stocks, bonds or commodities.

While their initial design was simple track the performance of the S&P 500—their popularity has attracted much more creative, and complex, offerings. Choice is great; however, it can also lead to confusion. It is crucial that investors fully understand the products in which they are investing and, importantly, how the product will react to various market outcomes. With that in mind, here are suggestions for avoiding common ETF investment mistakes.

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Mistake 1: Just reading the fund description

Understanding the top holdings of an ETF and the fund's corresponding rebalancing mechanism for an ETF is critical. Even popular funds such as Powershare's QQQQ (the "Qs"), which tracks the NASDAQ 100, can hold major surprises. The Qs is a market cap weighted fund and is rebalanced quarterly. At $300 per share, Apple Computer's market cap is $274 billion and, at $25 per share, Microsoft's is $220 billion. Microsoft represents 4.3 percent of the Qs. So what percent of the Qs is exposure to Apple stock? Most people would assume around 6 percent. However, Apple represents 20 percent of the Qs' market value.

The reason for this seeming discrepancy lies in the rebalancing rules, which most investors do not read. If you like technology, and also like Apple, this may not be a problem. However if you do not like Apple, you'd likely want to avoid Powershare's QQQQ. You might instead consider QQEW, which is an equal-weighted ETF containing all the NASDAQ 100 companies at roughly 1 percent each.

Mistake 2: Assuming an ETN is the same thing as an ETF

There is a critical difference between ETNs (exchange traded notes) and ETFs. Unlike ETFs, ETNs are not backed by an underlying basket of stocks. ETNs are simply a contract with the issuing firm to receive certain payouts depending on how the underlying index performs. As a contract, ETNs are considered an unsecured debt instrument. Should the ETN issuer be unable to pay per the terms of the contract, you become an unsecured creditor of the firm. We call this issuer risk. Lehman Brothers issued several ETNs, and its bankruptcy highlights the important distinction between an ETF and an ETN. So why would an investor use an ETN? Some indices are difficult to reproduce with a basket of stocks or bonds, and an ETN can solve this problem.

Mistake 3: Failing to develop and stick with a consistent investment strategy

Over a 20-year period from 1990 to 2009, the average stock mutual fund delivered 8.8 percent per year, net of fees. However, the investors in this pool of exactly the same mutual funds earned only 3.2 percent per year, net of fees. How can this be? According to Dalbar, an independent think tank, the reason for the difference is simple: Investors are buying into the funds when the prices are high and selling when the prices are low. The impact is as dramatic as it is devastating. ETFs are even easier to trade than mutual funds, and thus the challenge described above is even worse with ETFs.

Investors can benefit from this study by developing a personal investing policy they can stick with when the market goes up and when the market goes down. Does this mean investors should simply buy and hold? Absolutely not. The world changes and one's investments should be adjusted to reflect these inevitable changes. However, changes should be driven by a forward view of the specific investments. Investment policy changes should not be driven by one's emotional reactions to the market's inevitable fluctuations.

EFT Basics

ETFs can be a powerful tool and are a welcome evolution from mutual funds. They offer investors increased transparency and reduced costs. However, investors are well served to research each ETF beyond the marketing summary that describes the fund. The exposure, performance and risks of ETFs can vary dramatically from what many investors might assume if they rely solely on the fund description. The details are critical to ensuring that your portfolio of ETFs will indeed give you access to your areas of interest, will behave as you expect in various market conditions, and will stay within the risk constraints that you are willing to accept. UB

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