

# Lowly Analyst Newsletter

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## Year End Financial Checkup

Year end is a good time for a financial checkup.

Adults should have up-to-date wills, and beneficiaries should be reviewed. Asset owner and beneficiary should have a copy of the designation.

Your accounts should be correctly titled. Account can be titled as TOD, transfer on death, to any group of persons such as spouse or children.

You should have a durable power of attorney drafted by an attorney.

You should have a health care proxy.

You should have a living will. Make your own. Do not use a form as everyone is different.

Review your insurance with your insurance agent to be sure you have what you think you have. Include uninsured driver protection in the same amount as your liability and medical coverage. You should have an umbrella policy and maximum deductibles.

Place all your important addresses, e.g. physicians, plumber, in one notebook and tell those close to you where you keep it.

## The Market

Asset Classes: For December, mid growth up 0%, small growth 0%, micro down 1%, large growth down 1%, mid value down 2%, small value down 2%, large value down 2%.

Sectors: For December, Clean Energy up 15%, Oil 11%, Energy 8%, Natural Resources 7%, Gold 6%, Oil Equipment 6%, Commodities 6%, Silver 6%, Metal & Mining 4%, Technology 3%, Basic Metals 3%, Telecom 1%, Steel 1%, Software 1%, Swiss Frank 0%, Euro 0, Semiconductor 0%, Industrials -1%.

Foreign Investing: For December Malaysia up 5%, Canada 2%, Hong Kong 2%, BRIC 1%, Netherland 0%, Brazil 0%, Singapore 0%, Emerging Markets 0%, Germany 0%, France -1%, Austria -1%, S. Korea -1%, Latin Am. -1%, Mexico -2%, Australia -2%, Belgium -2%, Europe -2.5%, Italy -3%, United Kingdom -3%.

## Exchange Traded Funds (ETFs)

### 1. Introduction

Index funds have changed from the original S&P index funds. We will discuss the various types of Index Funds, Exchange Traded Funds, and Exchange Traded Notes.

### 2. Characteristics of Index Funds

Index funds invest in an index, e.g. SPDRs (SPY). Some indices are well known; others are created by the fund company for marketing reasons.

Index funds are an excellent way to invest. One of the reasons is that they have low costs. Costs are important to the investor. Suppose returns are 9% and inflation is 3%, giving an actual gain of 6%. Assuming your taxes are 30% (you have to pay taxes on withdrawals from IRA's), you have an after tax annual increase in purchasing power of 4.2%. A fund management fee of 1% results in a 24% lower return. Some index funds, e.g., the Vanguard Index Funds, can have low costs. Some funds charge only 0.2%, while actively managed funds have management fees and trading expenses of over 3%. Some Exchange Traded Funds also can have low costs.

In efficient markets index funds outperform actively managed funds. Markets are efficient if informed buyers and sellers are always present. Index funds outperform because they are always fully invested. At the bottom of markets actively managed funds hold much cash and are slow to invest when the market turns up. This is shown graphically by sector on my website [www.curtfey.com](http://www.curtfey.com).

Investments must be diversified. An S&P fund (mainly large cap) or a US total market fund (domestic only) is not a diversified portfolio. Invest in several different index funds.

### 3. How Index Funds Differ

Index funds must make three decisions:

- Criteria for inclusion of assets in the fund
- Weighting scheme
- Rebalancing strategy.

An index creator must decide on a weighting scheme. Traditionally indices are weighted by market capitalization, i.e., stock price times shares outstanding.

Rebalancing is required since the stocks in an index, including their prices, inclusion criteria characteristics, and the number of shares outstanding, change.

#### 4. Traditional Index Funds

Originally index funds used an index that existed prior to the fund's starting date, like the S&P. They are traded like any mutual fund, at net asset value at the end of the day. Funds are endowed with certain characteristics. Many of them are heavily US large cap weighted. For example the S&P contains 89% large cap, no micro cap and no recently issued stocks.

Funds can be no load and low expense; they are sometimes high fee, e.g. in a variable annuity. Funds charge no transaction fee if bought from the issuer, and a mutual fund fee if bought elsewhere. Mutual fund fees differ sometimes from stock fees. E.g. TD Ameritrade charges \$31 for funds and \$10.99 for stocks for some accounts. Just2Trade charges \$1.75 for both funds and stocks for some accounts. Dividends can be reinvested automatically.

Funds are capitalization (i.e. shares outstanding times price) weighted. The disadvantage of capitalization-weighted indices is the high weights of overvalued stock. Since capitalization equals to shares outstanding times price, the higher the price, the greater the weight. The index has the largest dollar amount of a stock when it is expensive and the least when it is a bargain, exactly the opposite from what is desirable.

#### 5. Exchange Traded Funds

The mutual fund industry is extremely competitive. Each fund group tries to develop new products to get a competitive advantage. Some of these new products are Exchange Traded Funds (ETFs).

Like stocks, ETFs are a share of a pool of assets that trade like stocks. They generally have lower management fees but have the transaction costs of stocks. For example, the Vanguard S&P index fund has expense ratios of 0.18%; the Vanguard S&P ETF, 0.08%. In new funds the sponsor often pays some fees for a while. ETFs trade whenever the market is open. You buy at the ask price, and you sell at the bid price. Brokers usually charge for each trade. Dividends cannot be automatically invested, but ETFs often have no income and capital gains dividends.

#### 6. Exchange Traded Notes.

Exchange Traded Notes (ETNs) have been around since 2006. There are currently about 20 ETNs available. iShares S&P GSCI Commodity-Indexed Trust (GSG) is one example. ETNs trade like ETFs and have the same objectives, but are completely different instruments.

ETNs are unsecured debt. They have the additional risk of reduction of credit rating and default. An ETN does

not own anything. The underwriting bank promises to pay, at maturity, the value of the index minus the fees.

ETNs are currently tax efficient. They pay no interest or capital distribution. The only tax liability is capital gain realized on the sale. Hence, under current law ETNs are a tax shelter, converting dividend income into capital gains. Tax laws can change however.

ETFs can have a tracking error; i.e., the price of the ETFs can be slightly different from the index. ETNs have no tracking error.

ETNs are often based on commodity futures indexes. Futures prices can differ substantially from current prices. This difference is a key risk in addition to the actual change of commodity prices.

#### 7. Equally Weighted Indexes

One weighting scheme is to put the same amount of dollars into each stock. Rydex Equal Weight Trust (RSP) is one example. In a capitalization-weighted index, a large part of the assets are in large firms. The reverse is true in an equally-weighted index. For example, the S&P index holds 89% Large Cap and 11% in Mid & Small Cap; an equally-weighted S&P holds 53 % Large Cap, 47% Mid & Small cap. The differences would be larger for other indices, e.g., the US total market, since the S&P contains only 0.2% small caps and no Micro Cap.

#### 8. Fundamentally-Weighted Indexes

Another weighting scheme is to weight indexes by fundamental characteristics such as sales, dividend, cash flow, and book value. PowerShares Dynamic Market Portfolio is an example. In 40 years of back testing, these ETFs performed better than the S&P, which is what I would expect.

Wisdom Tree has issued two fundamental weighted families of funds - one that is weighted by dividends and another by earnings. Prof. Jeremy Siegel, one of the most respected academics, advocates both schemes. These funds tend to be value ETFs, i.e., they include undervalued stocks that are still sound since they pay dividends or have earnings.

It is not clear which is better, value stocks or growth stocks. Actually one should have both in the portfolio. In some periods one or the other does better.

#### 9. Take Aways

- Index Funds, ETFs and ETNs have generally higher returns than actively management funds.
- Not all Index Funds, ETFs, and ETNs are created equal.
- The S&P index or US total market index is not a balanced portfolio.