

# Beating the Market with ETFs and Tactical Asset Allocation

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# Beating the Market--outline

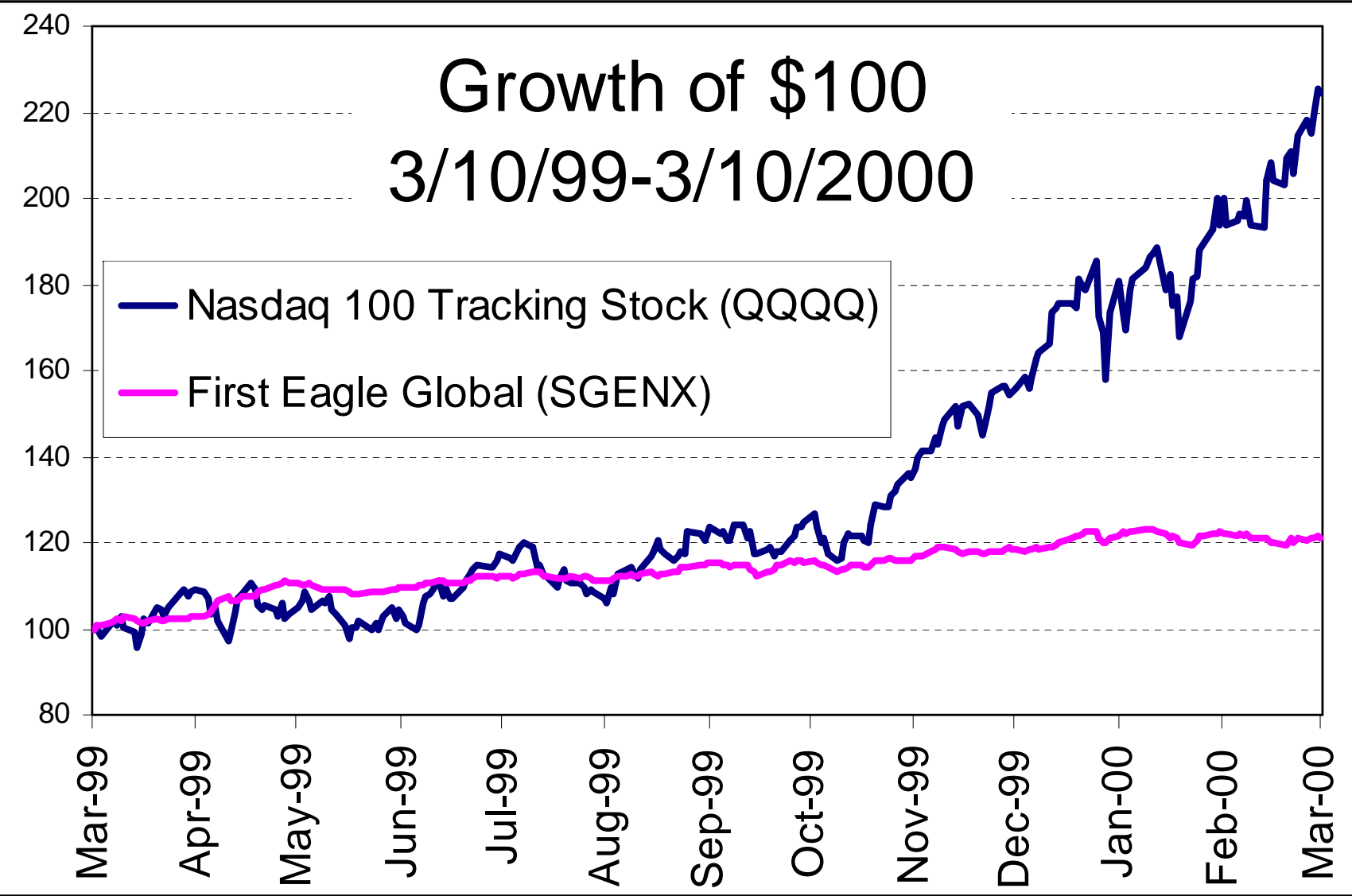
- Navigating the market: A simple way to optimize risk and reward
- Take the easy way out: The only portfolio you will ever need for long term investing
- Where the money is: Relative strength as a tactical asset allocation tool.
- Conclusion—Some new ETFs that look promising.

# A Simple Way to Measure Risk

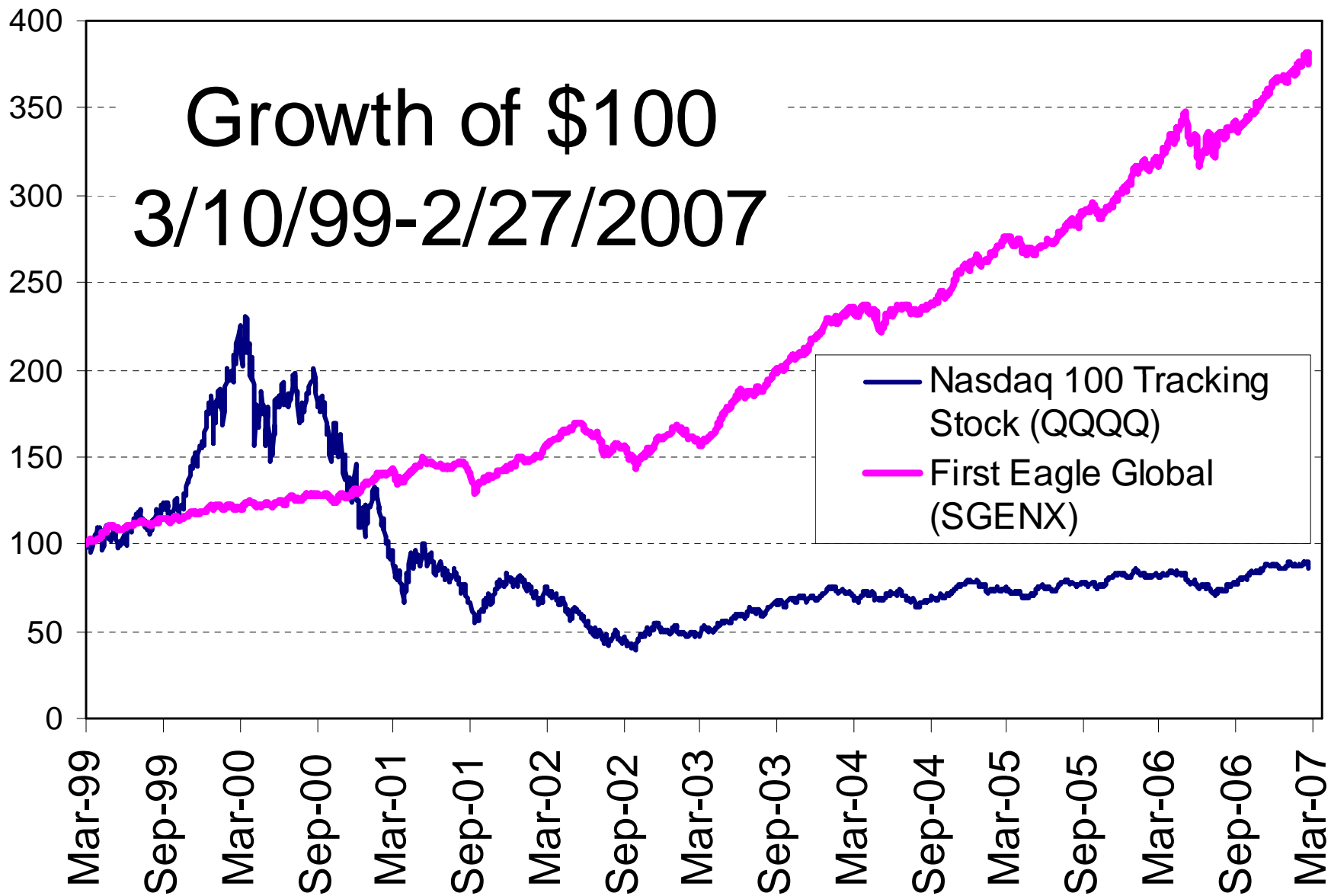


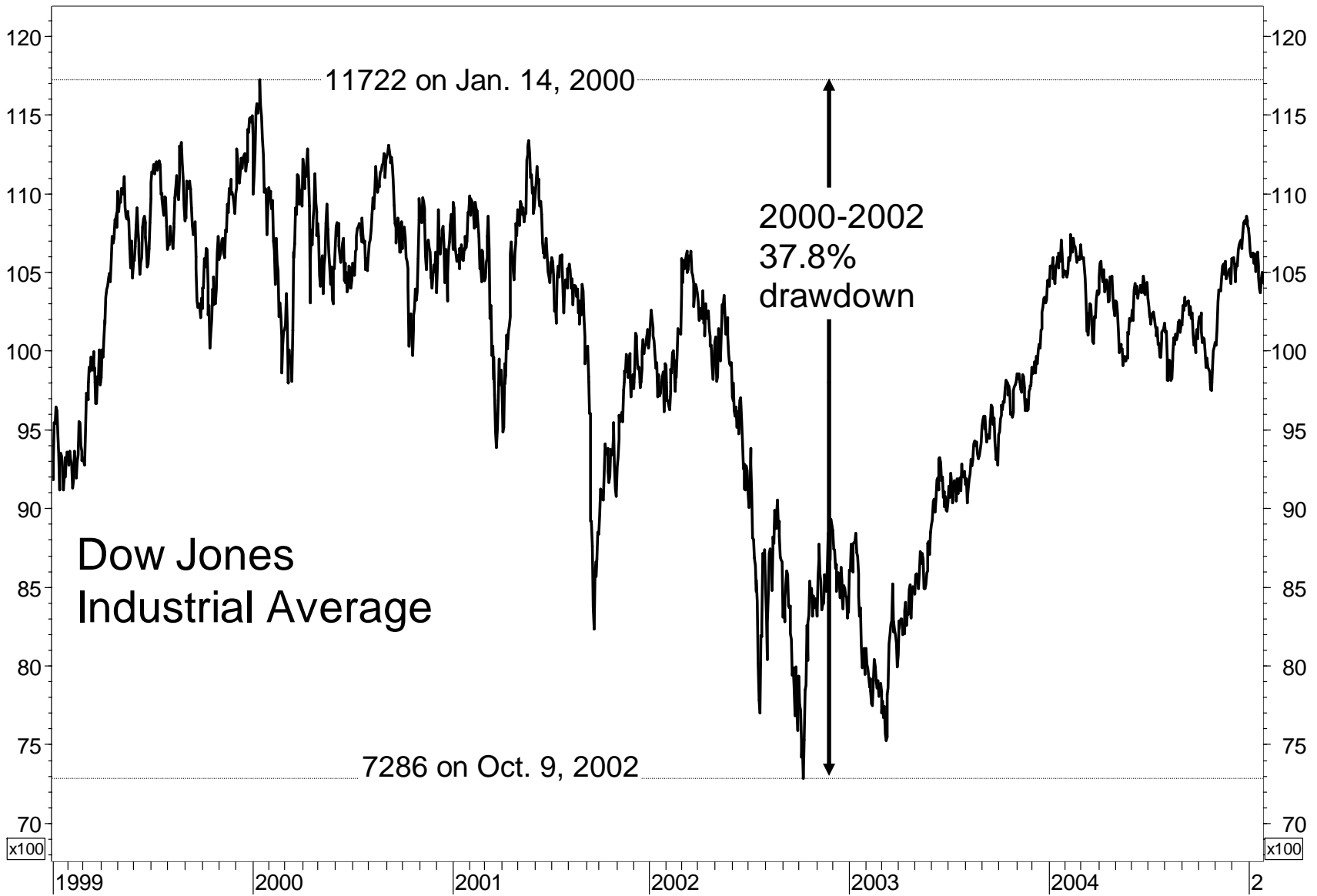
# Growth of \$100 3/10/99-3/10/2000

- Nasdaq 100 Tracking Stock (QQQQ)
- First Eagle Global (SGENX)



# Growth of \$100 3/10/99-2/27/2007





Dow Jones  
Industrial Average

11722 on Jan. 14, 2000

2000-2002  
37.8%  
drawdown

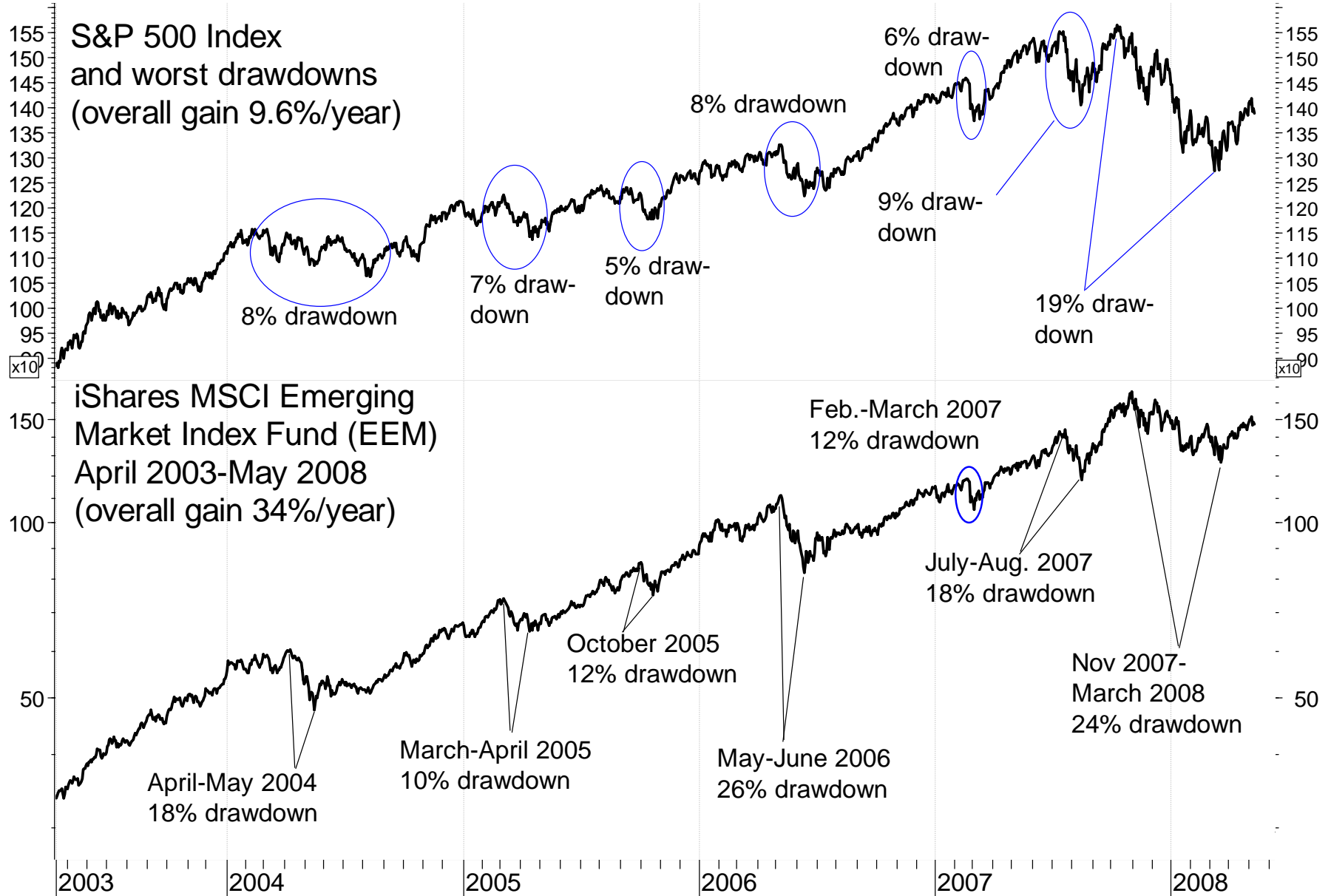
7286 on Oct. 9, 2002

x100

x100

# iShares MSCI Emerging Market Index Fund (EEM) April 2003-May 2008





# Different areas of the stock market



# Market capitalization

- Value of all a company's shares = market capitalization.
- Large-cap = \$10 billion and over
- Small-cap = \$2 billion and under
- As a general rule, compared to small-caps, large-cap stocks have tended to be
  - safer
  - slightly less profitable
  - Better when the U.S. dollar is weaker (large-caps have more of their earnings from sales abroad)

# Value versus growth stocks

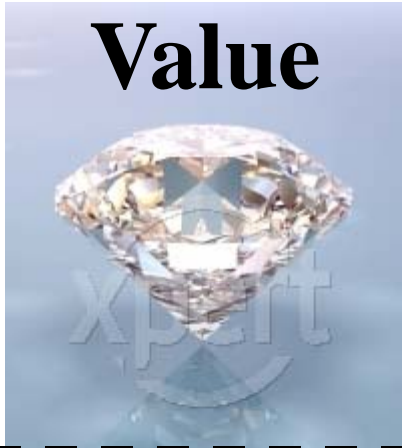
- Value stocks appear to be good bargains based on the *current* situation of the company.
- Growth stocks appear expensive based on the *current* situation but the price is potentially justified by the future situation.
- As a general rule, compared to growth stocks value stocks have tended to
  - Pay higher dividends
  - Be less risky
  - Gain less during strong market climates
  - Hold up better during weak market climates

# Value and growth stocks (cont.)

- Industries more likely to have value stocks
  - Financials
  - Large oil companies
  - Utilities



- Industries more likely to have growth stocks
  - Technology
  - Healthcare
  - Consumer discretionary (homebuilding, media, entertainment)



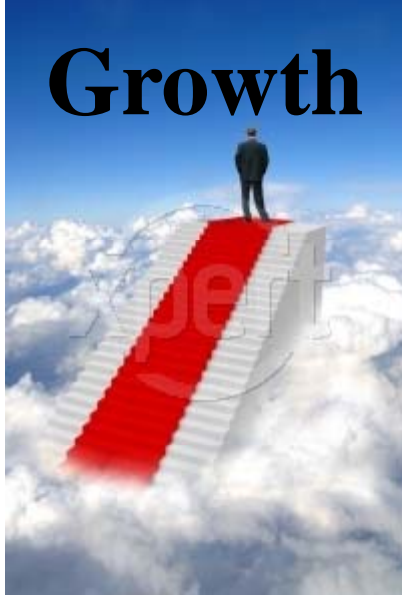
**Large-cap**

Large-cap value



**Small-cap**

Small-cap value



Large-cap growth

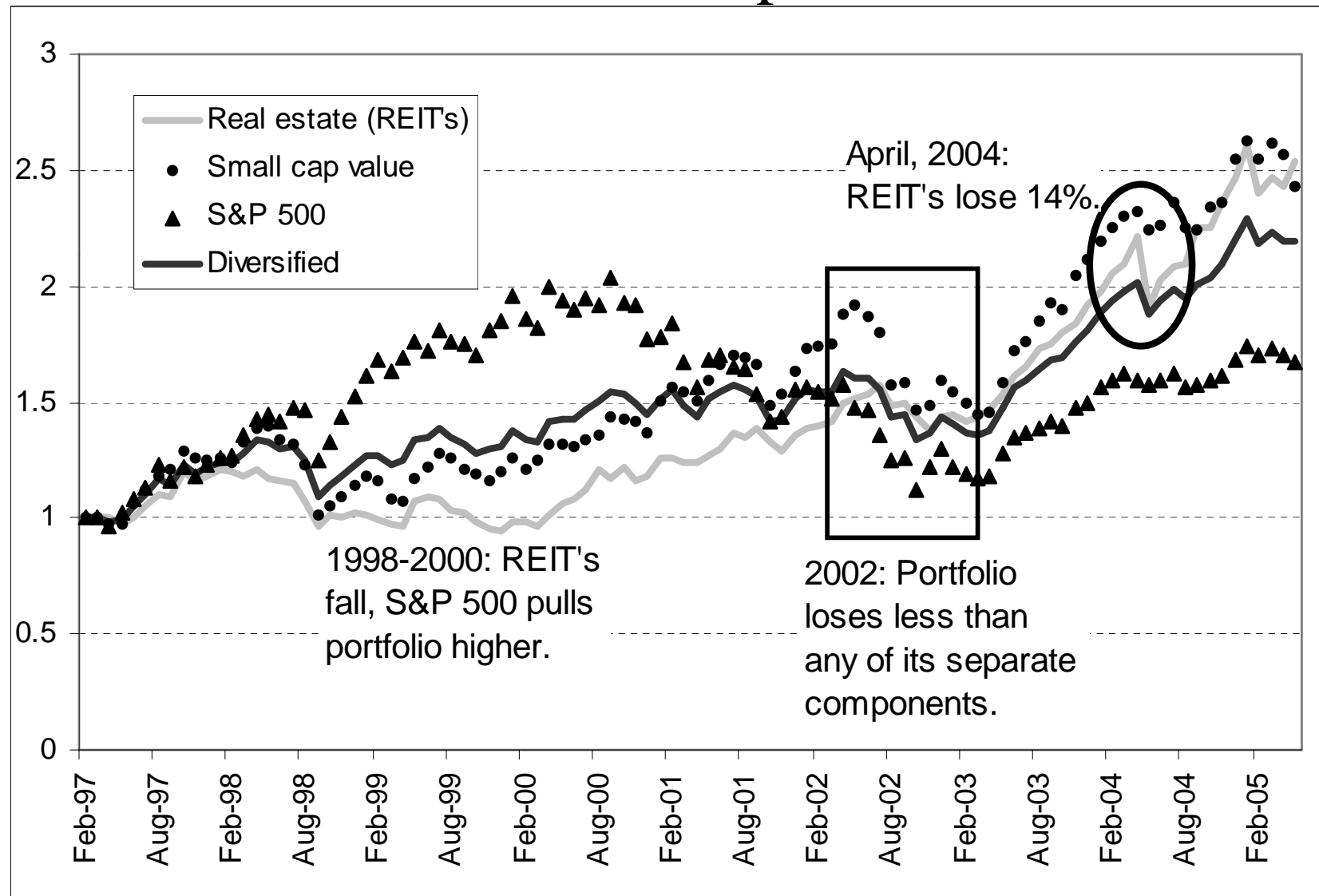
Small-cap growth



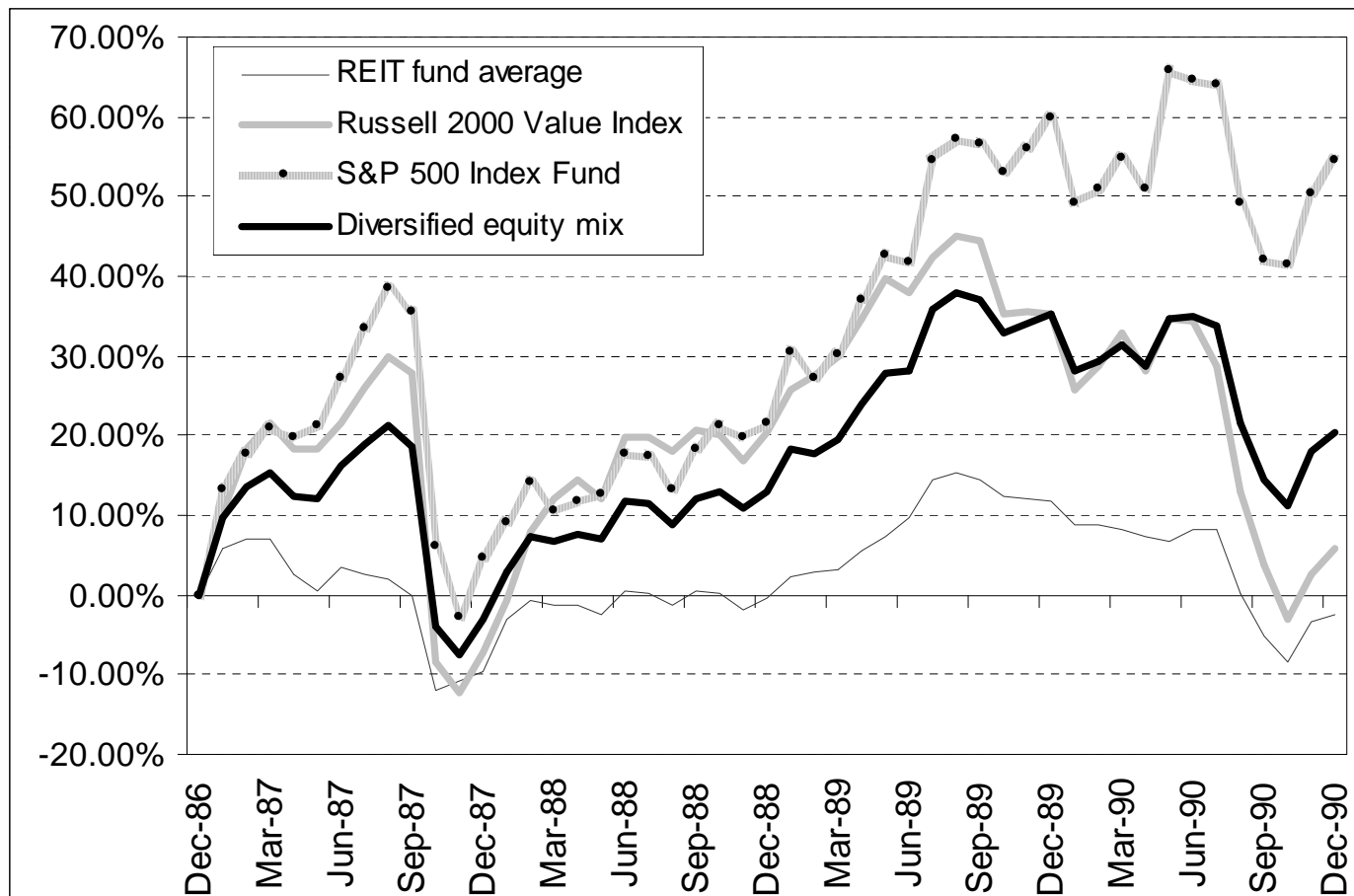
## Diversification:

Improve safety by not putting all your eggs in one basket.

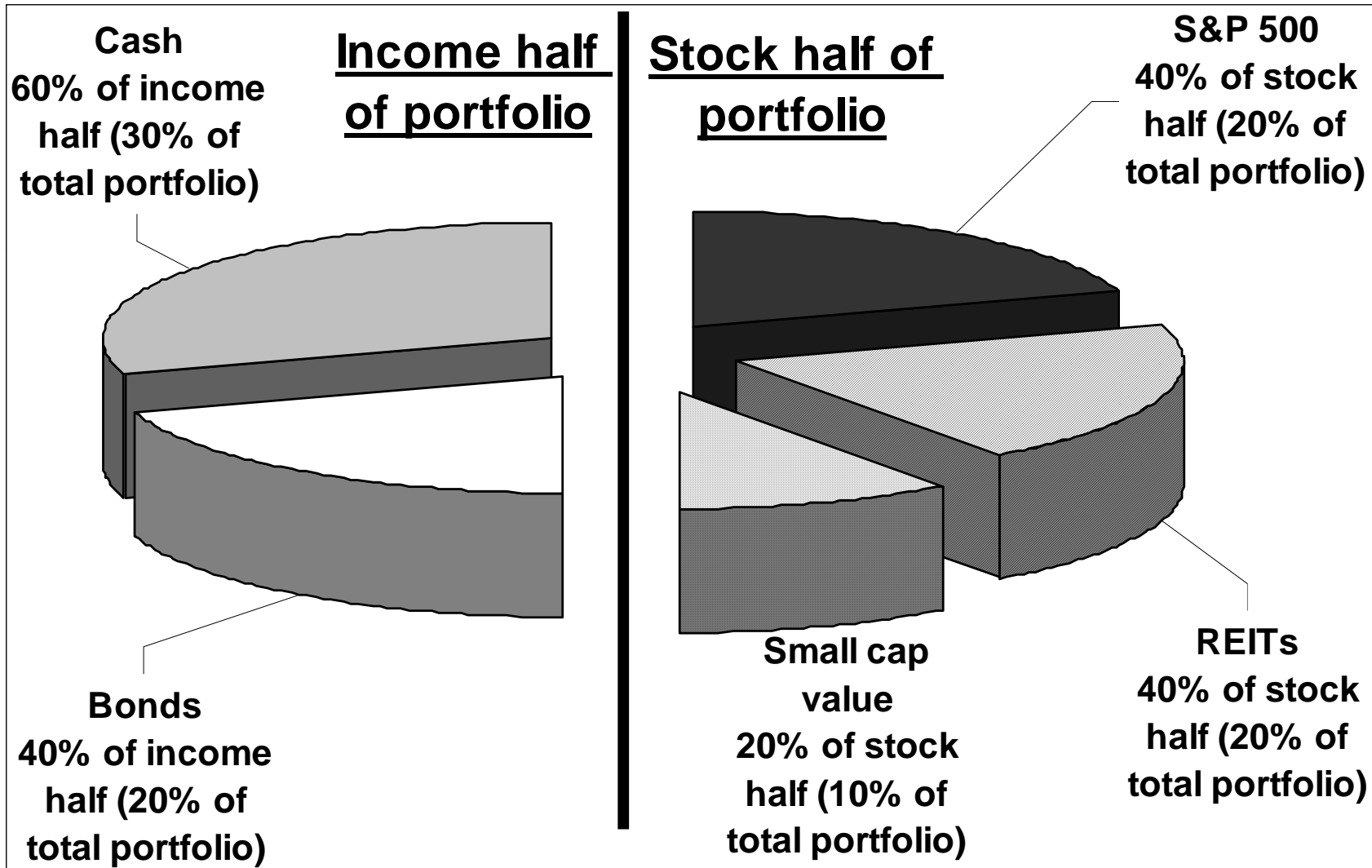
# A properly diversified portfolio should have a better balance between risk and reward than any of its individual components



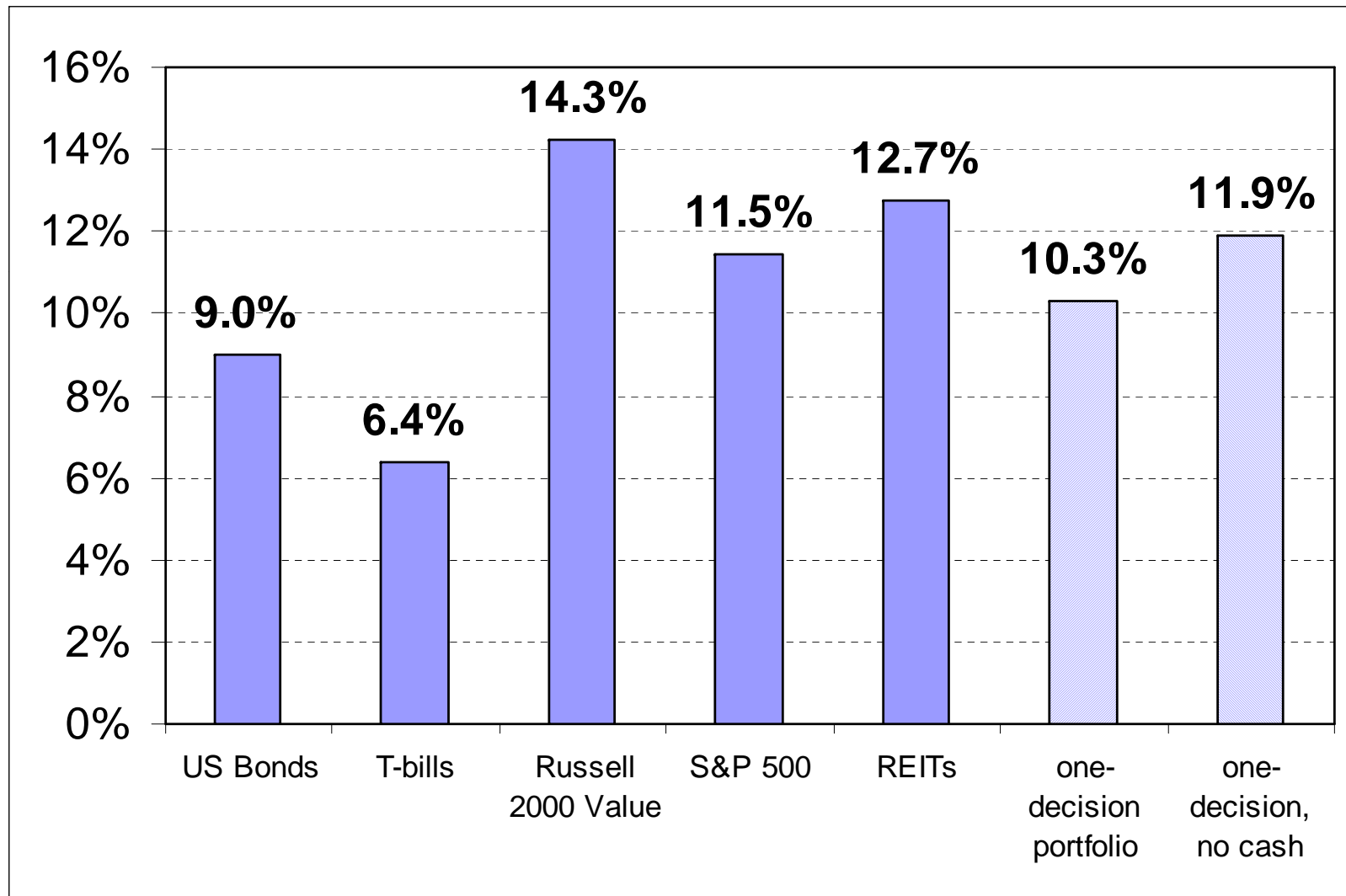
# REITs and Small-cap Value have not always been more profitable than the S&P 500



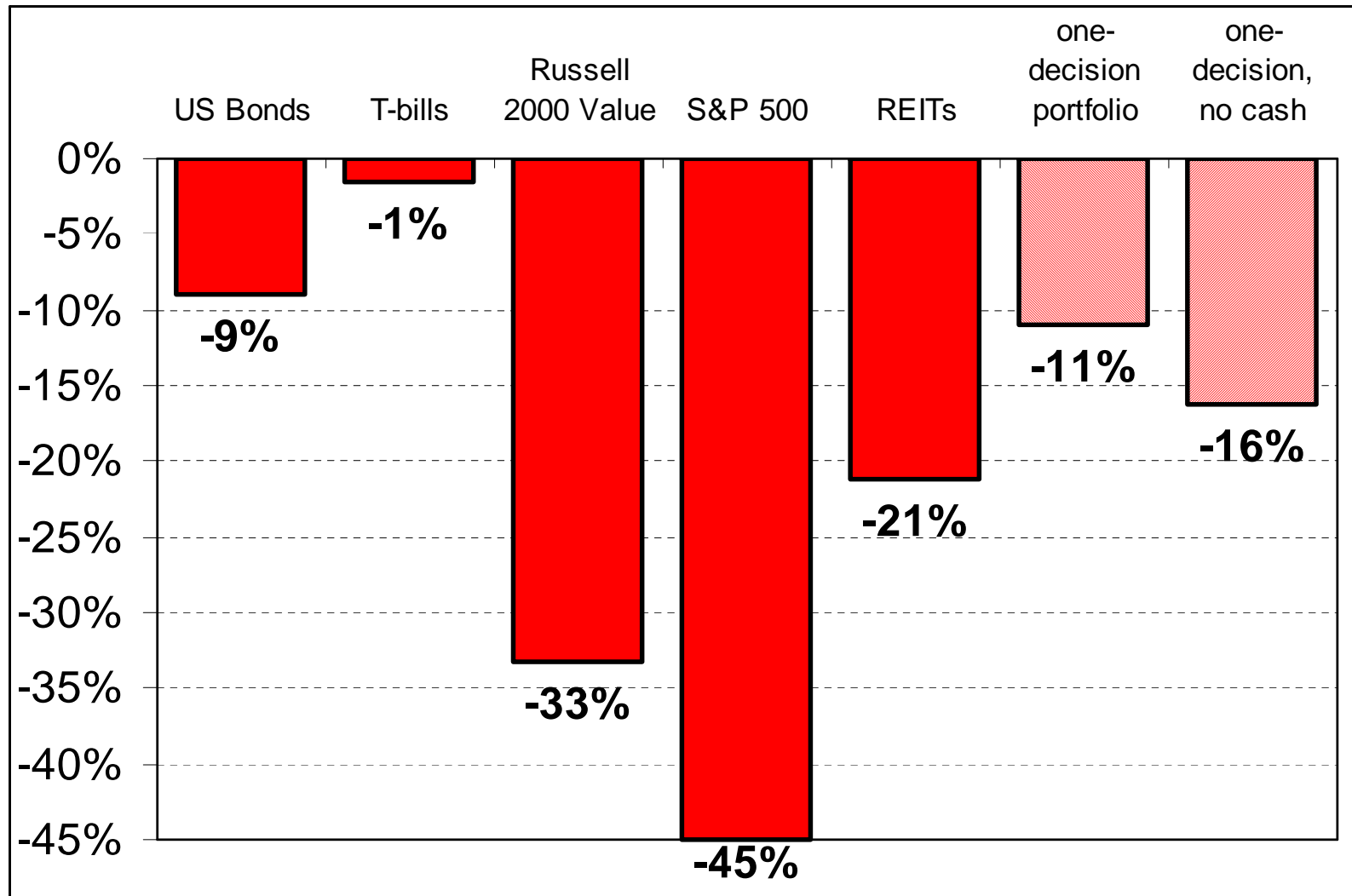
# Diversification in action: The One-decision portfolio

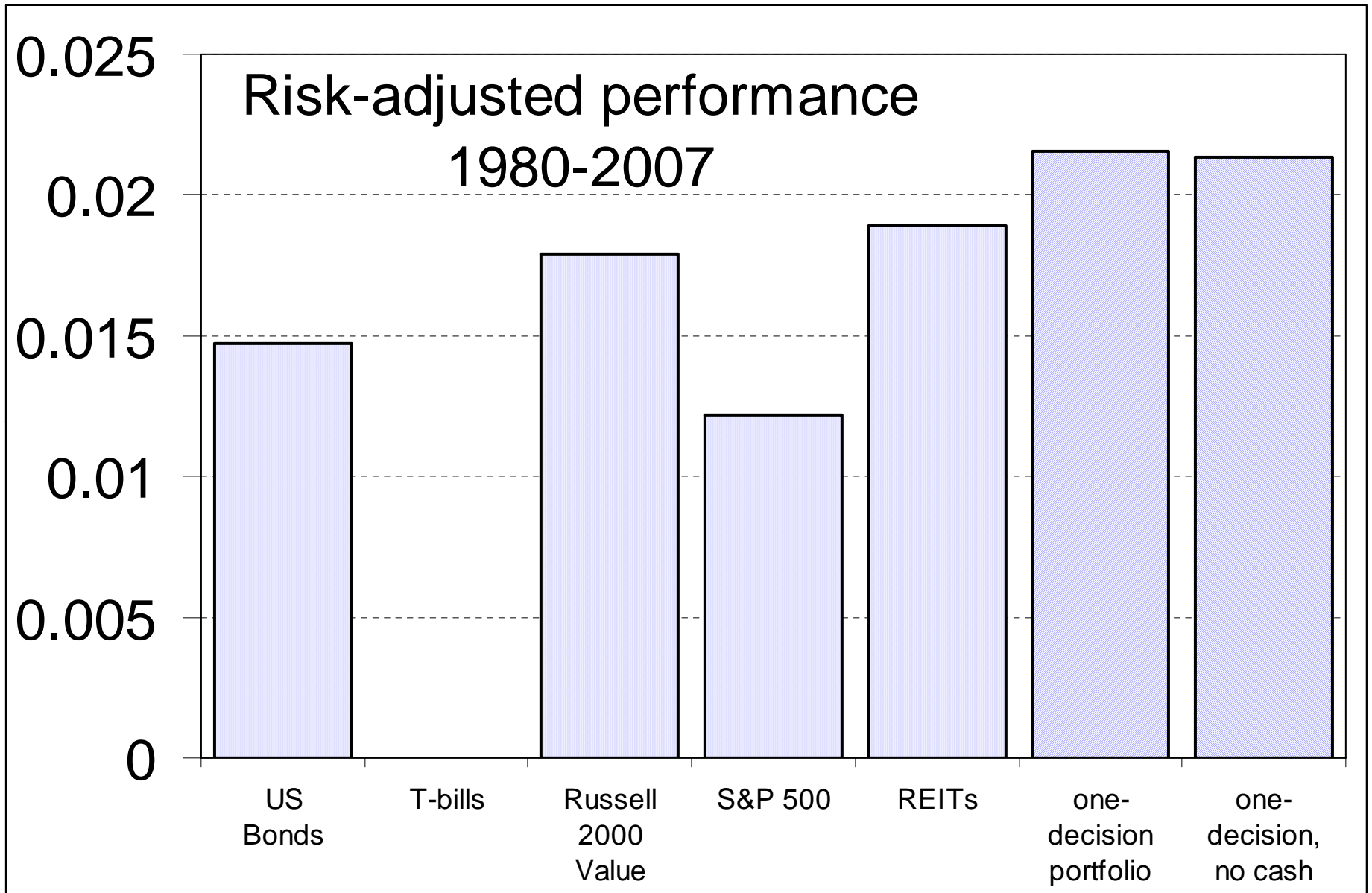


# Compounded annual gains for the components of the one-decision portfolio 1980-2007



# Drawdowns of the one-decision portfolio and its components





# Implementing the one-decision portfolio

## Vanguard portfolio

- 20% S&P 500 Index fund (VFINX)
- 10% Small-cap value index fund (VISVX)
- 20% REITs (VGSIX)
- 20% U.S. investment grade bonds (VBMFX)
- 30% cash (Vanguard Prime Money Market or NJ Tax-exempt money market if tax bracket is above 30%)

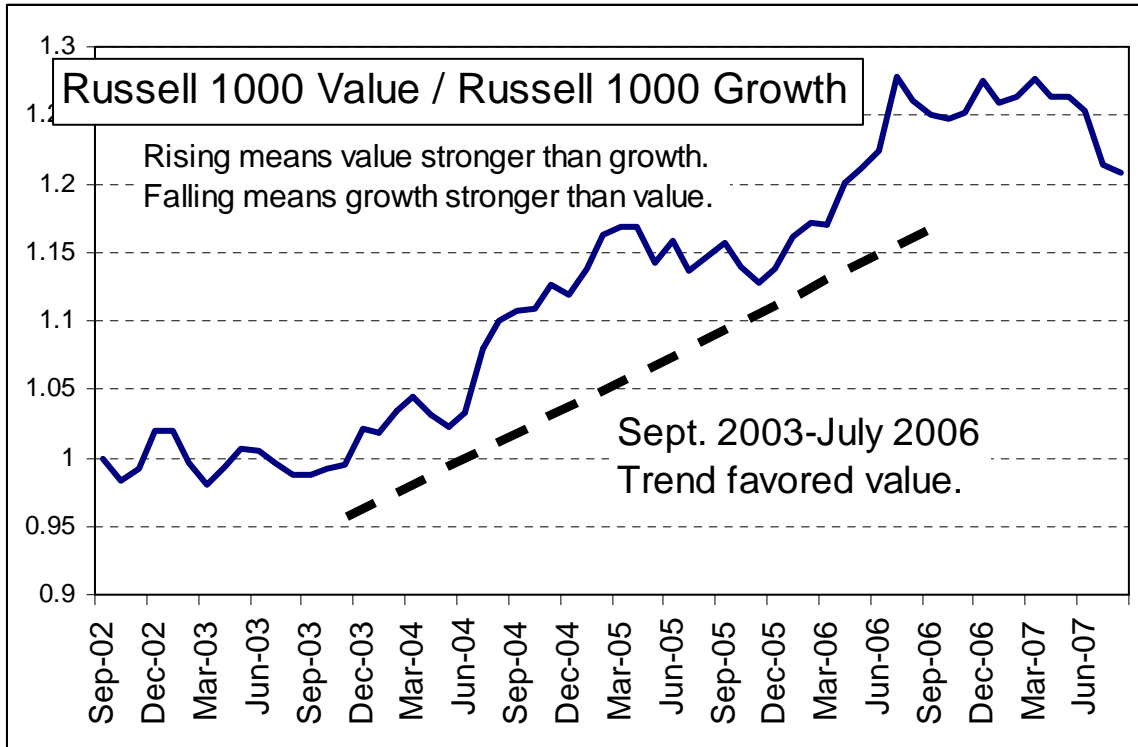
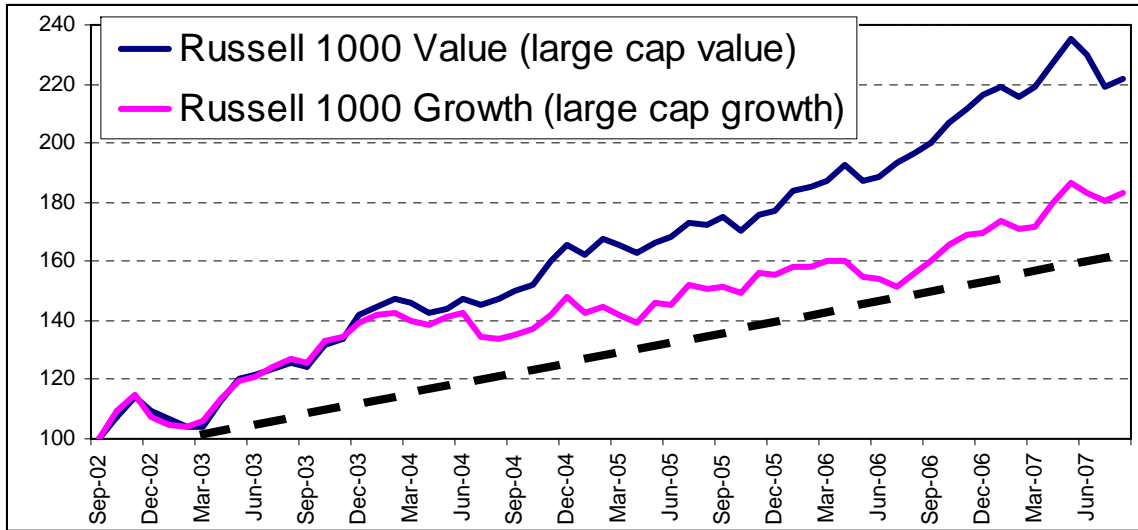
## ETF/Fund portfolio

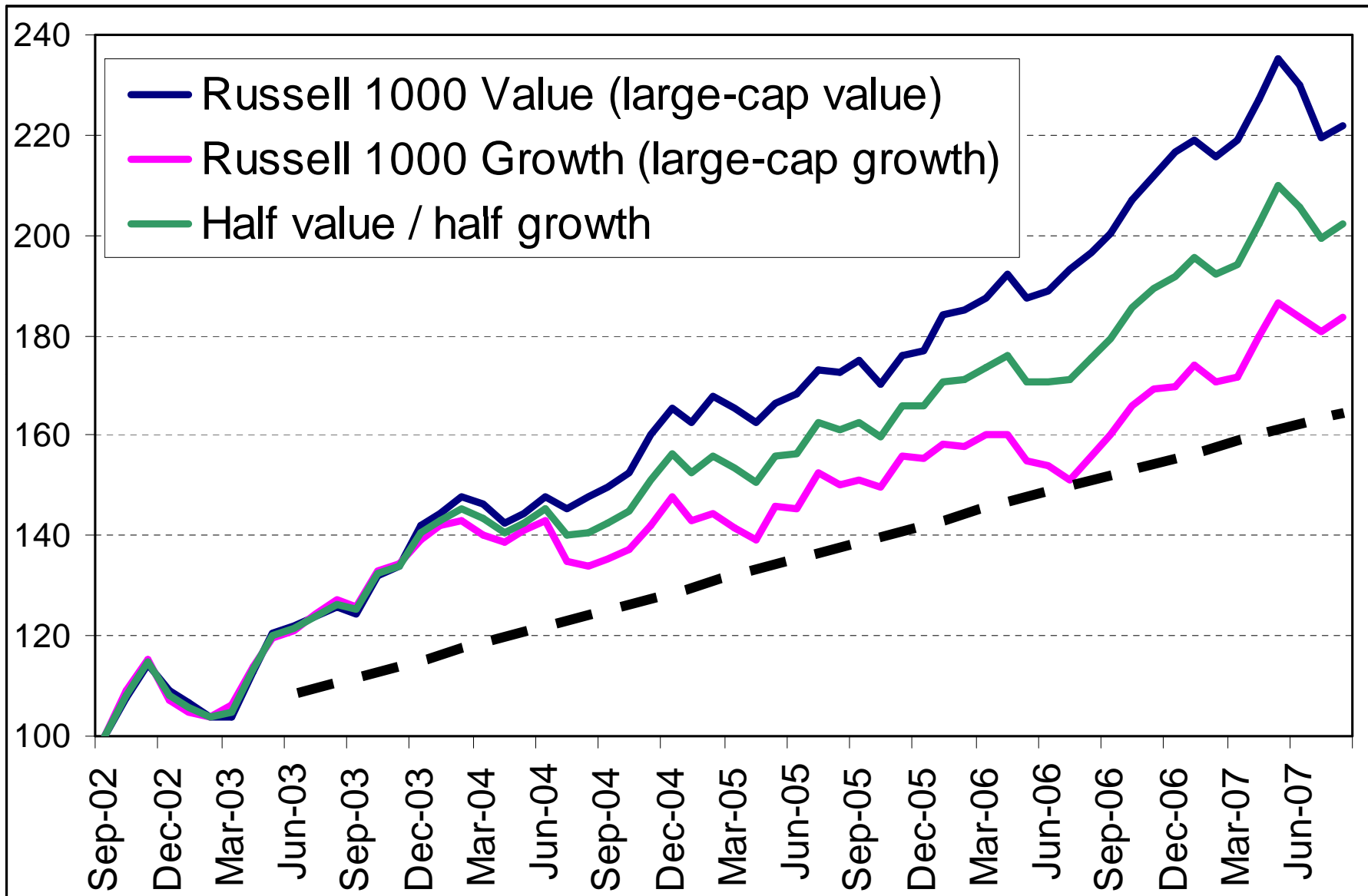
- 20% S&P 500 Index ETF (SPY)
- 10% iShares S&P 600 Value Index ETF (IJS)
- 20% iShares Cohen & Steers Realty Majors (ICF)
- 20% U.S. investment grade bonds (AGG)
- 30% Highland Floating Rate (XLFAX—only through discount brokerage with no load)

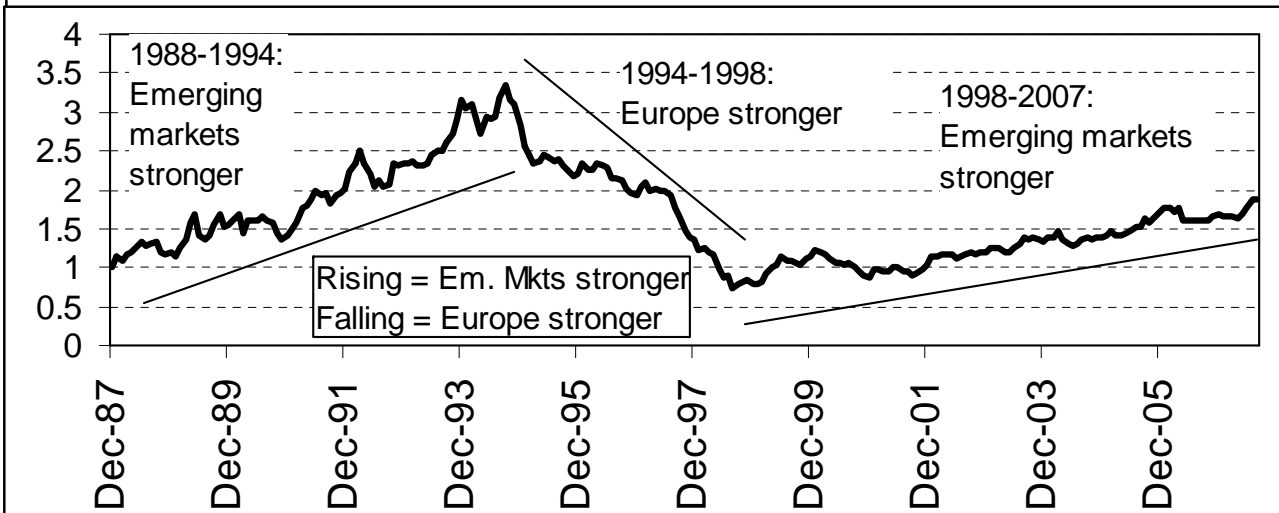
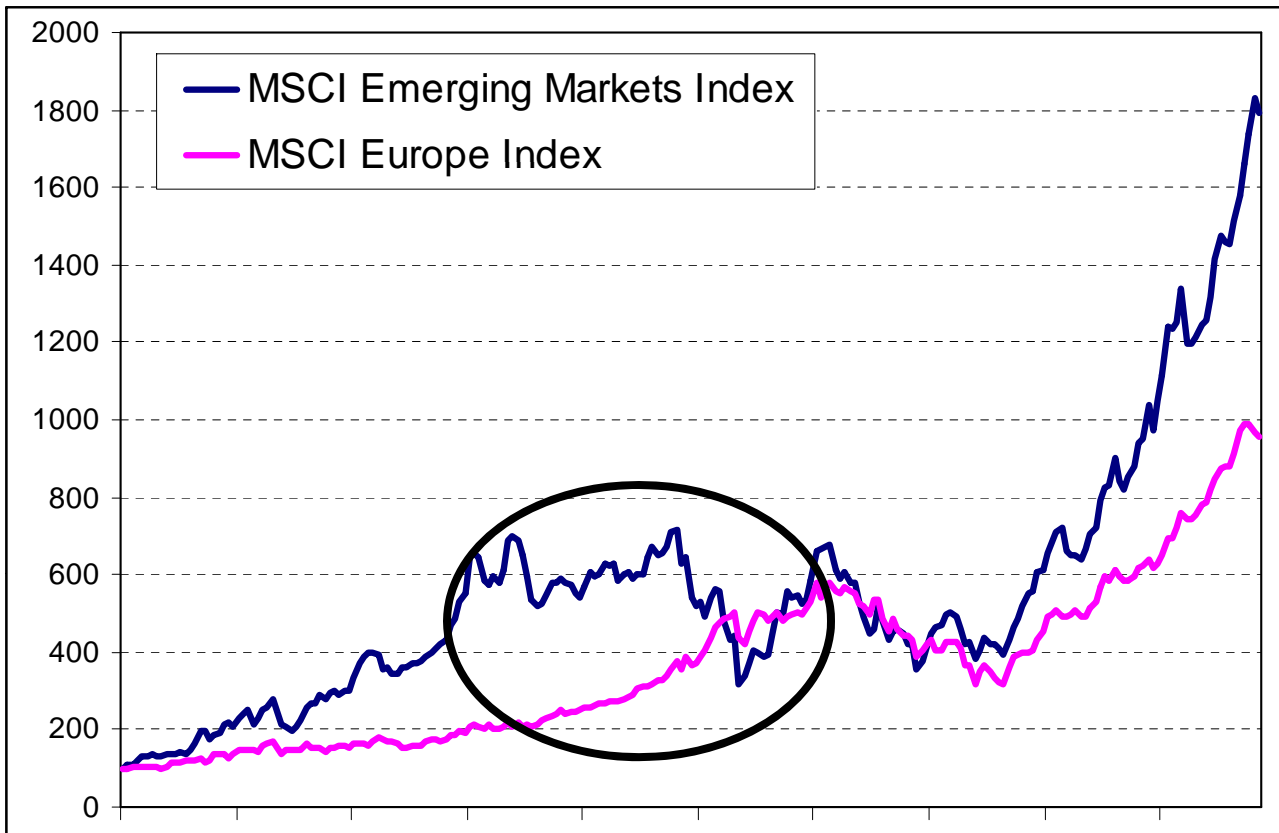
# Trend-Following Strategies

- Attempt to recognize new long-term trends *after* they have begun (but early enough to be able to profit)
- Can outperform a broadly-based benchmark when a strong trend is in force.
- Can trail a broadly-based benchmark when the prevailing trend is in the process of changing or when there is no major trend.





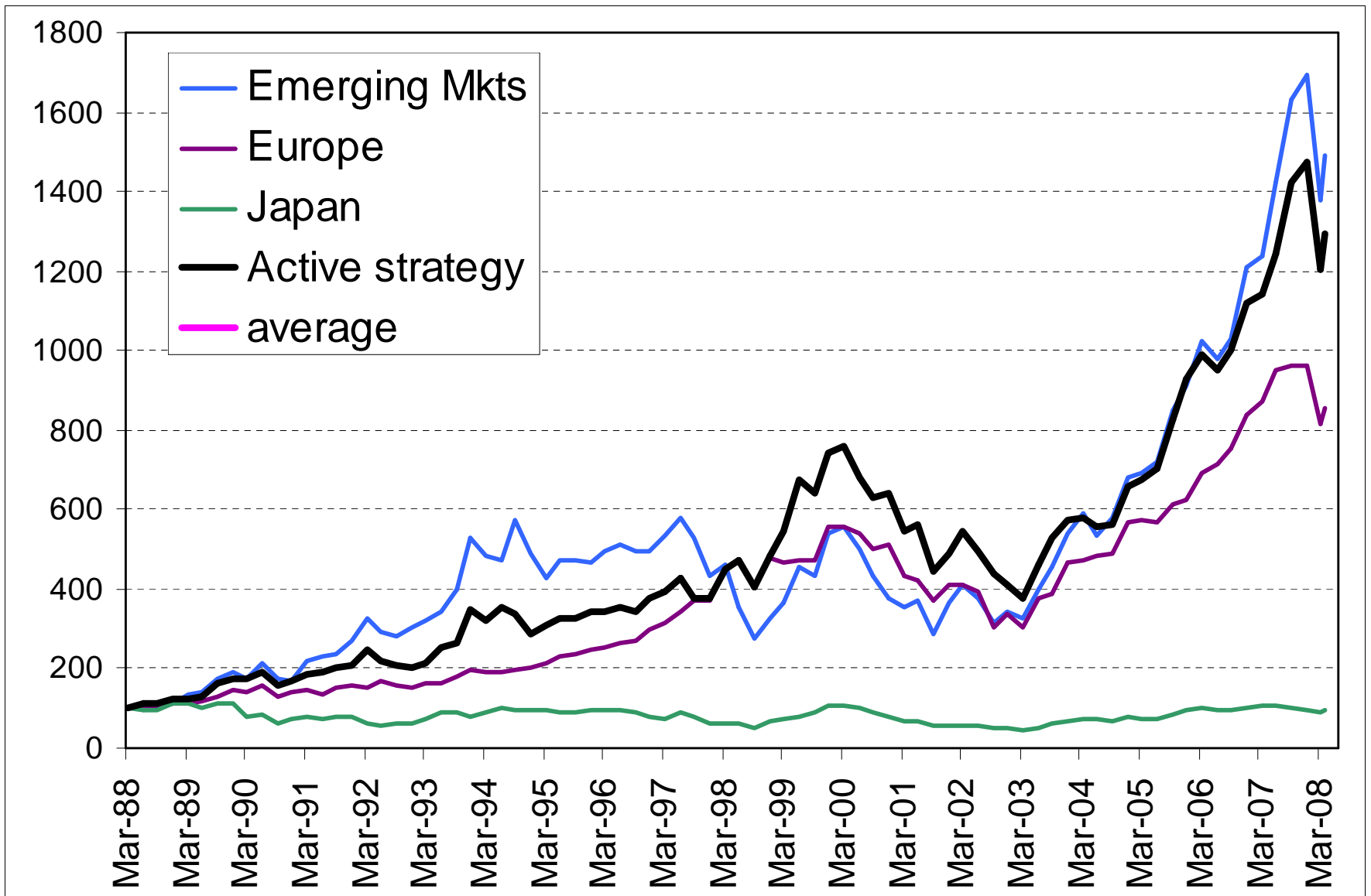




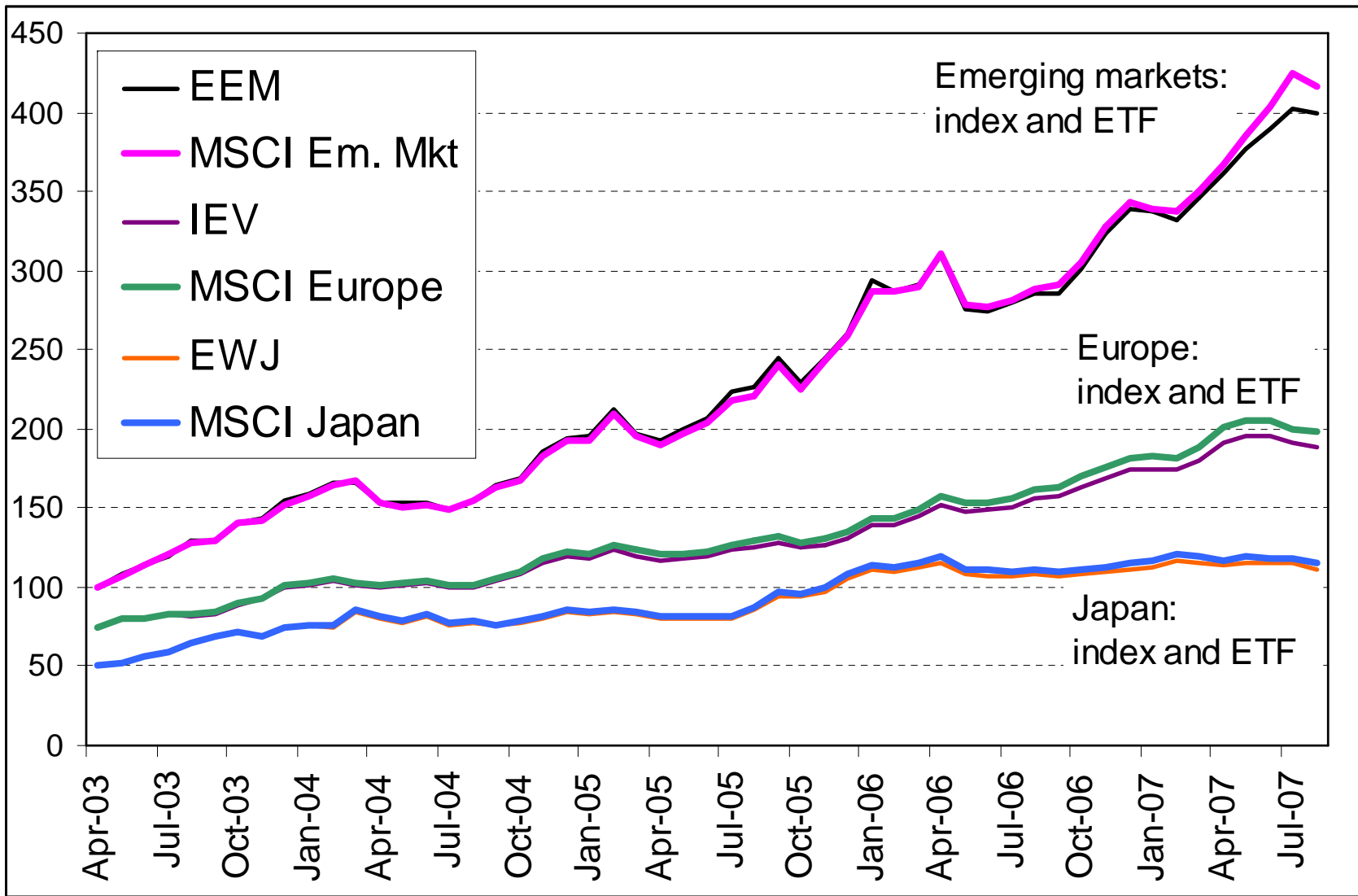
# Example: Selecting Which Part of the World in which to Invest

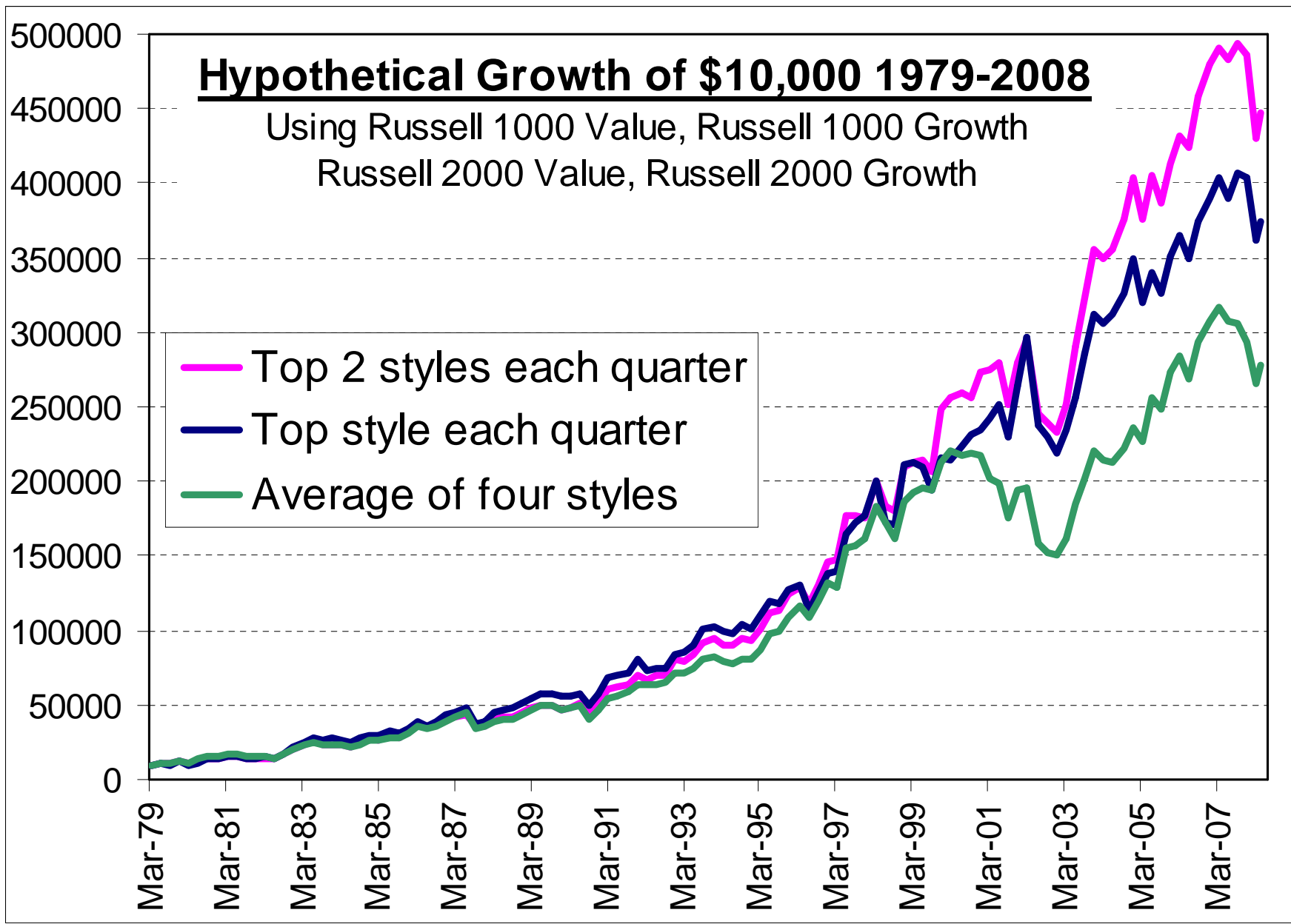
- iShares MSCI Emerging Market ETF (EEM)
- iShares MSCI Japan (EWJ)
- iShares S&P Europe 350 ETF (IEV)

On the last day of each quarter, select the single one of the three ETFs above that gained the most. Hold that for the upcoming quarter.



Source: <http://www.mscibarra.com>





# Implementing the U.S. Equity Style Allocation Model

- iShares Russell 1000 Value ETF (IWD)
- iShares Russell 1000 Growth ETF (IWF)
- iShares Russell 2000 Value ETF (IWN)
- iShares Russell 2000 Growth ETF (IWO)

## *Advanced strategy*

- *Use iShares S&P 500 Growth ETF (IVW) and S&P 600 Growth ETF (IJT) instead of IWF and IWO.*

# Current model recommendations for the second quarter of 2008

- Among U.S. equity investment styles, small and large cap value are selected (IWN and IWD)
- Among foreign markets, Japan (EWJ) is selected.

# New ETFs That Can Work for You.



Future investment results cannot be guaranteed.

# Pros and cons of new ETFs

- New asset classes (commodities and currencies).
  - More international exposure.
  - Higher dividend income (Wisdom Tree, iShares DVY and PFF)
  - New indexing methodologies might perform better than float weighting in certain investment climates
    - Equal weighting (Rydex)
    - Fundamental weighting (Wisdom Tree)
  - Specialized funds (PHO)
- Lower liquidity
  - Higher expenses than original ETFs
  - Unproven methods of index construction.
  - Little real-time trading experience.
  - Less transparency (proprietary indexes such as Claymore, Power Shares)

# Promising New ETFs

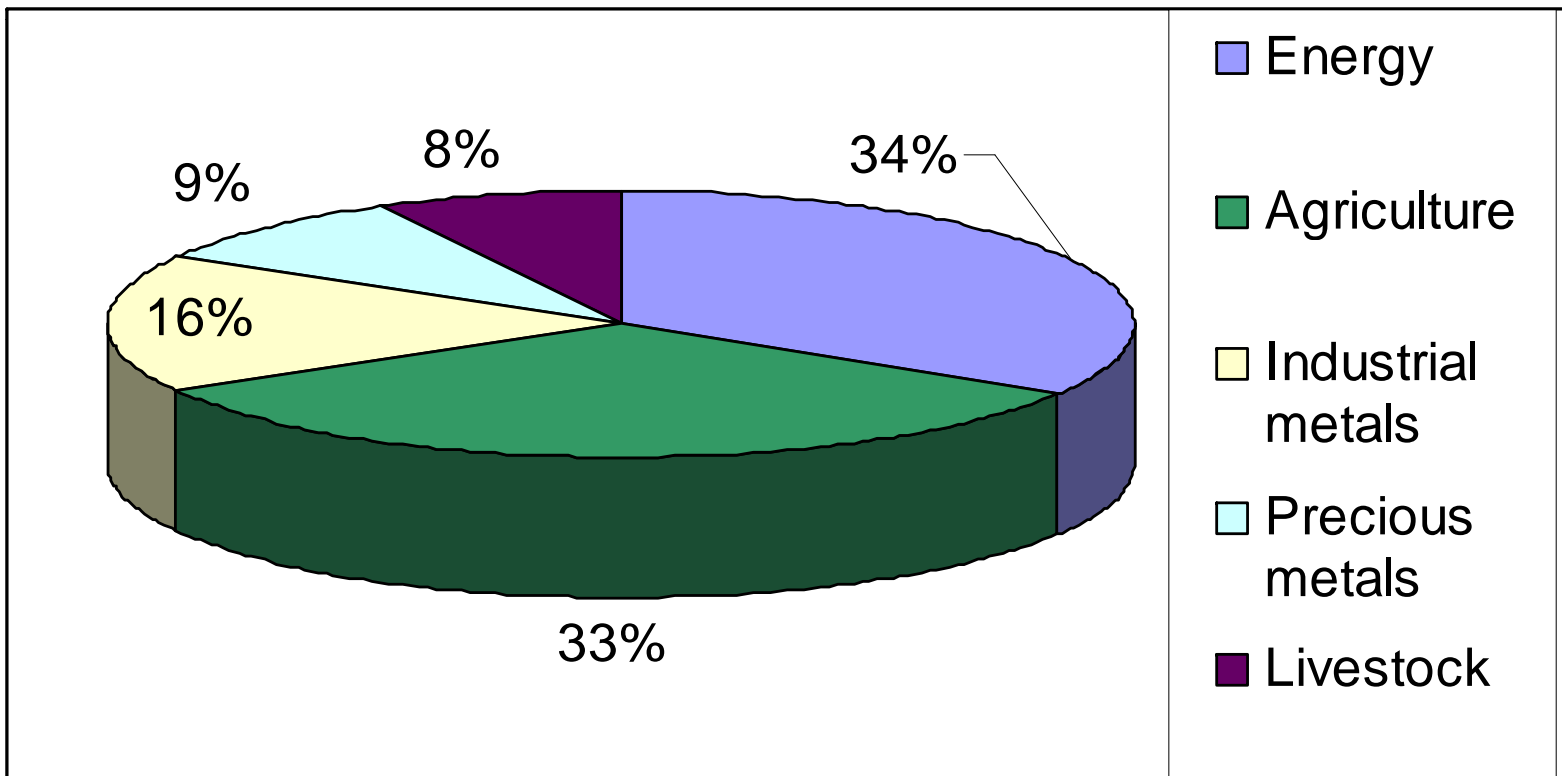
- Exchange-traded Notes (ETNs) for commodity and currency exposure
- Investment income
  - Equities with high dividend yields
  - High-yield bond ETFs: PFF and HYG
  - Tax-free bonds

# iPath Exchange-Traded *Notes* (*ETNs*)

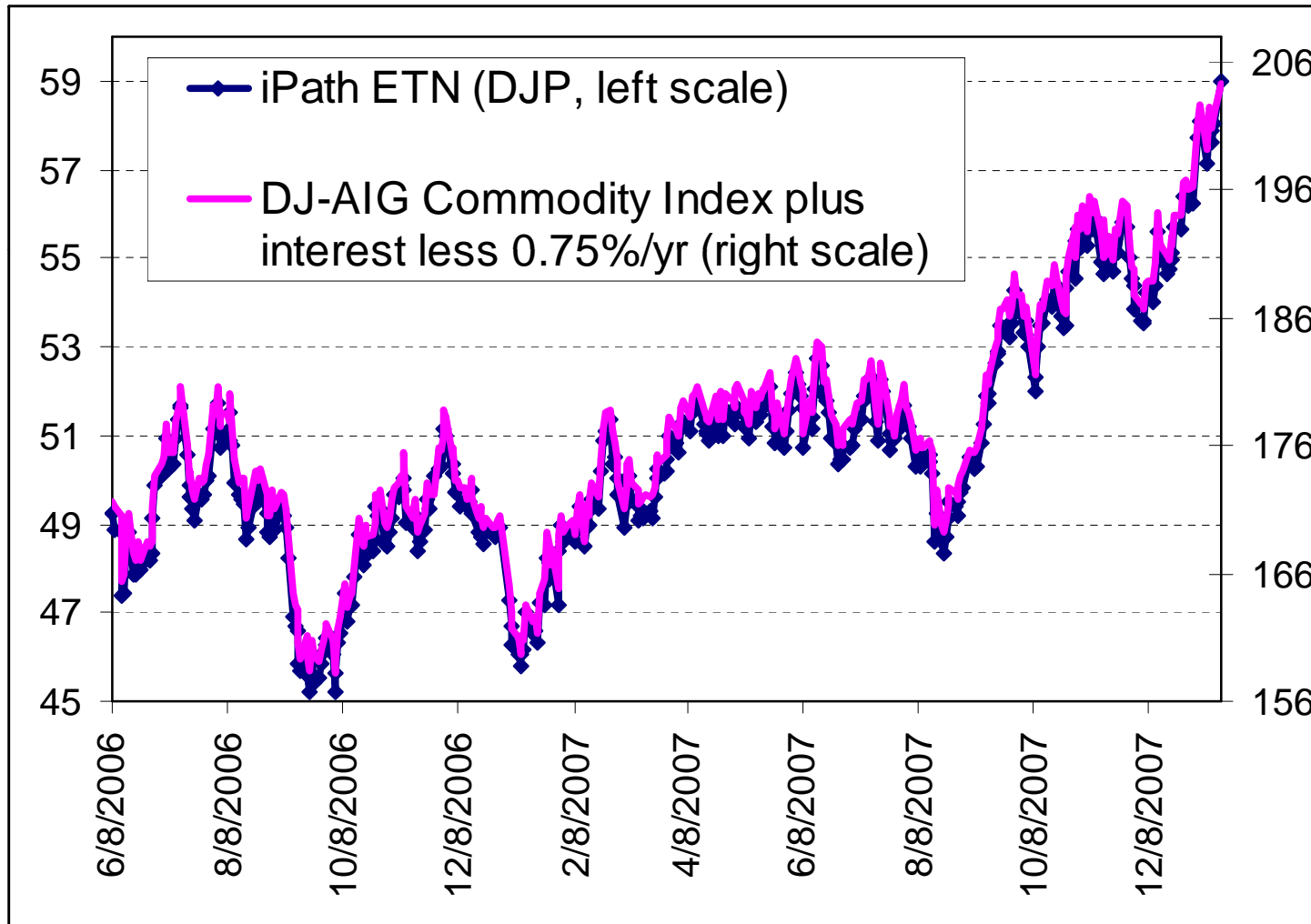
- These track investments that you otherwise could not buy or short directly.
- ETNs track a variety of commodity indexes and foreign currencies.
- Unlike ETFs, ETNs do not represent proportional ownership of a portfolio. Rather, ETNs are derivatives with Barclays as the counter-party.
- For now, ETNs enjoy better tax treatment if held for more than a year.
- Commodity ETNs have an expense ratio of 0.45%.

# Example—DJ AIG Commodity Index Total Return

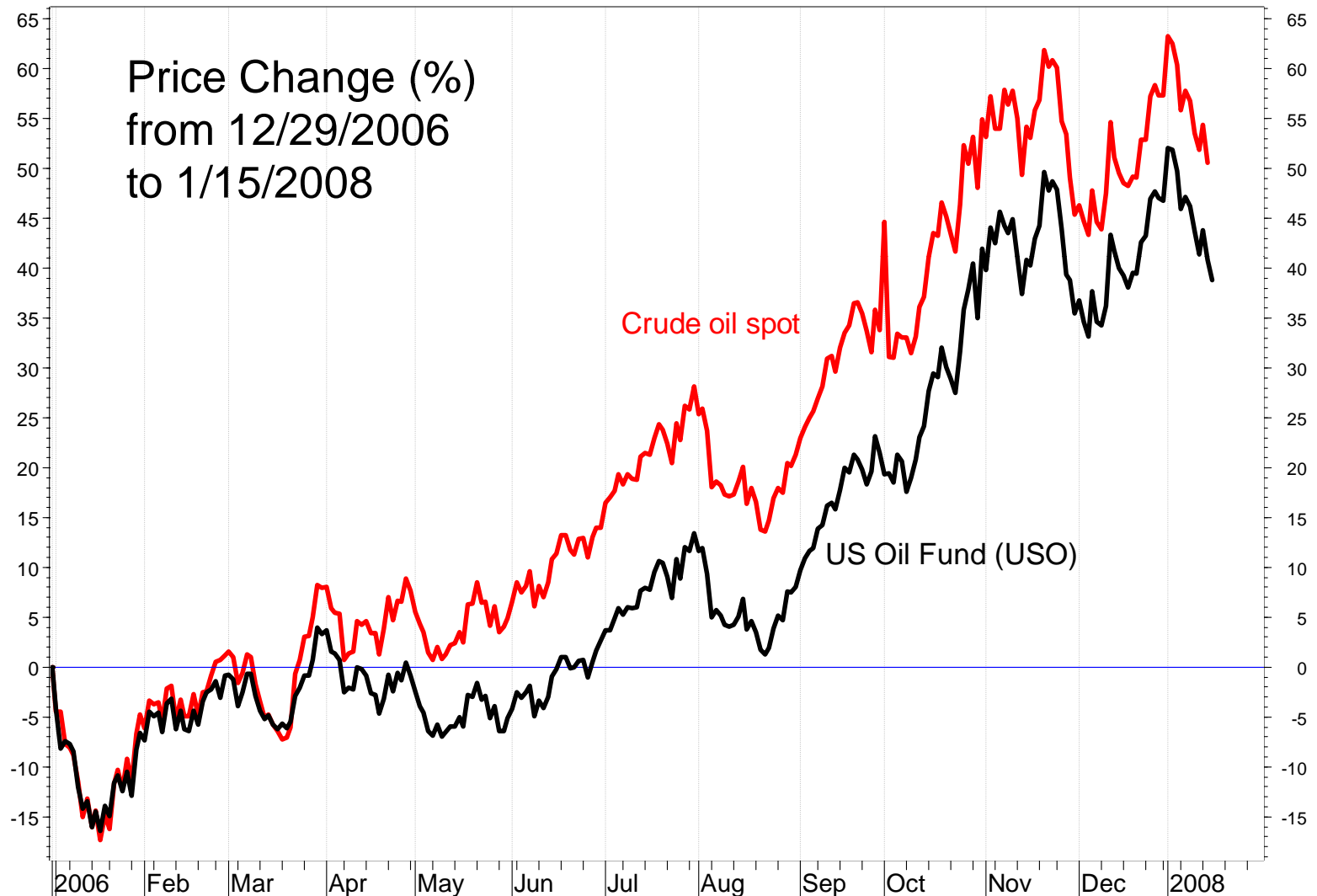
- Goal is to match the return of an unleveraged investment in the underlying future including interest on cash collateral.

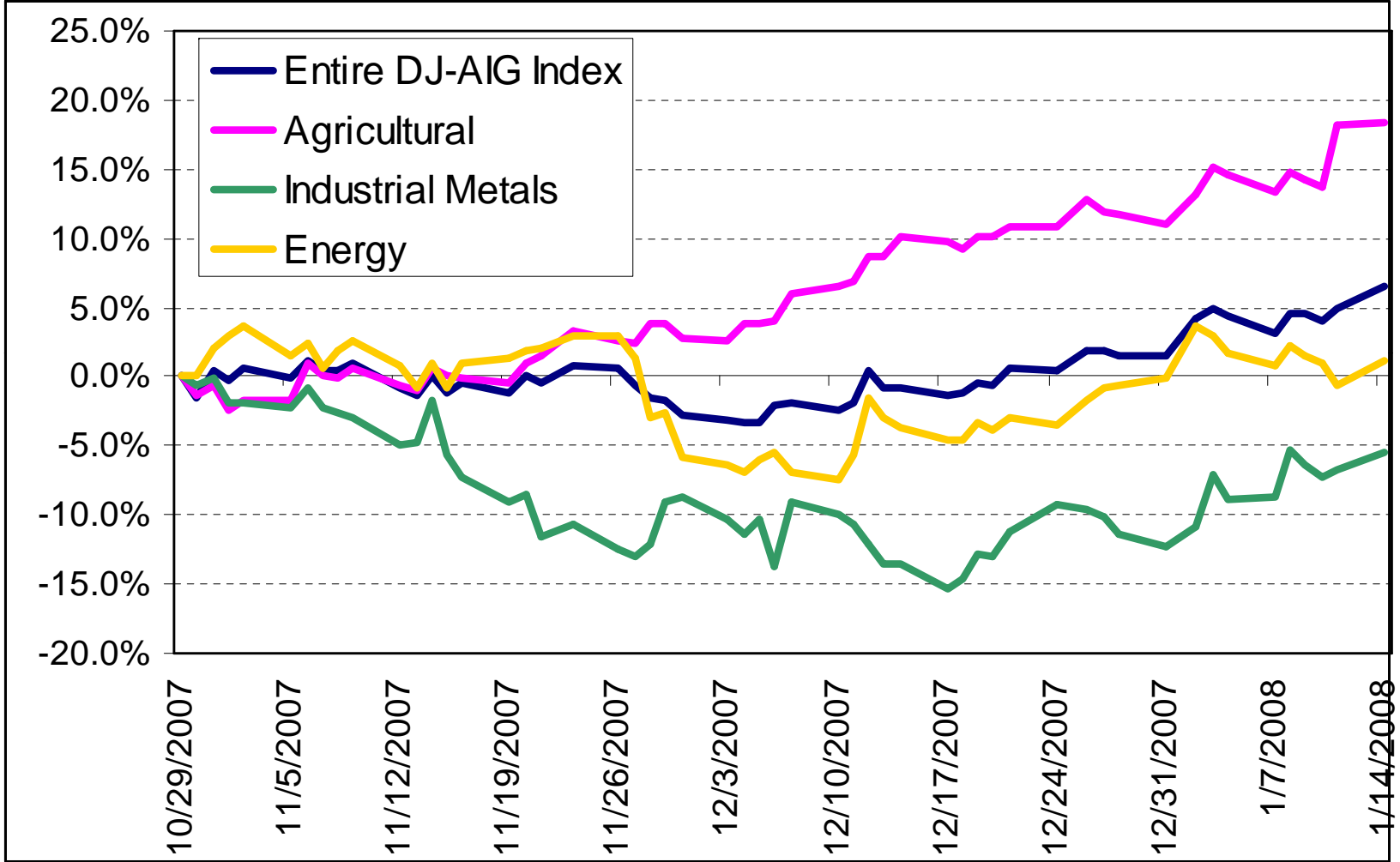


# DJP has closely tracked its benchmark



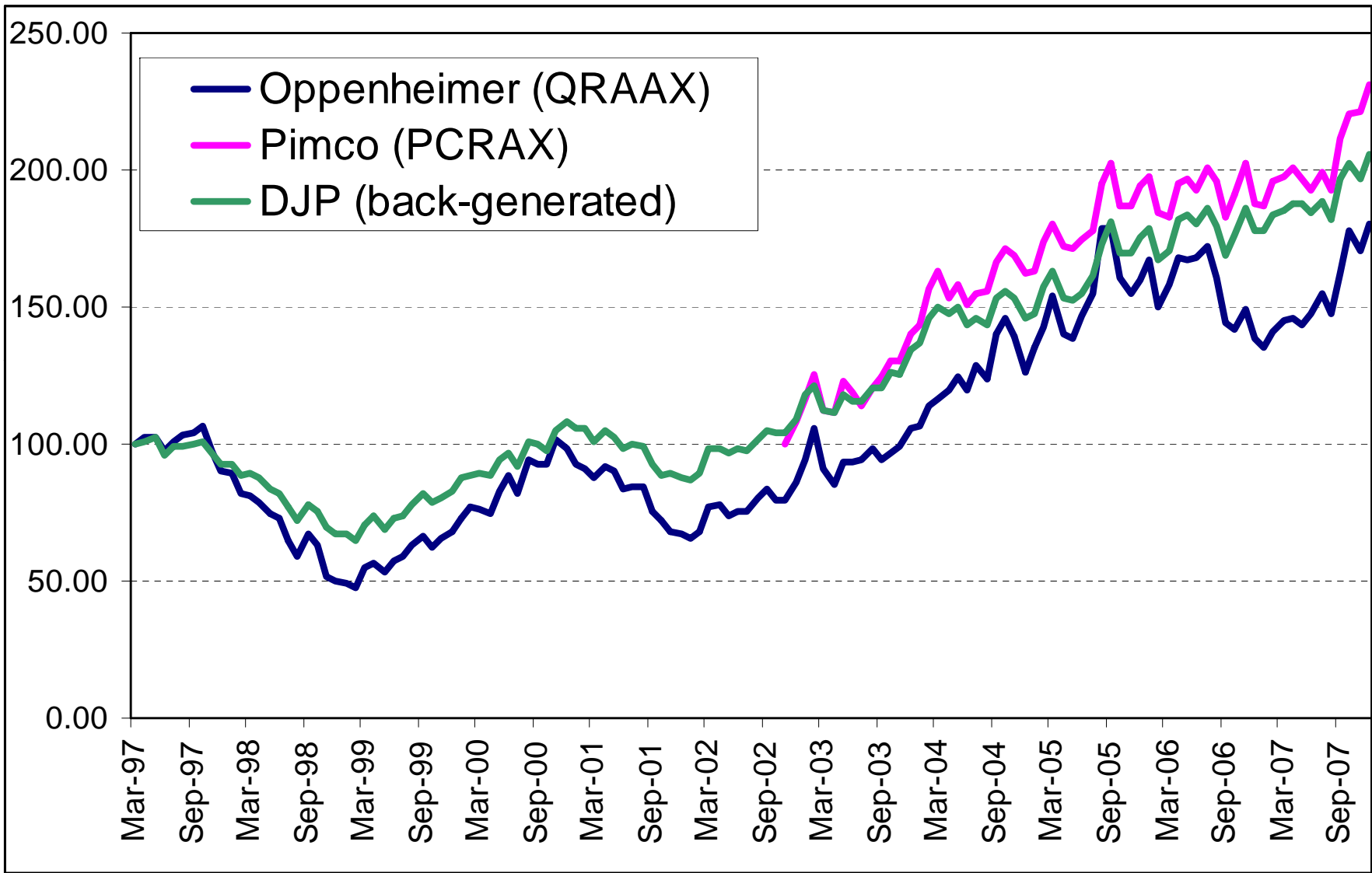
# An example of poor ETF tracking: USO versus spot crude





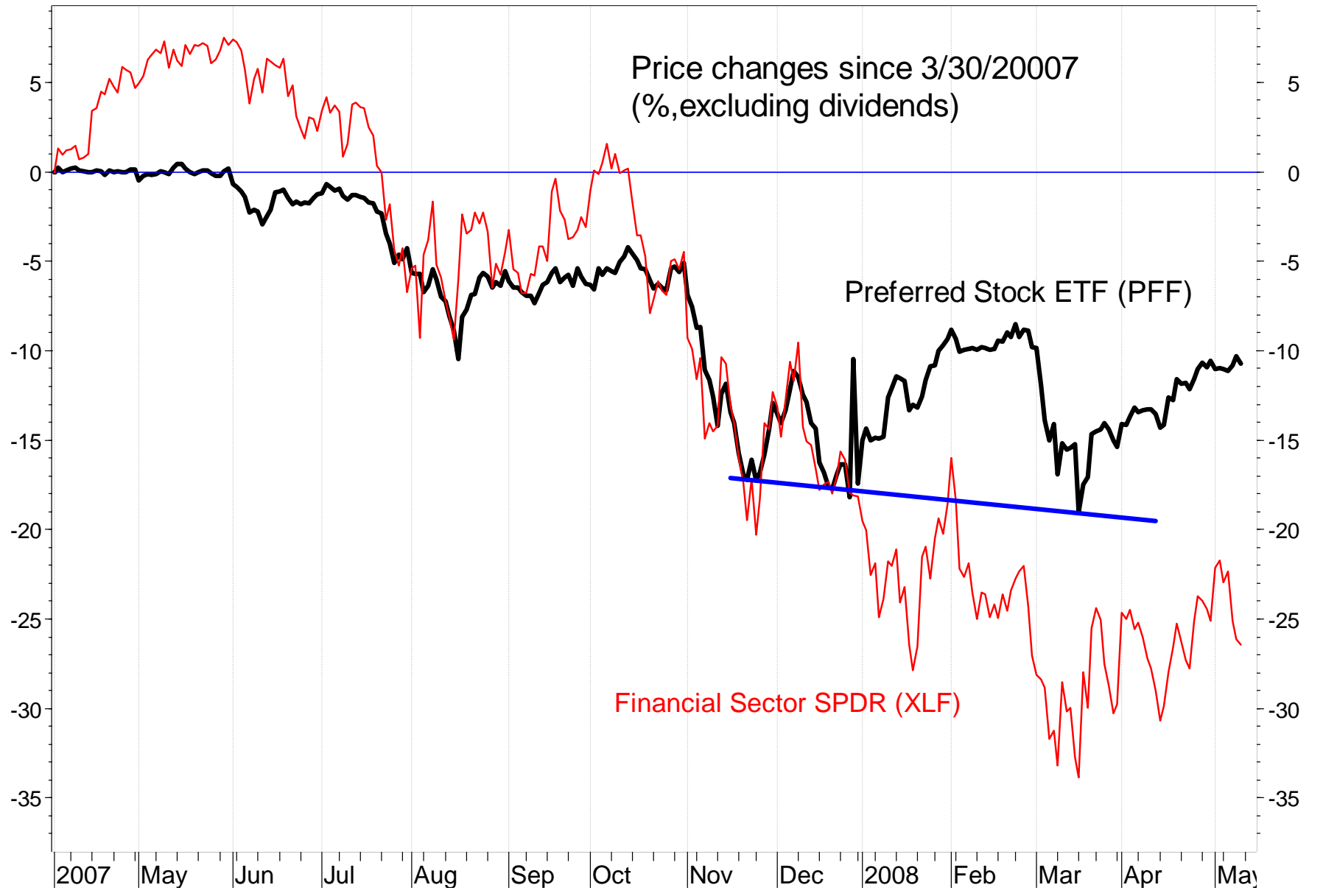
# Mutual Fund Alternatives

- Oppenheimer Commodity Strategies Total Return (QRAAX)—Active strategies to invest in commodities
- Pimco Commodity Real Return Fund (PCRAX)—Invests in a passive mix of DJ-AIG Commodity Index (same as DJP) and TIPS.



# ETFs for Investment Income

- Preferred stocks: PFF has yielded 7%/year so far.
- High-yield foreign and U.S. stock ETFs from Wisdom Tree yield more than 5%/year
- Bonds
  - Junk bonds (iShares HYG)
  - Muni bonds (TFI, MUB)

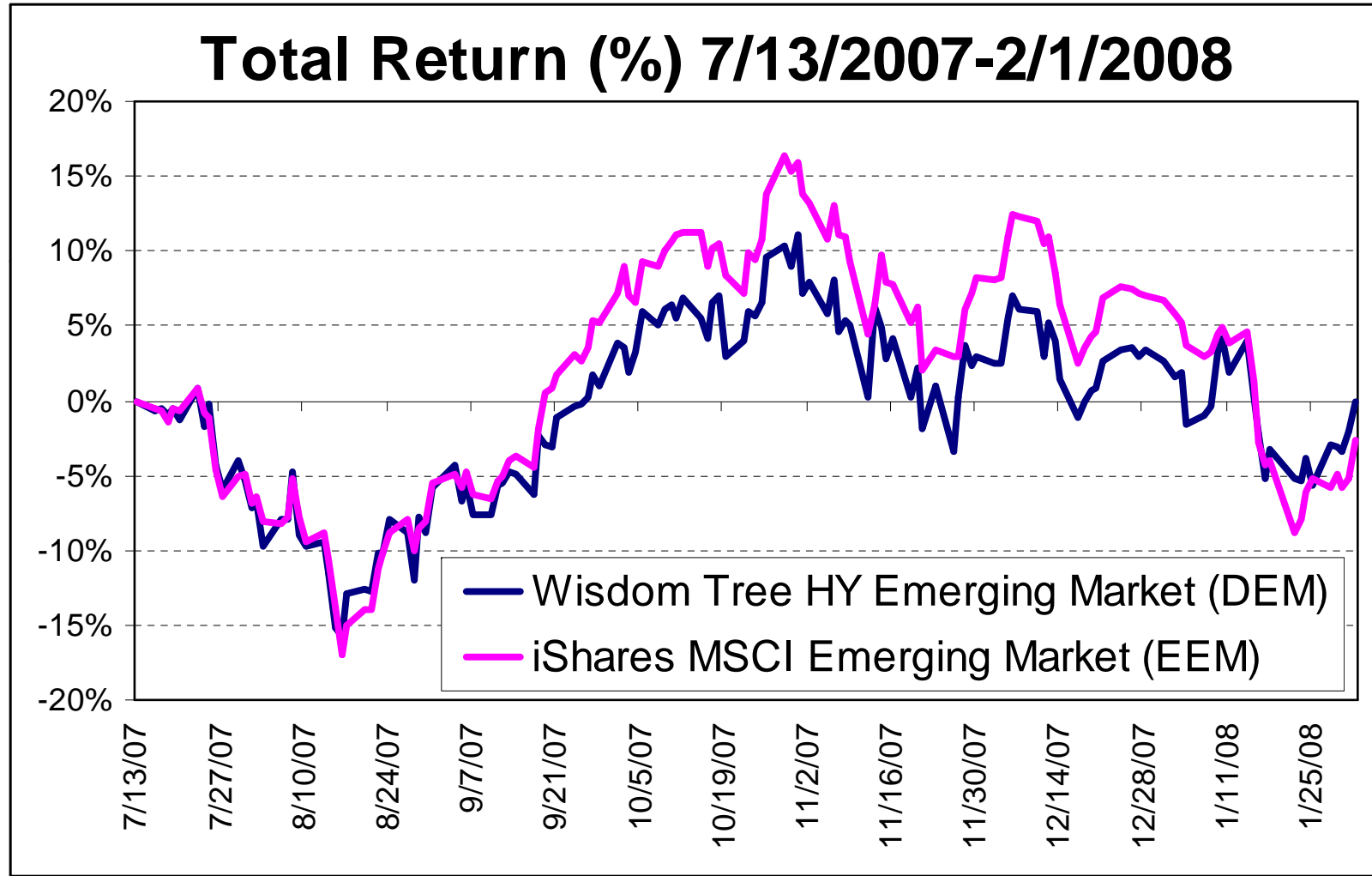


# Selected Wisdom Tree Funds

- High Yield Emerging Market (DEM)—Energy, materials, telecom (yield 5.0%, expense 0.6%)
- Pacific Ex-Japan High Yield (DNH)—Mainly Australian/New Zealand banks (yield 7.0%, expense 0.6%)
- Small-cap Dividend Fund (DES)—Majority financials (yield 5.9%, expense 0.4%)

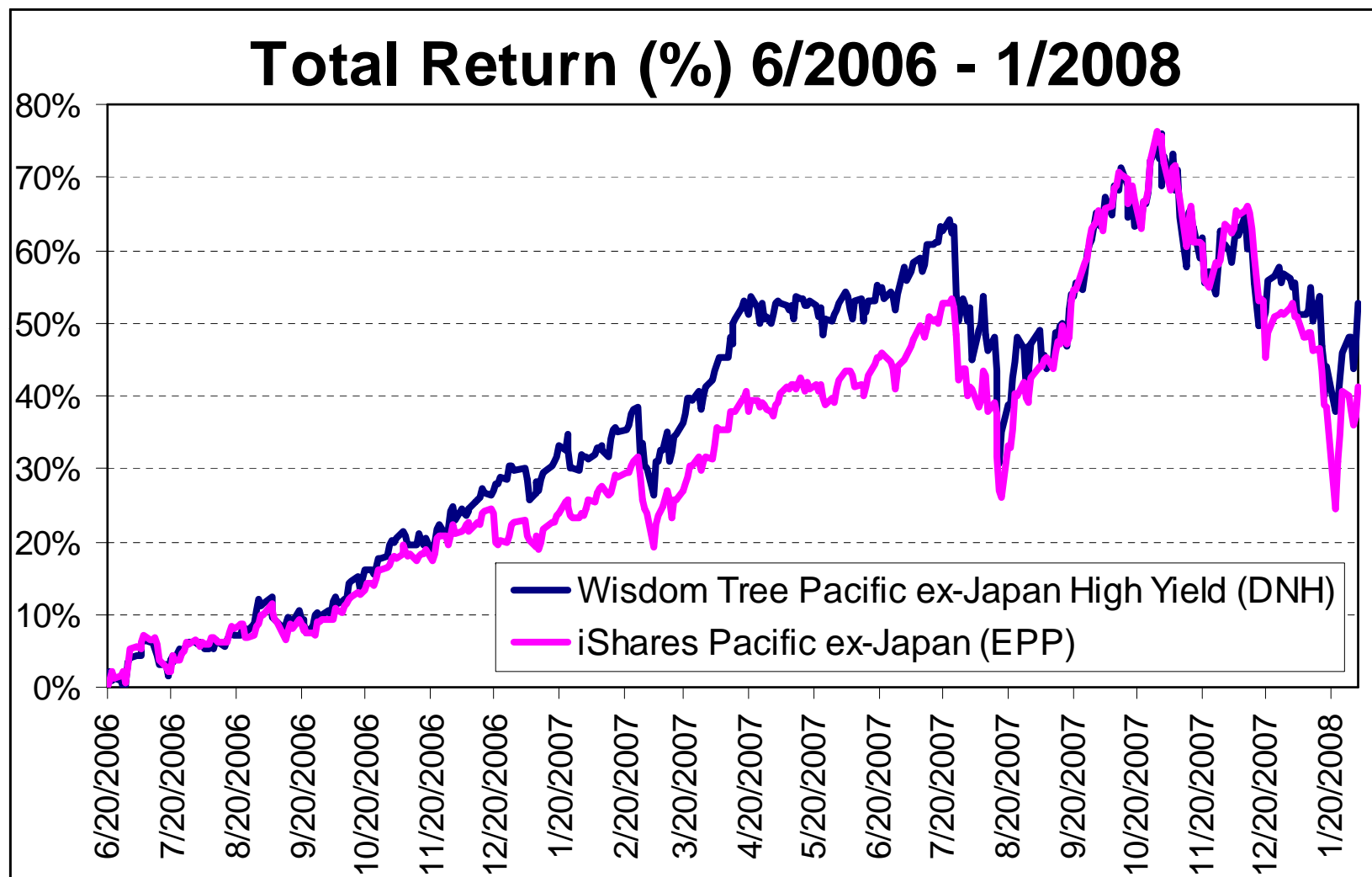
source: <http://www.wisdomtree.com/etfs/estimated-dividend-yield.asp>

# High-Yielding Emerging Market Stocks (DEM)—not overweighted in financials



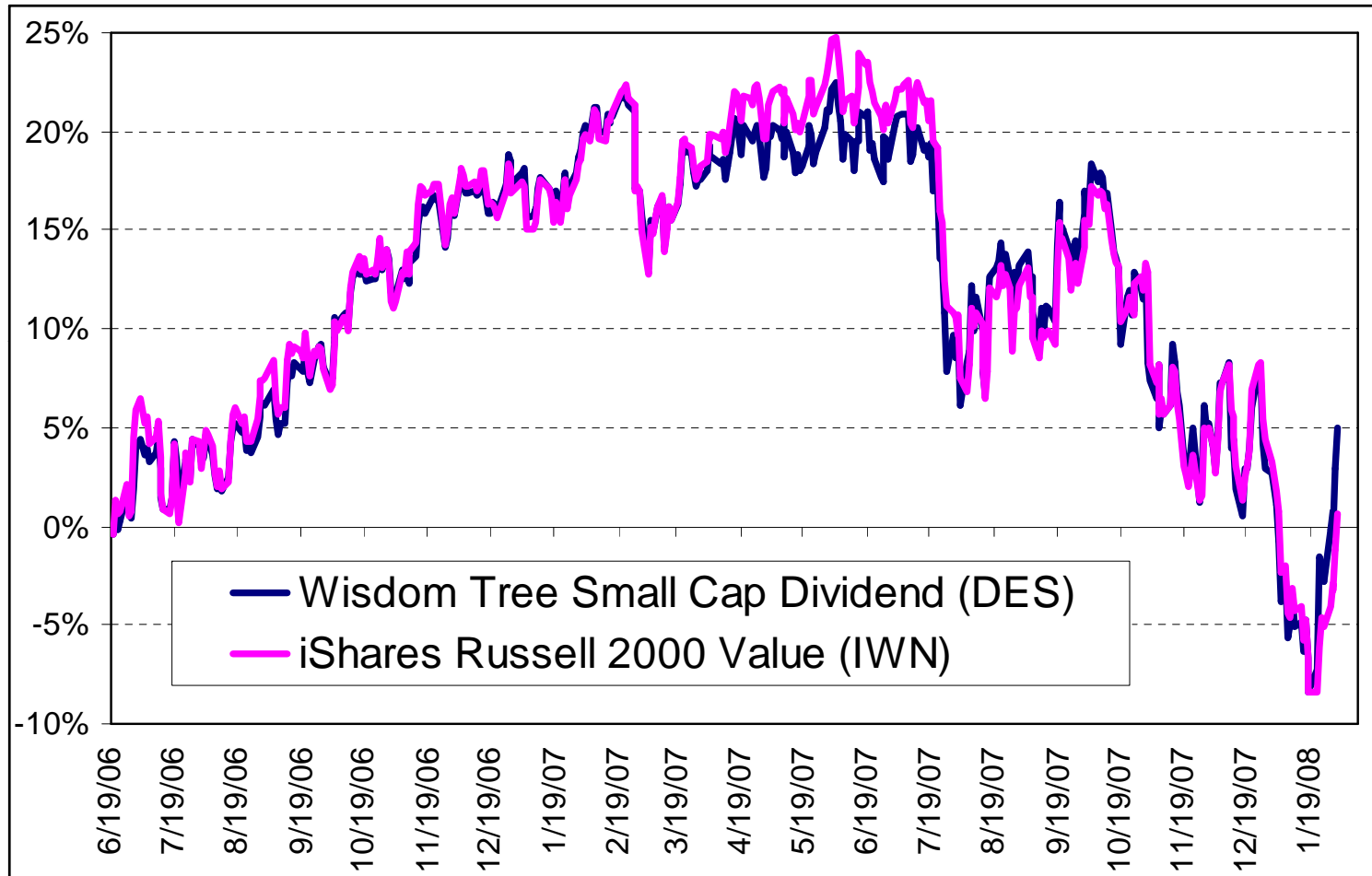
Less volatile compared to EEM (but history is very short).

# Watch your style exposure



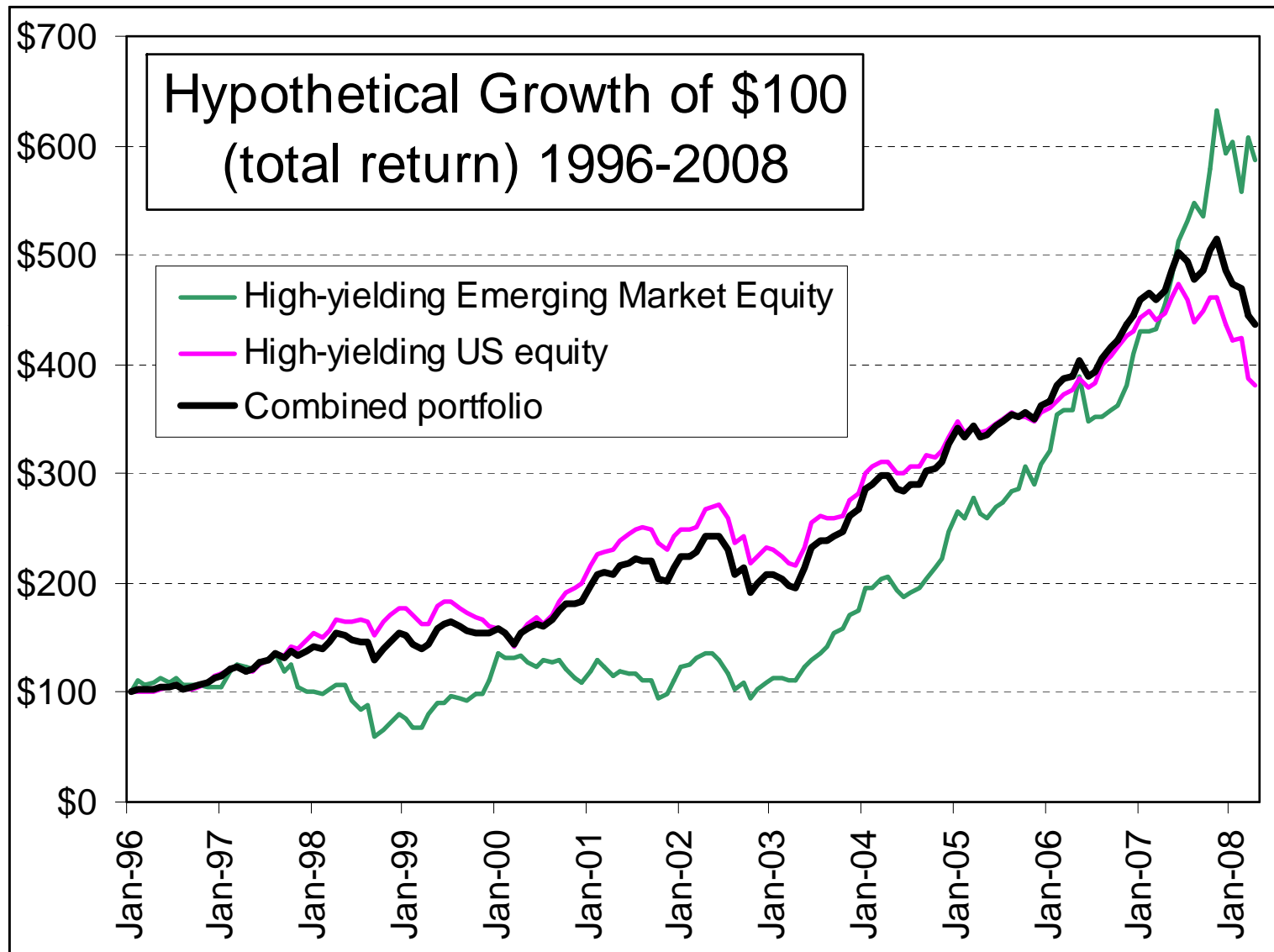
**Both EPP and DNH are heavily weighted in Australian banks.**

# High dividends from small caps



DES: 56% financials, IWN 34% financials. Yet, the investment behavior has been very similar (6/19/2006-2/1/2008)

# Diversified high-dividend portfolio



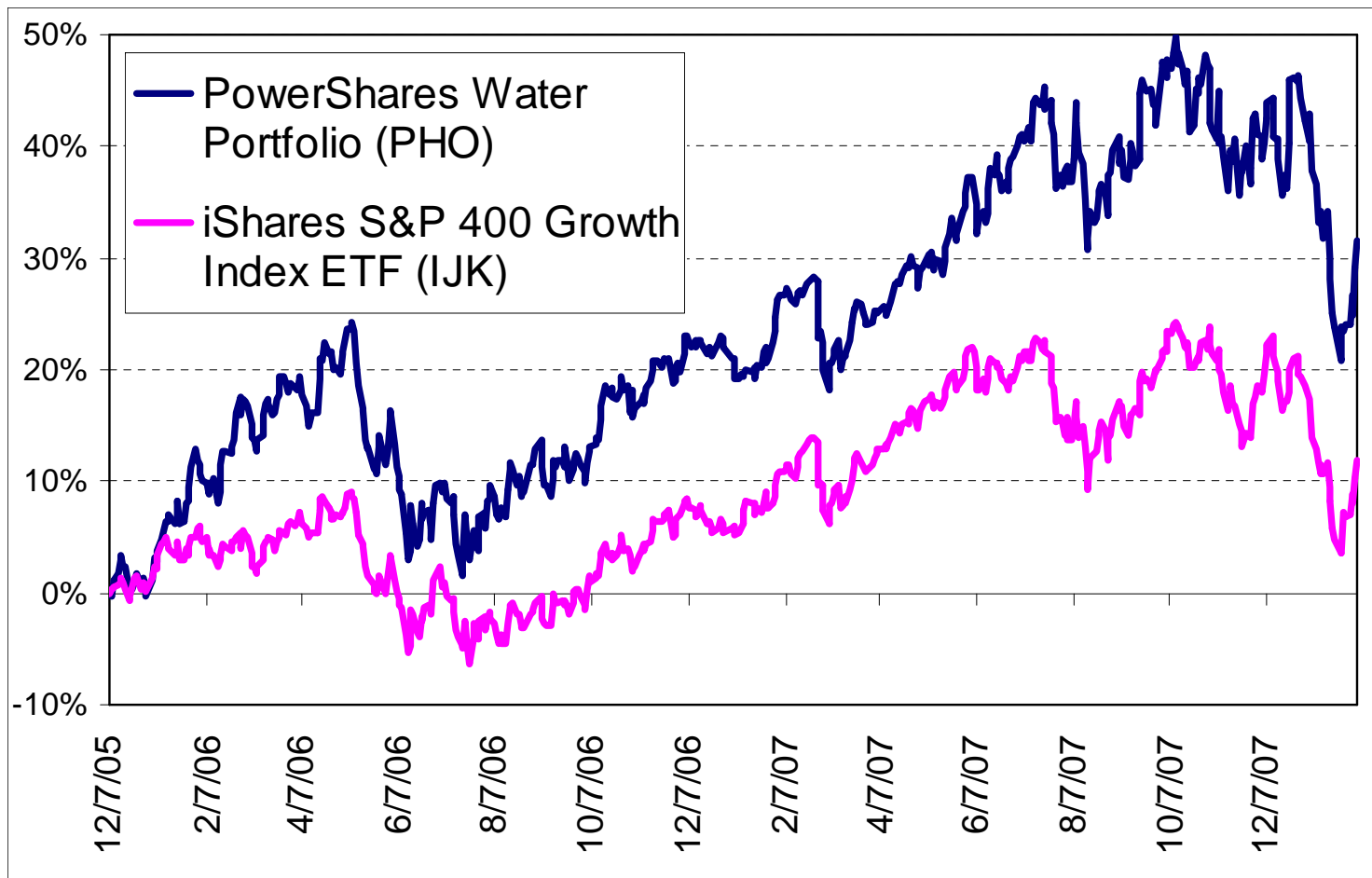
# Municipal Bond ETFs—Low costs should be a big advantage.

- iShares S&P California Muni Fund (CMF)—expenses 0.25%, SEC yield 3.5%, average maturity 8.9 years, 46 holdings.
- SPDR Lehman California Muni Bond ETF (CXA)—expenses 0.2%, SEC yield 4.0%, average maturity 8.6 years, 29 holdings.
- **Tough competition: Vanguard California Intermediate-term Tax Exempt (VCAIX)— lower expenses, less interest rate risk, more diversification-**  
-expenses 0.15%, SEC yield 3.6%, average maturity 6.8 years, 600 holdings

# Miscellaneous ETFs

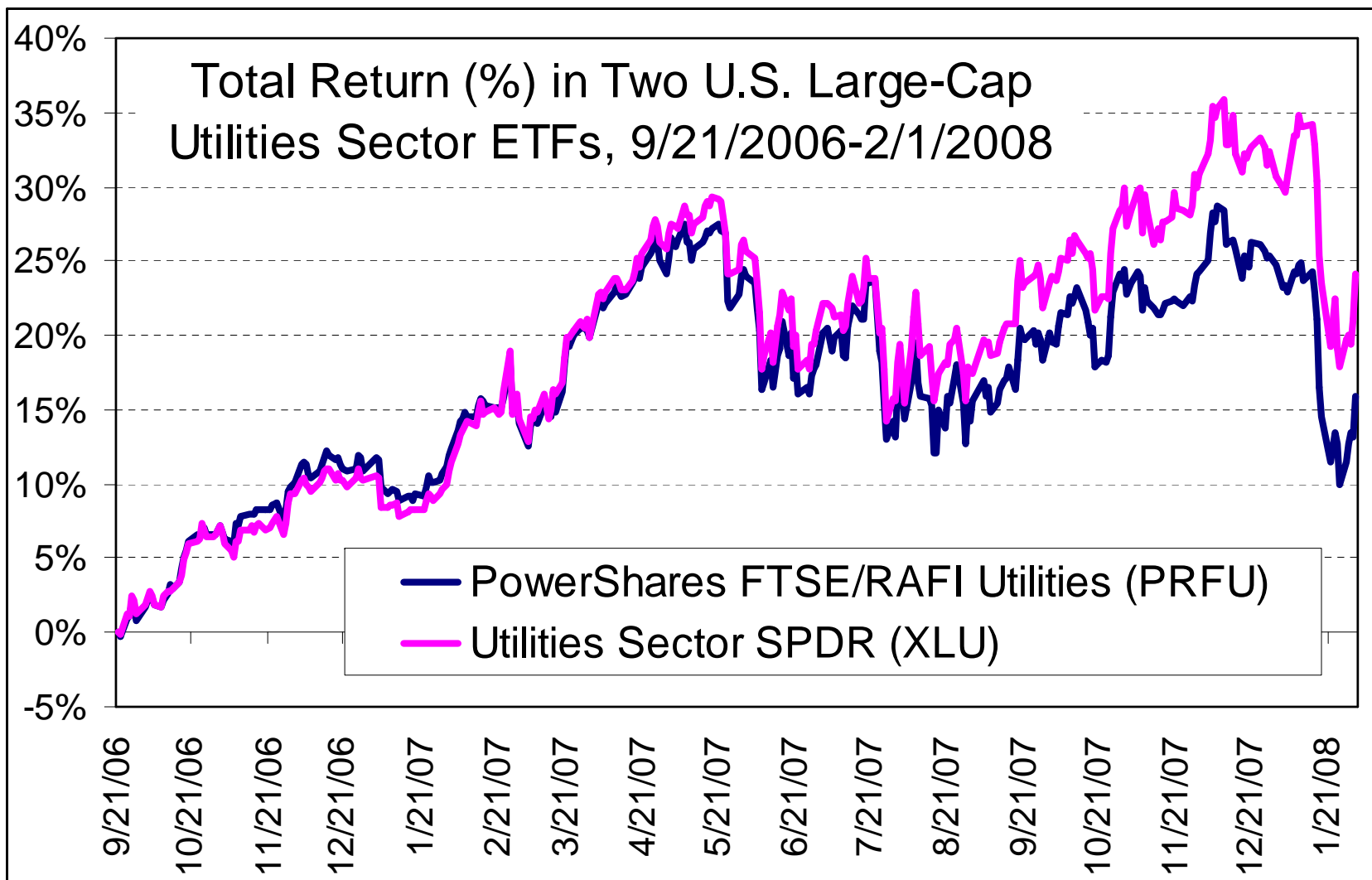
- Water resources (unavailable as a mutual fund)
- Utilities
  - Large-cap: stick to basics
  - Small-cap: Use Rydex Equal-Weight (RYU)

# Water resources—a unique ETF (PHO) that is like a mutual fund in disguise.

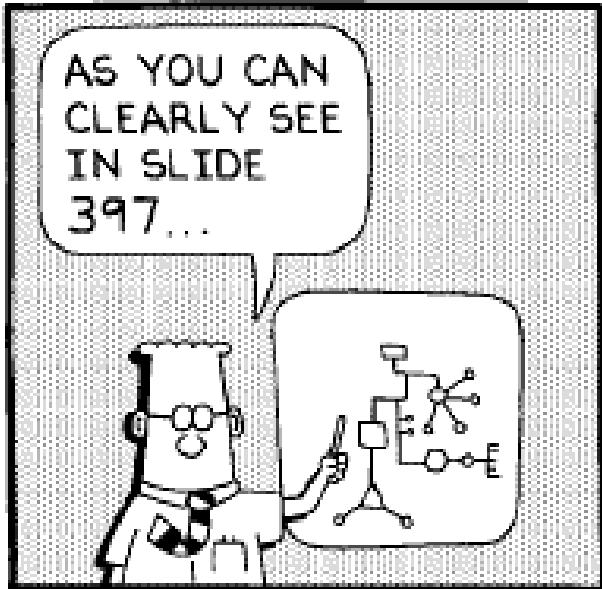


0.7% expense ratio. Tracks the Palisades Water Index (?), whose component stocks are mostly mid-cap and small-cap growth.

# Sometimes simple is best (utilities)



Expenses: 0.23% for XLU; 0.75% for PRFU



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Gerald Appel  
Editors

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Volume 34  
Number 34

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October 19, 2007

Is it safe to go back into the water? The commercial paper and inter-bank loan markets are cautiously returning to normal, but the source of credit problems, subprime mortgage and asset-backed bonds, are getting worse. (pages 4-5)

The stable state of the labor market indicates that there will be no recession in the next year. (page 5)

Picking stocks is not easy in the current environment. See how one money manager goes about separating the wheat from the chaff. (Review of *Active Value Investing*, page 6)

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**State of the market: The credit crunch rears its head again, to the detriment of financial stocks. Last week's losses have brought SPY into a near-term buying area.**

Even though bank stocks have been hurt by reports of their diminished third quarter earnings, the health of the banking system itself is being reaffirmed in a number of ways. The spreads between inter-bank loans (LIBOR) and Treasury bills is shrinking, as are the spreads between asset-backed and nonfinancial commercial paper. (See pages 4-5). Moreover, floating rate bank loan funds (which are heavily exposed to asset-backed bonds) continue to recover from July-August losses.

Intermediate term indications are mixed. On the plus side are favorable valuations, interest rate climate and seasonality. On the minus side, market breadth indicators have started to deteriorate after barely failing to reach levels that have historically signaled the best market environments. **We come down on the side of the bulls, expecting the Federal Reserve to continue its easy money policy for as long as it takes to get the U.S. past the potential credit crunch. In a roll reversal, this time growth abroad will jumpstart the U.S. economy, rather than the other way round.**

The chart of SPY below shows that there are potential support zones around \$153.35 and \$151.40. Intra-day on October 18, SPY has fallen to the first of these zones.

(Continued on page 2.)





**Beating the Market,**  
3 Months at a Time

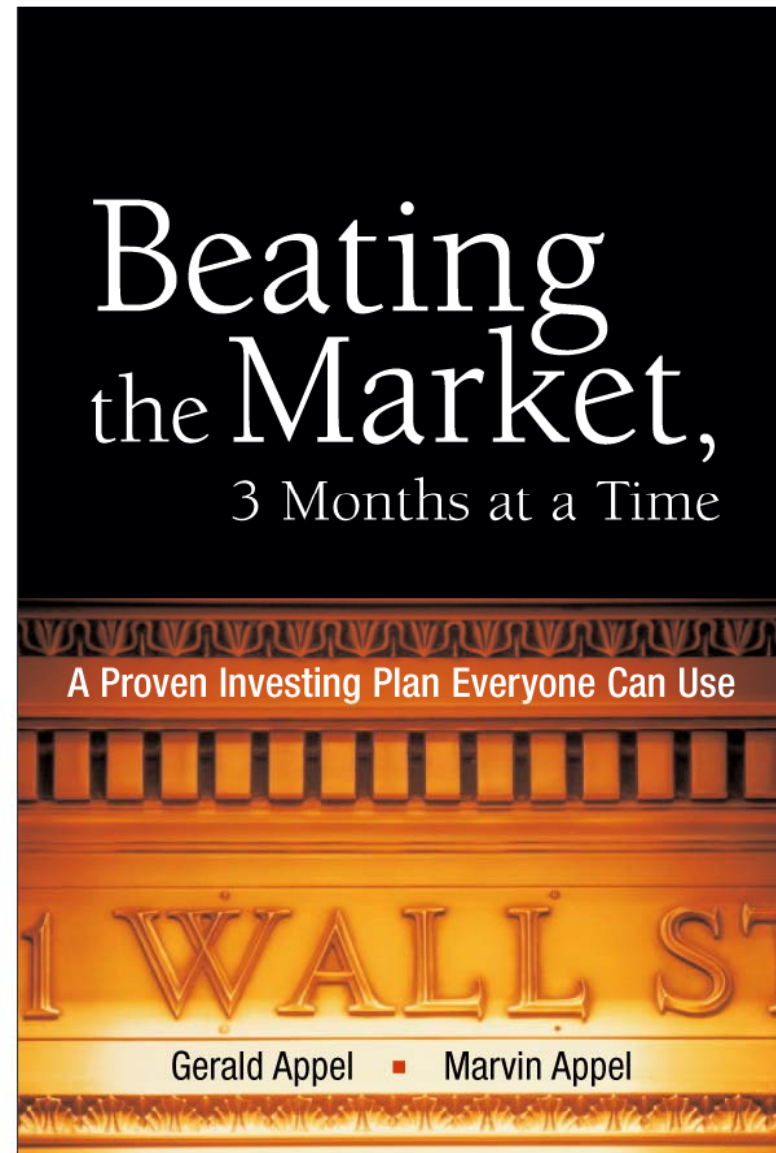
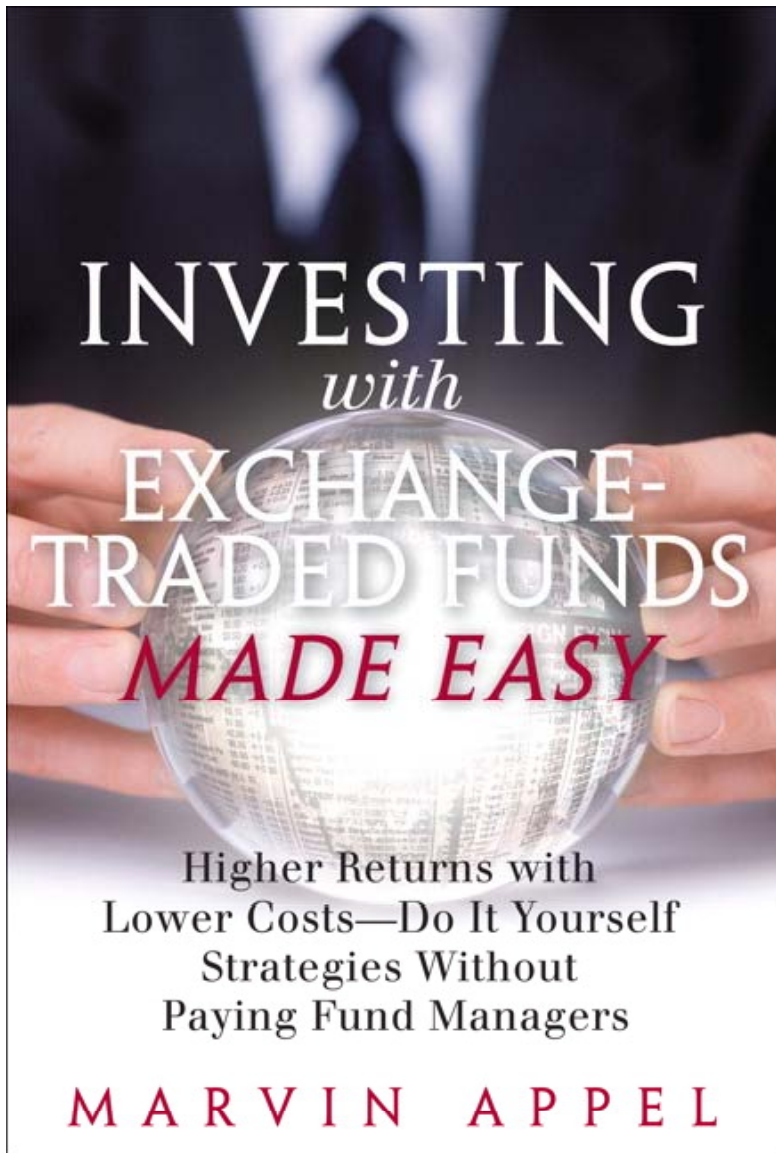
A Proven Investing Plan Everyone Can Use

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