ETF INVESTING

Ahead of the curve

Why ETF-only portfolios make sense for investors

By John Spence, CBS MarketWatch.com
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BOSTON (CBS.MW) -- For J.D. Steinhilber, exchange-traded funds are simply a better mousetrap.

The Nashville, Tenn.-based financial adviser is among a handful of investment professionals who recommend ETF-only portfolios. Steinhilber, who writes weekly commentary for subscribers with model portfolio picks, says he likes ETFs exclusively because they offer tactical exposure to asset classes at rock-bottom prices.

"The vast majority of portfolios are still put together in a haphazard fashion, and don't have an asset allocation orientation," says Steinhilber, founder of Agile Investing, in a telephone interview. "Most investors end up with a 'patchwork portfolio' that doesn't have a coherent overall structure or a long-term orientation."

Why is asset allocation, or how a portfolio is invested in stocks, bonds and other securities, so important?

Studies show that asset allocation is by far the most important factor in determining the variability of returns among institutional investors.

Armed with this knowledge, institutions have focused on targeted allocation and controlling expenses -- leading to indexed vehicles for their core investments.

Individual investors, too, would do well to follow this example, Steinhilber notes. "Think more like institutional investors," he says, "by focusing on asset classes and getting exposure to asset classes as efficiently as possible.

"My approach is to use low-cost and tax efficient ETFs to access asset classes, and make sure to be exposed to a broad range of uncorrelated asset classes at all times," Steinhilber adds.

Although ETFs and index funds share many characteristics, Steinhilber says he appreciates the flexibility of ETFs, which trade like stocks instead of being priced once at the market close like mutual funds.

"The back office, custody, clearing, and trading issues are much more simplified with ETFs because the mutual fund provider isn't part of the mix," Steinhilber notes.

However, when comparing ETFs against index funds, investors need to factor in the broker commissions they must pay to move in and out of ETFs. See previous story.

Breed apart

Although financial advisers have been promoting asset allocation with index funds for some time, Steinhilber is part of a new generation focusing on ETFs.

"Vanguard index funds are good tools for me, but if they impose redemption fees I may shy away from them, because I may need trading flexibility in tactical asset allocations," Steinhilber says. "Also, Vanguard may not be available on every custodial platform, which isn't a problem with ETFs."

ETFs are catching on with fee-based advisers, who are paid a straight percentage of assets under management, rather than racking up commissions on individual fund sales.

"Over the past several years, there's been a move away from a transaction and commission-based business, which is how Wall Street has traditionally operated, to fee-based business," Steinhilber says.

"Fee-based compensation aligns the incentives of the adviser and the client, and that's certainly a good thing," he adds. "The original commission-based model was flawed in its underlying concept, because the real value of a good adviser is delivering advice, especially with markets being much more accessible now."

While most advisers target high net-worth clients, a growing number of younger investors with smaller portfolios still need financial advice.

"Smaller clients are being neglected by most brokerage firms, and it all goes back to the cost structure," Steinhilber observes. "If you do the math, it's simply not profitable for adviser to work with smaller accounts."

However, this does present opportunities for firms like Steinhilber's that use low-cost ETFs, although the margins are certainly thin.

Uphill climb

Although the ETF industry has grown to an estimated $180 billion, the investments represent only a sliver of the $7.5 trillion fund business.

"Despite the huge marketing campaigns to build ETF awareness, quite frankly the asset growth hasn't been as big as you would expect, given the amount of dollars being spent on marketing," Steinhilber says.

Still, institutional investors and financial advisers are warming to ETFs. About 75 percent of hedge funds, half of all financial advisers, and a third of pension plans use ETFs, according to Greenwich Associates.

Although Steinhilber believes in his strategy, he knows many of his peers struggle with index funds or ETFs because they equate their professional value with choosing funds that could outperform a benchmark.

"I think the adviser's role is to help with asset allocation, making sure clients stay disciplined, stick to their plan, and don't let emotions hurt them at the wrong times," Steinhilber says. " Instead, most advisers are selling performance, but it's very easy to find an outperforming manager."

John Spence is a reporter for CBS MarketWatch in Boston.