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March 6, 2006


FUND TRACK

Run-Up in ETFs Points to a Need For Exit Strategy

Positions Can Be Scaled,
Based on Fundamentals
And Investor Sentiment

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March 6, 2006; Page C9

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Given the strong run-up in some exchange-traded fund sectors like emerging markets, energy, gold and Japan, it may be time for investors to rethink their investments.

To get exposure to these or other hot markets, many investors use ETFs because they don't have all the risks associated with owning individual stocks. But they aren't foolproof and a reversal in one of these areas could lead to considerable losses. That's why investors should keep in mind a disciplined exit strategy -- be it fundamental or technical analysis or monitoring investor sentiment -- to know when to get out.

J.D. Steinhilber, founder of AgileInvesting.com, an investment-advisory subscription service that provides advice on managing portfolios with ETFs, considers emerging markets, Japanese stocks and gold to be core asset classes, so despite those categories' recent hot streaks, "I wouldn't get out of those positions entirely." But he adds, investors "are prudent to scale up and down the size of their position based on a combination of fundamentals, and technical analysis and sentiment analysis."

In his newsletter earlier this year, Mr. Steinhilber noted the strong growth of the iShares MSCI Emerging Markets Index Fund, which invests in stocks from more than 20 countries including South Korea, South Africa, Taiwan, Brazil, Mexico and China. Some of the largest sectors represented by the ETF are industrial materials, financial services, energy and telecom. Mr. Steinhilber warned subscribers who have benefited from its nearly 40% rise over the previous 12 months to consider rebalancing to get back to their target allocations.

He also reduced exposure to international stocks in his recommended portfolios, based on a combination of fundamental analysis and investor sentiment.

Over the past four years, "the substantial valuation discounts that have made foreign stocks particularly attractive have largely disappeared," he said. At the start of 2002, the MSCI EAFE index traded at a price-to-book multiple that was 40% below that of the Standard & Poor's 500-stock index, while that valuation discount is now less than 15%, he said.

He noted that investor interest in foreign mutual funds and ETFs has been at "feverish levels." U.S. investors directed three-quarters of their net new money into foreign-focused funds in 2005. "Accordingly, we think it is appropriate to move back to what we would consider a more neutral 2-to-1 allocation relationship between domestic and overseas equity investments," he said.

Tom Lydon, president of financial-advisory firm Global Trends Investments and founder of ETFTrends.com, uses a technical discipline when deciding when to sell an ETF.

He looks at ETFs' 50- and 200-day moving averages -- the price of the ETF over a specified number of days divided by the number of days -- to form a trend line.

"It's a discipline that keeps you out of trouble and it's very simple, so the average investor can understand it," he says. For instance, if an ETF moves below the 200-day average, he believes it's time to sell.

He argues that an 8% stop-loss order -- placed with a broker to sell a security when it reaches a certain price -- "allows a comfortable amount of giveback."

A shorter term stop-loss, such as 5%, could be too low since markets often have a 3% to 5% correction before they move on and hit new highs, he says.

Take Japan, for instance. Over the past three years the **iShares MSCI Japan Index Fund** -- one of the most popular ETFs, which tracks about 280 publicly traded Japanese stocks -- has risen more than 27%, according to Morningstar.com. Recently, the ETF dropped about 6% from its highs, and if it were to go below 8%, Mr. Lydon says he's prepared to sell.

Knowing when to sit tight is as important as knowing when to get out.

Michael Krause, president of ETF Research firm AltaVista Independent Research Inc., notes that Wall Street was sour on small and midsize companies at the start of last year, because they had outperformed for five years.

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WHO'S NUMBER TWO? Capital Research & Management Co. remained the biggest U.S. manager of stock and bond mutual funds as of Jan. 31, while Fidelity Investments edged out Vanguard Group to grab the No. 2 spot, according to data from the industry's main trade association.

Los Angeles-based Capital Research, investment adviser to the American Funds, managed \$889 billion in long-term assets as of Jan. 31, according to data from the Investment Company Institute. Boston-based Fidelity managed \$830 billion, while Vanguard, in suburban Philadelphia, slipped to third place with \$826 billion.

As of Dec. 31, Capital Research managed \$847 billion, Vanguard managed \$795 billion and Fidelity managed \$794 billion in stock and bond funds.

Franklin Resources Inc., of San Mateo, Calif., managed \$285 billion in long-term assets at the end of January.

Fidelity remained the No. 1 mutual-fund company when money-market funds are included, with \$1.05 trillion in assets as of Jan. 31. Vanguard ranked second, with \$942 billion, followed by Capital Research at \$899 billion.

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