

A black and white portrait of Scott Burns, a man with a beard and mustache, wearing a suit and tie. The background is a light gray gradient.

Scott Burns

Director of ETF Analysis  
at Morningstar

A pink circular logo with the letters 'ETF' in white, bold, sans-serif font.

ETF

# Tactical ETF Investing

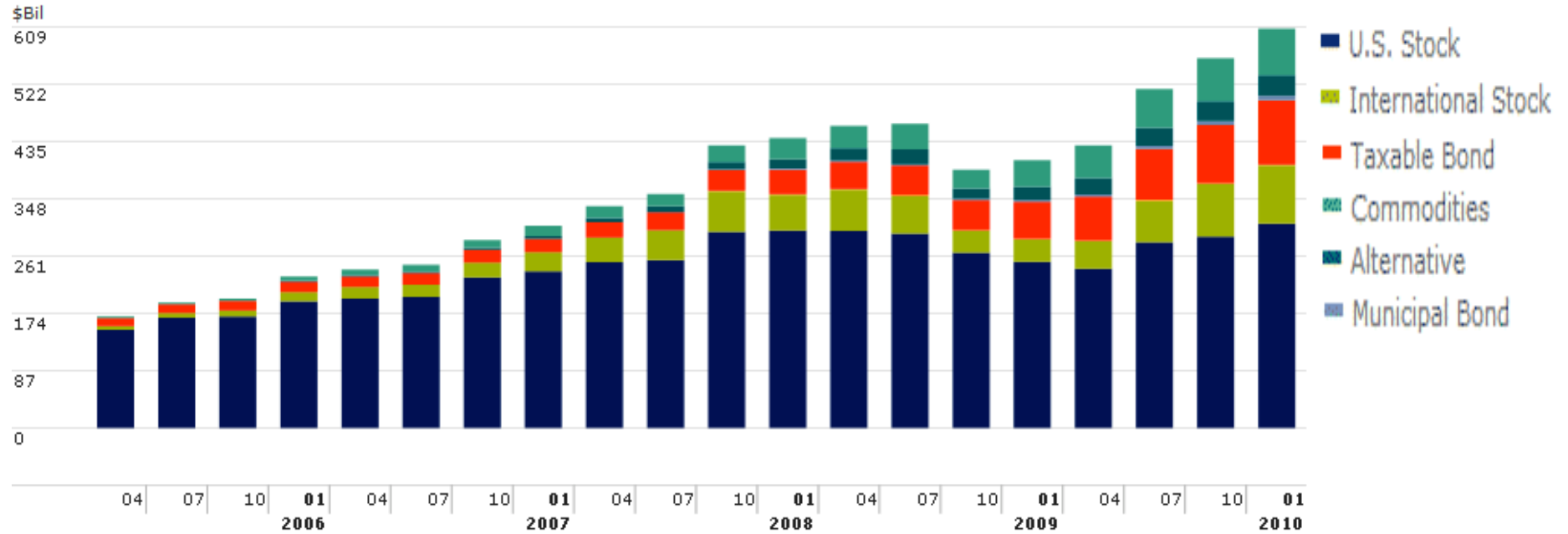
March 16, 2010

A red horizontal bar at the bottom of the slide containing the Morningstar logo in white.

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# ETFs: A Growth Story

## Total Net Assets by Asset Class, Quarterly



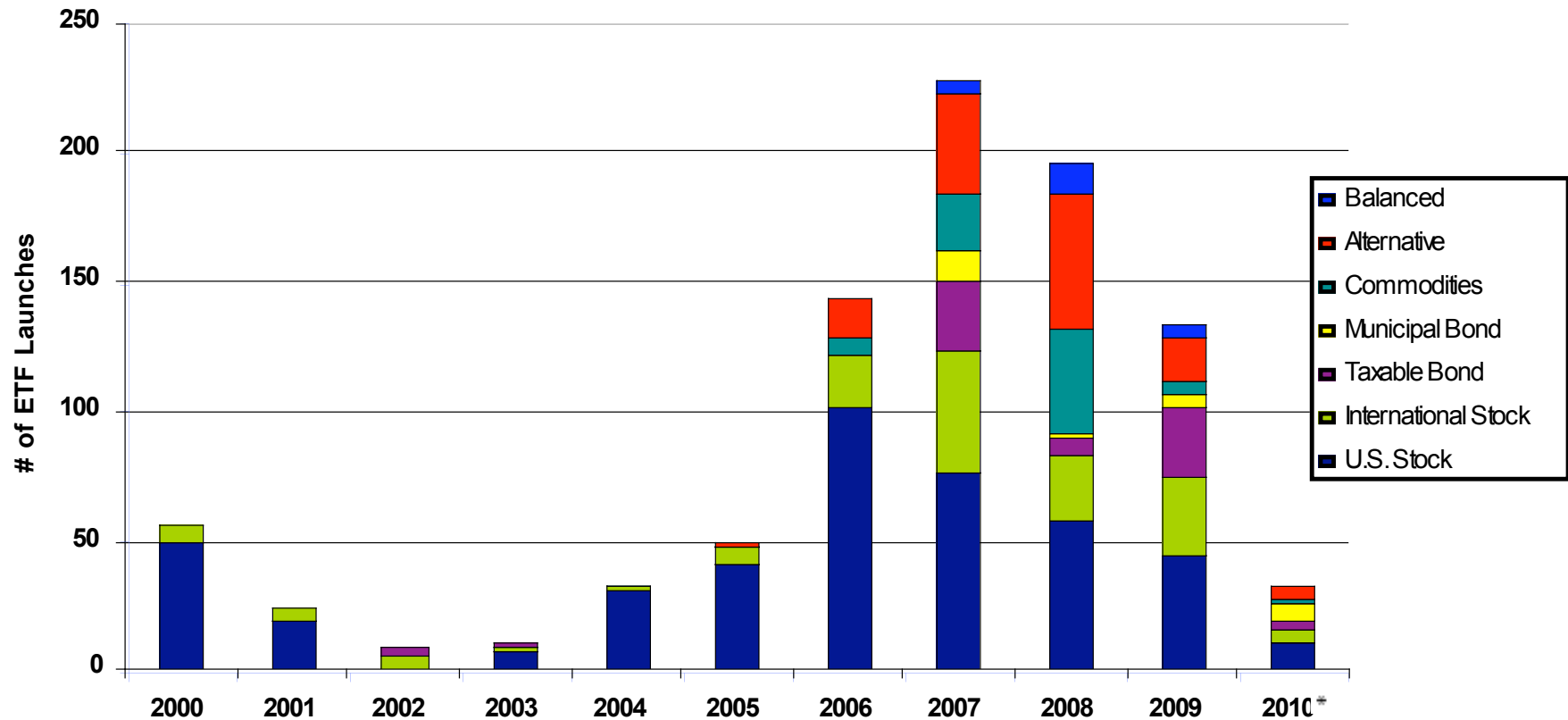
- Industry evolving beyond domestic equity
- Democratization of “difficult-to-access” asset classes

## Proliferation of US ETF Universe Asset Classes

Category/Asset Class	# of ETFs	Total Net Assets (\$bil)	As a % of Industry Assets
U.S. Equity	384	301.8	50%
International Equity	156	93.9	15%
Fixed Income	84	103.9	17%
<b>Total "traditional" ETFs</b>	<b>624</b>	<b>499.5</b>	<b>82%</b>
Commodity	75	70.2	12%
Currency	28	6.6	1%
Balanced	17	0.8	0%
Leverage/Inverse	148	30.0	5%
<i>Short (-1x, -2x, -3x)</i>	88	19.3	3%
<i>Long (2x, 3x)</i>	60	10.7	2%
<b>Total "alternative" ETFs</b>	<b>268</b>	<b>107.6</b>	<b>18%</b>
<b>US ETF Industry Total</b>	<b>892</b>	<b>607.1</b>	<b>100%</b>

Data as of Jan. 31

# ETF Launches by Asset Class



\* Data for 2010 through Feb. 17, 2010

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## Advantages of ETFs

- Tax Advantage
- Cost
- Diversification
- Liquidity
- Immediate market execution
- Access to new investments

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## Potential Drawbacks of ETFs

- Transaction fees – Sometimes
- Limitations within tax protected accounts (401K)
- Product proliferation burden – do your homework
- You're free to choose between a mutual fund, stock, or ETF

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# Putting Actionable Ideas to Work

Tactical ETF Investing

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## Tactical ETF Investing - Key Questions

- Investment Thesis
- Suitability and Risks
- Evaluate Your ETF Options
- Understand the Fundamentals
- Portfolio Impact
- Nuts and Bolts



***The process should be iterative:  
“Wash, Rinse, Repeat”***

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## Tactical ETF Investing – Investment Thesis

- A good investment process starts with the idea first and the fund second
- Ask and answer questions about your thesis to refine your scope
- Write your thesis down
  - The reasons, the risks and the expected rewards
  - Gives you a basis for future buying and selling decisions
  - Helps control behavioral biases

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## Tactical ETF Investing – Suitability and Risk

- You need to pay attention to potential volatility and downside risk
- Lower risk investments allow you to buy bigger chunks for your portfolio at a time and keep them on a longer leash in terms of maintenance
- Higher risk should be a smaller part of your portfolio with some capital kept in reserve should you need to average into your holdings

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## Tactical ETF Investing – Evaluate Your ETF Options

- The mantra: “Know what you own! Know what you own! Know what you own!”
- Index/Fund construction
  - What are you actually buying?
  - Does it live up to its name?
  - What is the weighting strategy?
  - Active or passive?
  - What are the underlying securities? Stocks, Bonds, Derivatives?

# Tactical ETF Investing – Understand the Fundamentals



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- Proprietary ETF data leverages our equity research
- ETFs are rated as undervalued, fairly valued or overvalued based on holdings in the portfolio
- Proprietary data points include: valuation rating, fair value estimate, expected return, hurdle rate, excess return
- Two model ETF portfolios: “Hands On” portfolio and the “Hands Off” portfolio
- ETF industry commentary



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## Tactical ETF Investing – Portfolio Impact

- ETFs are inherently baskets of securities
  - The potential for overlap is tremendous when you add baskets of securities together in a portfolio
- Correlation = hidden portfolio overlap
  - Even if the holdings don't overlap, a group of ETFs may be subject to the same macroeconomic or market forces
- Use X-Ray tools to detect and understand the impact of adding the ETF to your existing holdings

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## Tactical ETF Investing – Nuts and Bolts

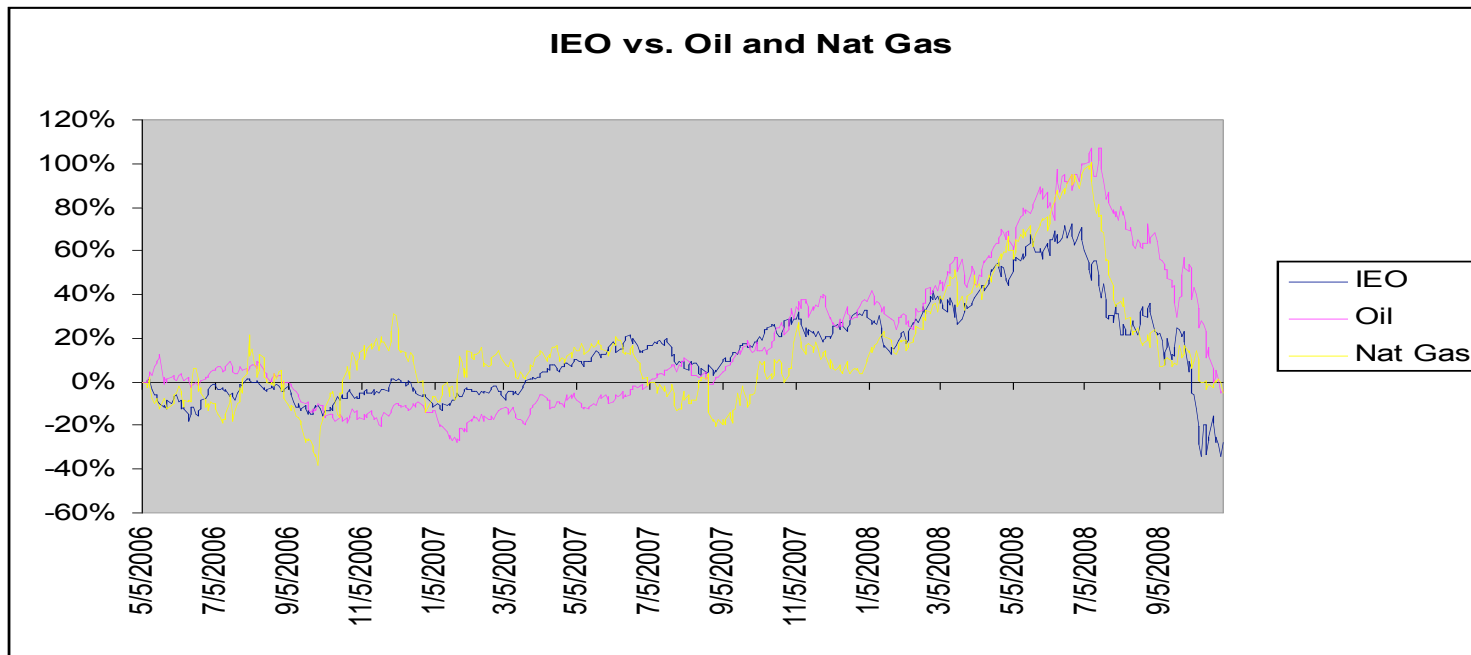
- Expense Ratio
- Liquidity of both the ETF and the underlying
  - Bid-Ask spreads are a cost just like your transaction fee
- Taxes are not the same for all ETFs
  - In general ETFs are very tax-efficient, but they are only as tax efficient as their underlying holdings
- Tracking Error

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## Active ETF Investing – Selection Process Example #1

- **Investment Thesis** – Domestic Oil Producers overly punished during commodity price collapse.
- **Suitability** – Satellite thesis as opposed to Core, maintain smaller weighting.
- **Portfolio Impact** – Seeking to gain exposure to names not largely represented in large-cap indexes
- **Alternative Investment Options** – Several specialized theses can be met.
- **Fees and Taxes** – Cap weighted equity ETFs are tax efficient and cheaper than mutual fund peers.

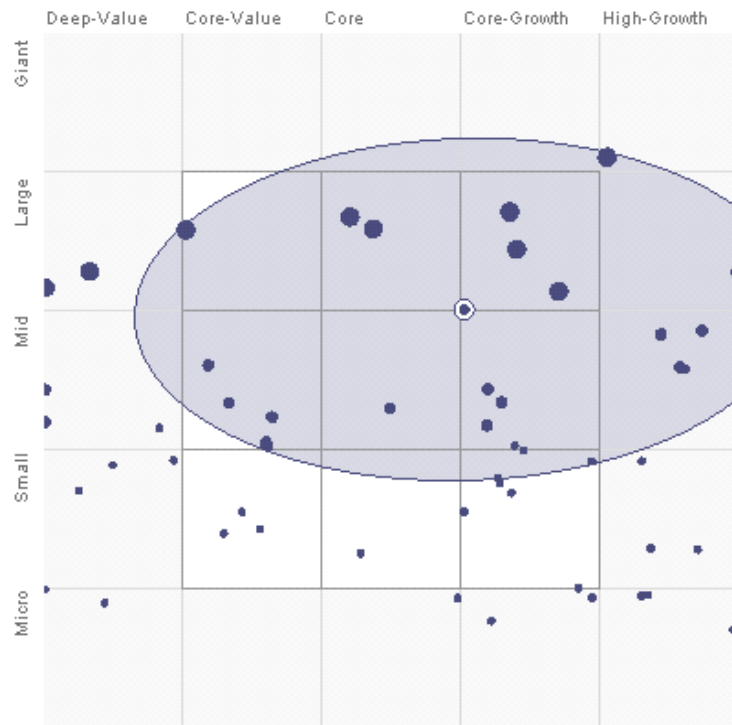
## iShares Dow Jones US Oil & Gas E&P Index (IEO)



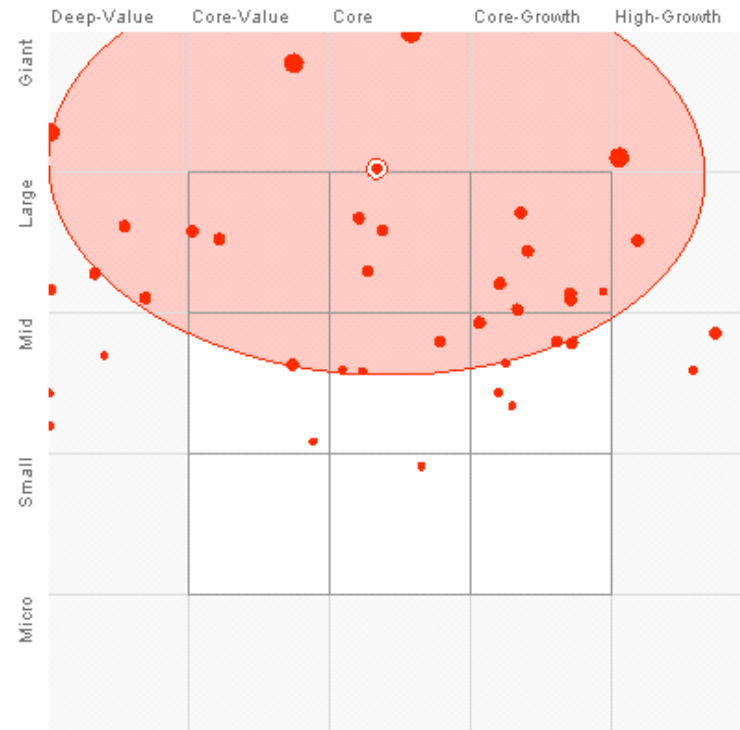
- Equity Research shows the basket of companies is discounting cheaper oil and gas than market
- Companies have balanced exposure to both commodities
- Trading on declining cyclical factors, secular growth in use of natural gas persists
- Demand for gas by electric generation is growing over 4% annually despite slowing electricity demand
- Investors can hedge commodity price exposure by shorting oil and natural gas ETFs

# Two Energy ETFs, Two Different Portfolios

## iShares DJ US Oil and Gas Explor (IEO)



## Energy Select Sector SPDR (XLE)



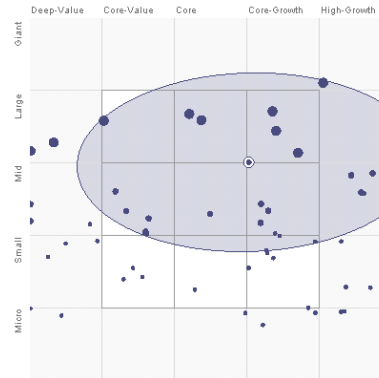
Source: Morningstar Direct; style charts as of Apr. 30, 2009

Information is for illustrative purposes only and is not a recommendation or an offer to purchase or sell a specific security. Information is subject to change at anytime without notice.

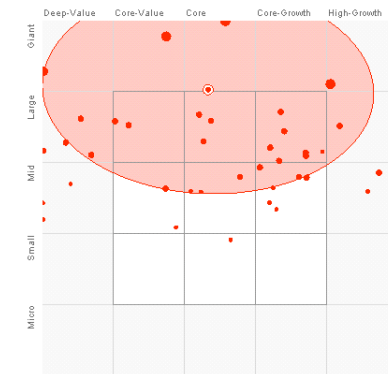
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# Matching Our Thesis

iShares  
Oil & Gas  
Exploration &  
Production



Energy  
Select  
Sector  
SPDR



<b>Benchmark Index</b>	Dow Jones U.S. Select Oil Exploration & Production Index	Energy Select Sector Index
<b>Inclusion criteria</b>	Oil & gas extraction companies among top 95% of float-adj. U.S. market cap	Energy stocks in the S&P 500
<b>Weighting Scheme</b>	Market-cap	Market-cap
<b>Turnover Rate</b>	15%	7%
<b># of Stock Holdings</b>	57	40
<b>% Assets in Top-10</b>	58.0%	64.4%
<b>Avg. Mkt Cap (\$Mil)</b>	7,898	40,115
<b>Price / Cash Flows</b>	2.4	3.4

Source: Morningstar Direct

# Two Energy ETFs, Two Different Portfolios

## iShares DJ US Oil and Gas Explor (IEO)

Top 10 Holdings	P/E	P/CF	Port %
Occidental Petroleum Corp.	9.1	5.6	10.47
Apache Corp.	NA	4.5	7.29
Devon Energy Corp.	NA	3.2	6.64
Anadarko Petroleum Corp.	6.2	3.1	6.17
XTO Energy, Inc.	11.4	2.9	6.15
EOG Resources	7.2	4.0	5.09
Southwestern Energy Co.	NA	10.6	4.45
Chesapeake Energy Corp.	17.5	2.1	4.34
Valero Energy Corp.	NA	3.7	3.77
Noble Energy, Inc.	9.5	4.6	3.66

## Energy Select Sector SPDR (XLE)

Top 10 Holdings	P/E	P/CF	Port %
ExxonMobil Corp.	9.0	7.4	21.20
Chevron Corp.	6.5	5.6	13.95
ConocoPhillips	NA	3.7	6.59
Schlumberger, Ltd.	12.6	10.1	5.01
Occidental Petroleum Corp.	9.1	5.6	4.32
Apache Corp.	NA	4.5	2.96
Devon Energy Corp.	NA	3.2	2.83
Marathon Oil Corp.	6.6	3.1	2.60
XTO Energy, Inc.	11.4	2.9	2.51
Anadarko Petroleum Corp.	6.2	3.1	2.46

Source: Morningstar Direct. Portfolio holdings as of Apr. 30, 2009, Stock data as of May 14, 2009.

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## Active ETF Investing – Selection Process Example #2

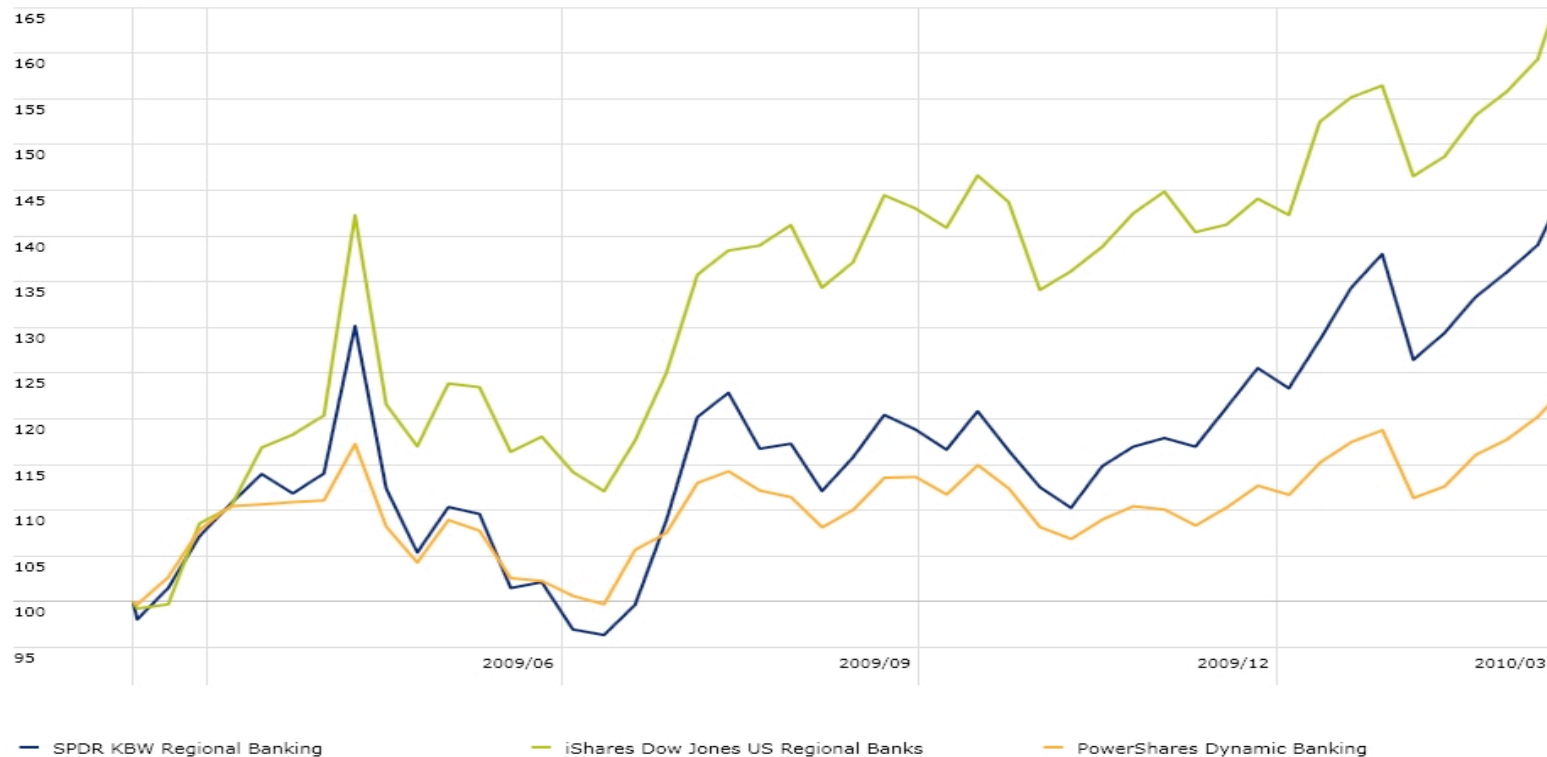
- ETFs can have names that imply they are similar, but the holdings can be quite different
- Let's take a look at 3 regional banking ETFs
  - iShares DJ US Regional Banks IAT
  - SPDR KBW Regional Banking KRE
  - PowerShares Dynamic Banking PJB (note, not technically a regional banking ETF, but the holdings are mainly in regional banks)

## Active ETF Investing – Selection Process Example #2

- When we look at the returns from the past year, we see three vastly different sets of performance

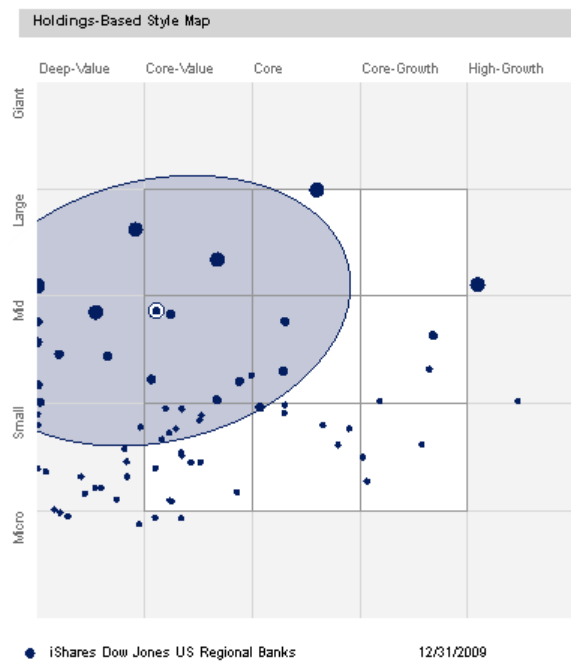
### Investment Growth

Time Period: 3/13/2009 to 3/12/2010

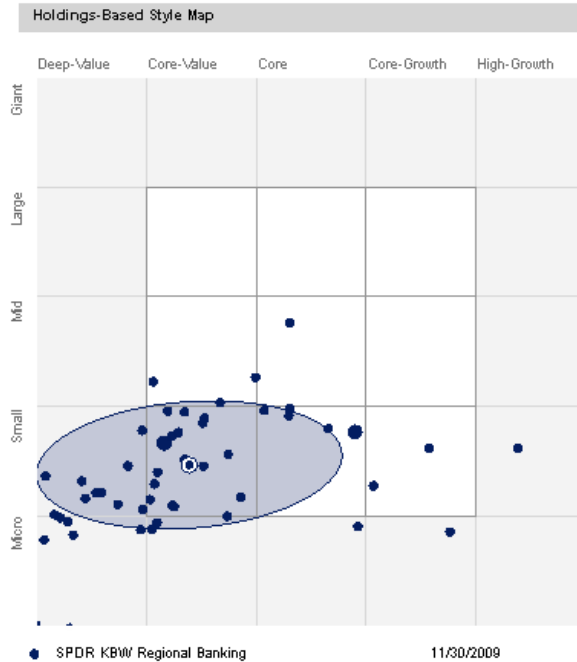


# Active ETF Investing – Selection Process Example #2

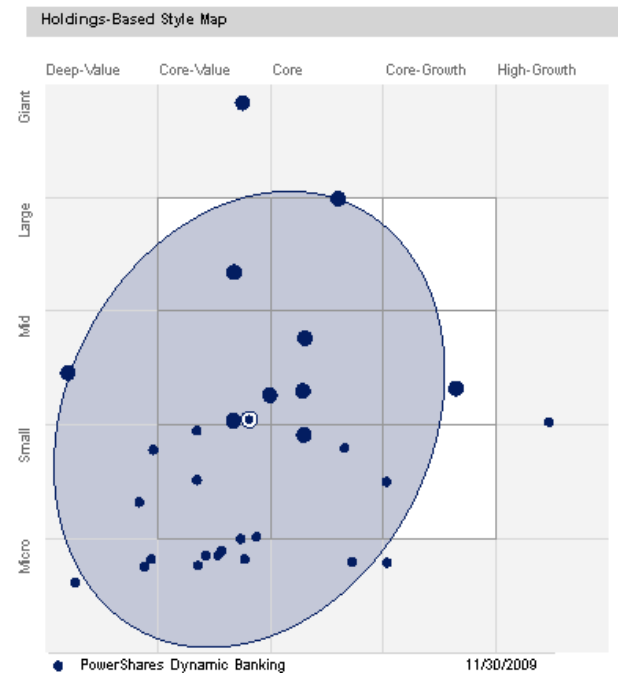
- Why the different performance?
- Let's take a closer look at the holdings



iShares Dow Jones US Regional Banks



SPDR KBW Regional Banking



PowerShares Dynamic Banking

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## Active ETF Investing – Selection Process Example #2

- The holdings are different because the index strategies are different
  - iShares DJ US Regional Banks IAT = Cap Weighted
  - SPDR KBW Regional Banking KRE = Equal Weighted
  - PowerShares Dynamic Banking PJB = Factor selected and fixed weighted
- How the index is constructed will impact future performance as much as the current holdings
  - The holdings today, may not be the holdings of tomorrow

***As always:***

***“Know what you own! Know what you own! Know what you own!”***

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