

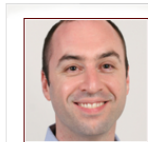


ETF Investing Guide: One-Page Summary of the Entire Guide

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July 01, 2006

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Stock Picking

- Stock picking is not attractive as a core investment strategy for non-professional investors: it's extremely hard to beat the market by picking individual stocks and your stock picks may be correlated with your employment risk (*Was Peter Lynch Really Right?*); and buying and selling individual stocks can lead to poor long term after-tax performance (*Your Stock Picks Aren't As Good As They Seem!*).
- Tech stocks attract many individual investors, yet investing in tech stocks is particularly difficult. 5% of tech stocks historically account for 100% of their return, so picking them is challenging and sticking with your winners can lead to a highly concentrated portfolio (*The Problem With Tech Stocks*).
- Purchasing individual stocks probably won't give you adequate diversification. Focusing on stock picking also distracts you from asset allocation, yet most investment performance is attributable to asset allocation rather than stock picking (*Did Stock Picking Distract You?*).
- Individuals who try to pick stocks trail the market by about 2 percentage points annually on average (*Measuring Stock Pickers' Underperformance*). And that excludes taxes, which would likely make the number considerably worse.
- In theory, you can beat the market with thorough research focused on the areas of greatest information inefficiency (*How To Beat the Market*). One possibility is small cap stocks, though they have lost much of the attraction they had after the market collapse of 2001 (*The Challenge of Trying to Pick Small Cap Stocks*).
- But there are two caveats: first, due to the resulting portfolio concentration and risk, picking illiquid stocks is only attractive for a small part of a portfolio (*Considering Small Caps*). And second, you should only try to pick stocks for a small part of your portfolio if you know you're good at it, i.e. if you've calculated your performance after fees and taxes and found that you're really capable of beating the market. Many investors, however, never measure their after-tax, after-fees performance, and believe they are great stock pickers when they're not.

Mutual Funds

- Actively managed mutual funds are generally a bad deal (*Why You Shouldn't Buy Mutual Funds*). Research suggests they under-perform the market indexes by 2-3 percentage points per year in aggregate, adjusting for survivorship bias.
- Mutual fund ratings give you little useful information (*Mutual Fund Ratings*), and if you switch into and out of mutual funds because of changes in ratings you'll get hit with taxes and possibly large fees.
- The under-performance of mutual funds is not a surprise when you take a realistic (but cynical) look at the mutual fund business. Fund companies' interests are not adequately aligned with investors' interests. Fund companies are incented to spend heavily on advertising to grow assets under management, to highlight only their best performing funds, and to merge underperforming funds out of existence (*How to Run a Mutual Fund Company*).
- Mutual funds are not a particularly effective way to build a diversified portfolio. Mutual fund managers vary the amount of cash they hold, so you don't know your overall stock exposure. And they often stray from their style guidelines or have unconventional interpretations of those guidelines, making it hard to avoid sector and stock overlap in a portfolio that includes multiple funds (*So You Thought Mutual Funds Help You Diversify?*).
- If you try to diversify by owning lots of mutual funds, you can end up with a portfolio that effectively resembles an index fund, but with higher expenses, more cash and unforeseen concentrations in individual stocks (*So You Thought Mutual Funds Help You Diversify?*).

Index Funds and Exchange-Traded Funds (ETFs)

- Index funds provide the best combination of diversification and performance (*Why Indexing Wins*).
- Exchange-traded funds (ETFs) are the cheapest and most convenient way for individuals to build and manage a portfolio of index funds, as long as the transaction fees to buy and sell the ETFs represent a small percentage of the amounts you are investing (*The 7 Advantages of ETFs Over Index Mutual Funds*).
- A (model) portfolio of index ETFs has annual expenses roughly 18% less than a similar portfolio of Vanguard index mutual funds (*ETF Investing*).

Learn to Trade ETFs Yourself!

- No Investment Advisors
- No Miscommunication or "apologies"
- You CAN Learn to Trade Yourself



See How!

www.HighProbabilityETFTrading.com

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Guide: ETFs Are Cheaper Than Index Mutual Funds).

- ETFs are more tax efficient than index mutual funds, and easier to manage for tax-loss selling ([The 7 Advantages of ETFs Over Index Mutual Funds](#)).
- Asset allocation and portfolio rebalancing are easier with ETFs than with index mutual funds ([The 7 Advantages of ETFs Over Index Mutual Funds](#)).
- ETFs are particularly attractive in combination with ultra-low cost online trading ([The Single \(But Serious\) Disadvantage of ETFs](#)).
- ETFs don't make sense if you want to invest small amounts regularly ([The Single \(But Serious\) Disadvantage of ETFs](#)). In that case, the cost of buying the ETFs - even in an online brokerage account - outweigh the advantages of ETFs compared to index mutual funds.

Building an ETF Portfolio

- It only takes ten or eleven ETFs to give you broad and granular exposure to the US stock, bond and real estate ("REIT") markets, plus the stock markets of the largest developed and emerging economies ([A Core ETF Portfolio](#)).
- This ETF portfolio will have lower fees and expenses than any portfolio of mutual funds I'm aware of. (See the comparison with Vanguard index mutual funds in [The 7 Advantages of ETFs Over Index Mutual Funds](#).)
- If you're really lazy, you can go for a simpler portfolio of only 5 ETFs. It offers the same diversification as the core portfolio, but with slightly higher annual expenses and lower flexibility ([The Low-Maintenance ETF Portfolio](#)).
- A portfolio of ETF index funds is highly diversified; in contrast, a portfolio of actively managed mutual funds can suffer from overlap and thus concentration in particular stocks ([So You Thought Mutual Funds Help You Diversify?](#)).
- The Core Portfolio omits the most popular ETFs ((DIA), (QQQQ) and (SPY)) because the indexes they track are too narrow, they are concentrated in a particular sector, or a lower cost alternative is available ([Why You Shouldn't Own DIA, SPY or QQQQ](#)).

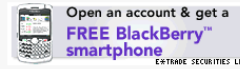
Choosing an Online Brokerage

- Pick an online brokerage based on the cost per trade, the ease of managing your portfolio, the ability to identify tax lots and track realized and unrealized gains and losses, and the availability of banking products to maximize the interest earned on cash ([The 4 Criteria for Picking a Brokerage](#)).
- Don't underestimate the importance of interest earned on cash. Many investors currently have a large proportion of their assets in cash, so better interest on cash can outweigh cheaper trades. And as interest rates rise, this becomes more important ([The 4 Criteria for Picking a Brokerage](#)).
- Consider consolidating your bank accounts (savings and checking) and brokerage accounts (taxable and retirement) with a single online broker. That allows you to see your total assets more clearly, and thus your asset allocation ([The 4 Criteria for Picking a Brokerage](#)).
- Expect the largest online brokerages to introduce tools to make asset allocation and portfolio management easier, and to offer increasingly sophisticated online banking tools.

How to Manage Your Portfolio

- Make sure you assemble your core ETF portfolio in an online brokerage account, where the trading costs of managing the portfolio are low ([The 4 Criteria for Picking a Brokerage](#)).
- Tax loss selling can help you in two ways. It can allow you to swap short term capital gains or current income tax liabilities for long term capital gains liabilities, which are generally lower. Also, it can defer your tax liability, allowing you to save more upfront and benefit from the compounding effect of long term investing ([Turning Taxes to Your Advantage](#)).
- If you are investing in a regular taxable account, then at least once a year sell the tax-lots of ETFs that are trading below where you purchased them, and switch into similar but not identical ETFs ([Turning Taxes to Your Advantage](#)).
- Consider tax-loss selling (moving sideways into a similar ETF) whenever an asset class moves dramatically lower ([Turning Taxes to Your Advantage](#)).
- Tax-loss selling is easy with ETFs in an online brokerage account that tracks individual lots. It's harder or impossible with many mutual fund accounts because they often don't report the tax basis of individual lots, and they don't offer enough alternatives for sideways moves within the same asset class. And if you own mutual funds in a brokerage "fund supermarket", you shouldn't: the fees are too high ([Turning Taxes to Your Advantage](#)).
- Portfolio rebalancing offers two significant benefits for investors: it reduces the risk of your portfolio by preventing over-concentration in a single asset class, and it imposes a "buy low, sell high" rule on your trading behavior ([How to Make Money By Rebalancing](#)). Rebalancing could have saved a lot of people a lot of money during the recent US stock market "bubble".
- Rebalance your ETF portfolio by setting regular time intervals, or (better) percentage limits for each asset class as rebalancing triggers ([Rebalancing Rules](#)).
- Decide on a rebalancing rule, and stick with it. When you rebalance,

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either return your portfolio to its original asset composition, or consider "overcompensating" in the other direction by a preset amount ([Rebalancing Rules](#)).

- Be careful not to rebalance too frequently in taxable accounts without offsetting tax-loss selling; you'll end up realizing capital gains ([Rebalancing Rules](#)).
- Rebalancing is easy with ETFs in an online brokerage account, where you can track your asset allocation easily, transfer assets among numerous ETFs, and set limit orders to buy and sell funds at pre-determined target prices. It's harder in a mutual fund account where only a limited number of low-cost index funds are offered and you can't use limit orders ([How to Make Money By Rebalancing](#)) and ([The 7 Advantages of ETFs Over Index Mutual Funds](#)).
- If you're investing in a taxable account, consider combining tax-loss selling and portfolio rebalancing. Tax-loss selling allows you to benefit from portfolio rebalancing without incurring capital gains. And if you execute the two together, you minimize both your tax bill and trading fees ([Combining Tax Loss Selling & Rebalancing](#)).
- Don't let tax-loss selling and rebalancing turn you into an active trader if your transaction costs will rise too much ([Combining Tax Loss Selling & Rebalancing](#)).

Emerging Markets & Closed-End Funds

- Despite their volatility, allocating a small portion of your portfolio to emerging markets stocks can increase your diversification and lower your geographic risk. It can also give you exposure to countries that are expected to grow faster than the USA and Europe and whose stocks may be cheaper using traditional valuation metrics ([Why You May Want Exposure to Emerging Markets](#)).
- Emerging market stocks are volatile and, until 2003, under-performed the USA and Europe over the long term - so be careful ([Why You May Want Exposure to Emerging Markets](#)).
- Active portfolio management makes more sense in relatively illiquid markets. Emerging markets are probably the most promising area for active managers ([Why Use Closed-End Funds?](#)).
- Closed-end mutual funds trading at discounts to net asset value can be a good way to get exposure to emerging markets. You are buying stocks at a discount, and emerging markets stocks are arguably well suited to the closed-end fund model ([Why Use Closed-End Funds?](#)).
- While there's no guarantee the discounts will narrow, they often do ([Why Use Closed-End Funds?](#)).
- Buying funds at a discount means you are purchasing stocks at a more attractive valuation and in many cases with a higher dividend yield, than otherwise ([Why Use Closed-End Funds?](#)).
- Be careful when buying closed-end funds in practice. They are often illiquid, so large orders can move prices if you don't use limit orders ([Buying Closed-End Funds in Practice](#)).
- Some web sites rank closed-end funds by discount to net asset value. You can find those sites in [The ETF Resource Page](#).
- Closed-end funds can be treated like ETFs for portfolio management. You can use the same techniques for tax loss selling ([Turning Taxes to Your Advantage](#)) and portfolio rebalancing ([How to Make Money By Rebalancing](#)). Since closed-end funds and ETFs both trade like stocks, you can manage them easily in a single account.

Brokers, Financial Advisors, & Investing for the Wealthy

- The traditional broker-client relationship is crippled by a fundamental conflict of interest: the broker is not directly compensated for giving objective advice, and is incentivized to maximize fees ([My Broker's an Honest Fox](#)).
- Asset-based-fees go some way to reducing brokers' conflicts of interest. But they don't solve all conflicts of interest, they incentivize the broker to spend too much time prospecting for new accounts, and they take a sizable chunk out of clients' investment returns ([Asset-Based Fees to the Rescue](#)).
- Asset-based-fees could cut investor returns by 25% based on current market forecasts ([But What if You Saved \\$275k Annually?](#)).
- Many independent financial advisors also charge-asset based-fees. If you need to consult a financial advisor, it's generally better to negotiate an hourly fee instead ([Financial Advisors](#)).
- Commoditization of financial products - particularly of index funds and online brokerage services - has steadily driven costs down and improved product quality. Fees for less commoditized financial products, such as managed accounts and actively managed mutual funds, have actually risen. As a result, wealthy investors should embrace ETFs and online brokerage accounts because they are better and cheaper than less commoditized financial products ([Me, Use an Online Broker? But I'm Rich!](#)).
- Separately managed accounts are the darling of the investment industry because they attract wealthy clients and charge hefty recurring fees. But the overall underperformance of investment managers versus their index benchmarks ([Why You Shouldn't Buy Mutual Funds](#)) and the crippling impact of high fees ([But What if You Saved \\$275k Annually?](#)) means that separately managed accounts are generally a bad deal for investors ([Separately Managed Accounts \(SMAs\)](#)).
- Most wealthy investors over-estimate their need for investment advice. Management of a portfolio of eight to twelve ETFs ([A Core ETF Portfolio in an online account \(Which Brokerage Comes Out Best?\)](#)) is easier and

in an online account (which brokerages come out best?) is easy and not time consuming, and likely provides better diversification and overall performance than most High Net (financial) Worth financial services using individual stocks and mutual funds (What Not To Do).

- For a \$10 million account, a basket of ETFs managed in an online brokerage account should outperform an asset-based-fee account targeted at wealthy individuals by about \$275,000 per year, by my estimate (But What if You Saved \$275k Annually?).
- If you need customized advice and products, split your assets between an active manager and an online brokerage to minimize fees. Use the online brokerage to manage the majority of your assets in ETFs. Ensure that the active manager is directly compensated for objective advice, fully discloses all fees, and provides a fully documented track record (What to Do With What's Left?).

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Great article David.

In fact I liked the information and tightness so much that I am citing some of your work in an upcoming post on my website.

Thanks again, and be on the lookout for it with full attribution.

Regards,
Chris

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