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Seven Great ETFs

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GOOD FUND MANAGERS always earn their salaries. And the ones in this month's print edition of SmartMoney can cash their paychecks with pride.

But it occurred to us that by devoting so much attention to active managers we were ignoring those investors who preferred index funds, especially exchange-traded funds. And as much as those 35 funds had a banner year in 2006, so, too, did the ETF industry. As of Dec. 29, there were 359 ETFs holding $417 billion in their coffers. A year before that date there were just 201 ETFs with $296 billion. Of the new offerings, 112 were specialty and sector funds, products that pushed the envelope on what has traditionally been an index fund alternative.

That means index investors don't need to settle for plain vanilla market returns any more. Granted, the most popular ETFs are still the low-cost, broad-based ones that track established indexes like the Standard & Poor's 500. But a fresh generation of newfangled ETFs may also give investors some extra returns on the margins. Now we have to couch that statement. After all, if you only save for retirement in a 401(k) you won't be seeing ETFs as one of your investment options. That's because you can't dollar cost average[2] into these funds without incurring a trading commission every time you buy one. However, if you also save in a brokerage account via lump sum contributions or use a financial planner, well, you could consider the ETFs on this list as excellent complements to active managers.

Before we get to those funds, though, one reminder about ETFs[3]. You have to pay close attention to the underlying benchmark. For example, the top 10 holdings in the S&P 500 and the Russell 3000 may look the same, but as you drill down, the Russell index has more exposure to small-cap and midcap stocks. That helps performance when those shares are in favor. Indeed, the average annual return of the Russell 3000 over the last three years has outpaced the S&P 500 by a full percentage point.

We mixed a little performance evaluation with expert advice to find ETFs in the same seven categories SmartMoney magazine used in its mutual fund wrap-up. Here are our favorites.

Large-Company ETFs

When it comes to investing in large-cap stocks it's tough to beat the magazine's two favorites. **T. Rowe Price's** Bob Smith, who manages the company's **growth fund** (PRGFX[4]), and John Linehan, who helms the **value offering** (TRVLX[5]), each have good long-term records and work for a shareholder friendly firm. Both funds would make excellent foundations for any portfolio.

Obviously, you could anchor that duo with a broad-based product like **SPDRs** (SPY[6]), which track the S&P 500. But a more intriguing choice is the **Rydex S&P Equal Weight ETF** (RSP[7]). This fund weights its portfolio in equal amounts vs. rewarding larger positions to companies with the biggest market capitalizations. This difference means smaller members of the S&P 500 can influence returns just as much as its largest constituents like **General Electric** (GE[8]), **Microsoft** (MSFT[9]) or **Bank of America** (BAC[10]). And that adds up: This ETF has returned 12.5% over the last three years, two-and-a-half percentage points better than the S&P 500 and the T. Rowe Price Growth fund. (Linehan beat that mark by three quarters of a point.) "I think it's a winner," says Rob Lutts, chief investment officer of Cabot Money Management.

We think growth-stock funds — Smith's included — will have a big 2007 after a few years of the doldrums. If you want exposure to large-cap growth stocks consider the **iShares Russell 1000 Growth ETF** (IWF[11]). It owns about 680 of the largest growth stocks on the market, including **Johnson & Johnson** (JNJ[12]), General Electric and **Intel** (INTC[13]). While you won't get Smith's stock-picking prowess, you will get a fund that has

many of the same holdings at a fraction of the cost. The iShares offering charges an expense ratio of 0.20%, vs. 0.72% for T. Rowe Price Growth.

Midsize-Company ETFs

Over the last five years the **MidCap SPDRs ETF** (MDY14) has kept pace with **Meridian Growth** (MERDX15), the magazine's top pick in this category. They both have average annual returns around 10.3% over that time period. But we would opt instead for **Vanguard's Midcap ETF** (VO16). Why? The Vanguard offering uses the Morgan Stanley Capital International 450 index, which Smartmoney.com gives investors access to a wider swath of companies with larger market capitalizations. The Vanguard ETF also charges 0.13% — one of the lowest fees in this category — compared with 0.25% for the SPDRs. Performance also swayed us. The Vanguard MidCap returned 9% last year, three percentage points better than the Midcap SPDRs. (Although, Meridian beat them both in 2006 with a 14.7% showing.)

Small-Company ETFs

SmartMoney's top pick here was **UMB Scout Small Cap** (UMBHX17), a fund that has a cumulative return of 87% over the last five years while keeping fees to a minimum. (It's expense ratio is a decent 1.06%.) But the fund is concentrated with only 50 names. That can make for a wild ride. While this fund has managed to stay in the top of its peer group in terms of annual returns, according to Morningstar, in 2005 and 2003 it was also in the bottom half of its category. If you don't have the stomach for a concentrated portfolio consider the **iShares Russell 2000 Value ETF** (IWN18). It owns 1,300 of the smallest value stocks in the Russell index. Some of the names here might not be familiar — its top holdings are **Realty Income** (O19), **Big Lots** (BIG20) and **Westar Energy** (WR21) — but the returns should raise your eyebrows: An average annual 15% over the last three years. But don't expect those highflying numbers to continue though. Small-cap stocks have been cooling off lately. We still think every investor should have exposure to small-company stocks, albeit, maybe just 10% of assets for the moment.

Multicap ETFs

The beauty of multicap mutual funds is that a manager is allowed to explore the entire stock market looking for bargains. That freedom is a luxury — and can generate terrific returns. Indeed, the magazine's top actively managed pick in this category, **Janus Contrarian** (JSVAX22), is No. 1 in its peer group over the one-, three-, and five-year periods, according to Morningstar. We didn't go looking for a substitute. Rather, with this category we wanted a decent wing man.

The **Vanguard Total Stock Market ETF** (VTI23) isn't categorized as multicap. But we beg to differ. It owns a whopping 3,700 stocks, split between large-company shares (72% of assets), midsize (19%) and small (8%). You'll find a portfolio mixed with big names like **Exxon Mobil** (XOM24) and unknowns like **Watsco** (WSO25) and **Imation** (IMN26). This ETF's dirt cheap expense ratio of 0.07% makes it an excellent portfolio cornerstone. So, too, does its returns: Over the last three years it's had an average annual return of 11%, a full percentage point ahead of the S&P 500.

International Company ETFs

Our dilemma with multicaps also applies to this category as well. We feel more comfortable investing overseas with an active manager, since he will have the ability to roam the world checking out prospective companies. And our colleagues' two picks, **Polaris Global Value** (PGVFX27) and **Dodge & Cox International** (DODFX28), are the best at what they do. If you would have given $10,000 to either fund five years ago you would have more than doubled your money by now. Pretty sweet.

While many portfolios have been recalibrated to include international funds, some of you may still be just getting your feet wet. If you have ever sat down with a financial planner they may tell you about a portfolio design strategy called "core and explore." In
short, the core of your portfolio is in conservative investments, while a smaller portion is earmarked for something more aggressive. You can do that with your international holdings, too, an easy way to test the waters before jumping in head first. Polaris Global Value and Dodge & Cox International would be the "explore" part, while the core could be the **iShares MSCI EAFE** (EFA29).

This fund saw tens of billions of dollars flow into it in 2006, a tip-of-the-hat to stellar international returns that have outpaced the U.S. Indeed, this ETF posted an average annual return of 17.6% over the last three years compared to 10.5% for the S&P 500. It owns 800 companies spread out over Europe, the U.K. and Japan,

each with an average market capitalization of $33 billion. Top holdings include **BP** (BP30), **HSBC Holdings** (HBC31), **Toyota** (TM32) and **Total** (TOT33). The only drawback is that it has little exposure to emerging markets, a niche that has provided some decent returns in the past. If you don't mind the risk, says our expert, pick up the **Vanguard Emerging Markets ETF** (VWO34). It owns companies in South Korea, Taiwan, Russia and South Africa. "[The EAFE ETF] really doesn't have a lot of exposure to emerging markets," says Paul Ohanian, vice president of financial planning firm WealthTrust-Arizona. "I would take a little allocation out of international and move it into VWO." Sounds like a smart move to us, too.