

# ARTICLES OF INTEREST

## EXCHANGE-TRADED FUNDS : DISCOVERING THE INVESTING GENOME

Exchange-Traded Funds (ETFs) are the newly-discovered building blocks of investment life.

*How crazy is that?*

Fundamental analysis of individual securities has driven investment decision-making for over 100 years. But there has been a basic inconsistency with this approach. Once a company has been thoroughly analysed and its securities added to a portfolio because of growth, valuation, or momentum characteristics, (or combinations of these factors and/or others) the first thing the experienced portfolio manager does is to diversify away exposure to that holding! How crazy is that?

Diversification was meant to dampen volatility not mute returns. Too often, portfolios hold too many securities to allow good stock selection to benefit a client. A stock that doubles in a 100 stock portfolio adds a modest 1% to overall return. It isn't always easy to find stocks that double. While it is possible that all holdings rise uniformly in a good year, portfolio returns often come from a small group of stocks that do exceptionally well. At least that is

my observation. Our research suggests that about 78% of a stock's return over time can be attributable to company specific factors (earnings and sales growth, pricing power, market share etc). The remaining 22% is attributable to overall market movement. When combined in a diversified portfolio of 50 stocks, 85% of the portfolio's return is attributable to the market and only 15% to individual stock returns! For holders of three such portfolios, about 97% of the overall return can be explained by the market (this is why large pension plans use indexing strategies extensively).

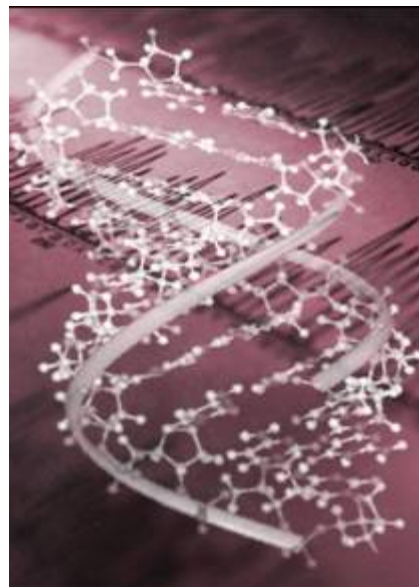
### ALONG COME ETFs

So along come ETFs. Most demonstrate broad diversification although many new ones are quite specific in their exposure to industries, sub-groups, countries, currencies, commodities etc. Inside an ETF, individual stock exposure is already diversified (making ETFs an ideal vehicle for individual investors). Having observed and studied ETFs over the past several years, we've discovered interesting characteristics and relationships about groupings of securities in general. These relationships always existed but were likely

overlooked in the quest for the "home run" stock.

Groups of securities display characteristics of risk and return that are quite often very different than the individual components that comprise the index. As a result of these characteristics, portfolios can be engineered to amplify, diminish and mute risk.

Diversification should now be more about managing overall portfolio risk and not so much about, for example, avoiding exposure to declining margins in SUV production because of supply chain delays in Chinese-manufactured catalytic converters due to water buffalo fouling of water used to generate electricity used to refine rare metal components (joking!). Conventional portfolio managers think they are adequately diversified if they have exposure to all or most of the groups represented by the S&P 500 in like proportion. Many judiciously under or overweight these Global Industry



Classification Standards® (GICS) sectors, trusting that their form of diversification will match those of their competitors. They would largely be correct.

However their competitors are not their clients. Are their clients well served?

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## ARE THEIR CLIENTS WELL SERVED?

To the extent that returns are relative to those generated by the competition, perhaps they are. But individuals can't spend relative performance. Absolute returns are what most people care about (hence the interest, from time to time, in hedge funds).

More sophisticated institutions and pension plans have used "core" and "tactical" or "satellite" investment structures for decades to distinguish between market related returns or beta ( $\beta$ ), and returns in excess of the benchmark indices or alpha ( $\alpha$ ). Thanks to ETFs, individual investors can replicate this strategy of these larger organizations in a cost effective way.

## CONCLUSION

Like the impact that genome research has had for the development of molecular biology, ETFs have opened a rich source of study for investment professionals and academics.

The study of groups of securities, that the development of ETFs has encouraged, has exciting potential for investors. An important development may be a focus on managing portfolios based on consistent volatility. However, human nature assures there will always be a place for those who try to "time" markets. Alas, ETFs also facilitate this speculative activity.

At the very least, for intelligent investors, ETFs allow for a sensible, effective and economical way to access investment

performance benefiting from diversification and professional management. ActiveBaskets™ and PÜR make using ETFs easier for advisors and beneficial for their clients.

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