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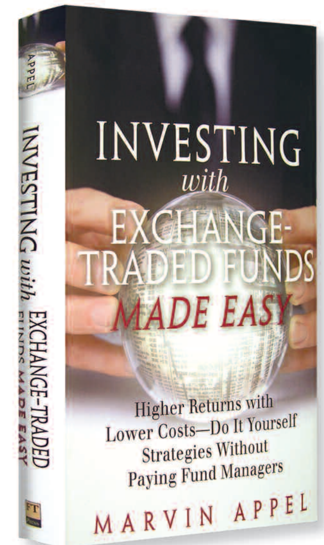
Investing With Exchange-Traded Funds Made Easy



by Marvin Appel

THE SUMMARY IN BRIEF

Exchange-traded funds (ETFs) offer exceptionally low expenses, outstanding performance and unparalleled transparency. They are one of the fastest growing investments in the United States, and the number and variety of choices can be overwhelming. Dr. Marvin Appel explains exactly how ETFs work, what they can and cannot do, and why they are not all equally attractive. Using objective data and proven, back-tested strategies, he shows how to quickly move into the right ETFs at the right time, consistently staying on the winning side of major market trends.

Several facets of ETF investing are discussed, including quantifying potential risk and reward, using ETFs to improve diversification, implementing simple "active strategies," deciding when to move into cash and more.

ETFs are a powerful investment tool, but it's important to understand how they work and what makes them different from other mutual funds. ETFs offer exposure to all the major investment styles and also offer the ability to move assets from one style to another to increase investment performance.

Appel provides a candid assessment of the risks, costs and rewards, creating a start-to-finish plan for becoming an informed and effective ETF investor.

IN THIS SUMMARY, YOU WILL LEARN:

- The big difference between ETFs and regular mutual funds.
- The truth about ETF costs, risks and opportunities.
- How to build your "one-decision" portfolio.
- Drive greater profits with simple asset allocation strategies.
- Choose ETFs that match your investment style.

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Published by Soundview Executive Book Summaries, P.O. Box 1053, Concordville, PA 19331 USA
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THE COMPLETE SUMMARY: INVESTING WITH-EXCHANGE TRADED FUNDS MADE EASY

by Marvin Appel

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Investing with Exchange-Traded Funds Made Easy © 2007 by Pearson Education, Inc. Summarized with permission of the publisher, FT Press Financial Times, Upper Saddle River, N.J. 253 pages, $24.99. ISBN 0-13-186973-6

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Now Individuals Can Invest Like the Big Players

ETFs are a powerful investment tool. However, before you use them, you should understand how they work and what makes them different from mutual funds.

ETFs are a special type of mutual fund. ETFs hold a basket of individual stocks, just as mutual funds do. Each ETF share represents a proportional piece of the portfolio of stocks, as with mutual funds. Therefore, many of the advantages of mutual funds also characterize ETFs:

- Ability to diversify with a single investment
- Ability to gain exposure to a particular investment style (small versus large company stocks, for example) or to a specific industry (utilities, technology, etc.) with a single investment without having to select individual companies

ETFs Avoid the Expense of Fund Managers

Most mutual funds have managers who pick which stocks to buy and sell, and when, according to their own judgments. In contrast, ETFs are passively managed, meaning that a predetermined set of rules is used to select the individual stocks that are held in each ETF. An ETF sponsor can update the selection of stocks in a passively managed portfolio but only on dates that it specified in advance. Because the rules for selecting a passively managed portfolio are available to everyone, it is unnecessary to hire a manager.

The fund sponsor for each passively managed ETF selects a set of rules that govern which stocks the ETF will hold. After these rules are in place, the ETF does not deviate. Investors in a passively managed fund or ETF know at any time exactly which stocks are in the fund and when that portfolio is scheduled to change. The accurate knowledge by individual fund investors of their funds' holdings is called *investment transparency.* Investment transparency is considered an advantage because when you buy an ETF, you know exactly what you are getting.

Another term used to describe passive investment management is indexing. The connotation of a market index, in addition to being passively managed and enjoying the same advantages of low cost and transparency, is that it usually aims to represent the performance of a particular market sector. Broadly based indexes can represent the entire universe of publicly traded shares in the United States, or even the world, or at the other end of the spectrum, a particular market sector.

ETFs Are Traded on Exchanges

The big difference between ETFs and regular mutual funds is that as an individual investor, you buy ETFs on a stock exchange. You do not deal directly with the sponsoring mutual fund company, and you bear the full costs of every transaction you make. With a purchase of an ETF, you must pay a broker's commission, similar to the charge you would incur to buy an individual stock. Whether this is an advantage to you depends on how you are using ETFs.

Unlike mutual funds, which need to create new shares to meet your purchases and to eliminate existing shares to meet your redemptions, when you buy or sell ETF shares, you conduct the transaction with another investor. You and the other investor exchange ETF shares for cash, but the number of outstanding ETF shares does not change as a result of your transaction; only the list of shareholders changes.

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a fund at 9 a.m. gets the same closing price for the day as one placed at 3:59 p.m. That closing price is set based on data from the market close at 4 p.m. Any order received at a mutual fund after 4 p.m. receives the next day's closing price.

Any trading model that utilizes daily data from the market close is likely to perform more poorly if trades are not executed on that same day. Investors who use mutual funds that allow unlimited trading must submit their buy or sell orders to the mutual fund before the market closes. There is a chance that some trading decisions made before the close will turn out to be different from the decisions that would have been made if the final closing data had been known earlier.

This means that for investors who utilize end-of-day trading strategies, ETFs have a big advantage that does not apply to individual stocks or mutual funds. Many ETFs trade until 4:15 p.m., 15 minutes after the regular market closes at 4 p.m. This allows you to wait until the market closes to collect data and then use that data to decide which trades to execute on the same day.

ETF Investors Have Hidden Costs Through the Bid-Ask Spread

The price you pay for your ETF depends on the balance of supply and demand for that ETF at the time your order hits the trading floor. An ETF's share price is usually slightly different from the market value of the fund's underlying holdings. Moreover, the price a buyer pays is generally higher than the price a seller receives.

The price you pay to buy shares is called the asking price or *ask*. The price you receive when you sell shares is the *bid*. The bid-ask spread is no less a cost to you than a broker's commission, despite being less visible. But to the unwary investor, the bid-ask spread is a hidden cost. Before you decide to buy an ETF, you should ask your broker for both the bid and ask so that you can get a feel for the cost per trade.

The Creation/Redemption Process Keeps ETF Share Prices Close to the Market Value of the Underlying Shares

Each ETF has a custodian who holds the shares. However, rather than keeping track of which shares belong to which individual investor, all the custodian has to do is make sure that the number of ETF shares in circulation is exactly the right amount for the custodian's holdings of underlying shares. In this regard, an ETF share (in the hands of an authorized participant) is like a claim check. Whoever submits the claim check can retrieve the stored item, which in this case is a basket of stocks. Because all investors know what goods the claim check represents, they can trade claim checks among themselves without needing to inspect the underlying merchandise for each transaction, while the custodian simply guards the merchandise until someone claims it.

Even though ETF shares are traded between investors far more frequently than they are exchanged for the underlying basket of stocks, authorized participants do have the option of switching between ETFs and the actual underlying shares in individual companies. If an authorized participant wants to create shares of an ETF, it can deliver the basket of stocks to the ETF custodian. Con-versely, if the authorized participant wants to redeem shares of an ETF, it can deliver the ETF shares to the custodian, who transfers the underlying stocks' shares in exchange. Creation or redemption of ETFs usually occurs in lots of 50,000 ETF shares.

The ability of authorized participants to create or redeem ETF shares in exchange for the underlying stocks gives them a financial incentive to keep the price of ETFs close to the market value of the underlying shares.

The process of simultaneously buying and selling essentially identical baskets of stocks in different places at the same time to profit from price discrepancies is called *arbitrage*. Firms that practice arbitrage help maintain a narrow gap between the ETF's market price and the value of its underlying shares.

The market provides two types of information throughout the trading day for you to consult when you are considering making a trade: the current bid and ask prices and the Indicative Optimized Portfolio Value (IOPV). IOPV is the fair market value of the underlying basket of stocks in the ETF. This is updated every 15 seconds.

ETF Performance Is Not Weighed Down by Transaction Costs

The only way for ETF shares to be redeemed is with a transfer of shares of individual stocks. No cost is involved in simply transferring stocks from one account to another, so the performance for remaining ETF shareholders is not adversely affected when ETF shares are redeemed. Those costs fall entirely on the authorized participant firms if they elect to liquidate shares they have received from a creation or redemption.

ETF Shares Are Often More Tax-Efficient Than Mutual Funds

The exchange of ETF shares for shares of stock avoids realizing capital gains when many shareholders want to unload the fund. This is because the exchange of ETF shares for shares of the underlying stocks does not create a taxable event. The only way for a long-term shareholder of an ETF to realize capital gains without selling his own shares is when a change in the basket of stocks forces the sale of some shares. Because all ETFs that are currently trading in the United States are passively managed and therefore have low portfolio turnover, the risk of a large capital gains distribution is minimal.

In contrast, in a regular mutual find, when shareholder redemptions force the fund to sell stock holdings to raise the cash needed to meet those redemptions, any profits on the stock sale generate capital gains that are passed on to the remaining shareholders of the fund at the time of its annual capital gains distribution. This means that long-term shareholders might have to pay capital gains taxes because some other shareholders sold out.

Special Risks of ETFs

ETF share prices are sensitive to the balance between supply and demand — a risk absent from regular mutual funds. ETF investors face the additional risk of relying on authorized participants to keep ETF prices in line with the underlying share values. During *fast markets* — periods marked by an overwhelming imbalance between supply and demand — authorized participant firms and specialists have been known to be slow to step up and fill the wave of orders. The result is that at the time you are most anxious to sell, you might not be able to get as fair a price (relative to the value of the underlying shares) as you thought you would. Also, if you buy or sell during a fast market, your bid-ask spread costs will be higher than normal.

A Guide to Different Investment Styles

The first decision that the individual investor must make is how much to invest in each area. The optimal asset allocation in general will be different at different points in the life of an investor and will depend on the economic outlook.

Even though stocks have been significantly more profitable over the years, the fact that bonds have had less than half the risk of stocks and have outperformed stocks almost one-third of the time suggests that all but the most aggressive investors should maintain some exposure to bonds in addition to stocks to improve their balance of risk versus reward.

The main functions of cash in an investment portfolio are to provide a source of consistently positive performance and to reduce volatility. Conservative investors can use a cash position to reduce the risk of having a losing year.

Size Matters

The first distinction between different stocks is the size of the company. From an investment perspective, company size is measured as the dollar value of all outstanding shares. While no universally accepted range of market capitalizations defines large-, mid- and small-cap stocks, generally these dollar amounts are a "soft" guideline:

• Large-cap stocks generally have market capitalizations over $10 billion, such as WalMart and Exxon Mobil.

• Small-cap stocks are generally considered to have total market capitalization of less than $2 billion.

• Midcap stocks have market caps ranging from $2 - $10 billion. As an investment style, midcaps have had the best performance in the past 25 years compared to large- or small-caps.

The distinction between different market capitalizations is relevant to the individual investor. Academic research has suggested and experience has demonstrated that market capitalization is an independent predictor of investment performance. The success of a small- or large-cap investment can depend critically on *when* you make it. A successful strategy that allocates investments to large versus small stocks might by itself significantly increase investment performance. Active investors who trade often will discover that the cost of trading ETFs that hold small-cap stocks is significantly greater than the cost of trading large-cap ETFs.

A new category of ETF was launched in August 2005 to represent the behavior of microcap stocks, which are the smallest of the small-caps. The underlying microcap index represents the broad universe of microcap stocks listed on national exchanges.

Microcap ETFs must overcome two inherent difficulties: The underlying individual stocks are difficult to trade, which in finance is called *poor liquidity,* and the sheer number of microcap stocks that are available.

All-cap or total-market ETFs can be useful proxies for the overall stock market. There are four ETFs that capture the behavior of almost the entire market capitalization of the United States: the iShares Russell 3000 Index Fund (IWV), the Total Market Vipers (VTI), the

StreetTracks Total Market ETF (TMW) and the iShares Dow Jones Total Market Index Fund (IYY).

Growth and Value ETFs

Other criteria are available with which to segregate groups of stocks besides market capitalization:

• *Value indexes* represent the collective behavior of stocks that appear cheap compared to the overall market in terms of their current earnings, dividends or value of the company's underlying assets.

• *Growth indexes* represent stocks that generally appear expensive relative to the overall market in terms of their current earnings, dividends or book values but are attractive to investors because they appear to have better future prospects.

• *Blend indexes* do not attempt to separate growth and value stocks.

A One-Step Strategy for Selecting Superior Investments: Indexing

It is important to understand how to make investments that perform like market indexes, because for most investment styles, such investments have outperformed the majority of actively managed mutual funds.

Market indexes define a stock market index as just the average price of a group of stocks. The selection of stocks in an index and the contribution each stock makes to the overall index are specified by objective rules that the public knows in advance.

Indexes typically represent the behavior of specific groups of stocks, the entire U.S. market, a cross section of the U.S. economy, small publicly traded U.S. stocks, large U.S. stocks, etc. Some indexes represent specific industry sectors such as semiconductors, gold mining companies, oil companies, for example.

The list of stocks that comprise an index and their weights in the index are determined at infrequent intervals by the index sponsor and then are distributed to the public. As a result, an index fund does not need a manager to pick stocks. The trader just has to make sure that the fund or ETF portfolio contains the right stocks in the right proportions.

The performance of an index fund is by definition average, but it saves the considerable cost of a manager, giving its performance net of expenses a head start compared to the average mutual fund.

Investment Risk: A Visit to the Dark Side

You cannot evaluate the merits of an investment until you have a thorough understanding of both its potential risk and return. Commit-ting your money before obtaining such an understanding is like buying a house without first conducting an inspection.

A handy concept in describing risk is *drawdown*. Drawdown is the largest investment loss sustained in the past, from a high point to a low point in investment capital. However, be alert to the period over which you measure a drawdown.

Bottom line: You need to measure drawdown during the worst market climate for each investment you are evaluating: 1973-1974, 1987 and 2000-2002 for large-company stocks; 1998 for small-company stocks; and 1998-1999 for value stocks. The larger the historical drawdown during its worst period, the riskier you assess the investment to be.

If a fund or ETF did not exist during the period that would be most informative to you, find a comparable investment that has a sufficiently long history and use that as a surrogate with which to measure risk.

Each major investment objective has one or more benchmarks. For example, the Dow Jones Industrial Average consists of 30 large U.S. company stocks; therefore, it is a benchmark for large-caps. The NASDAQ Composite is most heavily weighted in technology stocks so it is a technology stock benchmark.

When you have identified a benchmark for your fund, use charting software or Internet resources to plot the benchmark and the fund for the period when they were both actively trading. If they have experienced major dips and rallies of similar extents at the same times, it is reasonable to attempt to use the longer history of the benchmark to help you understand your fund.

Risk Assessment of an Emerging Market ETF

A longer-term look at stock markets in developing countries indicates that the emerging-market fund average has suffered four major declines between 1989 and 2005. The duration of these drawdowns ranged from 28 to 47 months. The question of how well the past performance of emerging-market stocks reflects their future potential has no clear answer; it is a matter of subjective judgment. Even though profit potential for emerging markets appears to be bright, you cannot assume that risk will be lower in the future.

Risk-Adjusted Performance

It is crucial that an investor understand the concept of risk-adjusted performance, because it is the most effective criterion for the investor to use in deciding where and how much to invest. The basic idea is to take a measure of profitability and divide that by a risk measure. As with any examination of investment performance, it is important to make sure that you have chosen a sufficiently rich period of investment history in your evaluation.

The simplest risk-adjusted performance measure is the ratio of compounded annual gain to drawdown, or GPA, short for gain per annum. A negative GPA indicates a loss in value.

One reason this measurement is useful is its intuitive interpretation: Comparing GPA and drawdown tells you how many years of average performance are required to recover from the worst historical loss in the period studied. For example, in 2000-2003, the drawdown of the S&P 500 was 45 percent. The long-term average return of large U.S. stocks has been approximately 11 percent per year. Therefore, the GPA-to-drawdown ratio has been approximately 1-to-4, or 0.25. This means that an investor should expect to require four years to recover from a severe bear market.

Another Measure — The Sharpe Ratio

A less intuitive but more widely used measure of risk-adjusted performance is called the Sharpe ratio. The performance measure used is not simply the average return. Rather, Sharpe ratio calculations use something called the *excess return*. The excess return is that amount of profit above what was earned from a risk-free investment. For example, if your investment returned 8 percent per year on average for the past 10 years, and if 90-day Treasury bills (used for the risk-free return part of the equation) returned an average of 3.6 percent per year during the same period, your excess investment returns is 4.4 percent (3.6 percent subtracted from eight percent).

Reduce Risk, Not profits, with Diversification

Diversification in your investments is often more difficult to achieve than you might think. If you are investing in ETFs, most of which are well diversified to begin with, diversification cannot turn straw into gold. On the other hand, if your investments consist of individual company stocks, diversifying can greatly increase the safety of your portfolio.

How to Determine What Should Be in the Optimal Portfolio

Procedures to determine the precise "best" portfolio mix remain the subject of debate. However, here are some commonsense guidelines:

- Identify the range of investments available to you.
- Use historical performance during a full market cycle that includes both a bull and bear market period for each investment.
- Find the risk-adjusted performance for each investment option during the period.
- Generally speaking, those investment options that have the best historical risk-adjusted performance should be most heavily weighted in your portfolio.
- Use a spreadsheet program such as Excel to calculate the portfolio's risk-adjusted performance. Then try a variety of portfolio weights and calculate how changing the weight of each component affects the portfolio's risk and return.

The major caveat in making investment decisions for yourself based on this type of analysis is that future results will probably not exactly repeat the past. What will transpire over the longer term is anybody's guess. As a consequence, the optimal portfolio in the future is unknowable. However, the qualitative conclusion that investors are better off (from the perspective of balancing risk and reward) by including both stocks and bonds in their portfolios compared to holding only one or the other remains valid.

The One-Decision Portfolio

The one-decision portfolio describes a specific application of the principle of diversification by giving you an investment recipe that in the past has generated attractive returns at low risk. The goal is to provide the best possible investment that requires only a minimal time commitment and does not require you to follow the market except to check on the value of a handful of holdings once each year.

As a general rule, diversification works best when you include a mix of different investments whose price movements have not usually tended to coincide with each other (said to be uncorrelated). These three areas — REITs, small-cap value and S&P 500 — have historically had a relatively low correlation with each other.

A mix of assets that has been far safer than stocks alone and far more profitable than bonds alone is 50 percent in bonds/cash and 50 percent in equity funds. The equity portion of the portfolio is simply the blend of 40 percent S&P 500, 40 percent REITs and 20 percent small-cap value. The income portion of the one-decision portfolio is 60 percent cash/40 percent intermediate-term investment-grade bonds.

Putting all this together results in the following one-decision investment mix: 20 percent S&P 500 Index, 20 percent diversified REITs, 10 percent diversified small-cap value stocks, 20 percent diversified intermediate-term investment-grade bonds and 30 percent cash (90-day Treasury bills, money market or bank CDs). Less conservative investors can omit the cash position while leaving the other four investment categories in the same proportion.

ETFs are available to gain exposure to each of these areas, except for cash. Particular selections include these:

- S&P 500 Depository Receipts (SPY) for the S&P 500
- iShares Cohen & Steers Realty Majors Index Fund (ICF) for REITs
- StreetTracks Dow Jones U.S. Small-Cap Value Index Fund (DSV) for small-cap value stocks
- iShares Lehman Aggregate Bond Index Fund (AGG) for intermediate-term investment-grade bonds

Rebalancing

What will your investments look like at the end of the year? In general, your investments will deviate from the prescribed portfolio because each of the components will have grown at a different rate. To restore the original balance in your portfolio, you have to sell off part of the investments that performed more strongly than the overall portfolio and place additional capital into those areas that did not earn as much as the entire portfolio. Rebalancing should be done after holding for one year and one day, rather than rebalancing on the same date each year. This way, any gains you realize will be taxed at the more favorable long-term capital gains rate.

An Asset Allocation Model for Small– Versus Large-cap ETFs

There have been great rewards for investors who have made good decisions about when to switch from large-caps to small-caps and back. Unfortunately, neither ETF sponsors nor the managers of most mutual funds will decide for you when you are likely to be better off in small-caps or large-caps.

The universe of small-cap stocks represents a wide range of industries, but the following factors seem to have influenced the relative performance of small-cap stocks overall:

- Strong economic growth
- Strong corporate profit growth
- Easy credit conditions
- Geopolitical stability

The asset allocation model that determines whether to be in small- or large-cap ETFs operates based on the premise that major trends favoring one or the other will continue to persist for years at a time, as they have in the past. The model consists of one simple rule: Invest for the coming year in whichever of the two alternatives returned more in the previous year.

As a practical matter, individual investors will not have access to total returns of benchmark indexes information on the last day of the year. However, you can get a good idea of the total return of the two ETFs that track these benchmarks from information available online: the iShares Russell 2000 Index Fund (IWM) and the iShares Russell 1000 Index fund (IWB).

To calculate the total return of an ETF, you need the price at the beginning and end of the period you want to study. Fortunately, ETF price and distribution information can be obtained by going to http://finance.yahoo.com or http://moneycentral.msn.com/investor/charts/charting.asp.

ETF Share Prices Drop by the Amount of a Distribution

The IRS requires ETFs and mutual funds to make taxable distributions to their shareholders so that they will pay taxes similar to someone who held the underlying individual stocks directly. Distributions are taxable to you whether or not you actually sell your ETF shares. It is important to recognize that the amount of a distribution does not affect your investment return from an ETF or mutual fund.

Because a distribution does not reflect the creation of new wealth, the amount distributed has to come from somewhere. The source of taxable distributions is the ETF's underlying assets. Therefore, the amount paid to you as a taxable distribution must reduce the fair value of the ETF shares. As a result, ETF share prices drop by the amount distributed.

Be careful when buying mutual funds or ETFs near the end of the year, lest you end up paying taxes on a distribution that reflects profits you never enjoyed. ●

Choosing Between Growth and Value ETFs

There are no universally accepted criteria to define precisely what is considered to be a growth or value stock. The lack of consensus has given rise to multiple growth and value ETFs, each of which is based on its own methodology.

Even though the universes of growth or value stocks contain multiple industry groups, certain changes in the economic climate have caused these diverse collections of stocks to move in relative unison. For example, three economic factors have favored value stocks over growth stocks historically: sharply rising commodity prices, a strong U.S. dollar and accelerating economic growth.

The Concept of Relative Strength

It is useful when making a decision about what to buy or sell to be able to tell at a glance which of two investments is currently stronger than the other. You can accomplish this by plotting the *relative strength* between two investments, which is simply a graph of the value of one investment divided by the value of the other.

The simple rule for rebalancing between value stocks and growth stocks is this: *A disparity of 10 percent in relative performance between growth and value defines the current long-term trend.* ●

International Investing

Investing abroad has become popular in recent years because foreign stock markets have in many cases been stronger than our own. However, investing abroad has inherent obstacles. Currency risk is added to whatever local stock market risk exists. This currency risk has no offsetting expectation of reward. Moreover, transaction costs are typically higher abroad than they are for managers who buy on U.S. exchanges.

An investor can improve his investment performance by taking positions in international stocks only when a long-term trend is favorable. You can identify a major trend by a 15 percent disparity in the performance of foreign versus U.S. stocks. ●

How to Use Interest Rates

Interest rates are perhaps the most important factor that influences the stock market. Generally speaking a six-month time frame for analyzing interest rate trends has produced the most useful tools to gauge the stock market. Two important features of the interest rate climate are important to follow when you're an equity investor: whether interest rates as a whole are rising or falling and whether it costs more for the U.S. Treasury to take out long-term loans or short-term loans.

Two interest rate climates have been bad for stocks. The first interest rate indicator is the six-month change in the yield on 10-year Treasury notes. When this interest rate is higher than it was six months ago, the interest rate environment is unfavorable for stocks. When the 10-year yields are lower than they were six months ago, the interest rate climate is favorable for stocks. The second warning sign is called an *inverted yield curve.* This describes a bond market in which the interest rate on long-term bonds is lower than the rate on short-term bonds. ●

The Ultimate ETF Investment Program

An investor can improve the performance of a strategy that continually invested in the S&P 500 and in small-cap value ETFs by following a three-step ultimate investment approach that has delivered attractive returns at reasonable risk:

1. Diversification – allocate 25 percent of your assets to investment-grade U.S. bonds and 25 percent to REITs using ETFs.

2. Decide whether international or U.S. stocks are favored; if U.S. stocks are favored, evaluate the interest rate climate. From that point, make a 25 percent allocation to large U.S. company stocks (SPY), foreign stocks (EFA) or a money market fund.

3. Select the best investment style from large-cap value, small-cap value, large-cap growth or small-cap growth and then determine whether growth or value is stronger. After you have made this decision, you can select a small- or large-cap ETF and allocate the final 25 percent of your portfolio.

The bottom line is that the rich variety of ETFs that are available and the degree of competition among ETF sponsors and index providers offer you the opportunity to be selective when you are shopping for ETF investments. Take advantage, and you will have a leg up on most other investors. ●