Two ETF experts, two different approaches

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I always have to laugh at the experts who believe it's simple to overhaul your investment strategy. Last week, I read one who suggested it was possible to change your strategy in the time it takes to order and savour a good brunch.

I can say this with absolute certainty: That will never be me. Nothing ever comes easy. Before I leap, I have to look. First, I have to read as much as I can and mull things over. Then comes the agonizing, a step that in itself can use up countless more hours than a decent brunch.

In my last column, I wrote that I plan to move my money from mutual funds to exchange-traded funds. I'm still determining what kind of ETFs to buy, but if my mailbox is any indication, I have plenty of company in considering this move.

Among the readers who shared their stories and asked questions were two experts who have different approaches to ETFs. In one corner, there's Marc Ryan, a retired securities lawyer who has launched the very informative and accessible website www.independentinvestor.info; in the other is Mark Yamada, president and CEO of PUR Investing Inc., a Toronto-based investment counselling firm that focuses entirely on ETFs.

Mr. Ryan's approach is fairly conservative: Think long term, keep your costs down and “try when you can to do what the institutions do.” That's because they're smarter than you are.

In Mr. Ryan's universe, an individual investor would pick ETFs that track major stock exchanges and be satisfied with matching the market, not beating it. After all, most investors don't beat the market. Investors would also avoid sector funds, which tend to have less institutional participation, have higher expense ratios and tend to be a little more faddish.

“Sector funds tend to get launched when a particular investment idea is hot. In a few years, if the idea loses favour, you don't know if the ETFs will still be around,” Mr. Ryan says.

For Mr. Yamada, ETFs are a breakthrough for individual investors because they allow them to be on the same level playing field as institutions in buying a large basket of stocks. He also believes that investors should follow the lead of institutional investors in other ways.

The technique that he suggests is similar to the approach I want to take in investing: having a core index portfolio, and a satellite portfolio to actively manage “to try to add value to that benchmark index.” My plan is to have a foundation of ETFs that track major indexes, but also set aside a smaller amount of money to be a little more aggressive. I had planned to do that with stocks, but Mr. Yamada suggests higher-risk ETFs, such as levered ETFs, which are designed to give double the return of the underlying index. Of course, by mirroring the market times two, it means that if the index is down 2 per cent, the ETF will be twice that – down 4 per cent.

Another of Mr. Yamada's “techniques” involves a different approach to rebalancing your portfolio – by using risk, not asset mix, as your guide. He uses the simple example of an investor whose portfolio comprises 60-per-cent stocks and 40-per-cent bonds. The traditional way of rebalancing would go something like this: When the market goes up, so too do share prices, so the asset ratio changes. The investor would then sell some stock or buy more bonds to get back to the 60-40 ratio.

But Mr. Yamada says that individual investors should adopt the approach of the more sophisticated institutional investors and consider their portfolios purely from a risk point of view. He gives the example of bathwater – if it becomes too hot, you can drain some out and add some cold water. If the market becomes too volatile for your risk level, you can add safer assets to dampen that volatility; if the market is cool, you can take more risk. And with the number and variety of ETFs available now – with risk levels ranging from relatively safe bond funds to the aforementioned levered funds – Mr. Yamada says you can create a portfolio comprised only of the funds.

Two experts, two very different approaches. There's plenty for me to mull over. Let others make their decisions over brunch – I'm going to have to take a little longer.

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