ETF INVESTING

Exchange-traded foundation

How to build a diverse, buy-and-hold investment portfolio using ETFs

By John Spence, MarketWatch
Last update: 3:35 p.m. EDT June 22, 2008

BOSTON (MarketWatch) -- As exchange-traded funds and notes branch out to cover almost every asset class under the sun, more financial advisers and sophisticated investors are using these indexed products exclusively to build long-term portfolios.

Such model portfolios can be notoriously dicey, because as a general rule, one size fits none. Every investor has his or own particular tolerance for risk, time horizon and financial goals.

However, model ETF portfolios can be a good starting point for the often frustrating task of creating an asset-allocation plan and sticking with it.

ETFs and their cousins, exchange-traded notes, have many different users.

Traders and hedge funds, for instance, can jump in and out of these vehicles -- the vast majority of which track indexes. ETFs and ETNs are listed on exchanges and trade much like individual stocks.

Yet due to their low costs, tax efficiency and diversification, these financial products can also be ideal vehicles for constructing buy-and-hold portfolios. Read related story on buy-and-hold investing.

Getting started

Academic studies have documented that the performance of long-term investors hinges mostly on asset allocation, or dividing money among major investment classes such as stocks, bonds, real estate, commodities and cash.

Armed with this knowledge and mindful of the draining impact of fees, some investors and financial advisers use passively managed funds such as ETFs to get cheap, broad exposure to asset classes. These investors know exactly what they're buying because the products are transparent and follow benchmarks, so investors don't have to keep up with manager changes or "style drift," for instance.

Again, it's important that investors take model ETF portfolios with a grain of salt. Any financial adviser, or financial journalist for that matter, can slap together a collection of funds and call it a model portfolio.

Instead, investors should regard model portfolios as a kind of recipe -- a starting point that can be tweaked or seasoned according to the individual's tastes.

Also keep in mind that the point of asset allocation is to build a diversified portfolio that doesn't leave investors with all their eggs in one basket. Adding non-correlated assets -- or those that zig when others zag -- to a portfolio can smooth out risk and provide the opportunity for higher returns. Diversified investors tend not to hit home runs or strike out badly, but rather churn out a steady stream of singles to build and protect capital over the long haul.

When coming up with an asset-allocation plan, advisers usually have clients fill out a questionnaire that helps them identify their tolerance for risk, and investment goals.

Investors with a healthy appetite for risk could end up taking a relatively bigger position in stocks, which have historically seen greater volatility but also larger rewards over long periods.

Conversely, a baby boomer approaching or in retirement may want to ratchet down risk and invest more in relatively safer and income-producing bonds.

Model portfolios

Rick Ferri is chief executive at Portfolio Solutions LLC, an investment firm that manages separate accounts using ETFs and index funds.

In a recent book, he provides a sample of market-index ETFs in a model portfolio, which is split into two parts: stocks and bonds. It's up to the investor to come up with the stock/bond split. After that big-picture decision, this is how the percentages within the major asset classes -- equity and bonds -- could shake out:

Equity portion

Allocation	Category	ETF (ticker)
45%	U.S. Total Stock Market	Vanguard Total Stock Market VTI
15%	U.S. Small-Cap Value	iShares S&P 600 Small-Cap Value IJS
10%	Real Estate	Vanguard REIT ETF VNQ
12%	Europe	Vanguard European Index VGK
12%	Pacific Rim	Vanguard Pacific Index VPL
6%	Emerging Markets	Vanguard Emerging Markets VWO

Fixed-income portion

Allocation	Category	ETF (ticker)
60%	Total Bond Market	Vanguard Total Bond Market BND
20%	Corporate Bond	iBoxx InvestTop Investment Grade Corp. LQD
20%	Inflation-Protected Securities	iShares Lehman TIPS TIP

Source: "The ETF Book," Richard Ferri (John Wiley & Sons)

A few points on these plain-vanilla portfolios: First, in the stock portion, using U.S. small-cap value stocks is a common diversifier because they tend not to move in lockstep with the broad market, and to deliver higher returns over long periods.

Also, investors have a wide selection when choosing ETFs for a particular asset class. One tool for finding ETFs tracking various sectors of the market is MarketWatch's ETF Screener, which sorts ETFs by market capitalization, sector, growth and value, geographic region, market sector and other criteria. See MarketWatch ETF Screener.

Although sector ETFs, for example, are seen as interchangeable, they can often differ their approach a particular industry. When shopping around, investors should pay close attention to fees, index construction, the investment manager and historical performance.

For more model portfolios, MarketWatch columnist Paul Farrell tracks several "Lazy Portfolios" designed for buy-and-hold investors. They can be easily replicated using ETFs and ETNs. Read more.

Investors can get as simple or complex as they want when constructing these portfolios. It can't be stated enough that the model above is just a jumping-off point. Additionally, some financial advisers recommend a "set-it-and-forget-it" approach, while others prefer so-called tactical approaches with limited trading to take advantage of short-term market moves.

With hundreds of ETFs and ETNs choose from, investors can diversify further into areas such as small-cap international stocks, precious metals, currencies, commodities, money markets and foreign bonds.

Within model portfolios, investors can go with a broad or targeted approach. A total stock market ETF can cover the U.S. market in one package.

Investors can also customize exposure with sector ETFs. You can further tailor the strategy by tilting to smaller or larger stocks, or to growth or value. The same goes for ETFs tracking bond markets.

John Spence is a reporter for MarketWatch in Boston.