Using Index Funds and ETFs to Build a Core Portfolio

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Key Points

- Being “average” is good
  - Consistently matching return of benchmark indices is high performance
- Asset allocation increases return
- Asset allocation reduces risk
- By lowering investors costs, index funds and index-based ETFs increase long term return

Index Funds

- A mutual fund that
  - aims to replicate the movements of an index of a specific financial market, or
  - uses a set of rules of ownership that are held constant, regardless of market conditions
- Advantages: low cost, simplicity, lower turnovers, and no style drift
- Only a small number of ETFs are index funds

Exchange Traded Funds

- Most ETFs are <u>not</u> index funds
- Look for passively managed ETFs
  - Holdings based upon a well known market indices
  - Avoid ETFs that try to time their investments
- Enhanced or fundamentally weighted ETFs
  - The jury is still out (actual return vs. back testing)
  - These ETFs have higher expense ratios
  - Can they out perform actively managed funds?
- Focus on index-based ETFs only
- Expense ratios matter!

Some Attributes of ETFs

- Generally more tax efficient that mutual funds especially index-based ETFs (See Morningstar)
- Lower portfolio turnover, more tax efficient
- No cash drag
- Fees generally much lower than mutual funds
  - More transparent; no deferred sales charges or other kickbacks to the dealer
  - But need to consider broker commissions and spread (difference between buy and sell price)
- Can trade whenever market is open

ETFs and Index Funds

- Avoid any index fund or ETF
  - Not based on a widely recognized index
  - Expense ratio greater than 30 basis points (0.3%)
  - That uses a methodology other than capitalization weighting to determine holdings
  - That does not closely correlate with the index it is intended to follow
  - That charges a load or 12B1 fees

Actively Managed Funds Underperform their Indices

- Most investment managers for mutual funds under perform the corresponding index for their fund
- All Large Cap Funds
  - Over 1 year, 75.4%
  - Over 3 years, 52.1% ***under perform*** their index
  - Over 5 years, 63.8%
- All Small Cap Funds
  - Over 1 year, 71.8%
  - Over 3 years, 68.1% ***under perform*** their index
  - Over 5 years, 65.2%
- Being "average" places you in the top third!
- Source: S&P's Indices Versus Active Funds Scorecard for mid-year 2010

Some Things to Consider

- Fund expenses and fees
- How are index fund holdings determined
  - market capitalization vs. fundamental weighting or equal weighting
- Tax efficiency
  - Turnover ratio
- Transaction costs
  - Buying and selling
  - Penalties for early sale

ETFs vs. Index Funds

- Index funds
  - Traded at the end of the business day
  - Usually have minimum purchase requirements (initial and subsequent)
  - Slightly higher expenses (a few basis points)
- Exchange traded funds
  - Can be traded anytime during the day
  - NAV and market price can vary
- Caution: most ETFs are <u>not</u> index funds

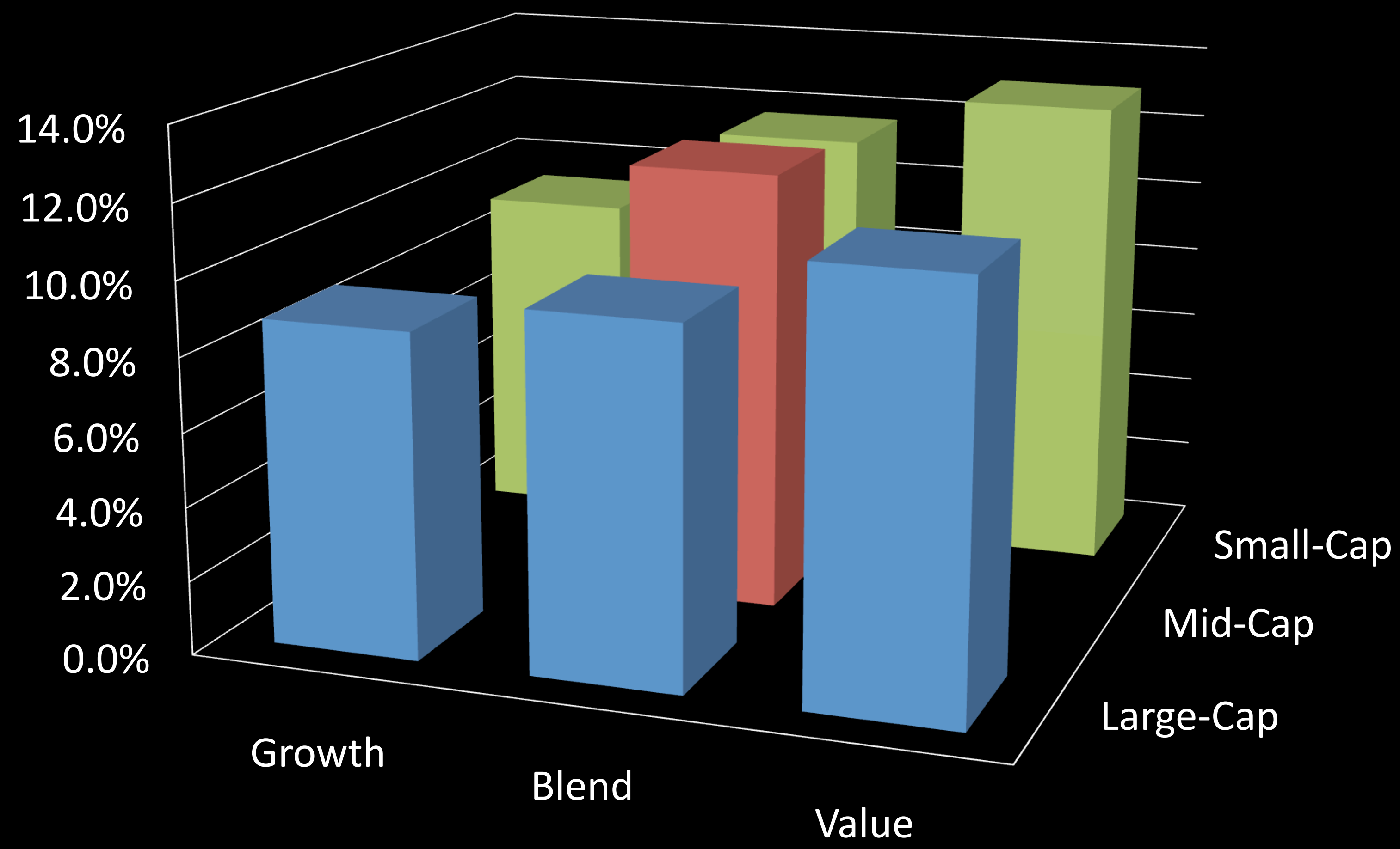
Asset Allocation

- Diversifying a portfolio by holding investments in several investment categories to reduce risk
- The best-performing asset varies from year to year and is not easily predictable
- Different asset classes offer non-correlated returns
  - Diversification reduces the overall risk in terms of the variability of return for a given level of expected return.
- ETFs are “the only free lunch you will find in the investment game"
- Academic research has painstakingly explained the importance of asset allocation, and the problems of active management

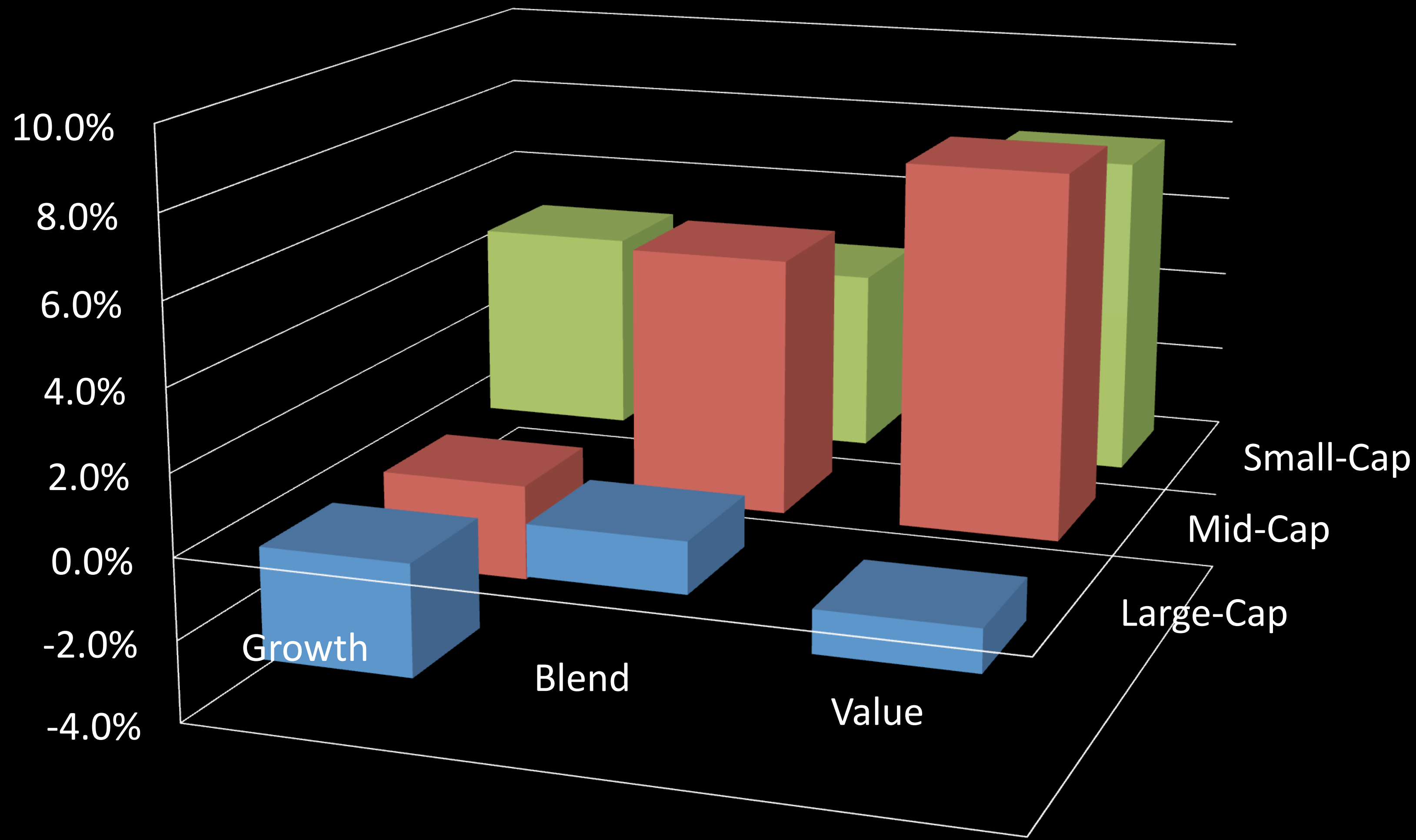
Examples of Asset Classes

- Stocks: value, growth or blend; large-cap, mid-cap or small-cap; domestic, foreign, emerging markets
- Real estate: domestic and international
- Natural resources
- Precious metals
- Cash (*i.e.*, money market accounts)
- Bonds: investment grade or junk (high yield); government or corporate; short-term, intermediate, long-term; domestic, foreign, emerging markets

Who won from 1972-2009 Growth, Value, Large or Small?



Who won from 2000-2009, Growth, Value, Large or Small?



Emerging Markets ETF

Characteristics	VWO	MSCI EMI
Number of stocks	836	748
Median market capitalization	$14.3B	$14.8B
Price/earnings ratio	15.2x	14.8x
Price/book ratio	2.0x	1.9x
Return on equity	21.9%	21.1%
Earnings growth rate	15.9%	15.2%
Equity yield	2.1%	2.3%
Turnover rate (last FY)	12.3%	—
Standard deviation (36 mo.)	33.0%	32.6%

Invests in 23 emerging countries in Europe, Asia, Africa, and Latin America.

12 months ending 30 June 2010

All World Int'l (ex-US) ETF

Characteristics	VEU	FTSE All World (ex-US)
Number of stocks	2,206	2,176
Median market capitalization	$24.2B	$24.3B
Price/earnings ratio	16.4x	16.2x
Price/book ratio	1.5x	1.5x
Return on equity	18.3%	18.2%
Earnings growth rate	4.8%	4.8%
Turnover rate (last FY)	9.4%	—
Standard deviation (36 mo.)	26.7%	26.0%

12 months ending 30 June 2010

Small-Cap ETF

Characteristics	VB	MSCI US Small Cap 1750 Index
Number of stocks	1,753	1,750
Median market capitalization	$1.3B	$1.3B
Price/earnings ratio	26.0x	26.0x
Price/book ratio	1.7x	1.7x
Return on equity	10.6%	10.6%
Earnings growth rate	5.4%	5.4%
Foreign holdings	0.2%	—
Turnover rate (last FY)	13.7%	—
Standard deviation (36 mo.)	26.8%	26.8

12 months ending 30 June 2010

MEASURING RISK

Standard Deviation

- Standard deviation or sigma (σ)
  - 68% of the values in distribution are within 1 standard deviation of the mean
  - Examples (over 35 years)
    - S&P 500: 17.5%
    - Lehman Brothers Aggregate Bond fund: 5.2%
    - T-bills: 3.1%
- Standard deviation is a measure of volatility
- Risk is a broader concept. Will my money be there when I need it?

Value vs. Growth

- Index funds use quantitative approaches to characterize stocks as either growth or value
- No one asset class consistently out performs
- Academic research suggests that value stocks slightly outperform growth stocks over time
- Combining a “blended” index with a value index gives a slight tilt toward value.

Large-Cap
Blend vs. Value vs. Growth

	VV (LCB)	VTV (LCV)	VUG (LVG)
Number of stocks	755	422	428
Median market cap.	$31.3B	$38.6B	$28.5B
Price/earnings ratio	16.5x	15.5x	17.7x
Price/book ratio	1.9x	1.4x	3.0x
Return on equity	20.3%	16.5%	24.5%
Earnings growth rate	6.9%	-0.5%	14.3
Foreign holdings	0.1%	0.1%	0.1%
Turnover rate (last FY)	8.3%	30.6%	29.4%
Std. deviation (36 mo.)	20.3%	21.1%	20.3%

12 months ending 30 June 2010

Small-Cap
Blend vs. Value vs. Growth

	VB (SCB)	VBR (SCV)	VBK (SVG)
Number of stocks	1,753	993	1034
Median market cap	$1.3B	$1.3B	$1.3B
Price/earnings ratio	26.0x	20.3x	35.9x
Price/book ratio	1.7x	1.3x	2.5x
Return on equity	10.6%	8.9%	12.7%
Earnings growth rate	5.4%	0.7%	11.0%
Foreign holdings	0.2%	0.1%	0.2%
Turnover rate (last FY)	13.7%	32.5%	37.8%
Std. deviation (36 mo.)	26.8%	27.6%	26.7%

12 months ending 30 June 2010

Correlation Among Asset Classes

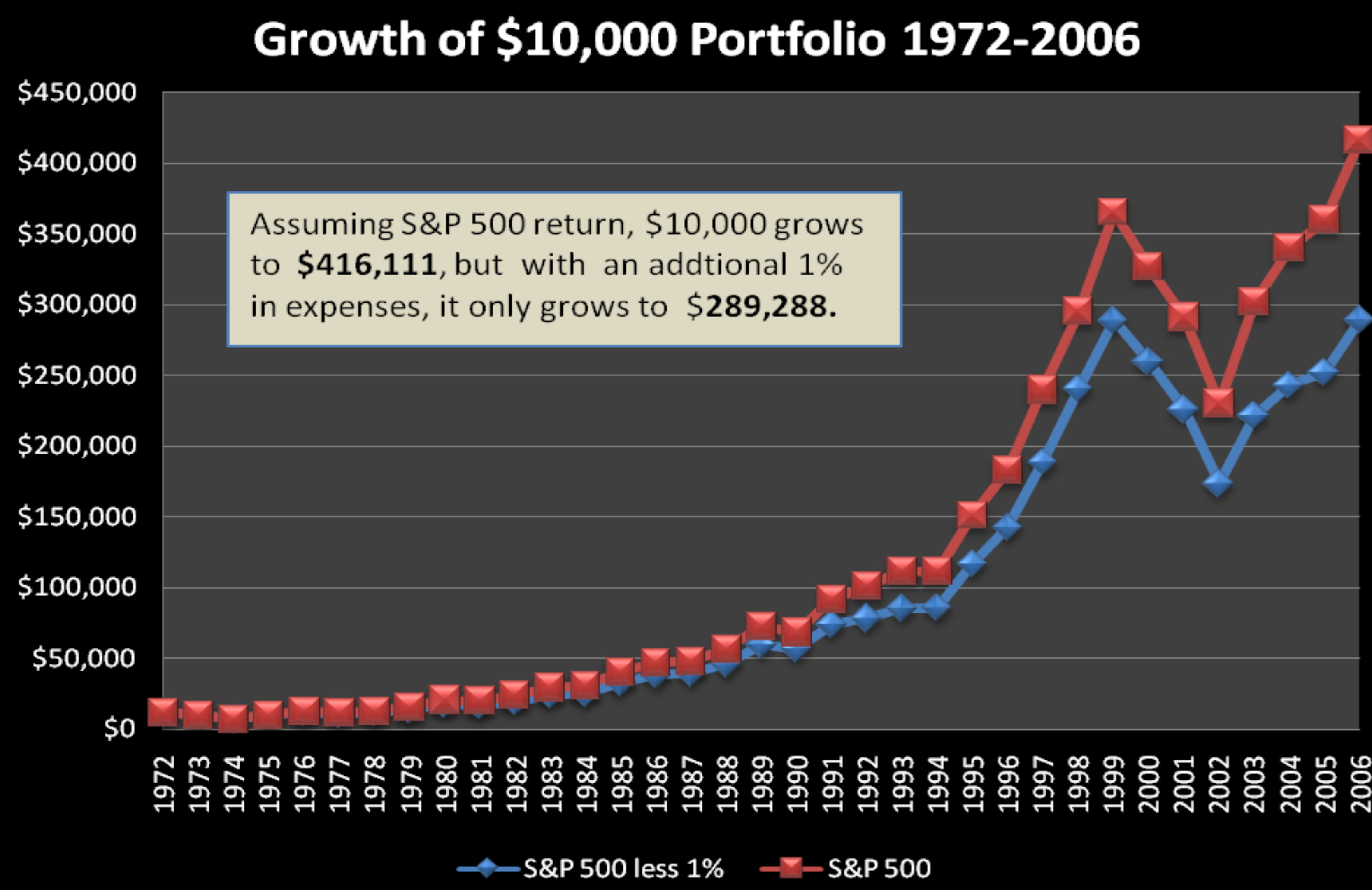
- Asset classes that are not closely correlated can reduce portfolio volatility
  - *e.g.*, some asset classes increase in value while others decrease
- 2009 bear market caused most asset classes to decline
- How many asset classes are enough?
  - 6-10 can provide excellent diversification
- Look across your entire portfolio

Callan Periodic Table of Returns

1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
BC Agg 8.96%	Russell 2000 Growth 51.19%	Russell 2000 Value 29.14%	MSCI EAFE 32.57%	MSCI EAFE 7.78%	S&P/Citi 500 Growth 38.13%	S&P/Citi 500 Growth 23.97%	S&P/Citi 500 Growth 36.52%	S&P/Citi 500 Growth 42.16%	Russell 2000 Growth 43.09%	Russell 2000 Value 22.83%	Russell 2000 Value 14.02%	BC Agg 10.26%	Russell 2000 Growth 48.54%	Russell 2000 Value 22.25%	MSCI EAFE 13.54%	MSCI EAFE 26.34%	MSCI EAFE 11.17%	BC Agg 5.24%	Russell 2000 Growth 34.47%
S&P/Citi 500 Growth 0.20%	Russell 2000 46.04%	Russell 2000 18.41%	Russell 2000 Value 23.77%	S&P/Citi 500 Growth 3.13%	S&P 500 37.58%	S&P 500 22.96%	S&P 500 33.36%	S&P 500 28.58%	S&P/Citi 500 Growth 28.24%	BC Agg 11.63%	BC Agg 8.43%	Russell 2000 Value -11.43%	Russell 2000 47.25%	MSCI EAFE 20.25%	S&P/Citi 500 Value 5.82%	Russell 2000 Value 23.48%	S&P/Citi 500 Growth 9.13%	Russell 2000 Value -28.92%	MSCI EAFE 31.78%
S&P 500 -3.11%	Russell 2000 Value 41.70%	S&P/Citi 500 Value 10.52%	Russell 2000 18.88%	S&P 500 1.32%	S&P/Citi 500 Value 36.99%	S&P/Citi 500 Value 22.00%	Russell 2000 Value 31.78%	MSCI EAFE 20.00%	MSCI EAFE 26.96%	S&P/Citi 500 Value 6.08%	Russell 2000 2.49%	MSCI EAFE -15.94%	Russell 2000 Value 46.03%	Russell 2000 18.33%	S&P 500 4.91%	S&P/Citi 500 Value 20.81%	Russell 2000 Growth 7.05%	Russell 2000 -33.79%	S&P/Citi 500 Growth 31.57%
S&P/Citi 500 Value -6.85%	S&P/Citi 500 Growth 38.37%	Russell 2000 Growth 7.77%	S&P/Citi 500 Value 18.61%	S&P/Citi 500 Value -0.64%	Russell 2000 Growth 31.04%	Russell 2000 Value 21.37%	S&P/Citi 500 Value 29.98%	S&P/Citi 500 Value 14.69%	Russell 2000 21.26%	Russell 2000 -3.02%	Russell 2000 Growth -9.23%	Russell 2000 -20.48%	MSCI EAFE 38.59%	S&P/Citi 500 Value 15.71%	Russell 2000 Value 4.71%	Russell 2000 18.37%	BC Agg 6.97%	S&P/Citi 500 Growth -34.92%	Russell 2000 27.17%
Russell 2000 Growth -17.42%	S&P 500 30.47%	S&P 500 7.62%	Russell 2000 Growth 13.37%	Russell 2000 Value -1.54%	Russell 2000 28.45%	Russell 2000 16.49%	Russell 2000 22.36%	BC Agg 8.70%	S&P 500 21.04%	S&P 500 -9.11%	S&P/Citi 500 Value -11.71%	S&P/Citi 500 Value -20.85%	S&P/Citi 500 Value 31.79%	Russell 2000 Growth 14.31%	Russell 2000 4.55%	S&P 500 15.79%	S&P 500 5.49%	S&P 500 -37.00%	S&P 500 26.47%
Russell 2000 -19.48%	S&P/Citi 500 Value 22.56%	BC Agg 7.40%	S&P 500 10.08%	Russell 2000 -1.82%	Russell 2000 Value 25.75%	Russell 2000 Growth 11.26%	Russell 2000 Growth 12.95%	Russell 2000 Growth 1.23%	S&P/Citi 500 Value 12.73%	MSCI EAFE -14.17%	S&P 500 -11.89%	S&P 500 -22.10%	S&P 500 28.68%	S&P 500 10.88%	Russell 2000 Growth 4.15%	Russell 2000 Growth 13.35%	S&P/Citi 500 Value 1.99%	Russell 2000 Growth -38.54%	S&P/Citi 500 Value 21.17%
Russell 2000 Value -21.77%	BC Agg 16.00%	S&P/Citi 500 Growth 5.06%	BC Agg 9.75%	Russell 2000 Growth -2.43%	BC Agg 18.46%	MSCI EAFE 6.05%	BC Agg 9.64%	Russell 2000 -2.55%	BC Agg -0.82%	S&P/Citi 500 Growth -22.08%	S&P/Citi 500 Growth -12.73%	S&P/Citi 500 Growth -23.59%	S&P/Citi 500 Growth 25.66%	S&P/Citi 500 Growth 6.13%	S&P/Citi 500 Growth 4.00%	S&P/Citi 500 Growth 11.01%	Russell 2000 -1.57%	S&P/Citi 500 Value -39.22%	Russell 2000 Value 20.58%
MSCI EAFE -23.45%	MSCI EAFE 12.14%	MSCI EAFE -12.18%	S&P/Citi 500 Growth 1.68%	BC Agg -2.92%	MSCI EAFE 11.21%	BC Agg 3.64%	MSCI EAFE 1.78%	Russell 2000 Value -6.45%	Russell 2000 Value -1.49%	Russell 2000 Growth -22.43%	MSCI EAFE -21.44%	Russell 2000 Growth -30.26%	BC Agg 4.10%	BC Agg 4.34%	BC Agg 2.43%	BC Agg 4.33%	Russell 2000 Value -9.78%	MSCI EAFE -43.38%	BC Agg 5.93%

Expenses and Impact on Return

- Typical Fees
  - Index funds: 0.1% to 0.3%
  - Actively managed funds: No limit (typically 0.7% to 1.5%)
- If you don't buy a mutual fund directly, you may have to pay some brokers fees
- <u>Never</u> pay a front end load or a 12b1 fee, unless you just like enriching strangers
- 1% really matters! (See next chart.)



1% a year really matters!

International Index Funds

- US now only accounts for less than 40% of the world equity market
- Developed countries
- Emerging markets
- Geographic regions (Europe and Pacific)
- Note: may be hard to find international small cap and value index funds

International Asset Classes

- Decide on overall allocation (e.g., 30-45%)
- Diversify within international asset class
  - Approach 1: Developed and Emerging Markets
    - FTSE All-World ex-US + Emerging Market
  - Approach 2: Regions and emerging market
    - Europe, Pacific, emerging markets, and BRIC countries
  - Approach 3: Use a style-based approach
    - LCB, LCV, SCB, SCV, etc. (DFA offers these types of funds through its exclusive agents -- but it is not clear that it is worth the extra effort and the extra fees)
  - Vanguard funds, Vanguard ETFs, and iShares ETFs offer comprehensive choices with low fees

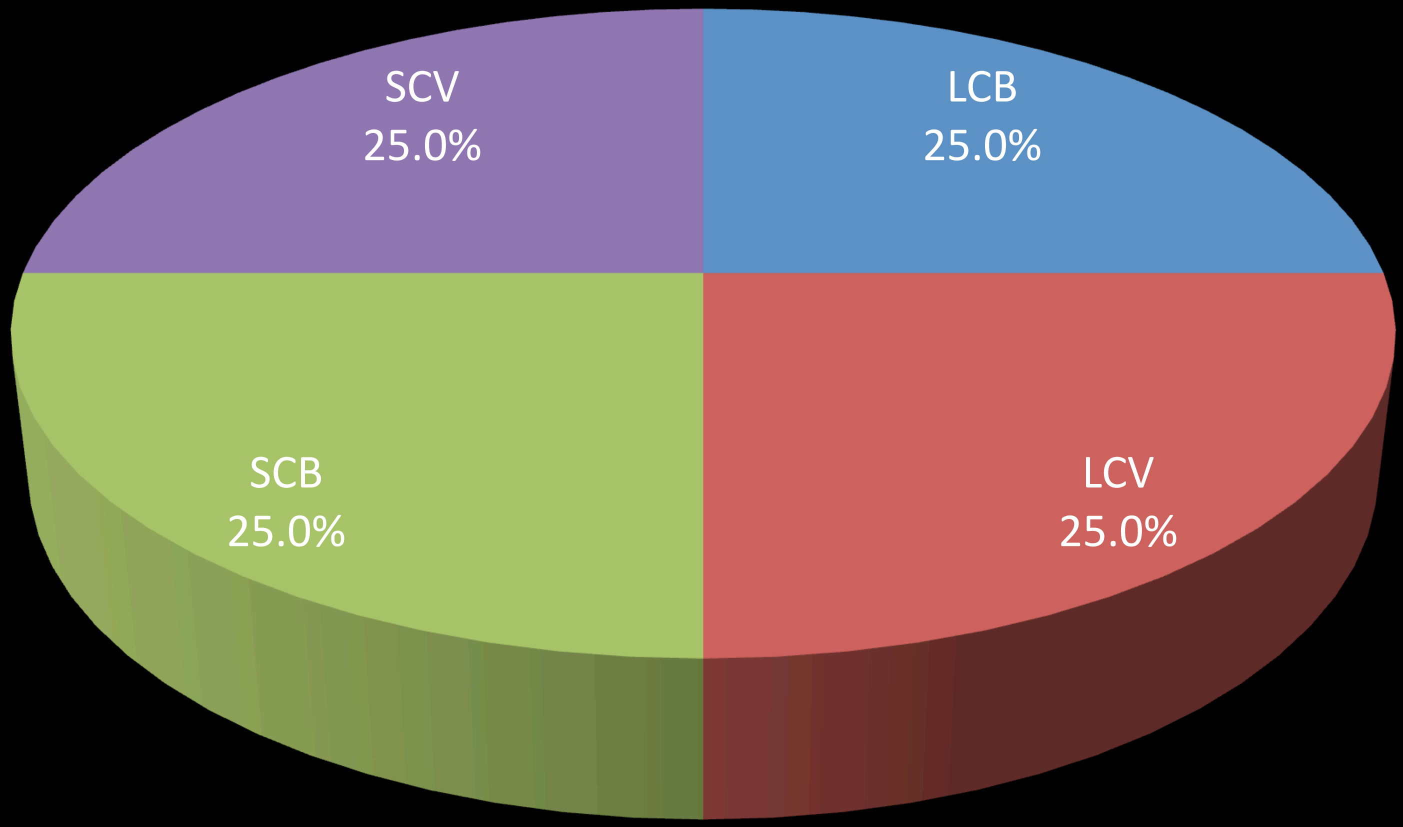
Other Asset Classes

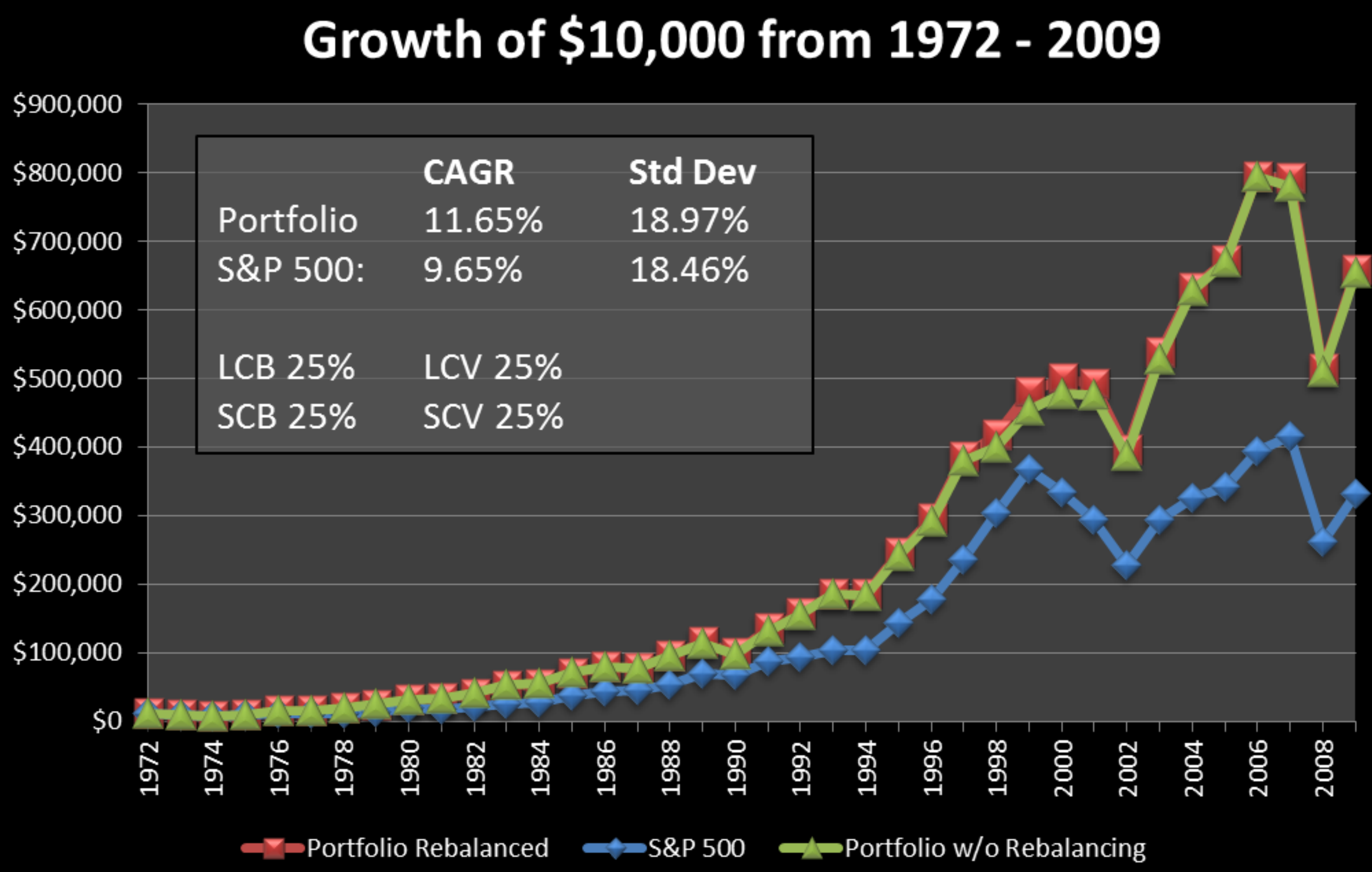
- REITs are not currently in favor but are a good way to have some real estate exposure
  - Now may be a good time to buy
  - Limit exposure to 5-10% of portfolio
  - Consider int'l REIT e.g., Wisdom Tree DRW
- Consider other asset classes
  - Look asset classes that do not have high correlation with the domestic stock market
  - Examples: commodities (e.g., timber) or gold
    - There are ETFs for these other asset classes
    - Expense ratios are higher for these asset classes

Cost of Living in 1972

• Yearly US inflation rate	3.27%
• Average cost of new house	$27,550
• Average income per year	$11,800
• Average monthly rent	$165
• Average price for new car	$3,247
• Gas per gallon	55 cents
• Kodak pocket camera	$28
• Wrangler jeans	$12
• Ladies Timex watch	$30 + up

US Equities Only





Growth of $10,000 from 1972 - 2009
CAGR
Std Dev
Portfolio
11.65%
18.97%
S&P 500:
9.65%
18.46%
LCB 25%
LCV 25%
SCB 25%
SCV 25%
$900,000
$800,000
$700,000
$600,000
$500,000
$400,000
$300,000
$200,000
$100,000
$0
1972
1974
1976
1978
1980
1982
1984
1986
1988
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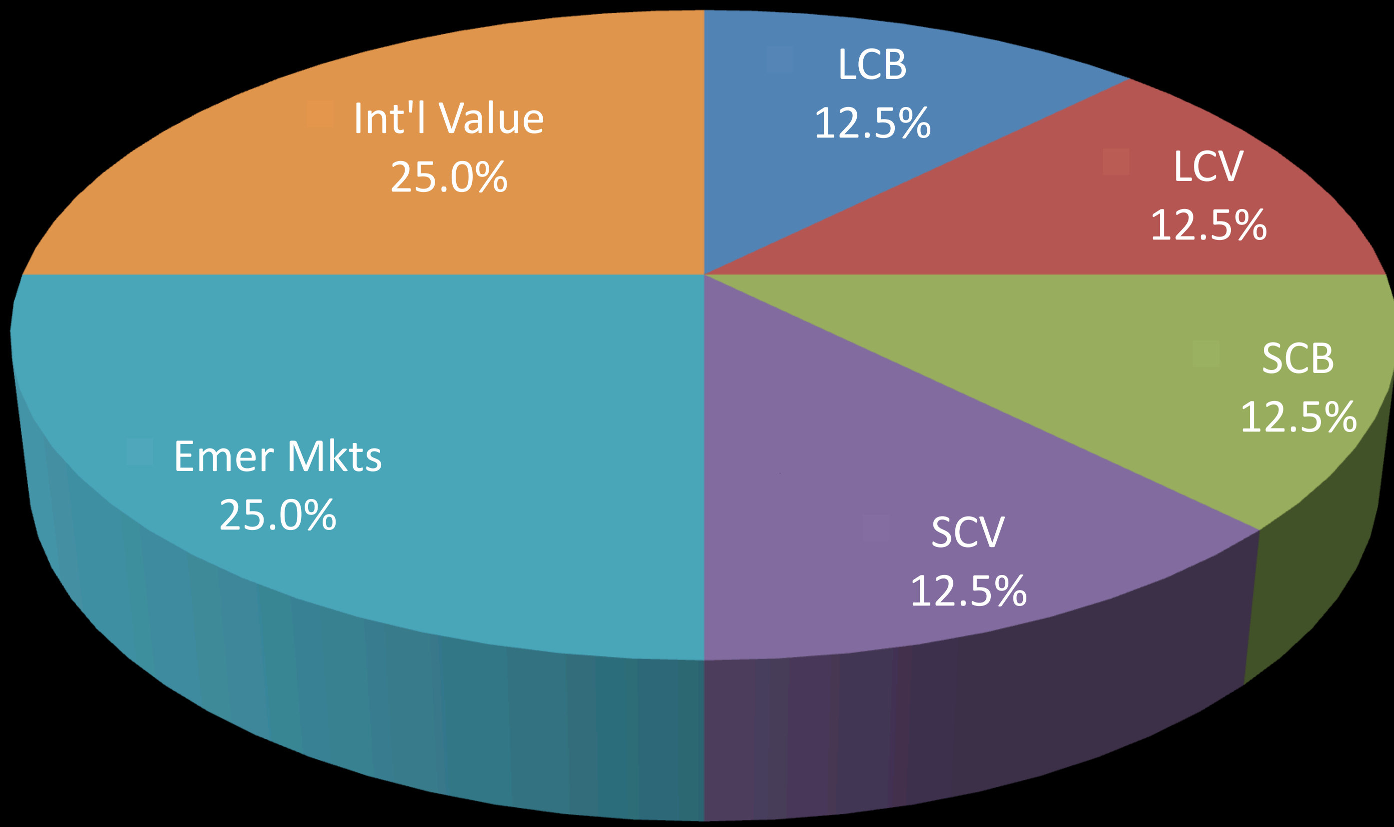
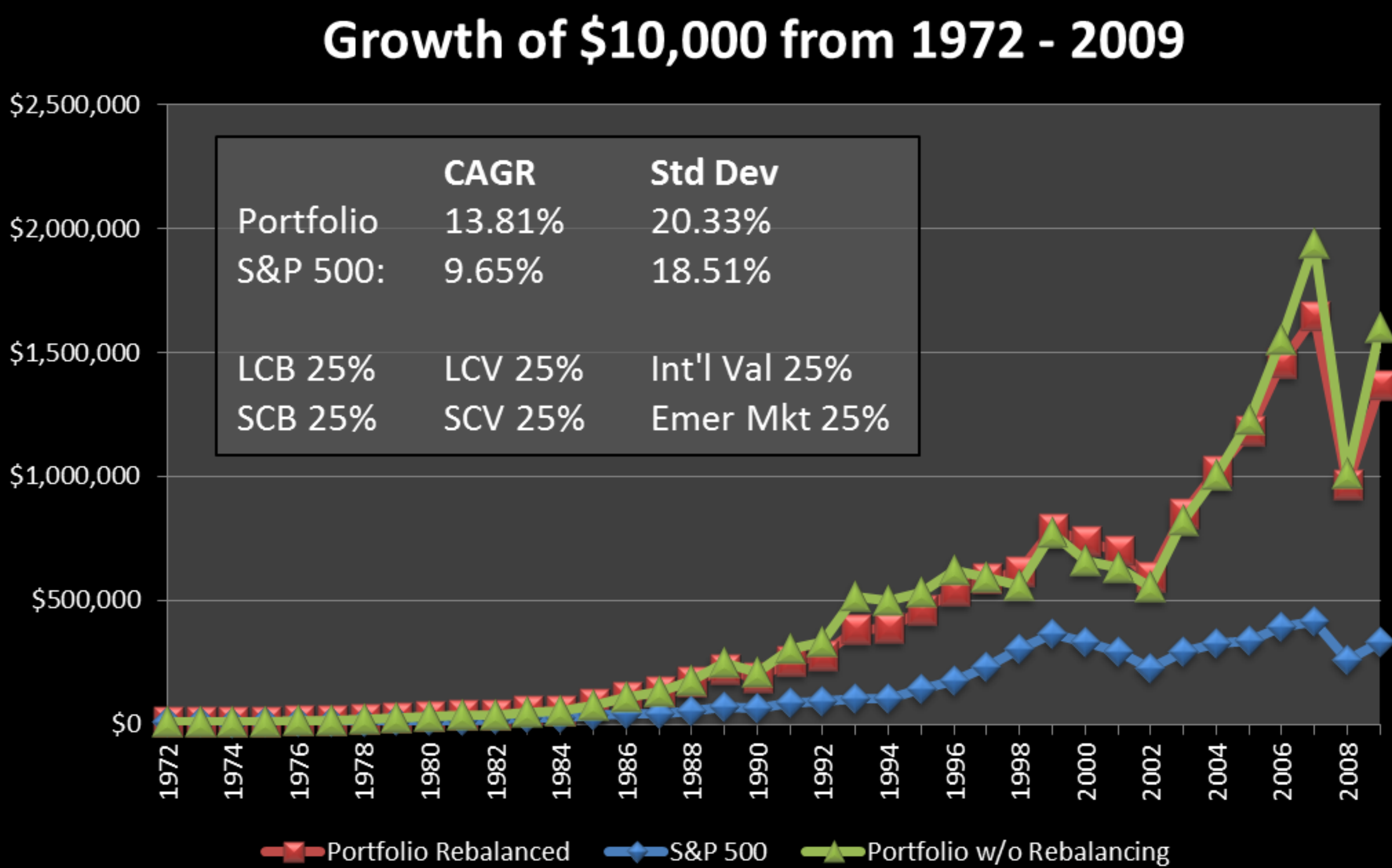
1994
1996
1998
2000
2002
2004
2006
2008
Portfolio Rebalanced
S&P 500
Portfolio w/o Rebalancing

US and International Equities




Growth of $10,000 from 1972 - 2009
CAGR
Std Dev
Portfolio
13.81%
20.33%
S&P 500:
9.65%
18.51%
LCB 25%
LCV 25%
Int'l Val 25%
SCB 25%
SCV 25%
Emer Mkt 25%
$2,500,000
$2,000,000
$1,500,000
$1,000,000
$500,000
$0
1972
1974
1976
1978
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Portfolio Rebalanced
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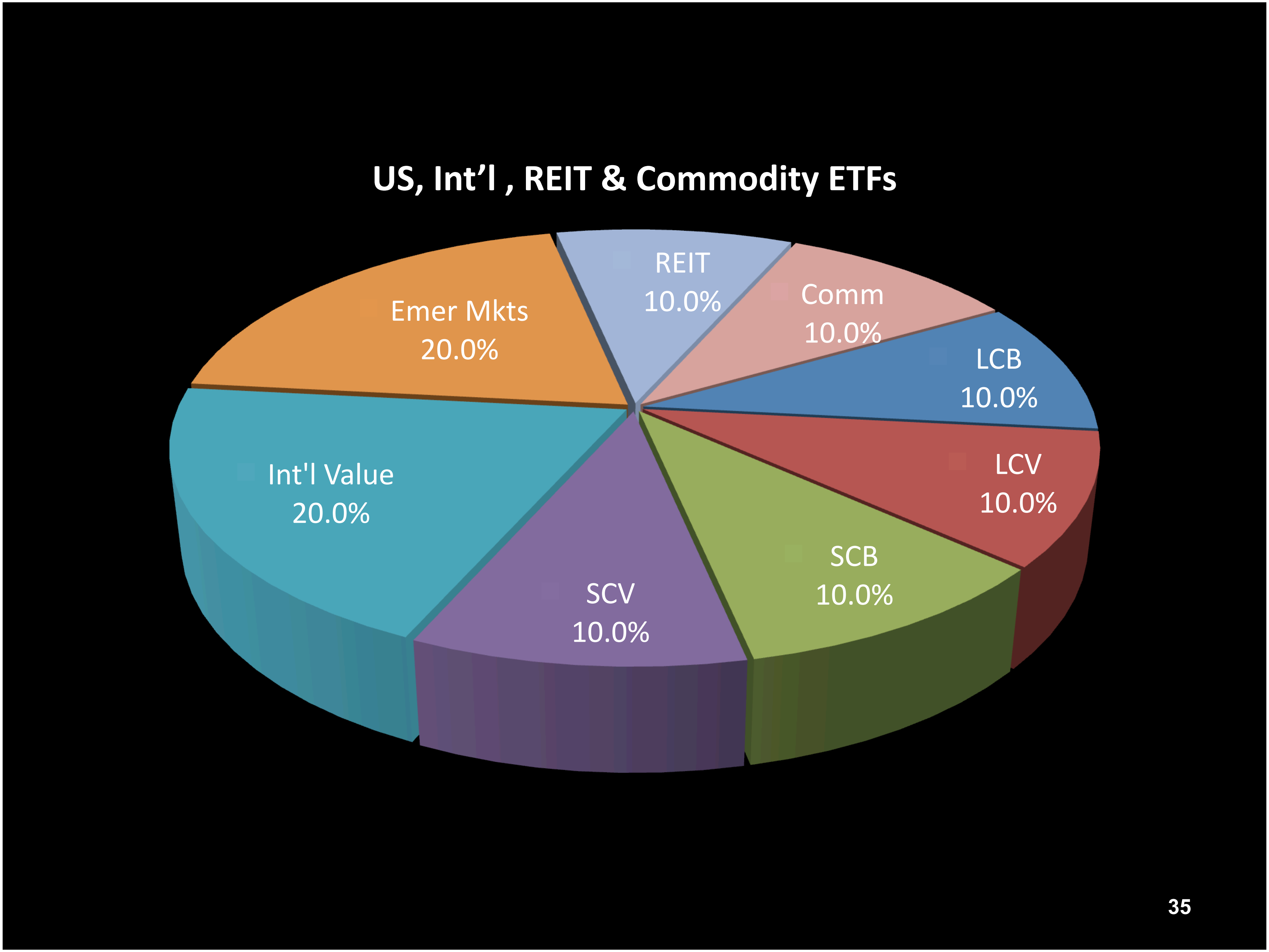
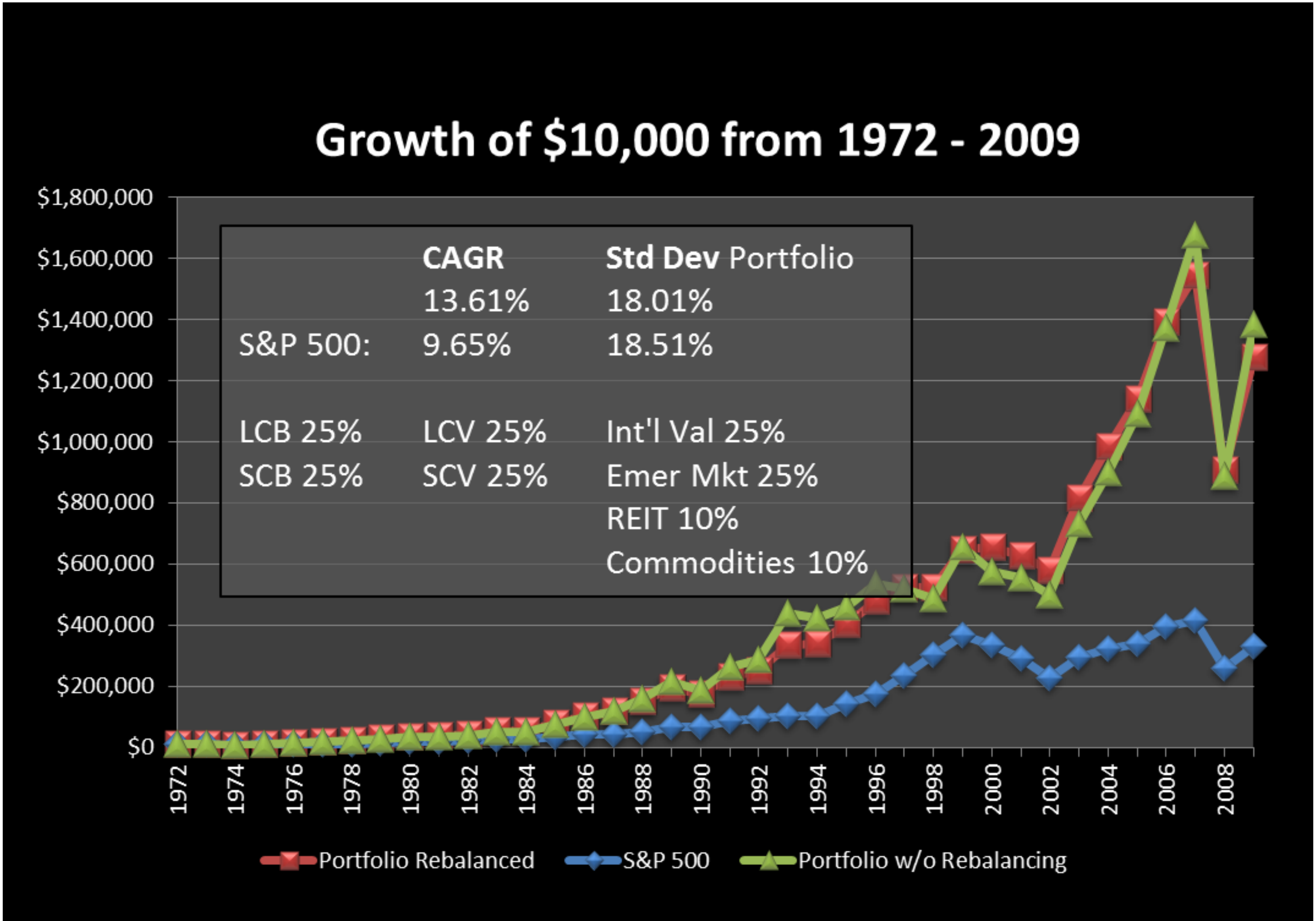
Portfolio w/o Rebalancing


US, Int'l , REIT & Commodity ETFs
REIT 10.0%
Comm 10.0%
Emer Mkts 20.0%
LCB 10.0%
Int'l Value 20.0%
LCV 10.0%
SCB 10.0%
SCV 10.0%



Growth of $10,000 from 1972 - 2009
CAGR
Std Dev Portfolio
13.61%
18.01%
S&P 500:
9.65%
18.51%
LCB 25%
LCV 25%
Int'l Val 25%
SCB 25%
SCV 25%
Emer Mkt 25%
REIT 10%
Commodities 10%
$1,800,000
$1,600,000
$1,400,000
$1,200,000
$1,000,000
$800,000
$600,000
$400,000
$200,000
$0
1972
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Portfolio Rebalanced
S&P 500
Portfolio w/o Rebalancing

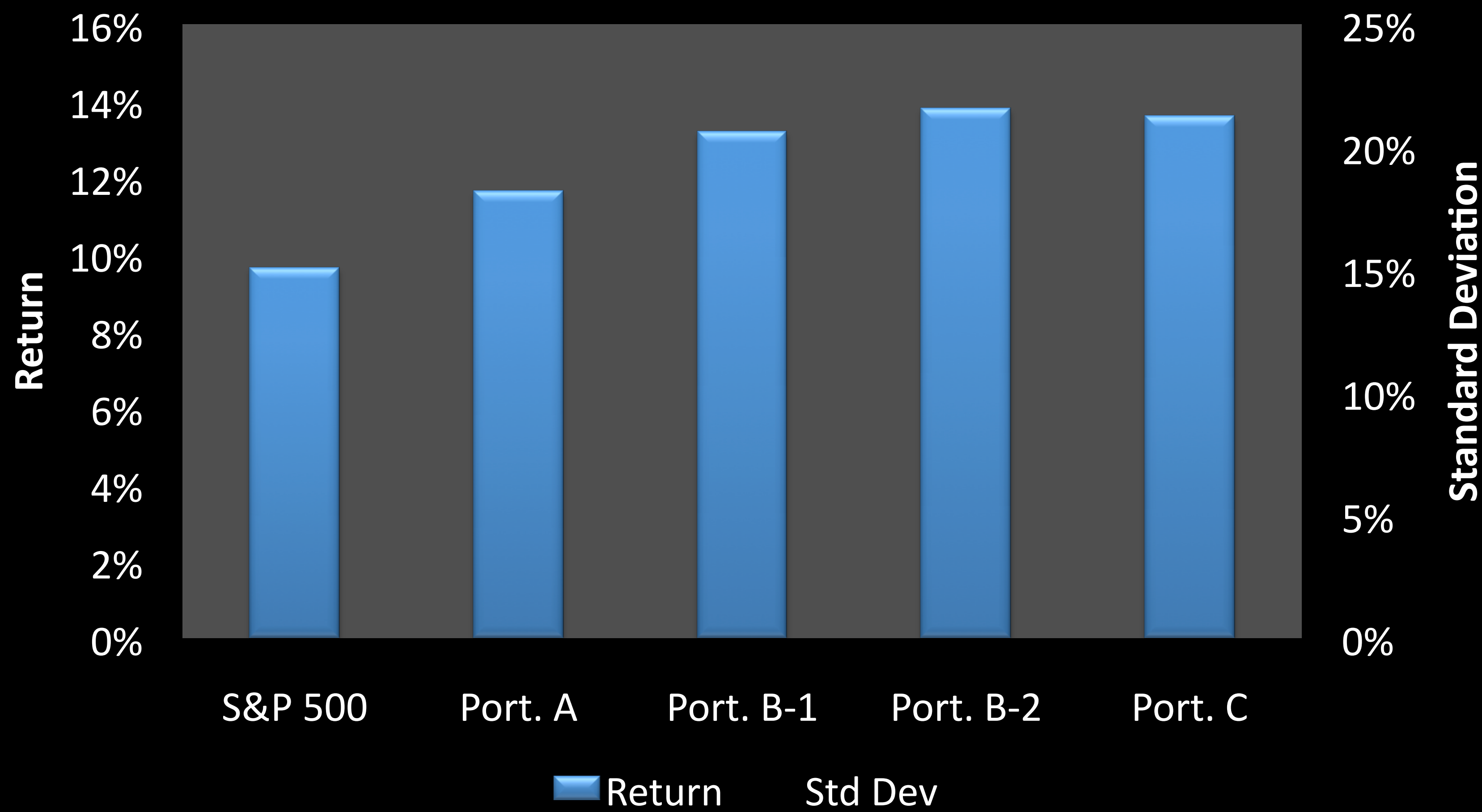
SUMMARIZING RISK AND RETURN

Portfolio Returns from 1972-2009

	S&P 500	Portfolio A 25% each: LCB, LCV, SCV, SCB	Portfolio B-1 12.5% each: LCB, LCV, SCV, SCB 25% each: Intl Dev Mkt, Intl Em Mkt	Portfolio B-2 12.5% each: LCB, LCV, SCV, SCB 25% each: Intl Value, Intl Em Mkt	Portfolio C 10% each: LCB, LCV, SCV, SCB 20% each: Intl Value, Intl Em Mkt 10% each: REIT, Comm
Standard Deviation	18.51%	18.97%	20.30%	20.33%	18.01%
CAGR	9.65%	11.65%	13.20%	13.81%	13.61%
$10,000 becomes	$331,138	$657,781	$1,111,422	$1,364,792	$1,275,004

Asset Allocation Increases Return and Reduces Risk

Return and Risk (1972-2009)

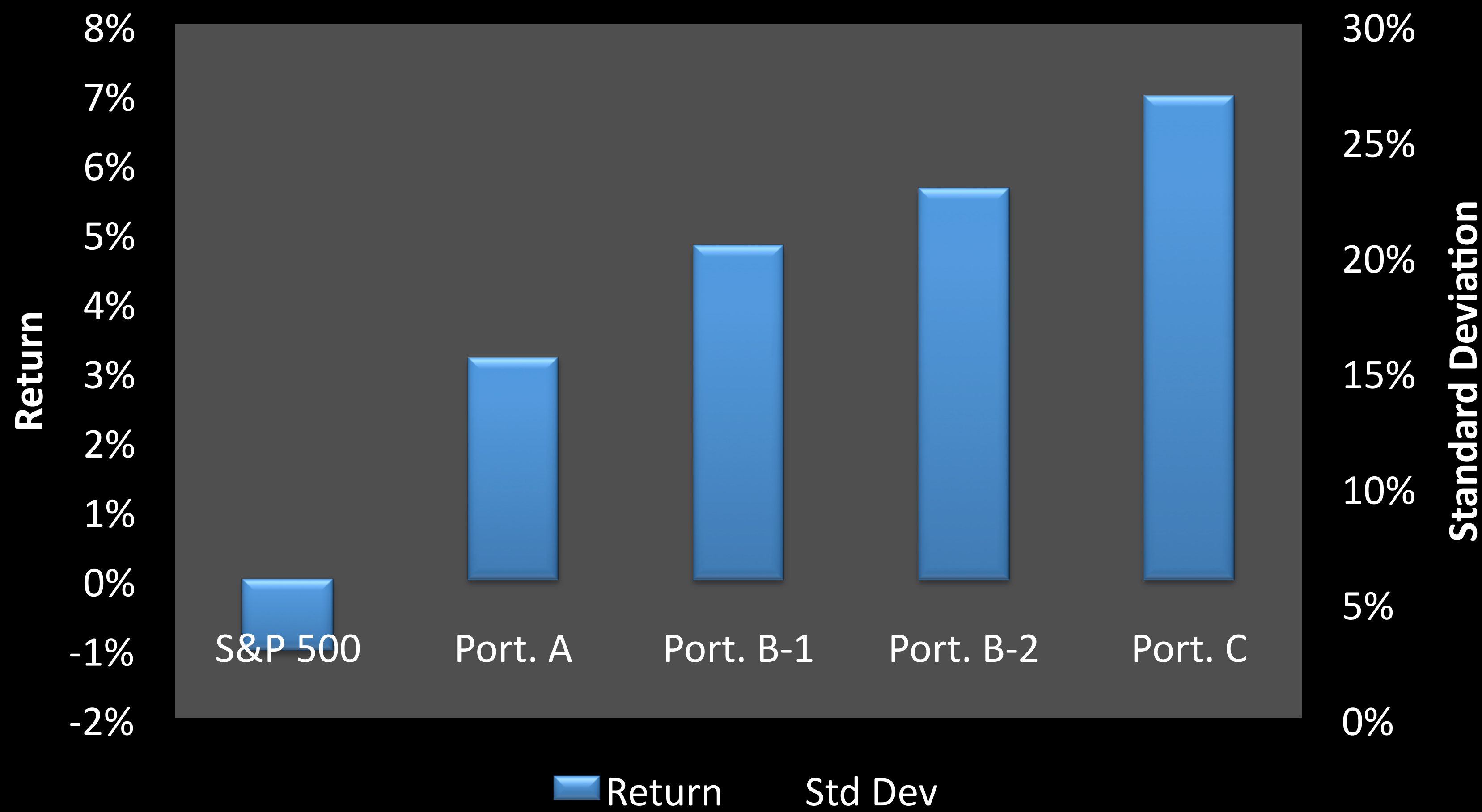


Portfolio Returns from 2000-2009

	S&P 500	Portfolio A 25% each: LCB, LCV, SCV, SCB	Portfolio B-1 12.5% each: LCB, LCV, SCV, SCB 25% each: Intl Dev Mkt Intl Em Mkt	Portfolio B-2 12.5% each: LCB, LCV, SCV, SCB 25% each: Intl Value Intl Em Mkt	Portfolio C 10% each: LCB, LCV, SCV, SCB 20% each: Intl Value Intl Em Mkt 10% each: REIT, Comm
Standard Deviation	21.08%	21.35%	26.03%	26.10%	24.39%
CAGR	-1.03%	3.19%	4.81%	5.63%	6.97%
$10,000 becomes	$9,016	$13,689	$16,001	$17,290	$19,622

Asset allocation is only the "free lunch" in investing

Return and Risk (2000-2009)



USING BONDS TO REDUCE RISK

Bonds as an Asset Class

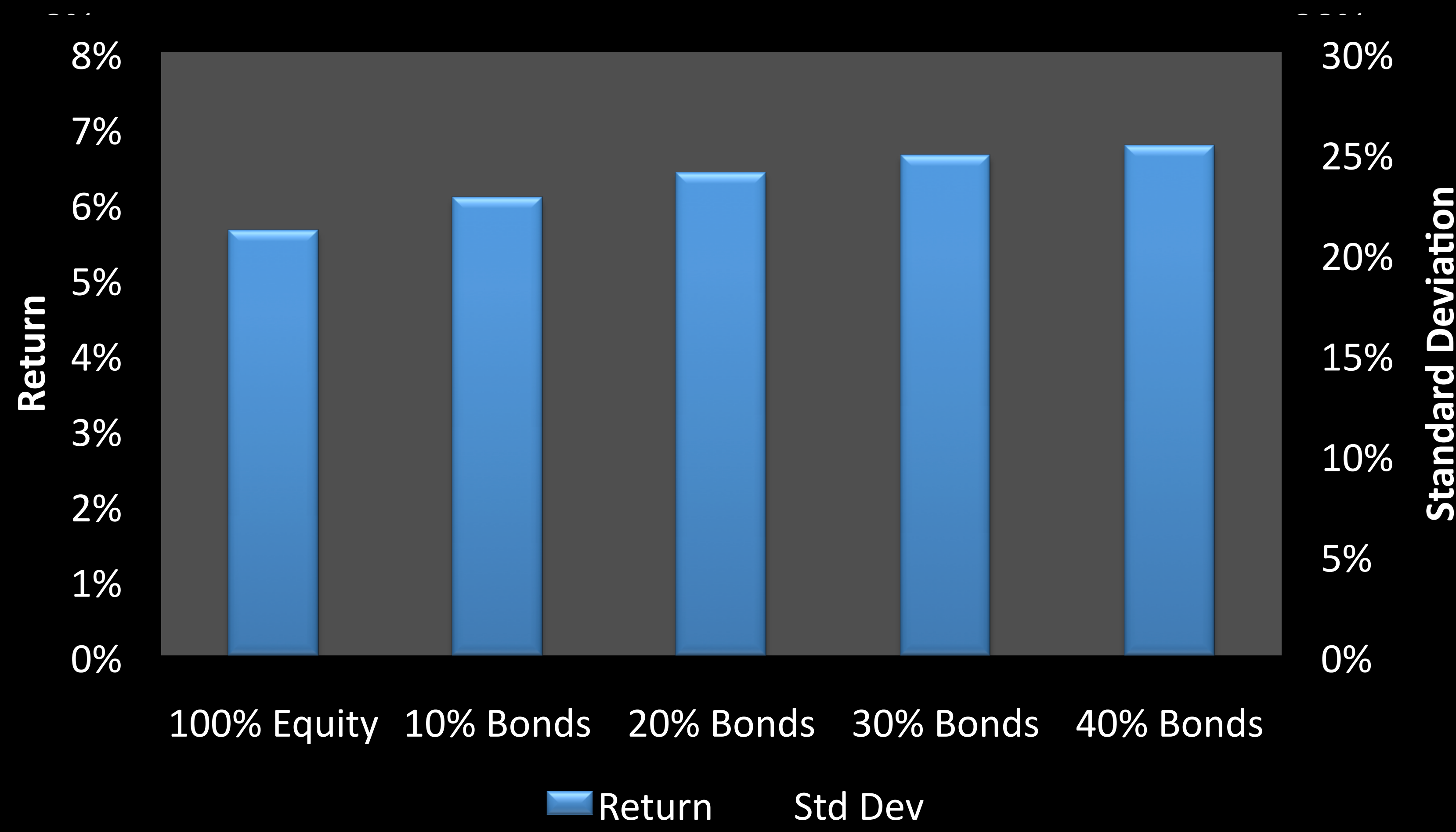
- Return on bonds from 1972-2009
  - 5 yr T-Bills 7.89%
  - 2 yr treasuries 7.36%
  - Total bond index 7.78%
- Return on bonds from 2000-2009
  - 5 yr T-Bills 6.72%
  - 2 yr treasuries 4.92%
  - Total bond index 6.06%

Adding Fixed Income Assets

- 10% - 40% depending on your risk profile
- Reduces portfolio volatility
- Slightly lowers return
- Should focus on short and intermediate terms bonds or money market funds
- Bond funds vs. bond ladders
- Watch bond fund expenses very carefully as you can't make them up in performance

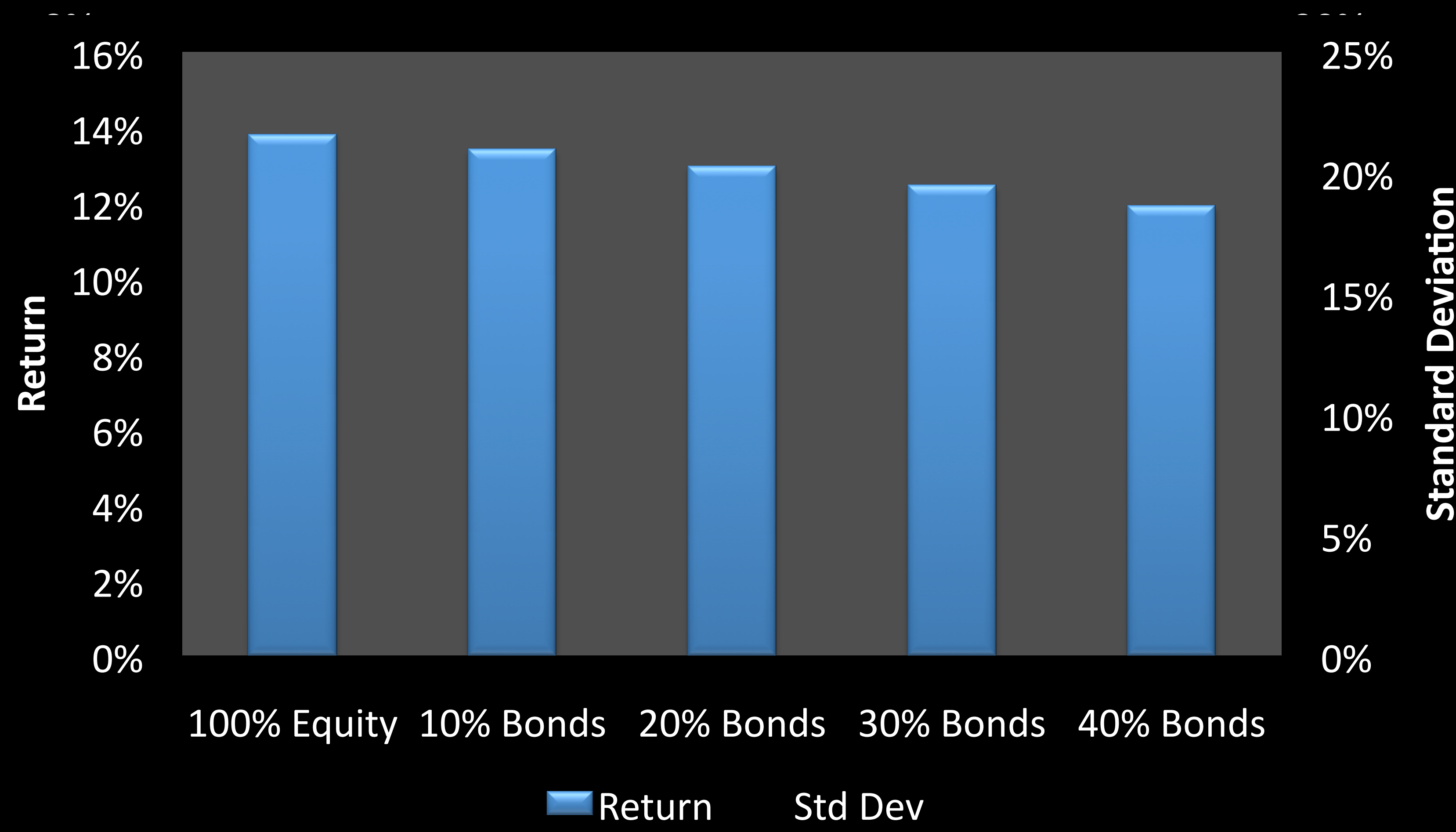
Adding Bonds (2000-2009)

Equally weighted US and Int'l Equities (Portfolio B-2)



Adding Bonds (1972-2009)

Equally weighted US and Int'l Equities (Portfolio B-2)



BUILDING A CORE PORTFOLIO

Creating an Index Fund / ETF Portfolio

- Decide on overall asset allocations
- Determine your personal risk profile
  - Used fixed income assets to reduce risk
- If you own stocks or mutual funds decide whether to replace them or include them
  - Morningstar x-ray will break down the asset classes in your mutual funds
  - Asset class for stocks are easily to find
- Implement portfolio at one time

Other Considerations

- Most index funds have a minimum, e.g., $3,000
- Expenses for ETFs are generally a few basis points lower than index funds
- Vanguard and Schwab do not charge brokerage fees for their ETFs

Model Portfolios

Index Fund / ETF	Ticker	Port A	Port B-1	Port B-2	Port C
Large Cap Value – LCV	VIVAX / VTV	25%	12.5%	12.5%	10%
Large Cap Blend – LCB	VFINX / VV	25%	12.5%	12.5%	10%
Large Cap Growth - LCG	VIGRX / VUG				
Mid-Cap Blend - MCB	VIMSX / VO				
Small Cap Value - SCV	VISVX / VBR	25%	12.5%	12.5%	10%
Small Cap Blend - SCB	NAESX / VB	25%	12.5%	12.5%	10%
Small Cap Growth - SCG	VISGX / VBK				
Micro Cap	BRSIX / PZI				
REIT	VGSIX / VNQ				10%
Int'l Developed – EAFE	VDMIX / VEU		25%		
Int'l Value	VTRIX			25%	20%
Emerging Mkt - EM	VEIEX / VWO		25%	25%	20%
Commodities	PCRIX / VAW				10%

Rebalancing Your portfolio

- Frequent rebalancing is not necessary
  - Once a year is probably enough
  - Watch out for short term capital gains
- Rebalancing helps you to sell high and buy low
- Stay with your asset allocation unless you have a good reason to change it
- Never chase returns with your asset allocation
  - Last year's winner is likely to be next year's loser (look at any of the tables of periodic returns)

Resources

- Books
  - The Little Book of Common Sense Investing by John C. Bogle
  - A Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing, 9th Ed. by Burton G. Malkiel
  - The Four Pillars of Investing: Lessons for Building a Winning Portfolio by William J. Bernstein
- Spreadsheet
  - Backtesting Spreadsheet from one of the members of the Vanguard Diehards Forum that will back test combinations of index funds from 1972-2009.
- Websites
  - FundAdvice.com - Website for Paul Merriam
  - Bogle Financial Markets Research Center
  - John Bogle's Blog
  - Seeking Alpha - ETF Section
  - Vanguard Diehard's Forum
  - Weekly Podcast by Paul Merriman

Summary

- Risk and return move inversely
- You can increase portfolio return without increasing risk with multiple asset classes
- You can decrease overall portfolio risk by adding a fixed income component
  - Depends upon your risk profile and when you need to have the funds available
  - Fixed income assets range from 10% - 40%

BACKUP

INDEX FUNDS AND INDEX-BASED ETFS IN RETIREMENT PLANS

What about Life Funds

- Asset mix varies greatly among offerings
- Be sure that the fund does not double up on expenses
- You can get a more precise risk allocation by doing selecting the asset classes yourself
- If you don't want to rebalance your portfolio periodically, then life funds may be for you – just understand what you are getting

Using Index Funds in 401(k) Plan

- What if my 401(k) does not offer index funds or index-based ETFs?
  - Make noise and complain!
  - Many offered funds have high expenses
- Use mutual finds if you have no alternative
  - Look for lowest cost funds that most closely follow major indices
- Look at 401(k) and non-retirement holdings together to build a portfolio
- Pay attention to overall asset allocation and taxes

Federal Thrift Savings Plan (TSP)

- Has lowest index fund expense ratio on the planet
- You can build a well diversified portfolio with only three holdings:
  - C Fund (large cap, S&P 500) ≈ SPY or IVV
  - S Fund (small cap, DJW 4500) ≈ VXF
  - I Fund (Int'l, MSCI Europe, Australasia, Far East) ≈ EFA
- You can use the fixed income funds to adjust risk:
  - G Fund (short term government backed securities)

Model TSP Allocations

- Aggressive (100% equities)
  - 30% C Fund (large cap blend)
  - 30% S Fund (small cap blend)
  - 40% I Fund (international)
- Conservative (70% / 30% equities/fixed income)
  - 21% C Fund (large cap blend)
  - 21% S Fund (small cap blend)
  - 28% I Fund (international)
  - 30% G Fund (government backed securities)