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ETF TUNE-UP

The middle of the year is a good time to re-evaluate ETF portfolios and do fine-tuning.

By Marla Brill

While major portfolio reviews often take place after Thanksgiving, the middle of the year is also a good time to step back, take stock and do some portfolio fine-tuning. A few moves to consider:

Prepare for a capital gains tax increase. Since ETFs are tax-efficient and often held in taxable accounts, tax issues come to the forefront, particularly now that we've had more than a year of record gains for the stock market.

If your losses from previous years are not big enough to offset the outsized unrealized gains, consider selling ETFs that have appreciated substantially to take advantage of today's low long-term capital gains rates. While investors have until the end of the year to make the decision, midyear is also a good time to make some adjustments if a position has shot up quickly and looks due for a pullback.

In 2010, the long-term capital gains rate for stocks is 0% for taxpayers in the 15% bracket or below, and 15% for taxpayers above that bracket. Beginning in 2011, the Bush-era tax cuts will expire, and the rates will revert to those levels in effect before 2001. Unless Congress saves the tax cuts, which appears unlikely amid huge budget deficits, the tax rate on long-term capital gains will increase to 20%—a 33% hike over current levels.

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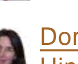

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With a $50,000 realized long-term gain, an investor could save $2,500 by selling this year instead of in 2011. It's OK to sell an ETF and buy the same one back if you want to record the gain now but maintain a position. Wash-sale rules keep investors from buying mostly identical securities within 30 days before or after a sale, but that applies to losses and not capital gains.

The decision to realize capital gains isn't clear cut, since the amount paid in taxes is no longer available to grow tax-deferred until the sale. But it can be a good move for people with shorter time horizons, such as those planning to sell appreciated securities within the next year or two to supplement retirement income or rebalance a portfolio.

Keep dividend-payers on a short leash. While dividends have historically been a big component of stock returns, the near-term outlook for them is cloudy. Last year, dividends paid on the S&P 500 index fell 21%, the biggest drop since 1938. S&P senior index analyst Howard Silverblatt doesn't see the dollar amount of dividend payments in the market rising to 2008 levels again until 2012.

Next year, dividend-paying stocks and ETFs face a new headwind in the form of higher taxes. For the last several years, qualified dividends, including dividend income generated by equity ETFs, were, like long-term capital gains, taxed at 0% for taxpayers in the 15% bracket and 15% for those above. With those low rates, it made sense to own high-dividend paying ETFs, even in taxable accounts. Unless Congress acts, dividends will be taxed at ordinary income rates as high as 39.6% starting in 2011.

While it's difficult to predict what the impact will be once tax rates increase, Westlake Village, Calif., financial advisor and CPA Mitch Freedman is already planning an exit strategy for high-dividend securities and ETFs held in taxable accounts. "Next year, the benefit of owning dividend-paying stocks in taxable accounts will be greatly diminished," he says. "Taxes are one of the biggest drains on investment returns, and once you remove a great tax break that's been in effect for several years, investors are going to take notice."

Test-drive some lesser-known indexes. The largest and most popular ETFs follow well-known, established indexes such as the Standard & Poor's 500 or Nasdaq. It might be surprising to investors that ETFs following newer or less-well-known indexes, however, have been beating their higher-profile cousins, and some managers see opportunity in them.

Jack Reutemann Jr. of Research Financial Strategies in Rockville, Md., for example, avoids market-cap-weighted ETFs that follow the S&P 500 index because he says they have a strong large-cap bias and are swayed by the returns of the 100 largest companies. "Large companies have thinner profit margins than smaller ones, their products are mature, and they are overbought by the mutual funds," he says. "And historically, their stocks have not performed as well as mid-caps and small caps."

Instead, to spread investments more evenly, he uses the Rydex S&P Equal Weight

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The Sea Change In Generational Wealth

Over the past decade, two of the major historical constants on long-term planning—the temporal limitations of the trust form as dictated by the Rule Against Perpetuities, and the inability of a trust settlor to avail him- or herself of spendthrift protection—have been undone in a growing number of jurisdictions.

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fund (RSP), an equal-weighted version of the S&P 500, as a core position. Over the five years that ended in the first quarter of this year, this equal-weighted index was up an annualized 4.37% while its market-cap-weighted S&P 500 cousin rose only 1.92%. For the year, the equal-weight index fund was up 75%, while the market-cap-weighted fund rose only 50%.

Advisors might also use less-well-known indexes to emphasize particular areas of the market. Paul Frank, manager of the $60 million ETF Market Opportunity Fund, has been migrating from large caps into mid-caps because he believes the latter may be acquisition targets for larger, cash-rich companies looking to expand. He implements this strategy using the MidCap SPDR Trust fund (MDY) and the Revenue Shares Mid Cap fund (RWK).

Harry Clark, president of Clark Capital Management in Philadelphia, believes that with the economy in expansion mode, small and mid-cap stocks will outperform large caps through the end of the year. To emphasize the value side, which he says is showing better relative strength than growth, he uses the iShares Russell Mid-Cap Value ETF (IWS) and the iShares Russell 2000 Value Index ETF (IWN).

Add to cyclical holdings. Standard & Poor's equity investment strategist Alec Young sees a number of signs pointing to a continued economic recovery rather than a double-dip recession. "The global yield curve is steeply sloped, and historically that has been a predictor of stronger economic growth ahead," he says. "While housing and employment numbers are improving slowly, the stock market seizes on direction, not absolute levels. And rapid growth in China is offsetting slow growth in Europe." Any market pullbacks during the year should be viewed as a buying opportunity rather than a longer-term sign of things to come, he adds.

With a recovery scenario in mind, Young recommends lightening up on ETFs in more defensive sectors such as utilities, telecommunications and consumer staples. On the other hand, he believes cyclical industrials will do well as the economy improves. He also favors information technology companies because they are cash-rich and stand to benefit from pent-up demand for system upgrades. Tech stocks are also selling at a slightly higher premium to the overall market, he says, yet have much better prospects for earnings growth. ETFs that focus exclusively on technology include the iShares Dow Jones U.S. Technology fund (IYW), the Technology Select Sector SPDR fund (XLK) and the iShares S&P North American Technology fund (IGM).

Look for continued weakness in Europe. For most of last year, the dollar weakened against the euro, boosting returns from overseas markets in Europe. But more recently a strengthening dollar, along with the flailing economies in Greece and other southern European countries, has sucked some of the wind out of European markets. Thus, the MSCI EAFE index has trailed domestic market performance since the fourth quarter of last year, mirroring the lag in all developed international markets. The further stabilization of the dollar, along with weak economic growth, points to persistent headwinds in Europe this year.

Emerging markets are a different story, Young argues. Even though stock markets

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in China have lagged the U.S. so far this year, that economy and others in the emerging space continue to see solid growth. Young recommends investors seek diversified ETFs following broad emerging market indexes rather than one of the numerous single-country opportunities and frontier offerings popping up in recent years. “Returns are all over the board in emerging market countries, and if you don’t pick the right box to land on, it’s easy to get burned,” he says. Popular broad-based emerging market ETFs include the iShares MSCI Emerging Markets Index Fund (EEM), the PowerShares FTSE RAFI Emerging Markets Portfolio (PXH), the SPDR S&P Emerging Markets ETF (GMM), and the Vanguard Emerging Markets ETF (VWO).

Protect against rising interest rates. While the Fed continues to rein in short-term rates, many believe the bellwether 10-year Treasury bond’s rate rise to 4% in April could portend increases at the shorter end of the yield curve. Currently, the fed futures markets say there’s a 75% chance the Fed will raise the short-term fed funds rate by November 2010.

In this kind of environment, stocks tend to do better than bonds, observes Liz Ann Sonders, chief investment strategist at Charles Schwab. Six months after the first rate hike, she says, stocks usually trade flat before heading up again. In the six months before a rate hike, bond returns begin moving into negative territory. After the rate increase, bond prices consistently move downward.

With money market yields at well under one-half of 1%, it’s less compelling for investors to sit on the sidelines to avoid interest rate risk. One option is to move some money into shorter-term corporate bond ETFs, which were recently yielding about 2.5%.

Another strategy is to lighten up on ETFs that invest only in Treasurys and other government securities, which are very sensitive to interest rate fluctuations, and shift into funds with less interest rate sensitivity, such as those focusing on investment-grade corporate or high-yield bonds. Some money managers also recommend spreading bets with a “barbell strategy”—combining ETFs that invest in short-term fixed-income securities at one end with those that focus on longer-term investment grade or high-yield bonds at the other.

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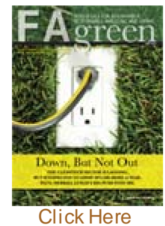

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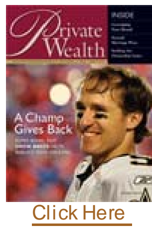

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