Part I

ETFS: A NEW WAY TO INVEST AND TRADE

Chapter 1

Taking an Active Approach with ETFs

In the last decade, exchange-traded funds (ETFs) have experienced strong growth, offering increased access to the market through a host of new products. With advantages such as transparency, liquidity, tax efficiency, and lower costs compared to other instruments, ETFs have become highly appealing to independent-minded investors. Whether you are a sophisticated investor who is well versed in ETFs or you are a novice who is just becoming familiar with these funds, there is a wider range of choices today to help you put your investment ideas to work for the short or long term without relying on a fund manager as an intermediary.

Although growth in the industry is positive, it's important for you to understand that not every new offering is appropriate for you to consider. The surge in ETFs has brought a number of new funds and issuers into the mix, hoping to catch the wave of investor demand. Not all the products that venture out, however, will make it. Some will founder without sufficient investor interest to remain afloat. To keep your portfolios from being dragged under by poorly performing

ETFs, you need to be particularly discerning as you pick the exposure you want and when you want it; whether to a broad-based index such as the S&P 500, an industry sector such as biotech or retail, or a particular country or geographic region such as emerging markets.

Given the ravages of the 2007–2008 bear market on 401(k) plans and other retirement accounts, the attributes of ETFs are more important than ever. Having suffered through the market downturn, you may be among the investors who are reluctant to hand over complete responsibility for their financial well-being. Tired of being told that investing is the realm of professionals and beyond the capacity of the average individual, you want the process to be demystified. The good news is, with ETFs you have greater ability to accomplish on your own what you may have once thought was impossible without the assistance of a broker and an incredible amount of financial knowledge.

The increased popularity of ETFs is evidenced by the numbers. According to the Financial Research Corporation, ETFs have grown at a rate of 35 percent compounded annually since 1999.[1] Barclays Global Investors, founder of the popular iShares funds, reported that total global ETF assets swelled to an all-time high of $857.5 billion at the end of the second quarter of 2009. The previous record of $796.7 billion was set in 2007. Asset growth increased by 34 percent in Europe, 35 percent in Latin America, and 39 percent in Asia (excluding Japan where ETF assets declined 7 percent), while the United States saw growth of 17 percent. Although the rate of increase in Europe, Asia, and Latin America outpaced that of the United States, it is likely that as international markets mature, they, too, will see their asset growth slow. The United States, with ETF assets of $582 billion in mid-2009, the highest level since December 2007, remains a stronghold of ETF investing.[2] What these numbers mean to you is that, as

[1]FRCNet.com, "Marketplace Underestimates the Threat Posed by Actively Managed ETFs, According to Latest Financial Research Corporation Study," Financial Research Corporation Press Release, April 13, 2009, http://www.frcnet.com/Press_Releases_07/Marketplace-Underestimates-the-Threat-Posed-by-Actively-Managed-ETFs.pdf.

[2]Cinthia Murphy, "U.S. ETF Growth Lags; Fund Costs Are a Bit Better," SeekingAlpha.com, September 21, 2009, http://seekingalpha.com/article/162606-u-s-etf-growth-lags-fund-costs-are-a-bit-better.

an ETF investor, you are in good company among growing ranks of retail and institutional participants, which will help ensure a healthy investment sector overall for the foreseeable future.

Understanding ETFs

Even if you are aware of ETFs, you may not understand how they are structured. Essentially, an ETF is an investment product that allows investors to buy and sell shares of a single security that represents a stake or part ownership in a portfolio of securities, such as an index. The defining features of ETFs are that they closely track an underlying index or portfolio and that trade throughout the day at market-determined prices. These attributes contrast distinctly with mutual funds, which are bought and sold only at the market close, and with closed-end funds that may trade at a premium or discount to the value of their underlying portfolios.

Not all ETFs are the same, however, and some do a better job than others of delivering on their investment promise. Too often investors do not get what they bargained for when it comes to their ETF choices. Therefore, you need to know how to identify ETFs that really do work, meaning there is a close relationship between the fund's price and its underlying portfolio, as reflected in its net asset value (NAV). The NAV is calculated based on the total assets of the fund, subtracting expenses and dividing by the number of shares outstanding. The price of most large, liquid funds does not deviate much from their NAV, although supply and demand can create some fluctuations during the trading day. With a thinly traded, specialized fund, the price can be a significant premium or discount to the NAV.

ETF issuers charge a management fee, which is deducted directly from the assets of the fund. Therefore, the investment return of the ETF could be lower than the underlying index. Investors also pay commissions and/or transaction costs to a brokerage firm when buying and selling ETFs, just as they would with a stock transaction. Because ETFs trade throughout the day, real-time prices for these instruments are available during trading hours, similar to any stock quote. Originally, ETFs were marketed mostly to institutional investors who used them to execute specific strategies, including hedging. Today, as retail activity has risen sharply, it is estimated that institutional players account for only about half the assets held in ETFs.

For discussion purposes, most people put the launch date for ETFs at 1993, the year that the SPDR S&P 500 (SPY), or "spider" as it is nicknamed, was launched by State Street Global Advisors. Although similar products existed in the United States and Canada prior to that date, the SPDR is considered to be the granddaddy of all ETFs; today it accounts for more than $69 billion in assets and remains the most liquid ETF in the world. The launch of the SPDR, which tracks the S&P 500, on the American Stock Exchange boosted the prominence of that exchange and gave it room to flourish. Since then, the Amex has merged with the New York Stock Exchange, and ETFs now trade on a sophisticated electronic platform, the NYSE Arca electronic exchange. Arguably, these two developments have improved the efficiency of ETFs, further helping them to achieve their number one objective: trading at or near their NAV.

This is an important concept for you to grasp as an investor. The determining factor of what makes an ETF successful is that it tracks its underlying portfolio—not whether the price of the fund goes up or down. Don't fall into the trap of buying an ETF simply because the price is rising. That fund may not be the best investment choice for you because it is illiquid and tends to trade at measurable premium or discount to its NAV.

Since the beginning, more than 700 ETFs have been introduced, providing exposure to a wide range of investment choices including broad stock indexes, industry sectors, fixed income, international, and global. In addition to funds that trade in the United States, ETFs have also been created to trade in international markets. Among the most popular ETFs are those that provide exposure to broad market indexes, such as the PowerShares QQQ Trust (QQQQ), which holds the component securities of the NASDAQ 100. In addition, there are sector funds that are very large in terms of assets such as the SPDR Gold Trust (GLD), which gives investors exposure to gold bullion. Several emerging market funds, such as iShares MSCI Emerging Markets (EEM), are also among the top 10 ETFs in terms of asset size. While broad indexes are still among the largest, increasing usage of funds such as GLD and EEM prove that investors are using ETFs to slice up and gain access to smaller parts of the market.

One of the fastest growing areas of the ETF industry is fixed income. This may reflect the needs of baby boomer investors who are seeking an income stream as they approach or enter retirement years. Increasingly, older baby boomers are forming a larger demographic of ETF investors.

There are also variations in how ETFs are constructed. The original ETFs that track familiar indexes such as the Dow Jones Industrial Average, S&P 500, and the Russell 2000 are weighted by capitalization. New ETFs have been launched that track indexes that are weighted differently, such as on the basis of revenue or dividends. Recent developments in weighting illustrate the fact that, whatever investment objective you are pursuing, there most likely is an ETF to match.

In short, ETFs are nothing short of revolutionary, particularly for individual investors looking to customize their market exposure. They are cost efficient in terms of fees charged and offer a high level of transparency to the specific stocks and industry sectors targeted by each fund. These attributes will drive continued growth in the popularity of ETFs among both institutional and retail investors, which will result in more new products and strategies being launched and more issuers entering the ETF arena. For you, as an individual investor, the array of choices can make for a lavish, but confusing, smorgasbord.

As you evaluate your choices, it is essential to remember that not all ETFs will attract sufficient interest to survive, no matter how enticing the investment objective or well known the issuer. Consider what has already happened during the past few years. Nearly 300 ETFs joined the market in 2007. The economic realities of 2008, however, revealed that the ETF industry had grown too large and too fast. In 2008, a total of 58 ETFs closed down, many due to poor investor interest. This compares with the first ETF closing, which happened in 2003, a decade after the first fund hit the market. As is still often the case, the first four funds to close were part of a series. Between 2003 and 2007, just one additional ETF closed its doors.

With the ETF market growing again, the same natural selection will come into play, weeding out the weakest and bolstering the strongest. You don't want to place your bets on ETF progeny headed toward extinction. Your aim should be to avoid low-volume funds while benefiting from new copycats that attract volume due to features like lower fees. If you can strike this balance, you will be well positioned to benefit from the growth in the ETF industry. The purpose of this book is to help you reach that objective.

Basic Tenets of ETF Investing

Whatever your investment preference—traditional, passive indexes or those that take a more customized approach—information is power. As a well-informed investor, you must be on the alert for emerging investment themes and sectors that appear well positioned to outperform. As you design a custom portfolio using specific ETFs that meet your objectives, there are certain basic tenets of ETF investing that must be heeded. Three of the most important are: appropriateness, liquidity, and concentration.

Appropriateness

As with all investments, the most important factor to consider before selecting an ETF is appropriateness. ETFs can be used to build core positions, as well as holdings that provide noncorrelated diversity to a portfolio. It is one thing to try to spice up your broad-based portfolio with exposure to a sector you believe will outperform, but it's something else entirely to add too much or to pick the wrong fund altogether. Some ETFs have an extremely narrow scope, which could pose far more risk than an investor is expecting. Choosing a narrowly defined fund on the belief that it will behave like a broader-based ETF would be like mistaking a bowl of jalapenos for spinach; they're both green vegetable products, but that's where the similarity ends.

Appropriateness requires you to think about what you are consuming as an investor. When judging appropriateness, investment objectives and time horizon are two important issues to consider. Are you using ETFs as a long-term investment in your retirement portfolio or are you being more opportunistic in the short term?

When it comes to ETFs, such as those offered by Direxion, Rydex, and ProShares, appropriateness is crucial. Some funds are intended to track their indexes on a daily basis and are not designed for long-term investors. If you decide to use leveraged ETFs—which offer double and triple exposure, short or long, to a particular index—you need to understand the risks involved.

Liquidity

Liquidity is a good measure of investor interest in an ETF product. You can find average daily trading volume numbers on major financial web sites such as Yahoo! Finance. Because ETFs trade in the open market and are affected by forces such as supply and demand, ETFs with higher trading volume tend to be priced closest to what they are actually worth. ETFs such as SPDR (SPY) and Financial Select SPDRs (XLF) see millions of shares trade hands every day. These ETFs are particularly easy to buy and sell, and tend to trade close to their NAVs.

ETFs have two types of liquidity: primary and secondary. Primary liquidity involves the actual liquidity of the fund's underlying basket of securities. In other words, does the fund hold stocks such as Apple and Microsoft that trade millions of shares every day, or does it hold small-cap stocks that are listed on an exchange in Russia? ETFs that have more liquid components would be expected to trade closer to their NAV than funds that have less liquid components.

Secondary liquidity reflects demand for the ETF itself. Are people interested in a particular ETF, or is there a better, more cost-effective alternative? ETFs that can't drum up much volume will tend to trade at a noticeable premium or discount to their NAVs. This secondary effect can also make an impact when a certain sector suddenly gets hot and investors rush into a particular set of ETF products. When the trading volume is increased and there are many more buyers and sellers, you will have more access to liquidity than when that sector is quiet.

Concentration

The third basic tenet of ETF investing is concentration. You must consider two types of concentration risk when adding to your portfolios: product concentration and portfolio concentration. Product concentration refers to dominance of one or a few stocks in an ETF.

If a single stock accounts for 15 percent, 20 percent, or more of an ETF's holdings, that one issue can have a great impact on the success or failure of the fund. If you are looking to mitigate security-specific risk, you should seek out more balanced ETF choices.

More important to consider is the effect that a concentrated ETF can have on your overall portfolio, that is, potentially magnify existing risks. If you already own Microsoft, then adding iShares Dow Jones U.S. Tech (IYW), which in October 2009 had an 11.9 percent allocation in Microsoft, will further accentuate your exposure to that company. Too much concentration can result from ETFs with significant, overlapping positions in a particular stock; for example, one ETF in which Google accounts for 10 percent of the holdings, and another ETF in which Google accounts for 15 percent. As you choose individual ETFs, keep the big picture in mind so as not to have an overconcentration of one issue or another. At all times, it is essential to keep sight of your objectives.

With an understanding of the three basic tenets of ETF investing, it's time to consider the first steps in choosing an ETF. The selection process begins with the description of an ETF's investment purpose, in other words, what the fund intends to do, whether to track a particular index, or to provide exposure to a particular basket of securities. If the investment purpose matches what you are seeking, then this may be a good ETF candidate for your portfolio. But the description only tells part of the story. Not paying attention to the details, such as sector exposure and concentration, would be like buying a house on the basis of the exterior. The façade may look nice, but the interior could be a disaster. In order for you to find a home for your investment dollars, you must consider much more than what the ETF says it will do.

Fund information that is available on most financial information web sites will reveal breakdowns of an ETF's holdings. What are the top securities in its portfolio and what percentage does each represent? What is the amount of concentration in any single stock? How does that impact other holdings in your portfolio? ETFs that track an index such as the Dow Jones Industrial Average have holdings that are spread across several sectors, such as technology, financial, industrials, and so forth. It is possible, however, that an ETF has a more concentrated exposure to a particular sector—whether energy, financial, technology, or another—than its name alone would apply. Unless you are aware of the sector components of each ETF you own, you could end up with a greater exposure to a particular industry than you would otherwise desire.

Other ETF data are also available at a glance; for example, the comparison between the NAV and the price. You would expect a broad-based index with excellent liquidity to have very little difference between its NAV and the price of the ETF. This is not always the case, however, especially with specialized ETFs that prove to be poorly constructed, fail to attract sufficient investor attention, or both.

Active Investing Approach

From funds that offer exposure to broad indexes to those that focus on a particular sector, ETFs are particularly well suited for investors who take an active approach. Before continuing our discussion, let us define what we mean by an active investor. For the purpose of this book, we are *not* defining an active investor on the basis of how many transactions a person makes every week or month. Nor do we mean to encourage a very short-term trading approach with positions that may last only a few days. Rather, we see active investing as encompassing a type of individual who wants to be actively involved in his or her investment decisions. Simply put, you are an active investor if you know what you want—and you are willing to do the necessary homework to target the specific opportunities you wish to pursue.

As an active investor, you are committed to building and managing your portfolio by researching market trends and sector opportunities. Even if you work with a professional advisor, you are continuously engaged, monitoring your portfolios, and ensuring that your investments remain reflective of your goals and objectives. Your mind-set as an active investor is to capture a market trend, seeking to be involved in particular industries and/or sectors as opportunities evolve.

To be an active investor requires that you become well informed—picking the right ETF, staying alert for a change in trend, and watching for the emergence of another opportunity. You know what is in your portfolio and pay special attention to concentration—meaning the overall exposure provided by specific ETFs, as well as the net effect of all ETFs, stocks, and other instruments working in concert. You are informed and empowered as you pursue your specific objectives according to your personal investment time horizons. With this involvement comes a high level of investor accountability. You must be willing to play the role of manager, overseeing portfolios of your own design.

Three Must-Know Types of ETFs

There are many ways that ETFs can pursue their overall goal of tracking their underlying portfolios. For example, an ETF can be made up of 100 different companies in the United States, or it could be made up of companies in other countries, or even hold derivatives. Before you become involved in trading ETFs, you should understand three basic categories of funds.

Domestically Traded Equity ETFs

The first group is domestically traded equity ETFs. All the components of these ETFs are stocks or American Depositary Receipts (ADRs) of foreign stocks that trade on U.S. exchanges. A domestically traded equity ETF and its basket of securities trade within the same regular market hours (9:30 A.M. to 4 P.M. Eastern Time). If there is sufficient investor interest, there will be no deviation between the fund price and the NAV. This group also tends to have lower risk because investments are easily hedgeable, a strategy that we will explore in Chapter 2. Their straightforward nature gives them a complexity rating of beginner—meaning they are fairly easily understood by investors who have some knowledge of ETFs.

Domestically traded equity-based ETFs boast different strategies to expose investors to various sectors or investment themes. A passive indexing strategy will rank all the stocks in a certain category by capitalization or another combination of criteria, and then allocate the fund's assets accordingly. Examples of this kind of ETF include the Financial Select Sector SPDR (XLF), which focuses on companies engaged in investment management and commercial and investment banking; iShares Russell 2000 Index (IWM), which tracks the Russell 2000; and Market Vectors Gold Miners ETF (GDX), which replicates the performance of the NYSE's Arca Gold Miners Index of gold-mining stocks. Even an international-theme ETF that uses domestically traded ADRs—such as PowerShares Golden Dragon Halter USX China Portfolio (PGJ), which is composed of U.S-listed securities of companies that derive a majority of their revenue from the People's Republic of China—is included in this category. If the underlying equity securities trade on U.S. markets, the ETF earns the label of domestically traded equity ETF.

International Equity ETFs

The second group is international equity ETFs, which are a step up on the complexity rating at intermediate to sophisticated. Examples of international equity ETFs include: iShares MSCI Emerging Markets Index (EEM), which invests in companies located in countries such as Brazil, South Korea, Taiwan, China, South Africa, and India, among others; iShares FTSE/Xinhua China 25 Index (FXI), which tracks an index of Chinese companies; and iShares MSCI Germany Index (EWG), which is composed of publicly traded securities in the German market.

As you would expect from the name, securities held by an international equity ETF are not listed on U.S. exchanges. This is an important point to understand. For example, while the ETF itself trades in the United States, the stocks in its underlying basket may be listed on exchanges half the world and numerous time zones away. The discrepancies can cause disconnect between the ETF market price and the underlying fund value. Once the foreign markets where its component securities are closed, the ETF may trade in the United States based on currency movements, what the Dow is doing, or any other number of factors. As a result, the price of the ETF may stray from its NAV, and possibly quite significantly, which often makes it impossible to immediately hedge investments in these funds.

Although many international equity ETFs are large and liquid, as an investor you need to be aware of the complexities of foreign investments, which can be affected by many factors including currency valuations. International funds may also be impacted by restrictions that result when countries put limitations on foreign investors. For example, Brazil recently imposed a transaction fee on security transactions. While most international equity funds take into account such limitations, you should be watchful for potential unexpected risk that can hit foreign securities, such as in an emerging market. A political situation could quickly put a particular country out of favor for investment. If you hold shares in an ETF that concentrates on that country, when you want to sell your shares you may have to accept a sharply discounted price. Another factor is that many international markets tend to be small, which makes liquidity an issue and affects the pricing of the ETF.

A further consideration with an international cap-weighted ETF is that the top holding could account for a sizeable portion of the portfolio because that particular company accounts for a significant part of the country's overall equity market. Individual country funds may also be very concentrated in terms of sectors because one or a few industries, such as energy or mining, account for most of the country's economy. Keep in mind our main criterion for an ETF: A fund that works is one that tracks its underlying value. If a structural issue with an international fund—such as being narrowly focused or overly weighted toward one equity—causes a discrepancy between the price and the NAV, then that ETF does not work.

Derivative-Based ETFs

The third group of ETFs does not track equities; rather, these funds trade based on a portfolio of derivatives to gain exposure to commodities, currencies, or leveraged strategies. These ETFs are composed of baskets of futures contracts and swaps. The investment objective of these ETFs is to reflect the change in percentage of the spot price of the futures contracts and/or the price of swaps that make up the basket. Because futures and swaps are complex and involve speculation, these ETFs are not for everyone. You should not trade ETFs that hold derivatives unless you understand what you are getting into and the inherent risks involved.

Examples of these types of funds are United States Natural Gas (UNG), which aims to track in percentage terms movements in natural gas prices; United States Oil (USO), which reflects the changes in percentage terms of the spot price of U.S. light sweet crude oil; Direxion Daily Financial Bull 3X Shares (FAS), which seeks to deliver 300 percent of the price performance of the Russell 1000 Financial Services Index using futures and swaps to enhance the trend of the index; and Direxion Daily Financial Bear 3X Shares (FAZ), which has an objective of delivering 300 percent of the inverse (or opposite) of the price performance of the Russell 1000 Financial Services Index and uses futures to replicate a 300 percent short position.

Because these funds are priced off derivatives instead of equities, they are subject to added levels of complexity and risk. Traditionally, derivatives such as futures contracts have been used by producers, whether a wheat farmer or an oil company, to hedge. Speculators have always been part of the derivatives market and contribute to liquidity. Now, however, regulators want to crack down on speculators, as we will discuss in detail later in the book.

These three categories of ETFs illustrate that not all funds are the same. As an investor, you need to know the implications of different types of funds and whether they pose appropriate or excessive risk. In addition, new types of funds are also being introduced. Examples include fixed income, actively managed, and target date ETFs. Target date funds (also known as life-cycle or age-based funds) adjust the ratio between equities and fixed income as a person approaches retirement (the target date). With baby-boomer investors in mind, ETF issuers are launching products such as target date ETFs in hopes of drawing interest from mutual funds. As these types of funds grow in number and popularity, you will gain an advantage by having an understanding of the particular ways in which these funds differ from other types of ETFs.

Expansion in the ETF industry will bring more issuers into the action, which can benefit investors. As more firms join the marketplace, fees will be driven lower. We've already seen proprietary ETFs launched by large financial firms such as Schwab, Vanguard, State

Street, and Fidelity, which in the past have been more closely associated with mutual funds. The aim is to develop a "sticky" customer base that will use the firm for ETFs, mutual funds, financial transactions, and other products. Schwab, for example, recently announced ETFs with no transaction fees for its customers.

No matter what type of ETF you are interested in buying, you must be discerning and not get distracted by a brand name. Becoming more responsible for your investment choices requires you to determine which ETFs are most likely to deliver on their main premise as stated previously: closely tracking an underlying index or portfolio.

The ETF Investor

There is no typical ETF investor. People who use ETFs range in age and have a variety of investment objectives. You can use ETFs to make up for losses in retirement portfolios, or you can trade ETFs in order to pursue greater financial freedom. Your portfolio can be built using funds that track broad indexes, and/or you can focus on sectors that you believe will yield short-term, aggressive growth.

ETFs can be used to realize virtually any investment objective. For example, one client at Dion Money Management has used ETFs to construct a portfolio that meets his number one objective: simplicity at tax time. This objective has governed all his investment decisions, more so than seeking a particular return or trying to opportunistically position himself in industries or market sectors. Over the long term, his return, factoring in dividends, has been consistent with the S&P and Dow.

Granted, not every investor looks to create a portfolio purely on the basis of simplicity at tax time. However, it is a unique example of structuring a portfolio to meet one's individual needs. Other Dion Money Management clients use ETFs for growth, income, capital preservation, and other investment goals, as you will read about throughout the book. Some investors are most interested in broad market exposure using index ETFs, while others may be attracted to ETFs that boast a particular strategy, such as the Vanguard Value ETF

(VTV), which tracks the performance of large-cap value stocks and sounds like a traditional mutual fund.

Others want a high-touch strategy with very narrowly themed ETFs in a customized portfolio. There are also hybrid strategies that combine the two, with a core portfolio that will not change dramatically over time and smaller satellite positions that investors can use to target changes in the marketplace on a shorter time horizon. (And for those investors who do trade ETFs, the tax efficiency of these funds is a positive attribute.) The point is whatever your objective—whether taking a conservative, long-term approach or being more aggressive with short-term moves that target specific sectors—ETFs are the best tools to use.

Portfolio Approach

Investors today are more conscious than ever of wanting and needing an investment approach that is cheaper and more transparent, which adds to the appeal of ETFs. Rather than pay commissions to construct a portfolio stock-by-stock (an exceedingly difficult endeavor, as will be explained in a moment), you can gain exposure to investment themes of your choice through ETFs. More important, there is no need to be a certain-sized investor. Using ETFs you could conceivably gain access to, say, the S&P 500, NASDAQ 100, or a sector such as a biotechnology with as little as one share.

As an active investor, you can use ETFs to gain exposure to a particular sector or market segment without engaging in stock picking. A difficult endeavor even for professionals, consistent stock picking is virtually impossible for the average investor. Even if you successfully identify the overall market trend and you pick the sector that is poised to grow, you can still end up in the wrong stock. A particular issue may be the laggard in its sector for any number of reasons. There are numerous intangibles that can hit a particular stock. A perfect example was the speculation surrounding Apple CEO Steve Jobs, who was noticeably absent from the public eye in early 2009, which fueled rumors about his health as well as corporate succession issues (not to mention the outlook for innovation) at Apple. These concerns sent shockwaves through Apple's share price until Jobs, who had received a liver transplant, returned to the company.

There is another reason why stock picking is often a losing endeavor for so many individual investors. Often by the time investors hear about a hot stock, particularly in the media, that security has already staged a considerable move. A stock that has moved up by a double- or triple-digit percentage may not have much more room to move to the upside. If you buy a stock at that point, you face the very real possibility of being the latecomer who ends up buying at or near the top. This phenomenon is the source of a rule of thumb among professional traders: Look for the odd lots in popular stocks. To explain, stocks typically trade in round numbers in the hundreds or thousands. However, when an odd number of shares such as 201 or 324 trades frequently, that is evidence that individual investors are getting more involved in the stock. Usually, that is a negative indication in the eyes of professional traders that a stock's trend is about to switch to the downside.

The lesson here, which bears repeating, is that your focus as an investor should be on ETFs that will provide exposure to a particular index, industry, or sector—not on finding a stock that you hope will become the next Google.

Conclusion: The Discerning, Active Investor

The dawn of the ETF industry brought transparent, passive indexing strategies that were designed to give investors access to specific sectors at lower fees than mutual funds. As the ETF trend caught on, issuers rapidly expanded their product lines, including with funds that were more specific and narrowly focused. Today, issuers are more conscious than ever of the role that ETFs can play for the larger investor community. As a new swell of ETFs hits the market, pressure is on you, as an investor, to understand what you are getting into and the impact your choices will have on your portfolios.

The proliferation of offerings could make things more difficult as you must now engage in comparison shopping on everything from concentration of holdings to how funds are weighted. The plus side of this process is that fees will become even more reasonable as larger firms compete. You need to be discerning. While ETFs allow access to increasingly exotic strategies, it will be up to you to ask yourself if you should be there in the first place. No matter how broad-based or narrowly focused the ETF, the main factors to consider will be appropriateness, liquidity, and concentration. Whether you want to build a portfolio of longer-term holdings or to trade shorter-term positions to take advantage of an opportunity, the main criterion is to find ETFs that work.

Just because you could make a particular type of investment doesn't mean that you should. There are two sides to every trade, and when it comes to buying and selling ETFs, you need to make sure you have plenty of company. Without sufficient liquidity, there will likely be a significant difference between the price of an ETF and its NAV. Accomplishing your investment goals requires an active mindset. Commit to becoming more empowered and informed to make the decisions, at the right time and for the right reasons.