

Name of the game: diversify

Financial advisers are increasingly turning attention to benefits of ETFs

UNTIL RECENTLY, commodities were the hot story. Now, with economic growth expected to cool and interest rates topping out, defensive sectors, such as utilities and financial services, are in vogue.

Having investors in the right sector at the right time is one of the keys to generating market-beating returns, as anyone who rode the oil boom to riches last year can attest.

At the same time, financial advisers know that being diversified across sectors is important to generating consistent long-term returns for their clients.

"If you're not diversified, you'll catch a great upturn one time and a really bad downturn another time," says Dave Cooper, a certified financial planner with Tower Wealth Management/Generation Financial Corp. in Edmonton.

What's the best way to achieve a balance between growth and safety?

Mutual funds are one option, but their high management fees can erode long-term returns. Buying a basket of stocks is another option, but it's not always suitable if a client's portfolio is too small to offer adequate diversification.

Increasingly, financial advisers are turning their attention to exchange-traded funds, which combine the diversification of a mutual fund with the trading flexibility of a stock.

ETFs have the added benefits of low cost and tax efficiency.

"If someone is ... looking for instant diversification, it's a great way to go," Mr. Cooper says.

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Advisers can use ETFs several ways, depending on the goals of their clients.

Consider a client who wants exposure to the financial services industry. Rather than investing in a single bank or insurance stock, buying the iShares CDN Financial Sector Index Fund (XFN) provides instant exposure to 25 different companies, including all the major banks, insurers and publicly traded fund companies.

Other iShares sector ETFs target energy, materials, golds, technology, real estate investment trusts and income trusts.

Because ETFs are designed to track the performance of indexes whose components are published every day, the adviser and the client always know what stocks they're investing in.

That's not the case with mutual funds, which may only reveal their holdings every six months.

ETFs can also be used strategically, depending on a client's tolerance for risk. For aggressive portfolios, ETFs serve as a convenient tool for over-weighting industries whose prospects appear especially bright, while under-weighting those that are expected to struggle.

Or, for less aggressive investors, investments can be made across a breadth of ETFs or other investment instruments to help spread the risk.

Another approach for managing risk is the core/satellite strategy, in which ETFs form the "core" of a portfolio and seek benchmark performance, and complementary mutual funds, individual securities or separately managed accounts are the "satellites" that attempt to achieve outperformance.

"The core/satellite strategy is used by the largest, most sophisticated institutional investors to manage risk, and ETFs can provide advisers and individual investors with access to this same strategy," says Geri James, head of Canadian ETF products for Barclays Global Investors Canada Limited, which runs the iShares ETF family.

Compared to a portfolio of actively managed funds and individual securi-

ties, a core/satellite strategy can provide a more comfortable degree of risk by diversifying the core across a variety of asset classes, Ms. James says.

Sector ETFs have a couple of advantages, says David Phipps, a certified financial planner and senior financial adviser with Assante Capital Management Ltd. in Ottawa.

For one, ETFs have "style purity."

"If you pick an ETF that is to mirror a precious metals index, you can be confident that it does exactly that. This allows you to very accurately determine what economic sectors you are investing in, and make a conscious decision about your chosen level of diversification," he says.

A second advantage is that ETFs, by virtue of not being actively managed, have lower fees than sector mutual funds.

However, ETFs may not preserve capital as well as an actively managed sector fund in a down market. This is because the fund manager can move to cash, while an ETF cannot do that," he says.

One way to smooth the bumps, of course, is to make sure a portfolio is properly diversified.

John Campbell, a professor of applied economics at Harvard University, calls diversification the "free lunch" of investing, because it cuts volatility without sacrificing performance.

"Many investors appear to ignore this free meal," he says.

The principle behind diversification is straightforward.

By spreading money across a variety of investments, one reduces the impact that any single holding has on a portfolio's performance.

To maximize the benefits, advisers aim to diversify not just across and within industries, but also across asset classes, such as stocks, bonds and real estate, and by geographic regions, including North America, Asia and Europe.

In Canada, the stock market's recent ups and downs underline the importance of being adequately diversified across sectors.

Energy stocks posted outsized gains in 2005 and early 2006 as oil and natural gas prices soared.

But with energy prices coming back to earth, the stocks are struggling.

In the third quarter ended Sept. 30, the S&P/TSX energy index fell 10 per cent. Metals and mining stocks have also cooled off after racking up sizzling gains over the past couple of years as China gobbled up resources.

Now that the commodity boom is losing steam, what will be the next hot sector? With the economy poised to slow and central banks in Canada and the United States expected to lower interest rates in coming months, some investors are betting on defensive, dividend-paying stocks such as pipelines, telecoms and utilities.

Canadian banks are also seen as a safe place to ride out any coming volatility.

For the third quarter, the S&P/TSX financials index gained more than 8 per cent. Information technology and telecom stocks performed even better, up more than 20 per cent.

But while betting on sectors can pump up returns, it also increases risk.

"I think almost every planner would tell you, you're asking for a lot of volatility" by placing large bets on certain sectors, Mr. Cooper says.

"That's why going with a well-diversified portfolio ... and sticking with it is the way to go.

"I wouldn't recommend anybody go more than 10 to 20 per cent in a particular sector, 20 per cent being someone who is younger and aggressive."

Being adequately diversified is always important, but it's especially critical now, he added.

With the U.S. economy slowing and Canada expected to feel the effects of any downturn south of the border, "this is probably an opportune time to really look at your portfolio," he says.