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Mutual Funds

ETF portfolio powers past the market

This group of exchange-traded funds easily beat the S&P 500 in the third quarter thanks to strength in natural resources and emerging markets. The story should hold for the fourth quarter.

By Timothy Middleton

I had to eat crow last quarter when the market made a fool of me, but this quarter I gave those birds … well, I gave 'em hell.

My model portfolio of exchange-traded funds zipped up 4.9% in the third quarter, while the market barely managed a 0.5% gain. In the first nine months of 2005, the model grew to $121,826 from $115,998, a gain of about 5%. In the same period the **Standard & Poor's SPDRs** (SPY, news, msgs), which are indexed to the **Standard & Poor's 500 Index** ($INX), rose 0.3%.

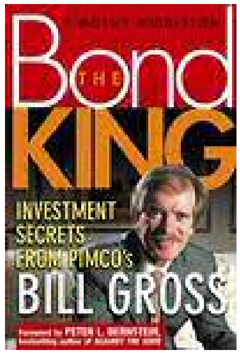
My biggest gains came from natural resources, which have been rallying for 18 months, and emerging markets, which began their climb a year before that. My biggest blunder was bulking up on bonds, which were slapped around by inflation fears.

But my fundamental bet last quarter, captured in the headline "The U.S. market looks good to me," was solid. Domestic stocks gathered virtually all of their gains of 2005 in the third quarter.

Growth gains

I also wagered that the growth style of investing was going to begin paying off for investors, and it did. The small-cap **iShares Russell 2000 Index Fund** (IWM, news, msgs) and the **Nasdaq 100 tracking stock** (QQQQ, news, msgs) each spurted about 3% in the quarter, six times the gain of the S&P 500.

(For publishing reasons all data, as well as all trades, are reported as of Sept. 21.)



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So for the quarter to come, I'm going to continue boosting my growth exposure. I'm cutting back **Dow Jones Select Dividend** (DVY, news, msgs), a big-cap defensive bet, in favor of a greater commitment to small caps and Nasdaq.

Here's how the portfolio ended the third quarter and is being refashioned for the fourth.

Middleton's ETF portfolio, third quarter 2005

Exchange-traded fund	3rd-qtr. performance	3rd-qtr. holdings	4th-qtr. holdings
Equities			
iShares DJ Select Dividend Fund (DVY, news, msgs)	1%	18%	10%
iShares GS Natural Resources fund (IGE, news, msgs)	16.2	11	11
iShares EAFE Index Fund (EFA, news, msgs)	7.9	11	15
iShares Russell 2000 Fund (IWM, news, msgs)	3.1	10	15
Nasdaq-100 Index tracking stock (QQQQ, news, msgs)	2.8	10	15
S&P SPDRs (SPY, news, msgs)	0.5	10	10
iShares Emerging Markets Index Fund (EEM, news, msgs)	13.9	6	6
Fixed income			
iShares Lehman Aggregate Bond Index Fund (AGG, news, msgs)	0.3	14	10
iShares Cohen & Steers Realty Majors Index Fund (ICF, news, msgs)	2.4	6	6
iShares Lehman 7-10 Yr Treasury Bond Fund (IEF, news, msgs)	- 0.3	5	0
Cash		$527	$3,732
Totals	4.9	$121,826	n/a

Notes: Data as of 9/21/2005. Totals do not add up due to rounding. n/a -- Not applicable.
Sources: Morningstar Inc., MSN Money

If Buffett can, I can

Warren Buffett endears himself to investors in **Berkshire Hathaway** (BRK.A, news, msgs) by readily admitting his mistakes. Here is mine: Last quarter, I added the **iShares Lehman 7-10 Year Treasury Bond Fund** (IEF, news, msgs), expecting interest rates to fall. Instead they rose. With the Federal

Reserve continuing to push them higher, I surrender: I'm selling out this position.

Short rates are approaching those for 10-year Treasury bonds, and that near-parity cannot stand for long since the risk of inflation is so much greater for the latter than the former. So I'll trim my stake in the **iShares Lehman Aggregate Fund** (AGG, news, msgs), which represents the total bond market, to 10%. Higher rates translate into lower bond prices.

Going on the offensive

On the equity side, I am sanguine about the market's prospects. Consensus earnings forecasts for the stocks in the S&P 500 surged to record highs two weeks ago. Hiking rates implicitly links the Federal Reserve to expectations of stronger economic growth.

The Conference Board's consumer confidence index is at a four-year high. Also, household net worth spurted 9.4% from one year earlier in the second quarter, to a record $49.8 trillion.

So I want my equity portfolio to be less defensive than it has been. I'm cutting **iShares Dow Jones Select Dividend** (DVY, news, msgs) to 10% of assets. This fund has done very well for me over the last 22 months, but I think growthier issues will do better in the future.

Not counting my natural resources fund (which I'll leave alone, expecting oil and commodity prices to remain strong), domestic big-cap stocks would account for 20% of total assets, and small caps and the Nasdaq 20% between them. I want more of those high-growth small-cap and technology stocks. So I'm raising my holdings in the iShares Russell 2000 Fund and the Nasdaq 100 tracking stock to 15% of assets each. That's up from less than 6% six months ago.

On the international front, I'll acknowledge another misstep. Last quarter, I slashed my holdings of the **iShares MSCI-EAFE Index Fund** (EFA, news, msgs), the broad benchmark of developed markets stocks.

But Japan and Europe have done surprisingly well (they surprised me, at least), and that momentum has room to carry on. I'm going to correct my mistake and boost this position to 15% of assets.

These changes leave 3.1% of assets unaccounted for. I'm going to hold them as cash. This puts my fixed-income component at 19% of assets. This is a moderately aggressive posture for this portfolio, where I would regard 25% to 35% in bonds as neutral.

While I usually compare my performance with that of the stock market -- since it makes me look good -- it's fairer to compare it with the **Vanguard Balanced Index Fund** (VBINX), which is 60% stocks and 40% bonds. Vanguard thinks the comparison is unfair, in particular because Balanced Index doesn't own foreign stocks. Vanguard is right, but my model is designed specifically to beat that measure because it is the standard or default compromise between the security of bonds and the riskiness of stocks.

For what it's worth, my portfolio has advanced 21.8% since the model was established on Nov. 28, 2003. In that period, Vanguard Balanced Index has gained 12.7%.

Trouble coming for Capstone

An exchange-traded index fund called **PowerShares WilderHill Clean Energy Fund** (PBW, news, msgs) has shot up about 18% in the last three months. That's slightly ahead of the average return of 16% for energy funds, according to Morningstar. But the outperformance, and then some, is due to a single small stock called **Capstone Turbine** (CPST, news, msgs).

Here's how it happened: The PowerShares fund has seen its assets surge to $160 million from $27 million on April 30, the end of its last fiscal year. Since it buys a fixed amount of any one stock, it has been an aggressive purchaser of Capstone. Thanks to this buying, and the stock's subsequent gains, Capstone had grown to be 7% of its assets.

Capstone, a money-losing manufacturer of equipment for the alternative energy market, has shot up about 250% in the last three months and briefly traded above $5 a share. It was changing hands last week at $4.40, up from about $1.25 in June.

The PowerShares fund tracks an index designed by Rob Wilder, a lecturer in environmental policy at the University of California-San Diego, and one of Wilder's colleagues. The index is rebalanced quarterly, which means this Friday. Capstone is way out of balance in the portfolio and will be slashed to about 3% of assets, Wilder says.

At last week's prices, the fund will be selling 6.4 million shares of Capstone. That is equal to several weeks of trading volume before the fund became such an aggressive purchaser of the shares. It is also roughly twice the number of Capstone shares held by all mutual funds combined.

So if you like the stock -- or the fund -- wait a few weeks before you buy. It could be a tumultuous period. Capstone could also be a marvelous short, except for two things: So few institutions own it you probably couldn't borrow very much to sell, hoping to buy back later at a lower price. And the stock is so cheap anyone with $30 million could drive the price up again and scalp the pessimists. A huge number of arbitrageurs and hedge funds have the money and the killer instincts for that kind of slaughter.

At the time of publication, Timothy Middleton owned the following securities mentioned in this article: Berkshire Hathaway, Vanguard Balanced Index Fund. He was not short any securities.

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