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Funds Of ETFs Try To Bridge The Gap

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You're intrigued with the ease of exchange traded funds, but don't know much about them. There are so many — no wonder you're hesitant to jump into the ETF trading pool.

A fund of ETFs might be a good way to get your feet wet.

As of March 31, there were 644 ETFs in the U.S., with $571 billion in assets. With so many, choosing a few to round out a portfolio could be daunting.

Investors who take the plunge like that ETFs are similar to mutual funds. But the differences kick in quick: ETFs are less expensive, more tax-efficient and can be traded like stocks throughout the day.

Their blooming popularity has attracted both investors and those who develop investment products.

"There's a land grab going on in the ETF world," said Bryce James, developer and lead portfolio manager of Aston/Smart Allocation Fund. "They're cheaper and more flexible than a mutual fund. What we're doing is offering the best of both worlds — the familiarity of a mutual fund with the benefits of ETFs."

Still, many investors stick with traditional mutual funds because they're familiar with them. Although ETFs have been available in the U.S since 1993, many investors don't understand how they work and shy away from including them in their portfolio.

To make it simpler to reap ETF benefits, a few investment firms launched funds-of-ETFs.

Some funds didn't really have a clear aim. One of the earliest — Everest3 — included**SPDRs S&P 500**, (SPY) the**Cubes** (QQQQ) and**Dow Diamond**s (DIA). That large-blend fund reallocated assets based on market conditions. It closed in 2004.

The more current crop varies their approaches more — and their costs. Some, such as AdvisorOne Amerigo and the 3-month-old Aston/Smart Allocation, are no-loads with expense ratios of less than 1.5%, including the underlying ETFs. That's not cheap, but that's the cost of having a professional involved.

Sales Commissions

Others have front-end loads. Seligman TargETFund Core, 2015 and 2025 charge a maximum 5.75%, though there are break points for those who invest large amounts. SmartGrowth charges a maximum 4.47% for its Lipper Optimal Conservative, Growth and Moderate funds of ETFs.

Investors also shell out 2.27% of assets a year in expenses, including the underlying ETF fees.

The Seligman funds are target retirement funds, which include equity, fixed income and REIT holdings, and decrease risk the closer you are to retirement. SmartGrowth's funds focus on different risk profiles using the all-equity Lipper Optimal Target Risk Indexes.

Most funds use a mathematical proprietary rating system to choose their holdings. Many managers rely on the traditional modern portfolio theory, averaging risk, return and correlation of a stock's entire history to predict future performance.

You start at the top and work your way down, first picking asset class, sector, market cap and then the stock.

In the case of Aston/Smart Allocation, James picks top-performing ETFs using a logarithm based on extreme value theory, which measures the actual frequency of extreme market moves. Starting at the bottom, you study a stock's risk and return. Then you compare and contrast it with other stocks and, finally, put together the portfolio.

No matter the method used, funds-of-ETFs seem to be holding their own against their benchmarks. AdvisorOne Amerigo going into Thursday was ahead of the S&P 500 by nearly 0.5 percentage point year to date, while Aston/Smart Allocation was nearly 5 points above the index. Seligman Target Core was 1.2 points ahead of the Dow industrials.

Saving Time

If you're short on time to helm your own ETF portfolio, a fund-of-ETFs could be a profitable shortcut. But you also could find a target retirement mutual fund with no management fee on top of its expense ratio, and perhaps save some cash.

Sticking strictly to mutuals doesn't mean you would miss out on ETF exposure. Many regular mutual funds include ETF investments. Mutual funds hold almost $15 billion in ETFs, according to fund tracker Morningstar. Some 170 funds have at least 5% of their assets in ETFs.

An October 2007 Yale School of Management study showed that almost 28% of all mutual funds are "closet indexers," and an additional 12% are index funds.

With actively managed ETFs already here, the next trend could be ETFs of ETFs. Investment and risk consultant Richard Kang isn't sure if that's good.

"To me, the real risk is that the overall portfolio provides little beyond market returns at a high price," he said. "In that case, the whole point of using ETFs has been lost."

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