ETFS 101, Part 5 – **OPPORTUNITIES & TRAPS**

So far in this series on Exchange-Traded Funds (ETFs), we've discussed a number of features that have contributed to the growth in ETFs over the past several years. We've also talked about how to choose an ETF and how to begin building a portfolio of ETFs.

Last month's article examined how the concept of indexing has changed over the years. Originally, indexes were simply a way to describe the market and explain its performance. Then with the advent of index mutual funds, indexes became an actual investment vehicle – something you could put money in, as opposed to a mutual fund that was actively-managed.

Today, particularly for ETFs, we also have "custom-designed" indexes, that were specifically engineered to implement a particular investment strategy or theme. And last month, we observed that today's ETFs are essentially the "wild west" of index investing, offering many opportunities and choices when constructing a portfolio, but also introducing new risks and traps for the unwary investor.

This month, let's talk about both the opportunities and the traps.

Both iShares Core S&P 500 (IVV) and Guggenheim S&P 500 Equal Weight (RSP) invest in the 500 stocks that comprise the S&P 500 Index, a broad-based index of large U.S. corporations. However, they offer distinctively different approaches.

IVV, like the S&P 500 index itself, is "market-capitalization weighted." This means that, while it may invest in all 500 stocks in the index, it allocates its money according to the size of a company as measured by its market capitalization (i.e., what all the stock in the company is worth). Because of this approach, the top holding in IVV is Apple (accounting for nearly 4% of the fund), followed by Exxon (at 2%), and Microsoft (with 1.85%). In fact, the top 10 holdings represent 17% of the fund, the top 25 are 30% of the fund, and the top 50 account for 46% of the fund.

RSP, as its name implies, is "equally-weighted," meaning that it invests an equal amount of money in each of the 500 stocks. Apple is also owned by RSP, but it represents just 0.20% of RSP vs. nearly 4.00% of IVV. The smallest position in IVV is Diamond Offshore (which is just 0.01% of the fund), but Diamond Offshore carries just as much weight in RSP as does Apple due to the equal-weighting approach. Not surprisingly, while both IVV and RSP invest in the same 500 stocks, their investment performance can vary significantly.

Why would an investor prefer one of these to another? If the investor's goal is simply to track the performance of the well-known S&P 500 Index, IVV or another similar ETF provides an inexpensive way to accomplish that goal. On the other hand, the equal-weighting approach of RSP helps reduce the bias and concentration risk towards the larger individual companies within the S&P 500 and provides more balance and diversification – and therefore could enhance longer-term performance.

Differences in approaches to index construction become even more pronounced when you get into ETFs that are focused on specific sectors (energy, financial, technology, etc.), countries or regions (China or Asian ETFs), and especially for thematic ETFs (environmentally-friendly or socially-conscious ETFs).

With ETFs, as with anything, you need to know what you actually own and why you own it. Open the hood and look inside – you may be surprised.

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