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## Exchange Traded Funds: A Top 10 List for Your Clients

Why being prudent is key.

by *Neal Frankle, CFP*

When I finally understood what my editor really wanted, I froze.

In January, I'd been asked to write an article detailing the previous year's top performing exchange traded funds (ETFs). I'd done my research and come up with the goods without too much hassle. That was easy, I thought. But then I sat back and realized what I'd really been asked to do.



Neal Frankle

### What Are Exchange Traded Funds?

An ETF is a basket of stocks — just like a mutual fund. The ETF buys stocks that the manager believes will mirror the returns of an index. The ETF usually holds on to the stocks in the basket rather than trade. The management fees associated with ETFs are usually 75 percent lower than that of mutual funds. Also, ETF's trade like stocks — you can buy and sell them during the day.

We all know that the reason investors read Top 10 investment lists is to consider investing in funds on that list. So my quick list could be misunderstood as a set of recommendations. Yikes.

You see why I tensed up? A simple review of the best performing funds is not only useless to your clients, but it could actually get them into hot water.

Let me explain.

In any particular year, the best performing ETF, stock or fund is likely to be a high-risk proposition: If the fund didn't carry big risks, it wouldn't have been able to deliver such amazing results. But many read these lists and blindly buy the highest-rated fund. They tell themselves, "Wow! This fund made 85 percent last year! If it only makes half that much this year, I'll be delighted!" They seldom consider the chances they're taking when they make such a choice. As a result, they expose themselves to undue risk and are often sadly disappointed.

On the other hand, sophisticated investors don't put a large percentage of their assets in high-risk funds — a Top 10 list of high-risk funds is useless to them.

So why am I writing about this in the middle of the year? Because chances are some of your clients use those Top 10 lists and as a result, are taking on too much risk with their portfolio. Now is the time to understand the possible pitfalls and to help your clients stop hurting themselves.

In order to understand the true nature of these lists, let's take a different approach: Along with the top five funds overall in 2006, let's look at a list of the top five funds in the moderate risk level as well. These funds are consistent with what a prudent investor might invest in at least a portion of their portfolio.

This way, your clients can have a better benchmark by which to measure and decide about how to invest in the future. And, at the end of the day, if your clients still decide to invest in the high risk funds, they will have done so from an informed position. Besides, they're probably over 18, so they'll do what you want anyway.

### Overall Top Funds

It will come as no surprise to you that international exchange traded funds were the top overall performers in 2006. China's economy is booming and that helped push Chinese ETFs to the top two spots for the year. iShares FTSE/Xinhua China 25 Index (FXI) and PowerShares Golden Dragon (PGJ) rocketed up 83 percent and 53 percent respectively. China needs to build infrastructure, so of course they're lapping up all the construction materials they can. In addition, its infrastructure expansion is

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fueling a thriving middle-class. These newly minted consumers have a real yen to purchase items they couldn't afford only a few short years ago. Chinese infrastructure growth creates plentiful jobs. This puts more money in the pockets of the employees and allows Chinese consumers to satisfy their pent-up demand. This translates into greater profits for Chinese companies and higher stock market prices.

Turning West, Spain hosts one of the fastest growing economies in Europe. It is experiencing a surge in mergers and acquisitions. It's also experiencing a surge in construction and a boom in real estate. iShares MSCI Spain (EWP) ended the year up 49.2 percent.

With the world's busiest port, Singapore benefits by China and Asia's strength. iShares MSCI Singapore (EWS) is a fair representative of the area and it ended up 45.8 percent in 2006 to finish in fourth place.

Rounding out the top five for overall performance, iShares Mexico (EWW) joined the list, up 43 percent for the year. Despite political turmoil, the Mexican economy boomed as a result of exploding trade and huge infrastructure investments.

### **Moderate Risk ETFs**

Let's turn our attention to the more diversified, moderate-risk funds. To determine the best performers, I excluded sector funds (those investing exclusively in one country or industry). I did this because risk is inherently reduced by broadening the investment base.

It shouldn't surprise anyone that international funds took the top five spots. What may be surprising is that these funds were Europe — rather than Asia-based. The weakening dollar versus the euro helped euro-denominated funds. Funds concentrated in Europe did very well.

Coming in first was iShares MSCI (EZU), which invests in Europe but excludes the United Kingdom (which is not euro denominated). EZU returned 35.5 percent in 2006. Next was Vanguard Europe (VWG) with a 33.1 percent return. iShares S&P Euro 350 (IEV) came in a close third with 32.6 percent followed by Dow Jones Euro Stoxx (FEZ) with a 31.5 percent return. The fifth best performing moderate risk ETF was iShares MSCI EAFE Value fund (EFV) returning 30.3 percent. This is a European large-cap value fund.

I want to point out two very important principles that are demonstrated by last year's performance.

First, notice that in the moderate-risk class. The top five had similar returns while the (higher-risk) overall top performers had a huge variance between the funds. In the 25 years I've been in this business, I've noticed that with the moderate risk category, it's much more important to be in the right general area of the market (Europe, in this case) than to pick the exact best fund. A moderate-risk investor can be in the right neighborhood, go to the wrong house and still be invited in for a spot of tea. As you'll see in a moment, if a more aggressive investor is in the right neighborhood but goes to the wrong house, he or she will likely get mugged.

I think it's also instructive to notice the geographic differences between the top performers in each category. Within the higher-risk group, the funds were mainly Asian or Latin American. Only one fund was from Europe.

Yet in the moderate-risk group, we found only European funds. The conclusion is that Europe as a whole was strong in 2006. Some Asian and Latin American countries were outstanding, while others must have been real dogs. (Had all of Asia or Latin America been strong, we would have seen a broader based Asian and/or Latin American funds on the moderate list of top performers.) This indicates that for higher risk investing, you take the real risk of big losses if you get it wrong.

Keep in mind that the market did quite well last year. You'd almost have to been working at it to have earned less than a double-digit return in 2006. Don't let this lull your clients into a sense of false comfort or make them cavalier about their investment choices. The past really is no guarantee of future results.

When your clients make their future investment decisions, please encourage them not to rely on Top 10 lists blindly — that includes mine. They should be clear on what kind of investor they are. If they're only willing to take moderate risk, they should stay away from the overall top performers, because they expose your clients to undue risk. Also, and this is critical, the market changes all the time. Statistically, the chances are low that what did well this year will do well next year. Investing is not a spectator sport.

For long-term success, it's vitally important to develop tools to help identify strong and weak markets. For a free white paper on how to do this — how to "take the market's temperature" — e-mail [me](mailto:neal@frankle.com).

**Neal Frankle** is the author of *Why Smart People Lose a Fortune: 5 Steps to Restoring Your Wealth and Sanity*. *He helps affluent*

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