IN CONVERSATION WITH KIM ARTHUR AND DICK FREDERICKS, MAIN MANAGEMENT

"We're looking for haystacks, not needles."

Kim Arthur and Dick Fredericks, Main Management

Main Management (San Francisco, CA) was created in 2002 by five professionals who had formerly worked together at an investment banking and asset management firm. Their advisory practice now manages $135 million in assets for approximately 30 clients. We spoke with two of the founders, Kim Arthur and Dick Fredericks. The following may not be representative of the experience of other clients and is not indicative of future performance.

ABOUT THESE ADVISORS

Q: You've all worked together before, so how did you come to join forces once again to create this firm?

Dick Fredericks: One of our partners came to the rest of us and said he felt that there was a better way to manage money. That better idea was Exchange Traded Funds. All of us have been on Wall Street, all of us have seen the result of single-stock risk, all of us know the costs involved in trading stocks and losing money in a single issue. We all just felt that the Exchange Traded Fund was the best client-oriented product that we had seen, so we decided to build a firm strictly around ETFs.

Q: Only ETFs? What kind of investing philosophy is behind that decision?

DF: This is classic investing. It's investing in the right way where you can try to diversify, keep your cost down, keep your trading cost low and keep your turnover low. It's the best way to compound value that I've ever seen. So, from a philosophy standpoint, ETFs allowed us to create a firm for all the reasons we knew were right.

Kim Arthur: When I first got in the business, I'd always read Warren Buffett's annual reports. I really respected how he'd buy and hold these companies. I thought, 'This guy is brilliant.' Did I do that in my own account? No. I was out there trying to pick single stocks, having a great time because I think I'm picking the next Microsoft. Instead of buying Microsoft, I'm trying to buy the next Microsoft.

Every day, inevitably, I'd come into work, turn on my machine, and the stock I had picked would have hit an air pocket. I'd gnash my teeth and wonder, 'Why have I done this again?' And the next week, I'd be doing the same thing again.

But as time goes on and you get more comfortable with yourself—you're building a family, building a career, building a business—you realize that managing portfolios with this kind of diversification lets you sleep well at night. It makes a huge difference.

SECTOR INVESTING

Q: Let's talk about how iShares ETFs fit into your investing process.

KA: Over the last four years, there has been a major change in the way that information is disseminated from the publicly-held companies to Wall Street. With full disclosure and Sarbanes-Oxley, management groups are scared to death of giving anything that might be considered inside information to preferred mutual funds or large buyers of their stock. So we now have a more equal dissemination of information.

What that's done is make it a lot more difficult to do single-stock picking. We feel that with sector investing—or style, or country investing—the suite of iShares ETFs gives you a very elegant solution. You can still seek to capture the alpha in the market that you believe you can get.

DF: When we pick an ETF, we're looking for a sector bet, we're looking for something that's out-of-favor, and we're looking for what we think might be the catalyst that will eventually move the group. To find that catalyst, we will typically do research down past 50 percent of all the stocks within an ETF.

Even if we were wrong about which stock will be the catalyst, we can still be right about the sector itself and catch the beta. And if it turns out we were wrong about the whole sector, we can swap out to another sector ETF without necessarily penalizing performance—all on a very tax-effective basis.

We summarize it in one sentence: We're looking for haystacks, not needles.

Q: How do you choose between two ETF providers that have similar sector products?

DF: We have a fairly elaborate process for that. I just mentioned that we research the composition, because we want to see what tail will wag the dog. There can be big differences in what makes up similar but competing ETFs.

Another difference can be liquidity. Expense ratio is important, too. We are extraordinarily careful to keep our expenses down.

KA: Also, the tax efficiency that the iShares Funds have provided is incredible. In 2004, zero capital gains distributions—which makes our job a lot easier.

Q: So just how heavily invested in iShares Funds are you?

DF: Seventy percent of our portfolios are iShares Funds.

KA: The other providers don't have the level of service that iShares has. Everything in this category points to iShares: the support, the service, the breadth of products, the fees. Last year, for instance, Barclays brought down the fees dramatically on the international iShares ETFs. And they continue to drive down prices on sector products.

PARTNERING WITH ISHARES FUNDS

Q: How does Main Management distinguish itself from competitors?

DF: What really differentiates us is that we are a pure user of ETFs—and most of those are iShares ETFs.

We also differentiate through performance. Of course, every investor wants attractive performance, so all advisors are trying to do the same thing in that respect. But what we are really after is long-term growth that is tax effective, pre-tax and after-tax. That's when we get into the real comparisons with either mutual funds or hedge funds, and where iShares really help.

Q: Still, it must be a challenge to ask prospective clients to invest $1 million or more for benchmark-tracking performance.

KA: But we're *not* trying to give them benchmark-tracking performance. Our process and our philosophy are geared to delivering an enhanced return to the benchmark.

I think most investors are still not fully educated as to the breadth of ETFs that are out there. They're familiar with the S&P 500, or maybe the Nasdaq. But they don't realize how many sector and subsector iShares Funds are available. That's where our expertise comes in, and the opportunity for adding alpha.

Once clients are up to speed, they see that an iShares ETF is just like a security in that it can capture performance from a very specific part of the market. It just also happens to give you diversification, transparency and tax efficiency in one fell swoop.

Q: So your alpha comes from portfolio construction and tax management?

DF: Correct. Many clients are looking at their portfolios and think about tracking error versus an industry basket. We approach life differently. We're managing a portfolio. We're investing through ETFs, we're not trading through ETFs. Many people buy ETFs to sell them. We buy them to invest. We're not just trying to mimic an index—we're trying to make money for the client using a portfolio approach with ETFs.

Q: If there had been no iShares Funds, could you have built this firm in the way that you have?

DF: I would say no. Whenever we really think that there's an area in which we want to invest, we start looking around at who's got the product. iShares has had the product most of the time, by far.

Without them, I don't think we would have a firm.

To determine if the iShares fund(s) are an appropriate investment for you, carefully consider the funds' investment objectives, risk factors and charges and expenses before investing. This and other information can be found in the funds' prospectuses, which may be obtained by calling 1 800 iShares (1 800 474 2737) or by visiting www.iShares.com. Read the prospectus carefully before investing.

There are risks involved with investing, including possible loss of principal. Diversification may not protect against market risk.

In addition to the normal risks associated with investing, narrowly focused investments typically exhibit higher volatility. There is no guarantee that distributions will not be made in the future.

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iShares Fund transactions will result in brokerage commissions and will generate tax consequences. Mutual funds and iShares Funds are obliged to distribute portfolio gains to shareholders. Certain traditional mutual funds can be tax efficient as well.

When comparing stocks or bonds and iShares Funds, it should be remembered that management fees associated with fund investments, like iShares Funds, are not borne by investors in individual stocks or bonds. The annual management fees of iShares Funds may be substantially less than those of most mutual funds. iShares Funds transactions will result in brokerage commissions, but the savings from lower annual fees can help offset these costs.

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