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ETF SPECIAL REPORT

What You Need to Know About Sector ETFs

By BOB O'BRIEN

ETF Special Report: By selecting sector funds, investors smooth out returns and get more aggressive.

MANY INVESTORS TAKE the rifle-shot approach to portfolio strategy: Their goal is to hit just the winners. But with the proliferation of exchange-traded funds, an increasing number are opting for the shotgun approach. Their aim is to buy whole sectors of the market via ETFs.

Of today's 760 ETFs, there are 140 covering domestic industries -- which can range from the nine broad categories that Standard & Poor's uses to much narrower niches -- like the B2B Internet HOLDRs (ticker: BHH) fund, with just two stocks. Some $30 billion has been invested in the S&P categories in 2009, a record, says Select Sector SPDRs, an affiliate of State Street Global Advisors.

That's up from $2.5 billion a decade ago. The explosion in sector-based ETF volume shows that investors have been listening as more financial advisors urge them to use these funds as a core part of their portfolios. All of the strategies -- aggressive or defensive -- try to fulfill the ambition of any stock portfolio: maximize returns and reduce risks.

Matt Collin's for Barron's
Financial advisors are coming up with new ways to allocate sector-driven portfolios.

"Many of the advisors we deal with have concluded they can generate more stable alpha using a sector approach instead of choosing the right stocks in a sector," says Sue Thompson of Barclays iShares. Alpha refers to the outperformance that a strategy provides over its benchmark.

One of sector-investing's appeals is that it can reduce volatility. Diversification across an entire industry group means that returns tend to be smoother than they are when an investor picks individual stocks, some of which may head in extreme directions.

This attribute can make it a key part of a defensive strategy. "When you buy individual stocks, you can make the right decision on the sector, and still end up with the wrong result," says Jim Ross, senior managing director at State Street Global Advisors.

Using this approach also allows you to bet on the most basic of fundamentals. For instance, you can play an economic recovery by investing in raw materials via a fund like the Materials Select Sector SPDR (XLB) or a faster rebound abroad through the Vanguard Emerging Markets ETF (VWO).

There are also liquidity benefits, a consideration that really hit home just after Lehman Brothers' collapse. "There was a period last year when you couldn't short a financial stock," because nobody would lend out the shares for the trade, says Dan Dolan, director of Wealth Management Strategies at Select Sector SPDRs. But you could still short a financial-sector ETF, he notes.

Despite its defensive qualities, sector investing can be aggressive. Kim Arthur, president of Main Management, which advises clients on this approach, says "the way to generate the best performance is to over-weight the best- performing and under-weight the worst-performing" sectors. "The ability to do this is clearly available," just by monitoring the groups. Discerning between winning individual shares in a given sector is much harder.

So when do you buy a stock or an ETF? "A lot of investors think that, if I use an ETF versus a stock, I'm condemning myself to getting nothing more than an average return," says Doug Sandler, chief equity officer at Riverfront Investment Group. "But I think that's foolish thinking."

In Riverfront's model, there are two criteria that argue in favor of investing in ETFs over a particular stock. What it comes down to, he says, is whether an industry has historically produced a broad dispersion of returns.

Sectors in which the median -- or midpoint -- of the performance range differs from the mean -- or average -- performance are known as "wide-dispersion" areas, Sandler says. They offer "the stock picker a field of opportunities from which to add value," he notes. Various tech sectors fit this description.

Industries like retailing, in which the average investor might know some companies well, can also be good for stock-picking, he says. In this case, the investor might have first-hand knowledge of The Buckle (BKE), the trendy jeans retailer whose shares are up 56% this year, versus the 23% rise in the broad Retail HOLDRs ETF (RTH).

Conversely, returns from utilities and beverages and other consumer products tend to be a "tightly dispersed" group. As a result, "the decision whether to be overweight or underweight the industry is generally more important than the actual stocks that one might select," Sandler says. These are sectors where buying the ETF is recommended over the stock.

The gray area includes sectors like biotechnology, where there's a wide gap between the median performance and the mean performance, but where stock-picking is the toughest. "In those worlds, where the dispersions are wide, but the odds of capturing that [individual winner] are low," Sandler says, "we'd use an ETF." Semiconductors, metals and mining, and Internet stocks, along with biotech would all qualify.

"What we're trying to do is spend time at what we're good at," Sandler says -- "and not dilute it away in areas where we're not good."

But experts caution that investors shouldn't be too dogmatic: Don't fall in love with a strategy and thus miss turns in the economy and other fundamentals.

Rotation is what gives the investor the ability to generate alpha, Main's Arthur says. "It's a little bit art, and a little bit science."

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