

Do You Know What's in Your ETF?

**Judging by Fund Names,
Investors May Be Surprised
By What's Inside -- and What's Not**
By IAN SALISBURY
August 12, 2006; Page B4

When Scott Sacknoff designed the index for the [PowerShares Aerospace & Defense Portfolio](#), an exchange-traded fund, he had a difficult decision to make: whether to include commercial satellite companies.

"We tried eliminating all those companies in the index," says Mr. Sacknoff, president of the Washington-based Spade Defense Index. "But it improved performance when we included them."

The result: an exchange-traded fund that would have risen 13% annually over the past five years, according to the firm's hypothetical back testing. But among the fund's traditional defense holdings such as aircraft and weapons makers are companies like [Sirius Satellite Radio Inc.](#) and [XM Satellite Radio Holdings Inc.](#), as well as television concerns [DirecTV Group Inc.](#) and [EchoStar Communications Corp.](#)

Exchange-traded funds, or ETFs, are index-tracking mutual funds that trade on an exchange like stocks. With assets surging past \$335 billion, the number of narrowly focused specialty ETFs has swelled. There are now at least 12 that follow just financial stocks, for example, and 12 more for health care.

The problem is that there's no official definition of what constitutes a defense or a financial stock, so investors need to look closely at what they buy -- or they could end up owning something they didn't expect.

Herb Morgan, president of San Diego-based Efficient Market Advisors LLC, says some funds may reach beyond their apparent purpose because they were launched "to meet a demand, regardless of whether it is practical to create such a product."

ETFs that specialize in very small companies or in single countries are popular with investors, but, Mr. Morgan says, those funds can also face problems because the stocks they are charged with buying can be difficult to acquire in large amounts.

For example, he cites Barclays Global Investors' [iShares Russell Microcap Index Fund](#), which "is forced to eliminate a large number of companies based on a lack of liquidity,"

Mr. Morgan says. "What's left in the index is a whole lot of regional banks, which tend to fall in that sub-\$500 million capitalization space."

Mr. Morgan also points to the [iShares MSCI South Africa Index Fund](#), which has 13% of its assets invested in Sasol Ltd. and 7.8% invested in [Standard Bank Group](#). "There just aren't enough companies to invest in," he says.

The prospectus for the iShares family single-country funds notes they are classified as "non-diversified," meaning they can invest most of their assets in securities representing just a few companies, a factor that could increase their risk.

Barclays spokesman Tom Taggart says single-country ETFs are designed for investors who want "to play a fine slice of the market" and naturally won't be as diverse as broad-market funds. Mr. Taggart also points out that investors can easily look up all of the funds' holdings, which are published daily.

Other exchange-traded funds can have unusual-seeming holdings because of their legal structure. Among the oldest ETFs on the market are [Merrill Lynch & Co.'s Holdrs](#). Unlike most ETFs, Holdrs are structured as "grantor trusts" rather than open-end investment companies, which prevents them from rebalancing their portfolios or buying new stocks.

As a result, Internet Holding Co. Holdrs Trust has more than half its value tied to just two companies: [Yahoo! Inc.](#) and [eBay Inc.](#), but doesn't hold a single share of [Google Inc.](#), which had its initial public offering after the fund was launched.

In still other cases, an ETF's holdings may come as a surprise because of marketing definitions that are commonly used among fund companies but can still be news to investors.

For instance, one way to get international investment exposure is to buy a global index ETF. But these funds, which own both U.S. and overseas stocks, may not be quite as cosmopolitan as they sound.

Global ETFs from both Barclays and its chief rival, State Street Global Advisors, own some foreign companies but keep the bulk of their assets at home. The [iShares S&P Global Technology Sector Index Fund](#) has almost 71% of its assets invested in U.S. companies, while State Street's [StreetTracks DJ Global Titans](#) ETF has more than 60% invested in the U.S.

Investors who already have core holdings in American stocks might want to consider a strictly "international" rather than a "global" fund to diversify their holdings.

Write to Ian Salisbury at ian.salisbury@wsj.com