INTRODUCTION

A Remarkable New Investment Product

A little over ten years ago, a watershed event occurred in the area of personal finance when the American Stock Exchange (AMEX) began trading shares of a unique, new investment product called Standard & Poor's Depositary Receipts (SPDRs) or "Spiders." Simple, flexible, low-cost, and tax-efficient, Spiders were the first of an entirely new type of investment product commonly referred to as *Exchange-Traded Funds* (ETFs) or *Exchange-Traded "Index" Funds* (ETIFs).

Exchange-traded index funds exist at the intersection of traditional index mutual funds and common stocks, incorporating the most attractive features of each structure. They are like stocks – flexible, easy to use, and actively traded throughout the day. At the same time, they are like index mutual funds – tax-efficient, cost-effective, diversified, and designed to track the performance of a given market index or benchmark. Shares of exchange-traded index funds can also be created or redeemed at the fund's net asset value (NAV) per share on any business day, similar to traditional mutual funds.

Like other revolutionary innovations, such as the automobile, television, or Internet, many initially dismissed the value of exchange-traded index funds. They were called "index funds for traders" and "unnecessary" by some financial professionals. Mutual fund companies went on the attack, as well, going to great lengths to discourage investors from using this new product. "Stick with what you know," was their advice, referring to traditional mutual funds. Ironically, many of the same mutual fund companies that once openly criticized exchange-traded index funds now offer them.

Not everyone was so quick to dismiss the value of this powerful new portfolio management vehicle. Large institutional investors, such as pension and hedge fund managers embraced them almost immediately. Even some mutual fund portfolio managers found exchange-traded index funds the perfect tool to quickly and efficiently gain exposure to a specific asset class or segment of the market. As is often the case, when institutional investors embrace a new product retail investors soon follow. It wasn't long before individual investors were using exchange-traded index funds to meet a variety of portfolio management needs.

Today, barely ten years since first introduced, there are over 120 exchange-traded index funds available covering virtually every possible asset class, investment style, market capitalization, economic sector, industry group, country, and geographic region. As of December 2004, total assets under management (AUM) for all exchange-traded index funds exceeded $175 billion and on any given day they account for over half of all trading volume on the American Stock Exchange. Based on the growth in popularity we have witnessed, it's safe to say that exchange-traded index funds are rapidly becoming the investment tool of choice for millions of investors.

A Portfolio Management Revolution Is Underway

Exchange-traded index funds are the most important financial innovation of the last thirty years and the catalyst behind a powerful new approach to portfolio management, called Strategic Index Investing. Unlike the vast majority of portfolio management strategies used today, Strategic Index Investing is not based on picking the right stock or finding the next "hot" mutual fund. Instead, the focus is on the use of index-based investments to access the key drivers of portfolio performance – investment style, company size, sector, industry, geographic region – in conjunction with proven active portfolio management strategies. In essence, Strategic Index Investing is where the efficiency of indexing meets the art of active portfolio management.

Strategic Index Investing is a comprehensive approach to portfolio management based on the use of exchange-traded index funds, the diversification benefits of asset allocation, the efficiency of indexing, and the flexibility of active portfolio management. It is designed for investors seeking to avoid the costs, tax inefficiencies, and erratic performance most often associated with traditional mutual funds and individual common stocks in conjunction with buy-and-hold investing. Most importantly, Strategic Index Investing offers every investor a way to construct a highly customized portfolio based on his or her specific goals, risk tolerance, and investing time horizon.

The Purpose of this Book

This book is designed to serve as a practical guide to the art of active index investing. As such, it has two primary objectives. First, to introduce, explain, and demonstrate the benefits associated with a powerful new portfolio management tool called exchange-traded index funds. Second, explain the principles of Strategic Index Investing. A portfolio management methodology based on the premise that actively managing a portfolio of passive assets represents the best way to maximize performance while minimizing risk.

In the process, the most popular investment products and strategies used today, such as actively managed mutual funds and buy-and-hold investing, are called into question. While new ideas are often difficult to accept and letting go of old habits is even harder, it's my sincere hope that you will approach the material put forth in this book with an open mind. And, if appropriate, use the ideas presented to improve your investment results.

What this Book Is Not

This book is not a get-rich-quick guide. It will not divulge a top secret trading strategy or foolproof moneymaking system. Such outlandish claims will be left to others so we can focus on constructing fundamentally sound portfolios based on proven financial principles.

After twenty years in the investment management industry, I've learned one undeniable fact: there is no such thing as a consistent, surefire, quick and easy way to make money in the stock market. Portfolio management is hard work. It takes planning, consistency, determination, and time. Fortunately, for those willing to pay the price the equity markets offer tremendous wealth creation potential.

How this Book Is Organized

When discussing portfolio management, it's important to understand that a limited number of key factors will ultimately determine success or failure. Investors who focus on these key factors will more often than not be successful while those who play it from the hip usually fail. In this book, I present what I believe are the key factors of portfolio management within the framework of Strategic Index Investing. To accomplish this goal, this book has been divided into four parts. A brief summary of each is provided below.

Part 1: New Ideas in Portfolio Management

The three chapters in Part 1 challenge many of today's most widely accepted investment beliefs and introduce a better alternative. In Chapter 1, we take a look back at the markets over the last few years and overview some of the problems investors have encountered. In Chapter 2, the most popular investment strategies and tools used today, such as buy-and-hold investing and traditional mutual funds, are examined. In Chapter 3, the key elements of Strategic Index Investing are introduced and a comparison is made between Strategic Index Investing and buy-and-hold investing.

Part 2: Exchange-Traded Index Funds — A Powerful New Portfolio Management Tool

Part 2 is devoted entirely to the examination of exchange-traded index funds. In Chapter 4, the benefits associated with exchange-traded index funds are discussed. In Chapter 5, exchange-traded index funds are compared to traditional mutual funds, both actively managed and index-based. In Chapter 6, we examine the internal workings of exchange-traded index funds. The benefits associated with indexing are discussed in Chapter 7 while Chapter 8 focuses on those companies responsible for creating most of the currently available exchange-traded index funds.

Part 3: Strategic Index Investing — Unlocking the Power of Exchange-Traded Index Funds

In Part 3, the focus shifts to the strategies used in Strategic Index Investing. Chapter 9 introduces and explains asset allocation. In Chapter 10, strategic asset allocation is examined. Chapter 11 shows the benefits associated with making tactical changes to the overall asset allocation. In Chapter 12, the importance of using exit strategies is discussed. Advanced portfolio management strategies, including the use of options, selling short, and margin are discussed in Chapters 13 and 14.

Part 4: Building a Better Portfolio

Part 4 explains the key elements of portfolio construction and management. Chapter 15 shows the steps necessary to construct a portfolio following the principles of Strategic Index Investing. In Chapter

16, investment advisory fees and services are discussed. Finally, Chapter 17 provides a list of important investment rules, which should be followed at all times.

An Important Distinction

In this book, the term “Exchange-Traded Index Funds” or “ETIFs” is used when describing this remarkable new investment product. This stands in contrast to the vast majority of those in the financial media, investment professionals, and investors who refer to them as “Exchange-Traded Funds” or “ETFs.”

There are several reasons why I believe “Exchange-Traded Index Funds” is a better name. Currently a wide range of very dissimilar products are commonly referred to as “Exchange-Traded Funds.” This includes closed-end equity mutual funds, closed-end bond mutual funds, Holding Company Depositary Receipts (HOLDERs), open-end unit investment trusts, and open-end index-based exchange-traded mutual funds. This can and does lead to a great deal of confusion.

I believe a more appropriate name, and one that emphasizes the importance of indexing, is exchange-traded “index” funds. This should prove especially important when actively managed exchange-traded funds are introduced, which will likely happen sometime in the near future. Therefore, throughout this book, the term exchange-traded index fund(s) or the abbreviation ETIF(s) is used.