Are ETFs A Good Investment?

TRUE MARKET
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Many traders make the mistake of buying lots of individual stocks under the premise they are diversifying their portfolio. But the more positions you have in your account, the more positions you need to manage. And the more risk you face.

ETFs can be a great investment. Depending on their weighting, they can remove a lot of company-specific risk. And they are a more flexible and affordable alternative to mutual funds.

True Market Insiders teaches you how to use sector relative strength to find great trades. With sector ETFs, we can show you how to invest in an *entire sector* with just one single position.

In this report, I'll explain what ETFs are, and we'll review the pros and cons of ETFs, while explaining why you might consider an investment into an ETF.

This is another tip of the hat to Financial Literacy Month, so I hope it helps.

What Are ETFs?

Exchange-Traded Funds (ETFs) are a basket of stocks, commodities, bonds, or even investment strategies that investors can buy and sell on an exchange just like an individual stock.

They are designed to track a group of assets like an index. But an index is not tradable, while an ETF is.

Let's use the **iShares Russell 2000 ETF (IWM)** as an example. It's intended to track the Russell 2000 Index, a small-cap stock index.

[Market capitalization](#) is one way to classify stocks. So, if you want exposure to small-cap stocks, you could start by analyzing the Russell 2000 Index which is comprised of stocks like:

- Ovintiv Inc (OVV)
- AMC Entertainment Holdings (AMC)
- Avis Budget Group Inc (CAR)
- BJ's Wholesale Club Hdlg (BJ)
- Chesapeake Energy (CHK)
- Tenet Healthcare Corp (THC)
- Tetra Tech (TTEK)
- Antero Resources Co (AR)
- Lattice Semiconductor (LSCC)
- Eastgroup Properties Inc (EGP)

But if you wanted *wide* exposure to the small-cap universe, that is, if you wanted to invest in all of those stocks at once, you would look for an ETF like IWM. Please take note of the “% Assets” column in the table below.

Top 10 Holdings (3.14% of Total Assets as of April 18, 2022)		
Company Name	Ticker	% Assets
Ovintiv Inc.	OVV	0.54%
Avis Budget Group, Inc.	CAR	0.42%
Antero Resources Corporation	AR	0.39%
Chesapeake Energy Corporation	CHK	0.38%
BJ's Wholesale Club Holdings, Inc.	BJ	0.35%
AMC Entertainment Holdings, Inc.	AMC	0.34%
Tenet Healthcare Corporation	THC	0.34%
Southwestern Energy Company	SWN	0.33%
Range Resources Corporation	RRC	0.31%
EastGroup Properties, Inc.	EGP	0.31%

You can see that many of the same stocks I listed for the Russell 2000 Index are also in IWM's top ten holdings. So, while IWM might invest into all of the stocks in the Russell 2000 Index, it does not invest in them equally.

You can see in the table that the distribution of the stocks in IWM are not perfectly even. But they're pretty close, with the largest holding—as of April 18, 20022—being **Ovintiv Inc. (OVV)** at 0.54%.

The relatively even distribution of stocks within IWM is what removes a lot of the company-specific risk. But if the weighting is not evenly distributed, then the ETF is weighted more towards certain stocks than towards others.

As an example, the **SPDR S&P 500 ETF Trust (SPY)** is intended to track the **S&P 500 Index**. However, 27.37% of its total holdings are made up of just ten stocks. In comparison, the top ten holdings of IWM represent 3.14% of its total holdings.

So, when you buy SPY, it's not really like you're investing evenly in the 500 stocks listed in the S&P 500. The price movement of its top holdings like **Apple Inc. (AAPL)** or **Microsoft Corporation (MSFT)** greatly impacts the price of SPY.

In the above 10-year chart, the blue line represents the **S&P 500 Equal Weight Index (SPXEW)**. And the black line represents SPY. You can see that at times the SPY tracks SPXEW closely, but at other times the two are uncorrelated.

It's important to look at the holdings of an ETF and their weightings to clearly understand what you're investing in and the risks you're taking. If you are trying to invest into a specific basket of assets, it's important to see that the ETF you're considering tracks that group of assets well.

And there are thousands of ETFs to choose from too. There are even things called “inverse ETFs.” These funds are designed to move in the *opposite* direction of an underlying group of assets. So owning an inverse ETF on the S&P would let you profit in a bear market, when stock prices are *falling*.

And, as I mentioned earlier, there are ETFs dedicated to baskets of stocks within certain sectors.

On our *Sector Prophets Pro* platform, you can access the **Relative Strength Matrix** and see the strongest sectors based on relative strength. (We focus on sectors because fully 80% of a stock’s move – up or down – is due to the sector it’s in.)

Instead of buying many stocks from within a given sector, you could instead choose to purchase an ETF dedicated to that sector. That way you’re investing in what the sector is doing rather than a stock that could struggle with unforeseeable company-specific risk.

If you’d like to find out more about *Sector Prophet’s Pro*, click here.

Now let’s discuss whether ETFs are right for you.

Are ETFs Good for Beginners?

Whether an ETF is right for you or not, only you can know. But in general, ETFs are worth looking into if you’re a new or seasoned investor.

Risk management is the most critical aspect of successful investing. So, it’s critically important that you can apply your risk management disciplines to all of your positions, all of the time.

A handful of ETFs can represent an investment into hundreds and hundreds of stocks. But you only need to manage the handful of ETF positions instead of hundreds of individual stocks.

Many investors choose to invest into mutual funds for similar reasons. But ETFs are better than mutual funds, for two reasons:

1. Lower fees
2. More liquidity

Mutual funds can only be sold at the end of the trading day, where ETFs can be bought and sold throughout the trading day.

So, while I don’t know if ETFs are right for you as an investor, I do know that the advantages of trading ETFs over stocks or mutual funds makes them worthy of your consideration.

Conclusion

ETFs are a great addition to your trading arsenal. They provide a means to invest into many stocks all at once without the additional costs or risks associated with mutual funds.

But it’s important to evaluate an ETF before buying them. Many of them are not equally weighted, some are illiquid, and others are invested into assets outside of the stock market.

If possible, check to see how well an ETF tracks a group of stocks by seeing if there is an index you can compare it to.

So, take the time to understand what the ETF is, how it's invested, its liquidity, and how correlated it is to the group of assets you’re interested in investing in before making any final decisions.

I hope this helps!

Karen Riccio

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