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Three Key Mistakes to Avoid when Investing in Sector ETFs

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The allure of high returns, low expenses, and commission-free trades is drawing increasing number of investors to invest in sector ETFs. Several hundreds of sector ETFs are available. Daunted by the time and effort required to evaluate them, investors tend to rely on thumb-rules to simplify the selection process. This often leads them to make some key mistakes.

Mistake I: Choosing Sector ETFs on Past Performance

Sector ETFs focus their investments in a sector or industry. If the stocks in the sector or industry perform quite well, the sector ETF could end as top performer among the broad universe of all ETFs. There is, however, no assurance this sector ETF will stay as top performer in future.

Oftentimes, returns suffer as the catalysts driving the sector's performance run out or valuation becomes excessive. As a result, performance chasers run the risk of buying at the top.

To guard against this risk, investors need to ensure stocks in a sector are not overvalued. Investors should also have a thesis on why they expect the sector to fare well in future. These analyses would also help investors enter sector ETFs as they turn around from a cyclical bottom and earn market-beating returns.

Mistake II: Choosing Sector ETFs for their Low Expenses

ETFs usually deduct a fee from the assets invested to cover management, operating, and marketing costs. Expressed as a percent of assets invested, this fee is called expense ratio.

Sector ETFs in general enjoy a well-deserved reputation as products with low expense ratios. The expense ratios of some sector ETFs are however lower than those of others. This tempts some investors to choose a sector ETF with the lowest expense ratio.

However, management, operating, and marketing costs are not the only ones investors bear when investing in sector ETFs. They incur two additional costs: (1) bid-ask spread cost of trading and (2) brokerage commissions.

In a round trip trade, the investor buys the ETF at the higher 'ask price' and sells it at the lower 'bid price'. ETFs with lower trading volumes often tend to have wider gaps between ask and bid prices, i.e., the bid-ask spread. Unless the investor is wary, a sector ETF's wider bid-ask spread can more than offset the advantage of its lower expense ratio.

Investors therefore need to look at the total cost of owning the sector ETF rather than just focus on the expense ratio. The total cost of owning the sector ETF includes its ex-

How AlphaProfit Helps

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AlphaProfit Investments, LLC is an independent investment research firm located in Sugar Land, TX.

AlphaProfit Sector Investors' Newsletter is featured among MarketWatch's top 10 investment newsletters. The newsletter has bagged Hulbert Financial's #1 rank several times.

☑ Goes Beyond Past Performance

AlphaProfit uses its **holistic ValuM investment process** to evaluate sectors on valuation, momentum, and news quality. This process ensures stocks in the chosen sector are attractively priced and have the catalysts needed to sustain growth in future.

☑ Goes Beyond Expense Ratio

AlphaProfit looks at all cost elements involved in owning a sector ETF to get a handle on **total cost of ownership**. The cost elements include expense ratio, bid-ask spread cost of trading, and brokerage commissions. AlphaProfit compares ETFs with similar objectives and risk profiles on total cost of ownership.

☑ Goes Beyond Commission-Free Tradability

To help subscribers maximize return and minimize risk, AlphaProfit **systematically evaluates** sector ETFs individually as well as part of the model portfolios. The due diligence includes fit with investment thesis, stock inclusion criteria, stock weighting strategy, and prospects for holdings. AlphaProfit also analyzes the impact of including a specific sector ETF on the volatility of model portfolios to determine the weighting provided to the specific sector ETF.

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Mistake III: Choosing ETFs for their Commission-Free Tradability

The rising popularity of ETFs among investors has prompted many companies to provide ETFs. Not wanting to be left out of this opportunity, larger brokers have jumped into the fray as well. The battle for gathering assets is intense.

Brokers with their own brand of ETFs often offer their house brand ETFs commission-free. To up the ante on the competition, ETF providers have gone beyond offering products with the lowest expense ratios. Many ETF providers have entered into partnership with brokers to offer their products commission-free.

The commission-free tradability of certain ETFs entices some investors to prefer them over those requiring a commission to buy or sell.

Choosing a sector ETF merely on its commission-free availability, while ignoring key criteria, is like 'putting the cart before the horse'.

To avoid disappointment down the road and improve the odds of selecting a winner, investors need to evaluate the sector ETF from multiple perspectives. They include the sector ETFs' fit with investment thesis, stock selection criteria, stock weighting strategy, and prospects for its holdings. Additionally, understanding the sector ETFs' fit with investments owned in the portfolio is a key step towards earning high risk-adjusted returns.

If a sector ETF passing such detailed evaluation is also available commission-free, it can be the right one to invest. The added advantage of being able to buy and sell it without commissions would be the 'icing on the cake'.