

The Best & Worst Technology Sector ETFs

Overall Sector Rating: Neutral Risk/Reward Rating

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We deliver the whole truth by incorporating critical data from the Financial Footnotes and MD&A that other firms miss.

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- Our top picks for ETFs for the Information Technology sector are: Internet Architecture HOLDRS (IAH) and Semiconductor HOLDRS (SMH).
- We rate the investment merit of the top 12 Tech sector ETFs.
- We benchmark the individual ETF ratings against the entire Tech sector and the S&P 500.
- Our ratings enable investors to analyze ETFs in the same way they analyze stocks.
- We can apply our top-ranked stock ratings to any ETF, mutual fund, or portfolio.
- Our ETF/fund analysis is based on aggregation of models for companies held by the fund and weighted according to the fund's allocations to those companies, excluding cash.



Figure 1: The Investment Merit of the Top Information Technology Sector ETFs

| Fund/Benchmark | % of Fund Allocated To Each Rating | | | | | Overall Fund Rating |
|-----------------------|------------------------------------|---------------|---------------|---------------|----------------|---------------------|
| | Very Attractive | Attractive | Neutral | Dangerous | Very Dangerous | |
| IAH | 72.99% | 15.67% | 9.62% | 1.60% | 0.12% | Attractive |
| SMH | 54.16% | 30.13% | 13.73% | 1.99% | 0.00% | Attractive |
| SOXX | 32.43% | 23.60% | 26.67% | 7.15% | 0.00% | Neutral |
| Overall Sector | 47.44% | 10.84% | 27.19% | 12.33% | 2.20% | Neutral |
| MTK | 33.42% | 11.85% | 29.12% | 8.65% | 2.65% | Neutral |
| BHH | 0.00% | 0.00% | 0.00% | 0.00% | 100.00% | Very Dangerous |

Sources: New Constructs, LLC and company filings

Methodology

Our Risk/Reward Ratings have a solid track record of outperformance for investors. You don't have to take our word for it. See how [Barron's ranked us #1 for stock-picking](#).

Custom ETFs: [Contact us](#) if you would like access to an ETF of only the Very Attractive and Attractive-rated stocks for a particular sector or index.

The report offers benchmarks for (1) investors considering buying Information Technology sector ETFs and for (2) comparing individual ETFs to the Information Technology sector and the S&P 500. Our analysis is based on aggregating results from our models on each of the companies included in every ETF and the overall sector based on data as of 04/05/11. We aggregate results for the ETFs in the same way the ETFs are designed. Our goal is to empower investors to analyze ETFs in the same way they analyze individual stocks.

To make an informed ETF investment, investors must consider:

- 1) The structural integrity of the ETF and its ability to fulfill its stated objective. We use [XTF, an ETF research firm](#), to find the top 12 ETFs with the best structural integrity rating.
- 2) The quality of the ETF's holdings. We determine an ETF's quality using our overall risk/reward rating system.

Given the [success](#) of our Rating system for individual stocks, we believe its application to groups of stocks (i.e. ETFs and funds) helps investors make more informed ETF and mutual fund buying decisions.

Recommendations Summary

If you require exposure to the Information Technology sector:

We recommend investors buy Internet Architecture HOLDRS (IAH) or Semiconductor HOLDRS (SMH). The Information Technology Sector earns a Neutral Overall Rating, but IAH and SMH allocate over 86% of their value to attractive-or-better rated stocks, have XTF ratings of 8.8 and 9.8, and earn Attractive Overall Risk/Reward Ratings.

If you require exposure to any other sector:

We recommend investors review our 9 other sector ETF reports, beginning with our Consumer Staples and Health Care Sector reports, which are the only two sectors to earn an Attractive Overall Risk/Reward Rating.

If you require exposure to an Information Technology ETF or an index ETF:

We recommend investors buy the following Information Technology ETFs over an S&P 500 ETF: IAH, SMH, XLK, IYW, VGT, and SWH. The S&P 500 earns a Neutral Overall Risk/Reward Rating while these 6 Information Technology ETFs earn an Attractive Overall Risk/Reward Rating.

If you are looking for exposure to the best stocks in the market:

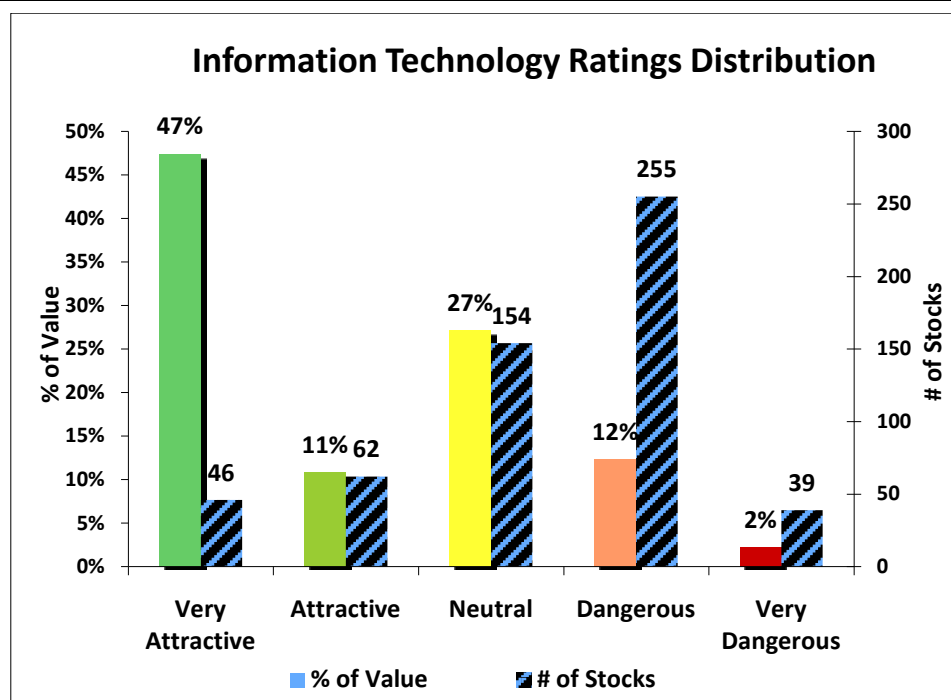
We recommend you buy our [Most Attractive Stocks](#).

Recommendations Detail

Click [here](#) for more info on risk/reward rating system and our approach to equity research.

If you want to be in a sector ETF, the Consumer Staples and Health Care sectors are the best places to shop due to their Attractive Overall Risk/Reward Ratings. However, there are still excellent investment opportunities in the Information Technology sector. Despite the Information Technology sector's Neutral Overall Risk/Reward Rating, a few ETFs manage to earn an Attractive Overall Risk/Reward Rating due to their heavy weighting in attractive-or-better-rated stocks. Figure 2 shows how the Information Technology sector's stocks and the market value attributed to them stack up under the microscope of our risk/reward rating system.

Figure 2: Information Technology Sector – Capital Allocation & Holdings by Risk/Reward Rating



Sources: New Constructs, LLC and company filings

The Information Technology sector has only 14% of its value invested in dangerous-or-worse-rated stocks and 58% of its value invested in attractive-or-better-rated stocks. Although the Information Technology Sector only earns a Neutral Overall Risk/Reward Rating, its heavy weightings of attractive-or-better-rated stocks create large opportunity for attractive-or-better rated ETFs.

The key takeaway here is that the Information Technology sector offers both good and poor investment opportunities. The value of each ETF is derived from its constituents, so ETFs that overweight attractive-or-better-rated stocks, like IAH and SMH, are great investment opportunities while ETFs that overweight neutral-or-worse-rated stocks should be avoided.

When analyzing the Tech Sector ETFs, we started by identifying those ETFs with acceptable structural integrity as measured by XTF. We chose the 12 ETFs whose XTF rating was above the sector average XTF rating.

Figure 3: Info Tech ETFs With Acceptable Structural Integrity

| TICKER | ETF Description | # of Cap-Weighted Holdings * | XTF RATING |
|--------|--|------------------------------|------------|
| SMH | Semiconductor HOLDRS | 19 | 9.8 |
| XLK | Select Sector SPDR-Technology | 84 | 9.6 |
| VGT | Vanguard Information Technology Index Fund | 419 | 9.5 |
| IYW | iShares Dow Jones US Technology | 167 | 9.3 |
| SOXX | iShares PHLX SOX Semiconductor Sector Index Fund | 31 | 9 |
| XSD | SPDR S&P Semiconductor ETF | 53 | 8.9 |
| IAH | Internet Architecture HOLDRS | 15 | 8.8 |
| SWH | Software HOLDRS | 14 | 8.2 |
| RYT | Rydex S&P Equal Weight Technology | 76 | 7.5 |
| BHH | B2B Internet HOLDRS | 3 | 7.4 |
| MTK | Morgan Stanley Technology ETF | 36 | 7.3 |
| HHH | Internet HOLDRS | 13 | 7.1 |

* # of Cap-Weighted Holdings excludes cash

Sources: New Constructs, LLC; XTF and company filings

Figure 3 shows clearly that not all Technology ETFs are made the same. Different ETFs have meaningfully different numbers of holdings and, therefore, different allocations to holdings. Given the differences in holdings and allocations, these ETFs will likely perform quite differently.

After determining the structural integrity, we analyzed the investment merit of each ETF based on how it allocated value to each stock it held. Figure 4 shows how the 12 Information Technology sector ETFs stack up versus each other and the overall sector based on their Overall Risk/Reward Ratings and the allocation of their holdings by rating.

Figure 4: Investment Merit Based on Holdings and Allocations

| Fund/Benchmark | % of Fund Allocated To Each Rating | | | | | Overall Fund Rating |
|-----------------------|------------------------------------|---------------|---------------|---------------|----------------|---------------------|
| | Very Attractive | Attractive | Neutral | Dangerous | Very Dangerous | |
| IAH | 72.99% | 15.67% | 9.62% | 1.60% | 0.12% | Attractive |
| SMH | 54.16% | 30.13% | 13.73% | 1.99% | 0.00% | Attractive |
| XLK | 46.95% | 14.56% | 28.15% | 6.96% | 1.69% | Attractive |
| IYW | 54.59% | 9.11% | 24.70% | 9.46% | 1.56% | Attractive |
| VGT | 48.09% | 10.72% | 25.89% | 10.95% | 2.10% | Attractive |
| SWH | 15.40% | 21.20% | 40.22% | 0.99% | 0.00% | Attractive |
| SOXX | 32.43% | 23.60% | 26.67% | 7.15% | 0.00% | Neutral |
| Overall Sector | 47.44% | 10.84% | 27.19% | 12.33% | 2.20% | Neutral |
| MTK | 33.42% | 11.85% | 29.12% | 8.65% | 2.65% | Neutral |
| RYT | 21.08% | 18.63% | 32.09% | 20.24% | 5.44% | Neutral |
| S&P 500 | 21.47% | 19.89% | 34.17% | 16.57% | 7.94% | Neutral |
| HHH | 0.00% | 21.27% | 65.75% | 12.96% | 0.00% | Neutral |
| XSD | 11.23% | 20.65% | 23.98% | 41.06% | 3.06% | Neutral |
| BHH | 0.00% | 0.00% | 0.00% | 0.00% | 100.00% | Very Dangerous |

Sources: New Constructs, LLC; XTF and company filings

Attractive ETFs:

IAH, SMH, XLK, IYW, VGT, and SWH – these 6 ETF earn an Attractive Overall Risk/Reward rating and therefore, they are the only Information Technology ETFs we recommend. We specifically recommend IAH and SMH from this group.

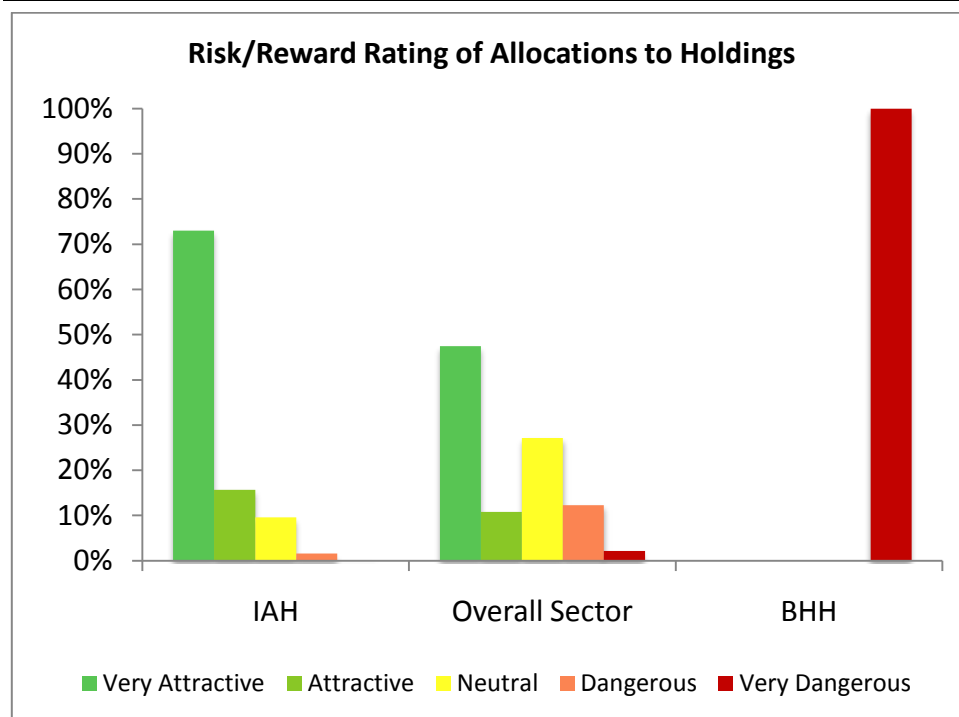
Neutral ETFs:

5 ETFs allocate the value of their funds in a way that earns them a Neutral Overall Risk/Reward Rating. We recommend investors buy the very attractive and attractive stocks in this sector before buying any of the Information Technology ETFs except those we recommend.

Dangerous ETFs:

We recommend investors avoid BHH because it has only two holdings, both of which earn a Very Dangerous rating. Figure 5 highlights just how different BHH is compared to IAH and the overall sector. Given the small market value of the very dangerous-rated stocks in the Information Technology sector, one has to wonder how Merrill Lynch, the issuer of BHH, determined it should allocate all of its value to very dangerous-rated holdings.

Figure 5: Attractive and Dangerous Information Technology Sector ETFs



Sources: New Constructs, LLC; XTF and company filings

Benchmark Comparisons

Sector Benchmark

IAH outperforms the overall Information Technology sector in quality of earnings ratings. IAH earns a Very Attractive Economic vs. Reported Earnings rating because its Economic Earnings are positive and rising while the sector's Economic Earnings are positive and decreasing. Also, although both IAH and the sector earn a Very Attractive ROIC rating, IAH's ROIC is 57% compared to the sector's ROIC of 43.3%.

IAH also outperforms the sector in valuation ratings. IAH has a Price-to-EBV of 1.1, earning it a Very Attractive rating, and a GAP of 4 years compared to the overall sector's Price-to-EBV of 1.9 and a GAP of 21 years.

Figure 6: IAH – Risk/Reward Rating

| Overall Risk/Reward Score | Quality of Earnings | | Valuation | | |
|---------------------------|----------------------|-----------------------------------|-----------|--------------------|----------------------------------|
| | Economic vs Reported | Return on Invested Capital (ROIC) | FCF Yield | Price-to-EBV Ratio | Growth Appreciation Period (yrs) |
| Very Dangerous | Misleading Trend | Bottom Quintile | <-5% | >3.5 or <-1.0 | more than 50 |
| Dangerous | False Positive | 4th Quintile | -5%<-1% | 2.4<3.5 or <-1 | 20<50 |
| Neutral | Neutral EE | 3rd Quintile | -1%<3% | 1.6<2.4 | 10<20 |
| Attractive | Positive EE | 2nd Quintile | 3%<10% | 1.1<1.6 | 3<10 |
| Very Attractive | Rising EE | Top Quintile | >10% | 0<1.1 | Less than 3 |
| Market-Weighted Avg | \$7.42 / \$11.03 | 57.0% | 2.8% | 1.1 | 4 |

Sources: New Constructs, LLC and company filings

Figure 7: Information Technology Sector – Risk/Reward Rating

| Overall Risk/Reward Score | Quality of Earnings | | Valuation | | |
|---------------------------|--------------------------|-----------------------------------|-----------|--------------------|----------------------------------|
| | Economic vs Reported EPS | Return on Invested Capital (ROIC) | FCF Yield | Price-to-EBV Ratio | Growth Appreciation Period (yrs) |
| Very Dangerous | Misleading Trend | Bottom Quintile | <-5% | >3.5 or <-1.0 | more than 50 |
| Dangerous | False Positive | 4th Quintile | -5%<-1% | 2.4<3.5 or <-1 | 20<50 |
| Neutral | Neutral EE | 3rd Quintile | -1%<3% | 1.6<2.4 | 10<20 |
| Attractive | Positive EE | 2nd Quintile | 3%<10% | 1.1<1.6 | 3<10 |
| Very Attractive | Rising EE | Top Quintile | >10% | 0<1.1 | Less than 3 |
| Market-Weighted Avg | \$4.02 / \$5.49 | 43.3% | 4.1% | 1.9 | 21 |
| Median | \$-0.03 / \$0.49 | 6.8% | 1.0% | 2.3 | 88 |

Sources: New Constructs, LLC and company filings

IAH more effectively allocates capital than the overall Information Technology sector. Per [Figure 4](#) above, IAH allocates 88.66% of its value to attractive-or-better rated stocks while the sector only allocates 58.28%. IAH also only allocates 1.72 % of its value toward dangerous-or-worse rated stocks compared to the sector's dangerous-or-worse weightings of 14.53%.

Market Benchmark

IAH outperforms the S&P 500 in quality of earnings ratings. IAH earns a Very Attractive Economic vs. Reported Earnings rating because its Economic Earnings are positive and rising while the S&P 500's Economic Earnings are positive and decreasing. Also, although both IAH and the S&P 500 earn a Very Attractive ROIC rating, IAH's ROIC of 57% dwarfs the S&P 500's ROIC of 18.2%.

IAH also outperforms the S&P 500 in valuation ratings. IAH has a Price-to-EBV of 1.1, earning it a Very Attractive rating, and a GAP of 4 years compared to the S&P 500's Price-to-EBV of 1.5 and a GAP of 26 years.

Figure 8: IAH – Risk/Reward Rating

| Overall Risk/Reward Score | Quality of Earnings | | Valuation | | |
|---------------------------|----------------------|-----------------------------------|-----------|--------------------|----------------------------------|
| | Economic vs Reported | Return on Invested Capital (ROIC) | FCF Yield | Price-to-EBV Ratio | Growth Appreciation Period (yrs) |
| Very Dangerous | Misleading Trend | Bottom Quintile | <-5% | >3.5 or -1<0 | more than 50 |
| Dangerous | False Positive | 4th Quintile | -5%<-1% | 2.4<3.5 or <-1 | 20<50 |
| Neutral | Neutral EE | 3rd Quintile | -1%<3% | 1.6<2.4 | 10<20 |
| Attractive | Positive EE | 2nd Quintile | 3%<10% | 1.1<1.6 | 3<10 |
| Very Attractive | Rising EE | Top Quintile | >10% | 0<1.1 | Less than 3 |
| Market-Weighted Avg | \$7.42 / \$11.03 | 57.0% | 2.8% | 1.1 | 4 |

Sources: New Constructs, LLC and company filings

Figure 9: S&P 500 – Risk/Reward Rating

| Overall Risk/Reward Score | Quality of Earnings | | Valuation | | |
|---------------------------|--------------------------|-----------------------------------|-----------|--------------------|----------------------------------|
| | Economic vs Reported EPS | Return on Invested Capital (ROIC) | FCF Yield | Price-to-EBV Ratio | Growth Appreciation Period (yrs) |
| Very Dangerous | Misleading Trend | Bottom Quintile | <-5% | >3.5 or -1<0 | more than 50 |
| Dangerous | False Positive | 4th Quintile | -5%<-1% | 2.4<3.5 or <-1 | 20<50 |
| Neutral | Neutral EE | 3rd Quintile | -1%<3% | 1.6<2.4 | 10<20 |
| Attractive | Positive EE | 2nd Quintile | 3%<10% | 1.1<1.6 | 3<10 |
| Very Attractive | Rising EE | Top Quintile | >10% | 0<1.1 | Less than 3 |
| Market-Weighted Avg | \$0.73 / \$4.08 | 18.2% | 2.5% | 1.5 | 26 |
| Median | \$0.23 / \$2.21 | 7.8% | 3.2% | 1.5 | 12 |

Sources: New Constructs, LLC and company filings

IAH more effectively allocates capital than the S&P 500. Per [Figure 4](#) above, IAH allocates 88.66% of its value to attractive-or-better rated stocks while the S&P 500 only allocates 41.33%. IAH also only allocates 1.72% of its value toward dangerous-or-worse rated stocks compared to S&P 500's dangerous-or-worse weightings of 24.51%.

Appendix: Risk/Reward Rating System

Our Risk/Reward Rating System assigns a rating to every stock we cover according to what we believe are the 5 most important criteria for assessing the risk versus reward of stocks. See table that follows for details.

| Overall Risk/Reward Ranking | The Overall Risk/Reward Ranking provides a final rating based on the equal-weighted average rating of each criterion. |
|-----------------------------|---|
| Very Dangerous | FCF Yield is not included in the average. |
| Dangerous | FCF Yield is not included in the average. |
| Neutral | All criteria are equal-weighted in the average calculation. |
| Attractive | All criteria are equal-weighted in the average calculation. |
| Very Attractive | All criteria are equal-weighted in the average calculation. |

| Economic vs Reported Earnings | Rates stocks based on how their Economic Earnings compare to their Reported Earnings. Values based on Latest Fiscal Year. |
|-------------------------------|---|
| Very Dangerous | Negative and declining Economic Earnings despite positive and rising Reported Earnings |
| Dangerous | Same as above except Reported Earnings are not rising or Reported Earnings are not positive |
| Neutral | Negative Economic and Reported Earnings |
| Attractive | Economic Earnings are positive |
| Very Attractive | Economic Earnings are positive and rising |

| Return on Invested Capital (ROIC) | Rates stocks based on their ROIC. Values based on Latest Fiscal Year. |
|-----------------------------------|---|
| Bottom Quintile | Very Dangerous = the bottom 20% of Russell 1000 companies |
| 4th Quintile | Dangerous = the bottom 40% of Russell 1000 companies |
| 3rd Quintile | Neutral = the middle 20% of Russell 1000 companies |
| 2nd Quintile | Attractive = the top 40% of Russell 1000 companies |
| Top Quintile | Very Attractive = the top 20% of Russell 1000 companies |

| FCF Yield | Rates stocks based on their Free Cash Flow Yield. Values based on Latest Closing Stock price and Latest Fiscal Year. |
|-----------|--|
| <-5% | Very Dangerous = less than or equal to -5% |
| -5%<-1% | Dangerous = more than -5% but less than or equal to -1% |
| -1%<3% | Neutral = more than -1% but less than or equal to +3% |
| 3%<10% | Attractive = more than +3% but less than or equal to +10% |
| >10% | Very Attractive = more than +10% |

| Price-to-EBV Ratio | Rates stocks based on their Price-to-Economic Book Value Ratio. Values based on Latest Closing Stock price and Latest Fiscal Year. |
|-----------------------------|---|
| >3.5 or -1>0 | Very Dangerous = greater than or equal to 3.5 or less than 0 but greater than -1 |
| 2.4>3.5 or <-1 | Dangerous = greater than or equal to 2.4 but less than 3.5 and less than or equal to -1 |
| 1.6>2.4 | Neutral = greater than or equal to 1.6 but less than 2.4 |
| 1.1>1.6 | Attractive = greater than or equal to 1.1 but less than 1.6 |
| 0>1.1 | Very Attractive = greater than or equal to 0 but less than 1.1 |

| Growth Appreciation Period (yrs) | Rates stocks based on their Market-Implied Growth Appreciation Period. Values based on Latest Closing Stock price and Default Forecast Scenario. |
|---|---|
| >50 | Very Dangerous = greater than or equal to 50 years |
| 20>50 | Dangerous = at least 20 years but less than 50 |
| 10>20 | Neutral = at least 10 years but less than 20 |
| 3>10 | Attractive = at least 3 years but less than 10 |
| 0>3 | Very Attractive = at least 0 years but less than 3 |

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