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# The Danger Within

By MURRAY COLEMAN

***Many investors don't know how good—or shaky—their ETFs' underlying stock holdings are.***

With stock markets showing signs of wear and tear after a two-year bull run, exchange-traded-fund investors should be alert for any sign of danger. And one big one could lie close to home.

"A lot of people select ETFs based on big-picture, macroeconomic trends. But they don't perform enough due diligence into what stocks a fund holds," says David Trainer, president of Nashville-based independent researcher, New Constructs.

In the latest *Barron's*-Zacks stock-picking competition (see **"Market Beaters"**), New Constructs came in second over one year and third over three years. It has consistently done well in the contest over the years.

Trainer evaluates exchange-traded funds by examining their portfolios on a stock-by-stock basis. Last week, his staff reviewed the holdings of several popular ETFs, using data complied by ETF research-specialist Marco Polo XTF.

One of the ETF sectors examined was technology. There, New Constructs found that the **Technology Select Sector SPDR** (ticker: XLK) held the most appealing stocks. However, "it only allocates about half of its assets to the best stocks," Trainer says. "The other half goes to companies that we see as relative laggards over the next 12months."

**THE TECH NAMES HE'S RECOMMENDING** to clients include: **Apple** (AAPL), **Microsoft** (MSFT), **Cisco Systems** (CSCO), **Analog Devices** (ADI) and **Linear Technology** (LLTC). "Each of these companies generates strong cash flows, but for various reasons expectations are very low that they'll be able to sustain or expand those levels going forward," says Trainer. For example, Microsoft's current price "implies that their future cash flows will decline by 10%," he notes. Trainer argues that the technology bellwether has free cash flow representing roughly 8% of its enterprise value—stock-market value, plus net debt. "That's a pretty strong yield," he observes.

His favorite nonleveraged ETF pick, based on its level of exposure to what he views as the strongest tech stocks, is the **iShares Russell Top 200 Growth Index** Fund (IWY).

ETFs in the consumer-staples sector are the best-positioned, according to New Constructs. Stocks such as **Wal-Mart Stores** (WMT), **Philip Morris International** (PM) and **H.J. Heinz** (HNZ) are at the top of the firm's Most Attractive list. The best play on the sector's healthiest companies is the **Consumer Staples Select Sector SPDR** (XLP), Trainer says. It allocates 74% of its assets to stocks he ranks as industry stalwarts.

On the other hand, New Constructs has red-flagged the **First Trust Consumer Staples AlphaDex** Fund (FXG). About 20% of its assets are in companies Trainer rates as "dangerous," while less than half its portfolio is allocated to stocks he considers as good bets. "An ETF can have some of the best stocks, but if it allocates too little to the good stocks and too much to the bad stocks, it can be a bad ETF," says Trainer.

Different analysts will come up with different evaluations. But one thing is certain: A key to determining success with exchange-traded funds is knowing how they allocate assets, and where their holdings might be headed.

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