Investing in Sectors Reaps the Benefits of Discovery, Development and Production

Basic Materials Funds: Two Hot Commodities?

by Danielle L. Schultz, CFP

With all the market turmoil, investors are seeking alternative investments that produce better returns and don't move in lockstep with the Dow Jones industrial average or the Standard & Poor's 500 index. Some investors have turned to gold and others to commodities in the hope of countering the market's downturns and snagging better returns. But these types of investments generally produce no dividends and often poorly reflect the value of their underlying investments. All return depends on buying and selling at precisely the right moment, which isn't the kind of long-term strategy BetterInvesting members are encouraged to follow.

An alternative is to consider investing in companies that produce basic materials or provide basic resources. Purchased individually, these stocks can give investors a white-knuckle ride, but purchased as part of a sector "market basket," the risk and volatility can be somewhat mitigated.

Investing in sector funds shouldn't make up the core of a portfolio, but they can provide you with diversification for the "satellite" or "explore" portion of your asset allocation. Vanguard Materials ETF (ticker: VAW) or Materials Select Sector SPDR (XLB) may be worth considering for that part of your portfolio.

One of the advantages of any ETF is that you can know the exact price you're paying or receiving. Unlike mutual funds, you don't have to wait for the end of the day to find out what the fund's shares were worth. To minimize the risk that your price will differ from the ETF's net asset value (NAV), Rick Ferri, author of *The ETF Book*, suggests waiting to trade ETFs until between 10 a.m. and 3:30 p.m. Eastern to avoid times when spreads between the bid and ask price are highest. He also suggests avoiding trading on volatile days.

Vanguard's mutual funds and ETFs track each other very closely, as the ETFs are considered simply a share class of the larger fund. Materials Select Sector SPDR is part of a family of ETFs designed to mirror certain market sectors and has no corresponding mutual fund. In the case of Vanguard Materials, for most investors the ETF will be the only choice. Unlike most Vanguard funds that have minimum investments of $3,000, the Materials mutual fund (VMIAX) has a minimum of $100,000, making it of interest mainly to institutional investors. But anyone can invest any amount into the ETF, and that's what we'll consider here.

A consideration for any investor is how widely or thinly the ETF's shares are traded. On a daily basis this may be of less concern to individual investors who will rarely be trading huge volumes of shares, but in extreme market conditions, trading may be slower for smaller funds. Here, Materials Select Sector SPDR has the advantage. It has assets of nearly three times the size of Vanguard Materials ($1.71 billion versus $559.71 million) and an average volume of 12.6 million versus 74,909 for Vanguard. In practice, however, neither fund has seen much difference between their trade prices and the value of their holdings. Although daily market swings and investor sentiment about a sector can produce gaps between any ETF's market price and its NAV, in general both ETFs track their NAVs well. Vanguard Materials has a 0.01 percent discount to NAV and Materials Select Sector SPDR recently had a 0.12 percent discount.

Investing Philosophy

Both of these funds are passively managed ones that seek to track an index. Vanguard Materials tracks the MSCI US Investable Market Materials 25/50 index. This index tracks an assortment of commodity-related U.S. manufacturing companies of all sizes. The sector includes manufacturers of chemicals, construction materials, paper, forest products and related packaging products, glass, and metals, minerals and mining companies. The Vanguard fund holds 134 stocks, each stock based on its weighting in the index.

Materials Select Sector has developed its own index, which is based on the materials sector of the S&P 500. It holds 30 companies, making its portfolio significantly more concentrated than VAW.

Portfolio and Management

Because these are passively managed index funds, the results to be expected aren't as dependent on the perceived investment skills of the manager as they are on the manager's ability to match the index. Michael D. Eyre, CFA, CPA, is the relatively new manager of both the mutual fund and the ETF, having been on the job since 2010. He's an internal manager with Vanguard (not part of an outside investing firm) and manages several other funds as well (Utilities, Mega Cap 300 Value and Growth indexes). XLB is managed by SSgA FM as the investment adviser, with portfolio managers Lynn Blake, CFA, who has been with the adviser since 1987; Mike Feehily, CFA; and John Tucker, CFA.

VAW purchases companies that operate in several subsectors. As of Aug. 31, 49.3 percent of the portfolio was in chemicals, 28.7 percent in metals and mining (6.6 percent in gold) and 11.4 percent in packaging and paper products. The remainder was in industrial gases, construction and forest products. XLB's 30 stocks, according to Morningstar analyst research, are allocated 61 percent to chemicals, 30 percent to metals and mining, 4 percent to containers and packaging, and 4 percent to paper and forest products.

What's missing may be as important as what's included — neither of these funds holds gas or oil companies, with both fund companies splitting off that type of investment into a separate sector known as energy. Energy funds are a more pure or narrow bet on the commodity prices of oil and gas, while VAW and XLB are a more diversified basket. The 10 largest holdings are nearly identical, but their relative weight in each portfolio differs, reflective of the greater number of stocks in VAW *(see tables, below)*.

Vanguard Materials ETF (VAW)	%
1. E.I. du Pont de Nemours & Co.	7.6
2. Freeport-McMoRan Copper & Gold Inc.	7.6
3. Dow Chemical Co.	6.4
4. Monsanto Co.	5.9
5. Praxair Inc.	5.0
6. Newmont Mining Corp.	4.0
7. Air Products & Chemicals Inc.	3.1
8. The Mosaic Co.	2.8
9. Alcoa Inc.	2.6
10. PPG Industries Inc.	2.6
10 largest holdings as of Aug. 31	**47.2**

Source: Company website

Materials Select Sector SPDR (XLB)	%
1. E.I. du Pont de Nemours & Co.	11.3
2. Freeport-McMoRan Copper & Gold Inc.	10.2
3. Monsanto Co.	9.7
4. Dow Chemical Co.	8.6
5. Praxair Inc.	7.9
6. Newmont Mining Corp.	6.3
7. Air Products & Chemicals Inc.	4.5
8. Alcoa Inc.	3.4
9. CF Industries Holdings Inc.	3.3
10. PPG Industries Inc.	3.3
10 largest holdings as of Sept. 16	**68.5**

Source: Company website

Performance

The Vanguard fund holds more than four times the number of stocks that Select Sector holds, but according to Morningstar's analyst research reports, performance of the two funds over the past five years has been 99 percent correlated.

VAW vs. XLB Performance

	1 yr	3 yr	5 yr	10 yr
Vanguard Materials ETF (VAW)	21.3%	(0.4%)	6.2%	Since inception (2004), 8.0%
Materials Select Sector SPDR (XLB)	18.1%	(1.0%)	4.7%	7.4%

Data as of Aug. 31 *Source: Morningstar*

Both funds have consistently outperformed the S&P 500 index but with significantly more volatility (beta of 1.32 for XLB and 1.38 for VAW). In addition, Morningstar reports VAW's 12-month yield as 2.33 percent, while Select Sector reports XLB's yield as 2.36 percent.

The total return of each ETF compared with the S&P 500, used as a proxy for the stock market in general, is seen in the table above. As you can tell, both of these materials ETFs have higher highs and lower lows than the general market, but held over time they have the potential to produce a solid return as part of your portfolio's asset allocation.

Total Return of Vanguard Materials ETF and Materials Select Sector SPDR Compared With the S&P 500 (%)

	2004	2005	2006	2007	2008	2009	2010
VAW		3.8	19.5	26.4	(46.6)	51.6	24.3
XLB	13.3	4.2	18.3	22.0	(44.0)	48.5	20.4
S&P 500	10.9	4.9	15.8	5.5	(37.0)	26.5	15.1

Data as of Aug. 31 *Sources: Morningstar, Wikipedia and http://historicalreturns-sp500.blogspot.com/*

Costs

Both funds are no-load and have low management costs, due to being index funds with passive management run by companies committed to keeping fees low. VAW's annual expense ratio is 0.24 percent; XLB's annual expense ratio is even lower at 0.20 percent.

Because these are ETFs, there's no minimum purchase. If VAW is purchased through a Vanguard account, there's no commission.

But brokerage commissions may apply if either of these funds is purchased through another brokerage. If you trade frequently, this may be a contributing factor in selecting which fund to hold. If you already have an investment or retirement account housed with Vanguard Brokerage Services, VAW may be an inexpensive choice to incorporate some alternatives into your asset mix. If your portfolio custodian charges for trades in ETFs, be sure you check whether you can trade either of these commission-free. XLB may be a good alternative "alternative" for its low management costs and liquidity.

These funds are mentioned for educational purposes only; no investment recommendations are intended. The author and some of her clients may have positions in some of the funds mentioned in this article.

Danielle L. Schultz, CFP, is a fee-only financial adviser with Haven Financial Solutions Inc., based in Evanston, Ill. She can be reached at www.HavenFinancialSolutions.com.