Trading Lesson

Which Exchange Fund to Track and Hold

by Thom Hartle

An exchange traded fund is an investment product that holds a pool of securities designed such that the return on the shares is comparable to the performance to an index. For example, an investor who purchases SPDRs does so with expectation that the returns will closely match the performance of the S&P 500, the standard benchmark for investors tracking the stock market. The general idea is that you own the top 500 companies in America.

Today's two most popular exchange traded funds are the Standard & Poor's Depositary Receipts (Nasdaq: SPY), often referred to as SPDRs and the NASDAQ-100 Index Tracking Stock (Amex: QQQ). Investors purchasing the QQQs, are interested in returns similar to the Nasdaq 100 index, which represents the technology sector. There are no financial stocks in the Nasdaq 100 index.

But, there is another fund that traders should track as both an indicator of the state of the market and for investment potential, and that is the Rydex S&P Equal Weight ETF Trust (Amex: RSP). Here we'll compare the three funds and show why the Rydex ETF should be on your radar.

Investors purchasing the QQQs, are interested in returns similar to the Nasdaq 100 index, which represents the technology sector. There are no financial stocks in the Nasdaq 100 index. There are over 150 exchange traded funds representing opportunities for investors to participate in markets ranging from fixed income securities to foreign stock markets.

The S&P 500 index is a market capitalization-weighted index, which means that a stock's price is multiplied by the total shares outstanding. In other words, the larger the number of outstanding shares, the larger the effect the individual stock price has on the movement of the index. This is known as a market capitalization-weighted index Table 1 represents the weighting of the top ten stocks in the S&P 500, which is composed of 500 stocks.

Table 1: Top Ten Stocks by weighting (Source: Nasdaq.com)

1	General Electric Co	3.01%
2	Microsoft Corp	2.88%
3	Exxon Mobil Corp	2.63%
4	Pfizer Inc	2.61%
5	Citigroup Inc	2.42%
6	Wal Mart Stores Inc	2.22%
7	Intel Corp	2.04%
8	American International Group Inc	2.04%
9	Cisco	1.62%
10	International Business Machines	1.55%
	Total	24.21%

The top ten stocks represent 24.21% of the calculation of the S&P 500. In other words, the performance of General Electric, Microsoft, and Exxon will have as much impact on the S&P 500 index as the performance of remaining stocks 497 stocks in the index.

Table 2: Industry Groups (Source: Nasdaq.com)

1	Financials	20.62%
2	Technology	17.62%
3	Health Care	13.27%
4	Consumer Discretionary	10.98%
5	Consumer Staples	10.98%
6	Industrials	10.85%
7	Energy	5.77%
8	Communication Services	3.43%
9	Materials	3.01%
10	Utilities	2.77%
	Total	99.55%

Table 2 is a breakdown of the S&P 500 by Industry Groups.

At the top of this list are the financials, which make up slightly over 20% the S&P 500. Movements of the financial industry will therefore have the greatest impact on the S&P500, followed by technology, then by health care, etc. For example, this past quarter the performance of American International group (NYSE:AIG), under pressure due to an ongoing investigation, and has pulled the S&P 500 down, as seen in Chart 1.

THE QQQs

The NASDAQ-100 index holds technology stocks only, and is also a market capitalization weighted index. Table 3 shows the top holdings.

Table 3: Top Ten Stocks by weighting (Source: Nasdaq.com)

1	Microsoft Corporation	9.00%
2	QUALCOMM Incorporated	6.66%
3	eBay Inc.	3.94%
4	Intel Corporation	3.92%
5	Cisco Systems, Inc.	3.80%
6	Amgen Inc.	2.91%
7	Nextel Communications, Inc.	2.88%
8	Dell Inc.	2.84%
9	Comcast Corporation	2.34%
10	Starbucks Corporation	2.18%
	Total:	40.47%

Table 4 is breakdown the S&P 500 by Industry Groups.

Table 4: Industry Groups (Source: Nasdaq.com)

1	Computer & Office Equipment	27.02%
2	Computer Software/Services	23.38%
3	Telecommunications	14.39%
4	Retail/Wholesale Trade	14.39%
5	Biotechnology	10.00%
6	Health Care	4.19%
7	Services	3.12%
8	Manufacturing	2.55%
9	Transportation	0.96%

Total:	100.00%

Table 3 shows that the dominant stock for the Nasdaq 100 is Microsoft. Chart 2 shows the impact of Microsoft on the Nasdaq 100, tracked by the QQQs.

SPDRs and QQQs these can be heavily influenced by the movements of certain stocks due to the market capital weighted calculation.

The Rydex S&P Equal Weight ETF Trust (Symbol: RSP) holds the same 500 stocks as the S&P 500, but it is not a market capitalization-weighted index. It is an unweighted version of the S&P 500 in which each of the 500 stocks has a weighting of just 0.20. Therefore, no one stock or industry has an unduly high influence on the performance of this exchange traded fund. The smaller, far more growth oriented companies, can therefore be more competitive on an economic basis. These smaller companies will have the same influence on the performance of the fund as the larger, less growth oriented companies.

The best way to show the difference between the SPDRs, QQQs and the RSP is a relative performance chart, as shown in chart 3.

Chart 3 shows the performance for all three funds on a percentage change basis, with all three set at zero on the first of the year. That the Rydex unweighted version of the S&P 500 has significantly outperformed the other two. This indicates that the broader market has been doing better than the QQQs, which have been held back by semiconductor stocks, or the SPDRs which have been hurt by insurance stocks, (AIG) and healthcare stocks(Merc's troubles over the drug Vioxx).

Finally, what about volume? Over the last 30 days the average daily volume for the RSP was 79,000 shares per day while the SPY was nearly 50 million and the QQQs was over 100 million shares per day. Obviously, the RSP is a vehicle for investors and traders who want an unbiased view of the market rather than day traders.

Conclusion

The many new exchange traded fund products available give traders and investors a host of opportunities to take advantage of changes that impact the economy, from rising oil prices to falling interest rates. In addition, because the Rydex exchange traded fund is not unduly influenced by the performance of a few large stocks or a problematic industry, tracking it can provide significant insight into developing market trends.

Thom Hartle is Editor of the Traders Expo Weekly. In addition, he is contributing editor for Active Trader magazine as well as a private trader. In a career spanning 25 years, he was editor of Technical Analysis of Stock and Commodities magazine (1990-1999), assistant investment officer and trader for the Federal Home Loan Bank of Seattle (1985-1990), vice-president sales for Drexel Burnham Lambert (1982-1985) and a commodity account executive for Merrill Lynch (1979-1982).