EXCHANGE TRADED FUNDS

ETF Experts' Sector Investing Strategies For 2012

Dueling Scenarios:

Financials, health care, homebuilders and master limited partnerships

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Pharmaceutical ETFs, up 19% year to date, enjoyed the healthiest returns in 2011 among all sector ETFs. Utilities, up 13%, and retail ETFs, up 12.5%, also proved strong. Which sectors does the ETF investing prescription call for next year?

We asked several strategists to weigh in.

Herb W. Morgan, *CEO of Efficient Market Advisors in San Diego, Calif., with $190 million in assets under management.*

SPDR S&P Homebuilders[XHB]: Be careful. This is a high-octane pick. But we like it so much, it's 5% of some of our managed portfolios. The National Association of Home Builders index reached an all-time low of 8 back in January of 2009. Since then, the business remains miserable but is improving on the margin.

Traditionally, this is how you get in early. Waiting until the industry is riding high again will cause one to miss the lion's share of the appreciation.

The index is now at 21 and climbing. Conditions won't be considered "good" until it hits 50, so investors need to be patient.

Strategists, from left, Herb Morgan, David Vomund, Chuck Dukas and David Fry like utilities, banks and master limited partnerships for 2012.

The U.S. continues to see population growth and household formation. We need 1.2 million to 1.5 million new homes to keep up with the demand for housing. New-home sales have been stuck around 300,000 for almost three years — for good reason. Just as the overproduction led to the drop, the underproduction is slowly soaking up the inventory. Even a modest pickup in sales, such as we saw with November starts rising to 685,000 and permits to 681,000, could provide excess appreciation for investors.

David Vomund, *president of Vomund Investment Management in Incline Village, Nev., with $12 million in assets.*

Utilities Select Sector SPDR[XLU]: In spite of all the market volatility and economic worries, utility stocks are up 11.7% for the year.

Utility stocks typically underperform other sectors when the economy is booming and the market is doing well. They are better suited for a slow-moving economy, such as today's. The companies are less sensitive to the economy than most, and many are monopolies in their regions.

There are half as many electric utility companies today as there were 50 years ago. It's expected that 10 years from now, there will be half as many companies as there are today. Many will be acquired at premium prices.

The attractiveness of the utilities sector is best seen in how fast it recovered from the early August and November selling. Whereas nearly every other sector has struggled to get back to its high, the XLU recovered all of its losses as soon the market showed a sign of life.

What can go wrong? If the economy turns strong or if interest rates rise by a lot, instead of a little, then more aggressive, high-yielding equities will be the better performers. This is unlikely.

Yes, utility stocks are dull and their 4% yield doesn't sound like much, but given the market's unprecedented volatility and the near-zero interest-rate environment, this slow-moving sector is providing shareholders with the income they need to meet their investment goals while offering potential capital gains.

Chuck Dukas, *founder of TRENDadvisor in Charlotte, N.C.*

Financial Select Sector SPDR[XLF], SPDR S&P Bank ETF[KBE], SPDR S&P Regional Banking ETF[KRE] and iShares Dow Jones U.S. Financial Sector[IYF]: Over the past three years, bailouts and bankruptcies in real estate, subprime and bank arenas placed a drag on the overall health of financial ETFs making it difficult for them to gain traction.

Four years after the financial crisis, this sector could be ripe for double-digit gains. Since 1950, the S&P has advanced (in the final seven months) a whopping 13 of 15 election years in an incredible bullish trend. Financials should have new life and legs in 2012.

Most of the financial ETFs have similar chart patterns, but we will focus on the volume leaders. Volume is the key indicator of supply and demand, along with price.

We will anticipate future price action if history (human behavior) is to repeat itself. With most of the selling pressure alleviated, meaning there's no more sellers, price expansion should unfold.

July, August and September brought the final wave of sellers, with heavy volume pressuring price. October provided excellent support to price, and volume expanded. A breach of the October lows for any of the ETFs would negate its advance.

David Fry, *founder of ETF Digest in New London, N.H.*

JPMorgan Alerian MLP Index ETN[AMJ] and Guggenheim Multi-Asset Income ETF[CVY]: Investors want to do better with their portfolios and are changing the asset mix. One issue that stands out is demographic changes, particularly as it affects baby boomer behavior.

Most, if they can, are getting ready for retirement. This means they're less interested in risk and more interested in income and a return of principal. Investment-grade bonds have run away from them and sport negative yields after realistic inflation data is factored in.

The alternative means investors will pursue higher-paying dividend sectors, which can offer income and possibly some growth.

Chasing high dividend yields can lead to trouble if dividends aren't secure. For example, there are many seductive high-yielding ETFs found in the financial sector, and in bank-preferred ETFs especially. They present more of a gamble, as many might have overseas exposure to euro zone banks or domestic banks with this exposure.

Currency risks pose another consideration, which can be positive or negative depending on your view.

This article is the second in a series on the outlook for ETFs in 2012.