MAKING SENSE OF THE MARKET

An increasingly varied ETF universe calls for a highly specialized strategist

BY JADE HEMEON

The rapid proliferation of exchange-traded funds (ETFs) has given rise to a new breed of money manager known as an "ETF portfolio strategist." These specialized money managers offer their expertise in assembling portfolios of ETFs. These portfolios are made possible by the rapidly expanding numbers and types of ETFs, which now include a wide range of core and niche asset classes. It is becoming increasingly challenging for ordinary investors and even financial advisors to analyze all the choices, then put together complementary ETFs and monitor those portfolios.

"There's a dizzying array of ETF products in Canada, and even more listed in the U.S." says Dan Hallett, vice president and principal with HighView Financial Group in Oakville, Ont. "Whenever there is such a large universe [of products], it creates the need and demand for someone who is able to sift through the universe and provide value-added analysis and insight."

This new breed of wealth manager has expertise in constructing portfolios entirely of ETFs, although many of these managers also manage portfolios of traditional stocks and bonds, or portfolios that mix ETFs and other securities. Growth has surged so strongly in this niche that the iShares division of BlackRock Asset Management Canada Ltd. of Toronto, the giant among ETF providers in Canada, has introduced its quarterly *Canadian Guide to ETF Strategists* to track the array of ETF strategies and portfolio managers. In

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addition, the Canadian ETF Association has created a membership category for professional investment managers who devise asset-allocation strategies focusing on ETFs.

ETF investment strategists typically have portfolio manager or investment counsellor credentials. These strategists usually manage money on a discretionary basis, offering a choice of model ETF portfolios along a risk spectrum that ranges from conservative to aggressive. The convenience of trading ETFs allows for strategies that once were inaccessible to retail investors, including access to globally diversified baskets of stocks, bonds, currencies, commodities and hedging vehicles.

"There are so many ETFs to look through, and it's a complex undertaking to understand all the products," says Ted Bader, director of iShares business development and author of the iShares quarterly guide. "These guys run the screens, talk to the [product] providers and navigate the ETF landscape."

The latest edition of the iShares guide, based on Dec. 31, 2013, numbers, tracks more than 30 ETF strategies by 16 ETF portfolio managers, with a combined $4 billion in ETF assets under management (AUM), up from 11 portfolio managers and $3 billion in AUM in June 2013, when the guide was introduced. Among the larger portfolio managers are Cougar Global Investments Ltd., HAHN Investment Stewards & Co. Inc. and ETF Capital Management, all based in Toronto.

"The more product there is, the more the need to discern what products can and can't do, and what they're suited for," says Yves Rebetez, managing director and editor with ETF Insight Inc. in Toronto, who maintains a website dedicated to Canadian ETFs. "And this presents an opportunity for people with the right skill set."

The profession of ETF portfolio strategist has been evolving for about 10 years, says Bader, but until recently hadn't been categorized as a separate advice channel. Morningstar Inc. of Chicago began to examine the ETF professional management industry about four years ago in the U.S., and now compiles a regular quarterly report; the latest issue lists 648 strategies managed by 153 firms with US$96 billion in AUM.

John Gabriel, ETF research strategist with Morningstar in Chicago, says the "value added" offered by a portfolio manager is in the asset allocation or in "actively managing passive products," not in individual security selection, which is where traditional active portfolio managers strive to add value.

"The reality is that ETFs are tools that advisors and investment managers use to make active tactical bets," Gabriel says. "These bets can be anything from sector rotation strategies and boosting a portfolio's exposure to emerging markets to speculative and momentum-based strategies. [ETFs aren't] all blending a 60/40 equity/bond portfolio, and some shops manage only fixed-income."

Bader says ETF strategists target a mix of institutional and individual clients. Much of the recent growth has been driven by subadvisory relationships with individual financial advisors who want to delegate investment management or a portion of it. In some cases, financial services firms are looking to hire a subadvisor for separately managed accounts that hold ETFs. Other clients cultivated by ETF specialists include pension and endowment funds and multi-family financial advisory offices looking to add ETFs to their mix.

"A lot of people and organizations are looking for a third-party manager to pick ETFs and make independent allocation decisions," Bader says. "Usually, an ETF portfolio can be managed at a lower cost than actively managed mutual funds. Instead of trading 100 securities, the manager might be trading 10 ETFs. ETFs are liquid and transparent — you can see what securities are in the underlying portfolios."

ETF strategists sift through about 300 ETFs that trade on the Toronto Stock Exchange and the more than 5,000 that trade globally that comprise the worldwide menu of ETFs. These strategists examine which ETFs are most liquid and offer the desired exposures, then determine the appropriate allocation mix.

"Much of the screening relates to liquidity issues," Bader says, "as there could be a need to get in and out quickly at large volumes."

ETF portfolio strategists, Bader says, are likely to need less "infrastructure" or business overhead than portfolio managers of actively managed mutual funds, which require detailed analysis of individual stocks and the expertise of research teams. Therefore, an ETF portfolio manager's fees are relatively lower.

For example, HAHN Investment's management fee is 1.5% a year for clients with accounts worth between $100,000 and $500,000, and this fee is added to any management fees charged by the underlying ETFs. For accounts of $500,000 to $1 million, HAHN Investment's fee is 1.15%. As accounts get bigger, the firm's fees drop as a percentage of AUM.

Traditional portfolio managers and investment counsellors often target high net-worth clients with accounts worth $1 million and up. The simplicity of ETFs can make it economically viable for ETF strategists to offer their management skills to smaller investors. HAHN Investment accepts accounts as small as $100,000. Wickham Investment Counsel Inc. of Hamilton, Ont., for its part, accepts a minimum of $150,000.

For financial advisors, delegating investment management to an ETF portfolio manager can free up time to concentrate on financial planning and business building. But, Gabriel cautions, not all ETF portfolio strategists are created equal. It's important to conduct due diligence on track record, qualifications and methodology and to examine security measures for assets.

"It's still early in the development of the profession," Gabriel says. "A lot of firms are just starting out, and it's still the Wild West. There's a wide range of experience and expertise." •

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BUILDING WITH THE BLOCKS

Larry Berman, ETF portfolio strategist and president of Toronto-based ETF Capital Management, says most of the outperformance (a.k.a. "alpha") in managed portfolios comes from asset allocation, and ETFs are the lowest-cost and most efficient way to allocate assets. Berman uses ETFs for exposure to both fixed-income and equities, then breaks it down further by such categories as geographical region, country and market capitalization.

As of Dec. 31, 2013, Berman's global balanced portfolio had 25% of assets in iShares DEX Universe Bond Index Fund, 25% in iShares MSCI World Index Fund, 15.6% in Vanguard FTSE Europe ETF, 15.6% in SPDR S&P 500 Trust, 12.5% in iShares MSCI All Country World Minimum Volatility Fund and 6.2% in iShares MSCI Emerging Markets Fund. "I can do whatever I want using 100% ETFs," Berman says. "And I can get exposure in any country around the world by using ETFs that trade in either Canada or the U.S."

When you know the ETF market well, you can zero in on products that meet specific objectives, says Tyler Mordy, president and CEO of HAHN Investment Stewards & Co. Ltd. For example, within the U.S. market, Mordy likes large, multinational companies that transcend borders and sell their products globally. He finds he can get better exposure to these companies through Vanguard Dividend Appreciation ETF than he could with another ETF that covers the broader S&P 500 index.

"We have abdicated individual security selection in favour of asset allocation, which we believe is the primary determinant of investment returns," Mordy says. "We are multi-asset class specialists. With ETFs, you can get exposure to Chinese bonds or to gold with a single click."

James Breech, president of Cougar Global Investments Ltd. of Toronto, analyzes the construction and methodology of the indices underlying ETFs, assessing liquidity and the ability of ETFs to track indices accurately.

Says Breech: "We want to know exactly which securities are in the ETFs we hold."

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