



An ETF Portfolio

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Over the past several years, investors have given increased attention to passively managed investment products. Index mutual funds acquired a significant following during the strong bull market of the 1990s, but with the great proliferation of exchange traded funds (ETFs) over the past few years, investors have been given even more tools for building their investment portfolio.

Many media sources, including *Canadian MoneySaver*, have provided interesting insight into the use of index funds and ETFs as core building blocks in the portfolio construction process. Today, some advisors provide services revolved around the use of ETFs as the “core” of their portfolio. Why? Because of some very strong arguments:

- With the ever increasing number of mutual funds, it has become increasingly difficult to pick funds that consistently perform well and, more importantly, that consistently beat their relative benchmark index. Are you chasing returns by picking last years “hot” fund manager? If most fund managers don’t perform well over the long term compared to their benchmark, investors have to be good at both buying funds as well as selling funds. In other words, timing fund selection. This is more difficult than simply selecting funds. Furthermore, mutual fund companies are not agreeable to unitholders who practice timing their funds. Those who see mutual fund selection as an exercise in futility may find peace of mind in the use of index funds or ETFs.
- Active managers have relatively high turnover rates compared to a passive strategy which puts investors of actively managed funds at a tax disadvantage. Recall how tech fund investors were punished twice—once when the bubble burst, then by the tax burden many investors realized based on high returns from previous unitholders. ETFs are very tax efficient and, to a certain degree, allow investors to plan their tax events (“tax harvesting” of capital gains, capital losses, etc.). Increased trading activity results in more than just tax consequences: commissions, bid/ask spread and market impact are also a drag on returns.

- Management fees - They are generally between 0.2% to 0.8% for a passively managed fund versus 1.5% to 3.0% for an actively managed fund. Many cite this as one of a number of reasons why active managers, on average, underperform their relative benchmark.

- Performance in down markets - Are active managers really better in down markets? What saved the Canadian equity manager in the down market of 2000? Was it skill or the fact that they were limited by fund regulations to not invest more than 10% in any particular issue (Nortel)? In any case, there is strong proof that active managers don’t always beat the index, even in down markets. This is from Barclays Global Investors (Canada): http://www.iunits.com/english/speakers/gerry_rocchi/indexing.pdf

- Natural diversification - Technically, you could have a well-diversified portfolio with as few as twenty stocks. However, would you rather pay commissions on twenty U.S. stocks or the commission on just one ETF like XSP (traded on the TSX) or SPY (AMEX) for you to have a well-diversified U.S. equity portfolio? You do the math.

- Passive instruments are ideal for asset allocation strategies as they limit the chance of style drift. For investors of actively managed funds, you have to consider that at one moment your manager may be growth oriented, the next they are value oriented. Well regarded managers stick to their style. Warren Buffett’s value style often leads him to say that he simply can’t find anything worthy to buy (usually because of inflated prices). But there’s the problem. Some (not all) managers are willing to compromise their style for the sake of returns. The question is whether the decision to modify one’s strategy actually results in improved returns.

These are very strong arguments for the use of ETFs and index funds. Lastly, think of indexing as a trade-off: you must be confident that the low possibility of doing any better than the index is made more appealing by the high

probability of doing better than most actively managed funds. However, the truth is that there are certain anomalies or inefficiencies in the markets that some active managers may be able to exploit, although it is difficult for them to continually take advantage of this due to: increased competition, cost of trading, cost of research, and other reasons.

Active management? Inefficiencies in the market? I thought you were against that! What I am saying is that it is hard to find successful “long-only” active managers who can exploit these inefficiencies. It is even harder to find them before they do well and select them in advance. This is especially true in the mutual fund world where costs often play a significant role.

Most mutual funds are actively managed. However, due to securities laws, they are constrained in terms of their flexibility of investment decisions. For example, they can not invest more than 10% into a single security, nor can they use leverage or implement short positions. The result of this is that returns for a large majority of mutual fund managers perform closely to a benchmark index. This means that the manager is bound by regulation to expose their portfolio to a significant amount of market risk, which is referred to as *beta*. More specifically, *beta* is the factor of a manager’s return that is attributable to the market. A beta of 1 means that statistically, the stock’s volatility is similar to that of the market. A higher beta means higher volatility relative to the market, and vice versa. Any excess return that a manager adds independent to that of the market is referred to as *alpha*. A manager that has a *beta* (returns generated from the market) close to 1 and a low alpha (returns in excess of the index due to manager skill) is effectively a “closet indexer”. In these cases, it may be wiser to buy the cheaper ETF or index fund.

Some investors may believe that it is unadvisable to use indexing for certain asset classes. In areas like emerging market equities and small cap equities, active managers have had proven performance results. Some managers, such as hedge fund managers, can exploit lesser constraints put upon them (they have the ability to short, apply leverage, etc.) to actually have a better shot at providing *alpha*. Furthermore, alternative investments (hedge funds, managed futures) often have the favourable characteristics of low correlations to stocks and bonds as well as good performance in down markets. However, they also have their own set of disadvantages (illiquidity, high fees, etc). Nevertheless, for those investors who want to go beyond indexing, another goal may be to find the active managers who can exploit the markets.

A key point here is the separation of beta (market risk) and alpha (the risk/return component beyond that which is inherent in the market). Later, I’ll discuss this issue a little deeper.

As you can see from the above, to fully appreciate this discussion, one must first come to grips with modern portfolio theory, efficient market theory, and thus, the “active versus passive” debate. Assuming that you agree that the use of passive instruments are appropriate for the portfolio construction process, this series of articles attempts to consider the following issue:

How do you defend an ETF-based portfolio during major down markets? This question moves our mindset from the concept of “portfolio construction” to “portfolio maintenance”. With the strong performance in the markets since the spring of 2003 and the increasing interest and use of ETFs over the past few years, a discussion on risk management may be prudent at this time.

Institutional methodology for portfolio management

From various studies, but most prominently from the Brinson/Beebower/Hood study titled “Determinants of Portfolio Performance” (1986), it is widely acknowledged that asset allocation is the main driver of portfolio returns, and more importantly the variability of those returns. Institutions, such as pension funds and endowments, determine a policy allocation that suggests the proportion to be invested into stocks, bonds, cash, the subcomponents of each, and any other additional asset classes. They may allow the actual portfolio’s asset allocation to deviate from this standard asset mix, but only to a certain degree. They may also adjust this asset mix periodically due to market conditions, changes in the global economic environment or other factors. This is a good way to first consider the portfolio construction process. Based on your objectives and risk tolerance, you and your advisor can decide on what would be a good asset mix and how much risk (volatility) you will allow for your portfolio’s holdings.

Next, many institutions decide on whether to use passive and/or actively managed strategies for each asset class and the appropriate proportions. Again, due to the advent of index mutual funds and ETFs, ordinary investors can now do what institutions have done for years: asset class investing with the use of indexed strategies for each asset class.

Back to basics: Building a simple portfolio for the everyday investor

There’s no such thing as a “one size fits all” portfolio. However, we can make some simple suggestions here as a start. First, the passively managed instruments that are the building blocks for our portfolio construction process:

1. Exchange Traded Funds (ETFs) - Consider ETFs as index mutual funds that trade on a stock exchange. Like mutual funds, they hold a portfolio of investments, but like index mutual funds, they are managed to very closely mimic a particular benchmark index. The benefits of this indexed approach have already been stated earlier. But, of course, ETFs are not

for everyone. If you plan on trading ETFs with a significant amount of frequency, then transaction costs begin to matter. For large accounts, the cost of trading may be less significant than they are for small accounts.

Depending on an investor's risk tolerance and experience, ETFs can be used in a large variety of ways. For most novice investors, ETFs can be used like mutual funds to build a simple portfolio of three to ten positions. This kind of thinking will be the premise for most of these articles. More advanced investors can consider using more ETFs, trading them more frequently, using them in margin accounts, shorting them, overlaying option strategies, applying tax harvesting strategies, day trading, etc. There's a wide spectrum of ideas here. Not all are for everyone!

ETFs can be purchased through a brokerage account, either self-directed or with a broker/dealer who can provide various levels of advice. If your advisor is only registered to sell mutual funds, you will have to go to option two.

2. Index mutual funds - I believe that index mutual funds are a good first step for novice investors who are considering a transition from a portfolio of various actively managed mutual funds (Canadian balanced fund, U.S. growth fund, global bond fund, etc.) to a portfolio consisting primarily of passively managed funds. The move straight to ETFs might be too much, especially for "do-it-yourself" investors who have only had experience investing in mutual funds, but not directly into the stock market.

Some disadvantages: Index mutual funds do not trade throughout the day. Like all mutual funds they have one price for each trading day. Therefore, you can't try to finesse your trade during the market hours. But why would you? Wouldn't you rather focus on your family or your day job? Index mutual funds also have higher MERs than ETFs. However, they are still significantly lower than those for actively managed mutual funds.

Advantages: Picking index funds is not as onerous as for actively managed funds. If you want to pick an index mutual fund for the Canadian equity asset class, there are plenty of choices. The same goes for index mutual funds for many other asset classes. I did a quick search using various online fund portals (Globefund, Morningstar, Fundata, etc.). To replace your actively managed Canadian equity mutual fund, there are about ten to twenty comparable index funds, depending on the site. How do you decide? Frankly, you can pick any of them. Their MERs should all be nearly the same. If any of them are significantly higher than the rest, I would take it off your list. But cost is certainly not the only consideration, no matter what kind of investment you are considering, although it does matter. Other considerations are: what index is it trying to replicate, how long has the manager(s) been operating the fund, size (for index funds, bigger is usually better).

If you are interested in building an index-based portfolio, you should discuss with your financial advisor if ETFs or index mutual funds would be more practical for your situation. Portfolio size, expected trading frequency and your advisor's securities registration are some of the factors involved in the decision process.

3. Dimensional Fund Advisors - One subset of the index mutual fund group is a new family of funds from a U.S. money manager called Dimensional Fund Advisors (DFA). John De Goey wrote about them in last month's issue of *Canadian MoneySaver* so I'll just give a short review. DFA are passive managers yet they do not manage index funds. ETFs and index mutual funds are built to replicate and closely track an index. Minimizing tracking error is the primary objective above all else. DFA rejects the idea of trying to mimic an index built by some third party (S&P, Dow Jones, TSX, MSCI, etc.), arguing that these indices were constructed as a benchmark for evaluating the results of active managers, rather than as a portfolio designed to capture the return of an asset class most effectively. Instead, they construct their own "index" in each asset class they manage but do not engage in stock picking or market timing, the two traditional sources of active management.

Could DFA funds be a replacement for ETFs? I see them as a good supplement. For example, in the U.S. equity asset class, holding something like an ETF or index fund linked to the S&P 500 plus the DFA U.S. Small Cap Fund and DFA U.S. Value Fund is a great match. On the international side, holding an ETF or index fund linked to the MSCI EAFE Index plus the DFA International Small Cap Fund and DFA International Value Fund makes sense. These holdings are all you really need in terms of equity exposure outside of Canada. If you are uncomfortable with direct investment in the stock market, you can get the required equity exposure through the exclusive use of DFA funds.

Am I endorsing DFA? That's not my purpose here. However, as an investment counselor, my job is to build portfolios as prudently as I can. ETFs have a role. However, using only ETFs could leave holes in the portfolio. DFA could fill some of those holes. The same could be said about some actively managed funds, including hedge funds. However, in the cost conscious world of passive investing, DFA is one manager to at least consider. One hurdle: You must find an advisor, such as Meridian Global Investors, who has been authorized by DFA Canada to invest in their funds. Take a look at their website at <http://www.dfacanada.com> for more information.

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