Defending An ETF Portfolio (Part 1)

Richard Kang

In the October 2004 issue of *Canadian MoneySaver* , I discussed some of the benefits of passive investing and in particular employing exchange-traded funds (ETFs) to build a simple, diversified, yet cost-effective portfolio. For many readers, ETFs and index mutual funds may make up a significant component of their portfolio. New funds offered by Dimensional Fund Advisors (DFA), described in my previous column as well as in a column in the September issue of *Canadian MoneySaver*, are another potential choice for those with a "passive" bent. In this issue, I switch gears from "portfolio construction" to "portfolio maintenance" and attempt to answer the question: What defensive strategies can be applied to an ETF portfolio to protect it from downside volatility? Risk management is the focus here.

Before I begin, I wish to note that there are investment counsellors that manage private accounts on a discretionary basis and are compensated based on portfolio size, as opposed to transactions (commissions). However, only a very small number build their practice around the use of ETFs or index funds. Even fewer are approved by DFA to advise clients on the use of their funds. I believe that all this will change in time as other professional advisors see the value of these tools in the portfolio management process. In this month's column I focus on a general methodology for defending an ETF portfolio used at our firm.

A long-term view for investing allows for patience. I believe, and countless academics and institutional practitioners agree, that the application of uncorrelated asset classes within a "strategic asset allocation" framework allows for (by definition) greater diversification and a certain degree of protection during down markets. It is likely the most conservative, cost-efficient and straightforward solution to the problem of protecting the ETF portfolio.

Institutional Application: Portable Alpha

I would like to present an argument here that shows how large institutional investors have been using a core index-based investment strategy and how they apply the use of uncorrelated asset classes as an overlay. Here I assume that the reader has a basic understanding of beta (market risk) and alpha (the returns above or below the market which an active manager provides). I begin with an example: Imagine that a pension fund has a proportion of its assets that must be held in U.S. equities. According to its guidelines, it must hold U.S. large cap stocks, However, they have conducted research providing evidence that U.S. small cap managers provide significant returns greater than its relative benchmark index (say, the Russell 2000). How can it prudently abide by its mandate for this asset class while still taking advantage of the opportunity presented from this research? Suppose that the fund invests the allowable amount to the selected U.S. small cap equity manager(s). However, this goes against the specified mandate. Therefore, the pension fund also implements the following trades: short Russell 2000 futures and long S&P 500 futures. Now, the fund has a long position in U.S. large cap stocks through their position in the S&P 500. The long position in the small cap fund and the short position in the Russell 2000 nearly "cancel" each other out. What's left is the "alpha" of the small cap manager. The alpha can either be some over- or underperformance relative to the index. What the fund has done is transfer the alpha of the small cap managers onto the S&P 500 index. Hence, the term "alpha transport" or "portable alpha".

The combination of the long position in the small cap fund and the short position in the Russell 2000 (assuming roughly equal dollar amounts) looks a lot like a market neutral long-short position, one subset of hedge funds. Hence, a long position in a passive index (in this case the S&P 500) plus an alpha-producing instrument (such as a hedge fund) provides a similar solution as to that explained above. It must be stressed that for this example to be a true representation of portable alpha, the hedge fund must be truly "market neutral" and provide alpha with insignificant beta exposure. Some large pension funds have been implementing this "enhanced indexing" strategy for years. Only recently, with the explosion of index funds, ETFs and alternative investments have retail investors had the tools to build portfolios in a similar manner. Hence, for the retail

investor, one does not have to deal directly with index futures or options. We have new tools to invest like the institutions. This concept of portable alpha allows for alpha to be transferred to another asset class by way of derivatives, although this could have also been accomplished through the use of ETFs or index funds.

However, one problem still remains: it is difficult to decide in advance which managers can truly provide alpha. What we prefer is to have the concept of portable alpha as a premise for an argument to use passive investing as a core strategy for a "total portfolio" which is enhanced by certain active managers, preferably alternative asset managers (hedge funds, managed futures, etc.) whose goal is specifically to provide alpha while minimizing beta.

Alternative Asset Classes

Like ETFs, we have also seen an explosion in the interest and money invested in alternative asset classes, especially hedge funds and so called "absolute return strategies". The use of alternative asset classes is really about uncorrelated returns. At one point in time several decades ago, an investor who had a portfolio of U.S. and Canadian stocks would have invested in bonds, European stocks and Japanese stocks to diversify their portfolio. Basically, when U.S./Canadian stocks were "zigging", these other asset classes may have been "zagging". If they were, that's negative correlation … when one is going up, the other is going down, and vice versa. If they were often all moving in the same direction (positive correlation), then the diversification into these other asset classes would be pointless. That's where we are today. Due to globalized economies and markets that are interconnected in various ways, what happens in the U.S. stock market causes a similar reaction in Europe and Asia, and vice versa. This does not happen all the time, but often enough. Therefore, what is there for an investor to do about this problem of "portfolio maintenance"? We need to consider investments that are uncorrelated to each other.

In the 1980s and 1990s, some investors began diversifying into gold and other commodities. Oil and energy stocks were another set of diversifiers. Real estate and REITs were another. The bear market of 2000-2002 brought investors from a "risk taking" mindset to a "risk aversion" mindset. Now, we see a new era of "risk management". Consider that governments are applying new standards (Basel 2, Sarbanes Oxley, etc.) towards various aspects of the financial world. In the financial services industry, this is part of the reason for the great interest in absolute return strategies, and specifically hedge funds over the past few years. Do they really provide absolute returns (i.e., no periods of negative returns)? As a whole, hardly. But some do provide very bond-like returns with minimal negative return periods. This may be why some large pension funds have included hedge funds as part of their fixed-income allocation.

Another consideration is the fact that certain alternative asset classes may be implemented by using ETFs. There are ETFs that can provide exposure to commodities/energy (both through stocks in these sectors), REITs and even real return bonds. Past articles in *Canadian MoneySaver* have gone over the benefits of these and other alternative asset classes. As in the traditional asset classes of stocks and bonds, using ETFs for these alternative classes provide broad exposure at a reasonable cost.

There are even investable hedge fund indices that are available for investors. With these new products, it is possible for an investor to build a portfolio based entirely of ETFs and passively managed products. I am not proposing that this is the best solution since I personally believe that having an expert choose hedge fund managers within a "fund-of-funds" structure is worth the added costs compared to a hedge fund index. In our firm, the only area where we do not employ the use of passive instruments is with hedge funds and managed futures programs, which are grouped as "absolute return strategies". As these products are not benchmarked to any index, they can not be treated as other asset classes. In fact, we do not consider them to be asset classes for the simple fact that they can not be properly benchmarked. The corollary is that since indexing can not apply, the use of active managers is warranted. Furthermore, unlike traditional managers who are restricted by mutual fund rules and other regulations, hedge fund managers are relatively unconstrained in terms of their ability to trade. Therefore, it is more obvious that these managers have the ability to differentiate themselves from the indices and truly provide "alpha". This does not contradict my support for indexing and passive management. As mentioned, hedge fund managers have fewer constraints put upon them compared to mutual fund managers. I believe the constraints put upon mutual fund managers are one of the reasons why they behave so similarly to an index, and have a difficult time beating the index. In other words, many traditional mutual fund managers provide plenty of beta and little alpha, but at greater costs than ETFs. Furthermore, the ability to short, use leverage and apply various techniques not available to mutual fund managers allow hedge funds to exploit market inefficiencies and truly provide alpha.

This argument for active managers can be extended to other asset classes. Perhaps you believe that an active manager can pick REITs better than an index fund or ETF. Perhaps you feel the same about both emerging market stocks and microcap stocks. If any of these apply to you, you might want to consider using passive funds and some actively managed funds for asset classes that warrant such a decision. It's up to you. Just remember that in the long run,

the difference in performance between the active manager and passive investment often comes down to the MER. It isn't always about costs, but it is certainly something for a keen investor to be wary of.

Traditional Versus Alternative Asset Classes

What investors have to understand is that passive instruments, such as the ETFs, provide a portfolio exposure to beta or market risk with the potential to receive returns. Use of alternative investments, and in particular "absolute return strategies" such as hedge funds aim to provide alpha and, ideally, very little beta. In other words, their returns normally aim to be determined, not by market movements, but by the active decisions made by the manager. Any changes in allocation from passive to active managers equates to a transfer of market risk to manager risk.

The combination of indexing and alternative instruments, (beta providers and alpha providers respectively) has been used by institutions for years and involves concepts such as portable alpha discussed earlier. What an investor would like to see by including alternative investments such as hedge funds is that they provide the same true diversification. If they help to protect the core portfolio, they should be doing their job. A good example is the bear market from the spring of 2000 to the spring of 2003. If an investor had some gold and commodity-based ETFs, a REIT ETF, and a fund of hedge funds, then these would have offset some of the losses from the stock market.

This is our firm's suggested course of action and is a philosophy found at many large pension funds and endowments. Due to the strong bull market that began near the beginning of 2003 and with the deteriorating macroeconomic environment (energy prices, uncertain Chinese economy, various problems with the U.S. economy), there could be a significant correction or worse, possibly even more than we saw in the spring and summer of 2004.

Richard Kang, President and Chief Investment Officer, Meridian Global Investors, 162 Cumberland Street, Suite 300, Toronto, Ontario, M5R 3N5 (416) 963-7378, rckang@investmgi.com.