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REFLECTIONS ON AN ETF MANAGEMENT STYLE

QUESTION: We had one of our Board Members strongly recommend going to "ETF's" at our last board meeting. Could you give me your pros and cons to this type of investment? And if you have pro's then let me know cautionary things to look out for.

Thanks

Anonymous

ANSWER: This turned out to be more of an epistle than I expected or intended. Feel free to use the "delete" button. Below are my thoughts regarding your question.

I use some ETFs for specific purposes. For example, symbol CEF is a Canadian gold depository. When I and doing a short term trade, where trading volume is a factor, and I need to trade in and out of a position, I use symbols QQQQ, SPY, when the trading costs are a factor to consider. Beyond these exceptions, I do not believe in using ETFs.

There are many things wrong with ETFs that are not generally considered by unsophisticated investors. The major index ETFs are very liquid and can easily be traded. However, most ETFs have limited volume, little transparency, and in some cases are very poorly structured, often with as few as 15 or 20 different stocks held in the funds.

My preference, when establishing long term investment positions is to do a correlated and balanced portfolio of investment assets, designed around the an asset mix using academic work done by Roger Ibbotson. Academic predictability requires the "law of large numbers" before it is valid. Predictable volatility depends on owning anywhere from 400 to over 1000 different stocks. Such an investment portfolio includes large and small cap, growth and value stocks, international stocks, emerging stocks, and fixed income securities. I don't confuse the portfolio design with hedge funds, long-short management styles, and/or sophisticated computer trading systems.

I do seek out investment managers who exhibit lower peer group volatility and an investment diversification style that generates higher beta relationships versus the S&P 500 Index. Characteristic managers in and Ibbotson investment allocations, have a higher probability of outperforming the Index.

ETFs are unmanaged indexes. By definition, each is designed to mirror a specific index. An ETF's low cost investment structure only guarantees a smaller difference between the price action of the index and its corresponding ETF, a negative differential!

For example:
In a down market, the beta = 1.05 to 1.10 (meaning the ETF loses more than the index)
In an up market, the beta = 0.90 to 0.95 (meaning the ETF gains less than the index)

To answer your question, I seek to outperform the general index - S&P 500 - and there is no way an ETF can accomplish this goal.

When managing a portfolio, I prefer to structure portfolios such that the volatility in down markets is less than the S&P 500 Index and, in up markets, that volatility is greater than the S&P 500 Index.

Add to this portfolio design, the basic, and essential, trend following requirement: When the long term market trend is down, liquidate all equity positions; and when the long term market trend is up, invest in equities.

As an aside, when I am managing a portfolio that is required to distribute a predetermined annual distribution amount - cash distributions such as for an endowment fund - the portfolio will typically contain (1) a laddered maturity fixed income portion, generally 70% of the total portfolio value, and (2) an equity growth investment component, which is about 30% of the total portfolio value. This design produces a predictable income cash flow, and a growth component that assures that the predictable income grows over time.

For what it is worth, the income portfolios I have structured during the last couple of years have yields that are greater than 6%, contain a minimum of 50% and up to 100% government guaranteed investments, and may also contain a mix of low risk, high quality corporate bonds, whole loan mortgage backed securities, some structured securities, and may also contain a small commitment to preferred stock investments. This portfolio is structured as a 10 year maturity ladder, with approximately equal cash flows each year.

In summary, ETFs are useful, but not exciting. They tend to "dumb down" management creativity, while at the same time promising lower yields for the investor. I would suggest that better managers are the ticket, a.) to preservation of capital and, b.) to better yields when this difficult economic time is succeeded by better growth potential.