All-Weather ETF Portfolio Strategies

As more and more advisors use ETFs, they are finding different and better ways to integrate these vehicles into their client portfolios.

Advisors are always looking for ways to improve client outcomes. These days an increasing number are turning their sights to exchange-traded funds (ETFs) to help them construct client portfolios. Where in the past an advisor might have looked to a basket of securities to create exposure to a particular sector or geographic region, now he or she can accomplish the same thing easier and cheaper with an ETF with just one trade.

ETFs hold certain structural advantages over mutual funds and individual stock issues, many advisors say. When constructing a portfolio for such volatile times, these funds can be particularly well suited, especially for an advisor who practices tactical asset allocation. Transparency, tax efficiency and low price are all reasons to use ETFs.

"If you buy an active mutual fund, you might see the holdings as of the last reporting period, which is three to six months ago," says Roger Nusbaum, chief investment officer of Your Source Financial in Phoenix and author of the blog *Random Roger*. "But you have no idea where those holdings are going to be six months in the future."

Beyond reporting transparency, ETFs may also help an advisor showcase his or her fiduciary responsibility. "We have a fiduciary responsibility to invest in our clients' best interest," says Casey Smith, president of Wiser Wealth Manager in Marietta, Ga., with $40 million under management. "Based on my fiduciary duty, I can't put a client in a mutual fund knowing that the fund manager is statistically not going to beat his index."

ACTIVE AND PASSIVE APPROACHES

But use of ETFs is not strictly limited to advisors that only utilize passive management. Both active and passive investors say they have plenty of use for ETFs in their portfolio designs. Passive investors maintain that they are only looking for exposure to certain asset classes and ETFs are a simple way to achieve this strategy. These investors note that ETFs make an excellent long-term holding, particularly for accounts that do not trade much.

But active managers can use passively managed ETFs with an overlay of their own active strategies. These portfolios also benefit from the low cost and transparency that ETFs are known for. In this case, advisors provide the active management, deciding the exact allocation to each asset class, typically using tactical asset allocation screens to make trading decisions. "I first figure out what exposure I want to different asset classes, and then I figure out the best way to capture that exposure," explains Nusbaum, who oversees $147 million in client assets.

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DAVID ARMSTRONG,
Monument Wealth Management

Ongoing analysis leads him to make portfolio changes. "We're big on taking defensive action when the S&P 500 goes below its 200-day moving average," Nusbaum says. When that happens, he prefers to use an ETF constructed with industrial companies because of its ability to mute market declines. "In trying to build up the industrial sector, we ask ourselves what's the best proxy for the industrials, and that will lead us to owning a combination of a couple of different funds," he explains.

ETFs FOR THE LONG RUN

But Nusbaum also uses ETFs to play long-term secular trends. For almost seven years, he's had a bet on the worldwide water shortage as a major investment idea. To address this focus, he uses ETFs that invest in companies looking to overcome this problem. To invest in worldwide food themes, Nusbaum likes funds that hold fertilizer stocks. Their geographic range adds diversification to the portfolio, he says.

For his part David Armstrong, managing director and co-founder of Monument Wealth Management in Alexandria, Va., is largely a buy-and-hold investor, and ETFs are a cost-effective way to stay passive. As with Nusbaum, Armstrong makes top-down calls and changes his investments when conditions warrant, but he's very slow to pull the trigger. He takes the long view and says that quarter to quarter, year to year, fundamental economic data doesn't change that often.

Armstrong switched to ETFs in 2000, after the passage of Regulation Fair Disclosure—better known as Reg FD—which required that publicly traded companies disclose financial information to all investors at the same time. "That basically called into question the value of sell-side research," he says. With all investors now on a level playing field, Armstrong believed that his value-add lay elsewhere.

Instead of spending his time on individual security selection, Armstrong puts his efforts into economic forecasting and directing his portfolios through that lens. "Information about publicly traded companies is so immediate that it's very tough to discover something about an individual company that everyone doesn't know already," he explains.

Over the past three years, he's hardly made any changes at all. "If you take a step back and look at the big picture, over the past three years very little about the economy has really changed," he says.

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BOB RALL, Rall Capital

IN THE MIX

Many advisors who use ETFs in client portfolios also use mutual funds and individual stocks in tandem. Bob Rall, president of Rall Capital in Merritt Island, Fla., for example, has a fondness for small-cap value funds, which are difficult to access through ETFs. On the other hand, he sees little point in owning large-cap growth mutual funds. That market's efficiency and liquidity don't allow fund managers to gain any advantage over an index, he believes.

Gary Gordon, president of Pacific Park Financial, a registered investment advisor in Newport Beach, Calif., and author of the blog, *ETF Expert*, uses individual stocks to round out the exposure provided by ETFs. For example, some preferred stock ETFs are heavy in the financial sector. That makes Gordon uneasy, given the financial sector's recent volatility. Another big component of those ETFs are utilities. "But if you buy a preferred stock outside those sectors, along with the ETF, you get diversification," he says.

Gordon has also purchased shares of Abbott Laboratories in conjunction with a healthcare ETF because "there's little correlation," he adds.

COURTING THE HIGH-NET WORTH

For high-net-worth investors, ETFs pose a unique opportunity to access sophisticated investment strategies, but with reasonable fees. While separately managed accounts with a cadre of advisors may seem like the type of personalized service high-net-worth clients expect, in many cases it may not serve their needs well.

"High-net-worth clients may be conditioned to think that they need individual stocks, but I'm convinced that's not what they need," Armstrong says.

Instead, an advisor should spend time with clients helping them identify goals and objectives, and then align their investments so that the investments can help meet them, Armstrong maintains. Plus ETFs can offer some of the hedging strategies that are typically used in hedge funds and separately managed accounts, but not mutual funds.

Chad Carlson, wealth manager and investment committee member with Balasa Dinverno Foltz in Itasca, Ill., whose typical client has $2 million in investable assets, says ETFs allow a level of transparency that other investments don't, and that helps him create sound portfolios for his high-net-worth clients.

TAX ADVANTAGES

Especially important to high-net-worth clients are tax implications, and it's hard to argue against ETFs in that regard. Unlike a mutual fund that operates under the Investment Company Act of 1940, and is therefore required to distribute capital gains taxes to shareholders (unless a manager runs the fund in such a way as to minimize taxes), advisors have a lot of leeway in when they buy and sell ETFs to optimize tax savings.

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CASEY SMITH,
Wiser Wealth Manager

"One of our most important strategies is tax-loss harvesting," explains Carlson. "We find that ETFs are great in this space because we can keep the same exposure in what we want and avoid the wash-sale rule."

For example, Carlson might harvest some losses by selling an emerging market ETF, but still maintain his exposure by purchasing another ETF that's based on a different index. After 31 days, he can repurchase the original fund and take the loss.

Today, the tax strategy that Carlson is implementing is tax-gain harvesting. Why? The Bush-era tax cuts are expiring at the end of the year. Once the presidential election is out of the way, the laws may be allowed to sunset, at least for those in the highest tax brackets. "We're taking some gains now in 2012, when the capital gains rate is 15% versus the 20% that it might be in 2013, so we can hopefully save on capital gains taxes," Carlson says.

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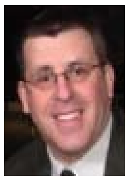

The tax advantages of ETFs are what originally led Smith to ETFs. In 2007, he had bought the book of business of an older, retiring financial advisor. The outgoing advisor was a shrewd stock-picker, but he had a knack for generating exorbitant taxes for his clients through his trades. "On the investment side he was making money," Smith says. "But on the tax side he was losing money. You had little old ladies paying estimated quarterly taxes of $20,000."

Switching to ETFs—and cutting down on portfolio turnover—helped Smith lower his clients' tax bills. During the financial crisis in 2009, Smith sold some investment losers to generate losses. "We turned around and bought ETFs that were similar but different," he says. The firm has managed the tax situation so much that "our clients don't pay quarterly estimated taxes anymore," he says.

There are certain asset classes where ETFs particularly outshine mutual funds on taxes. Small caps are one area, says Armstrong. Small-cap growth mutual funds have high portfolio turnovers. Selling frequently increases taxes, but Armstrong can still get the small exposure without worrying about the tax bite through ETFs.

HEDGING STRATEGIES

As previously noted, ETFs can be used for hedging, including leveraged and inverse ETFs, not to mention ETFs that employ hedge fund-like strategies. While some advisors don't set out to use hedging strategies, others, like Rall, say they had to change course after the financial crisis of 2008. "The biggest thing I kept hearing from my clients was that they didn't want to go through that again," he says. "Wealth protection is as important to most people as wealth enhancement."

Prior to the financial crisis he had used well-calibrated diversification strategies, but it was of little consequence when most correlations converged and declined sharply in tandem. "I was always an asset diversification-type manager, until I saw that it didn't work in a period like 2008 and 2009," he says.

Rall attended a workshop at the Chicago Board Options Exchange geared toward advisors to help them use options in their portfolios. He now implements a strategy of puts and options on ETFs. "Obviously I can't do that with mutual funds," he says. He buys long-term puts on broad indexes like the S&P 500, Russell 2000 and an emerging market index. Each month he and his staff sell short-term calls. "The short-term calls generate the premiums and help offset some of the cost of the puts," he explains.

Others hedge on a case-by-case basis. Nusbaum, for one, takes defensive action when the S&P starts to move below its 200-day moving average. His primary tool is a two-times inverse fund of the S&P 500. "We used that fairly early on when the market started to roll over," he says about the second quarter of this year. "It did go up when the market went down." He typically allocates just a few percentage points of a portfolio to the fund.

Others, however, say they don't want to get too active in hedging because it goes against the principle of using ETFs, not to mention that it can get expensive. That's the view that Carlson has adopted. "We don't want to be doing monthly or weekly trading," he says. "That goes against our philosophy."

The only hedging instrument Carlson uses is an allocation to global real estate, which has a low correlation to domestic equities. On the fixed-income side, he goes for mutual funds with an unconstrained bond fund, which is not beholden to any particular bond index or investment style and can roam the fixed-income universe in search of opportunity.

As with stocks and mutual funds before them, ETFs can be used in myriad investing strategies. As the market matures, more advisors are finding ways to implement them and more ways to craft their unique investment styles. ■

Added Disclosures

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