Passively Active

Exchange-traded funds are a growing phenomenon

BY ZOË VAN SCHYNDEL, CFA

KEY POINTS

- In 2004, roughly 70 percent of ETFs outperformed the S&P 500.
- Some pioneering investors use ETFs not only as trading vehicles but to actively manage money.
- A handful of hedge funds tailor their strategies to focus on trading ETFs.
- Investing in an index through an ETF gives money managers the broad market exposure they need.

The NASDAQ-100 Index Tracking Stock (QQQQ) is the most actively traded security in the world, with about 100 million shares traded daily. That's impressive trading activity for a passive investment product. In addition to the QQQQ, approximately 350 exchange-traded funds (ETFs) trade on 31 global exchanges. A few investing pioneers, ranging from financial planners to hedge funds, are using ETFs not only as trading vehicles but to actively manage money. Sometimes called trackers, ETFs are index-tracking mutual funds that trade on exchanges just like stocks. As an index-based product, these funds have become popular vehicles for investors who seek immediate exposure to the broad market as well as to specific sectors. The ETFs available to investors now range from the Deutsche Bank DAX DVG (FGQ1) and the iShares FTSE/Xinhua China 25 Index Fund (FXI) to the Vanguard REIT VIPERs (VNQ).

US ETFs represent approximately $225 billion in assets, while globally the total is more than US$300 billion. ETF asset growth has brought such fund powerhouses as Fidelity and Vanguard into the market. ETFs, however, are relative newcomers to the mutual fund scene. Of the approximately 150 US ETFs on the market, the oldest and largest is the S&P 500 SPDR (SPY), launched in January 1993; SPY has grown to over US$50 billion in assets. Next in popularity is the QQQQ, with close to US$20 billion in assets.

Money Managers and Active ETFs

Over the past six years Jim Kelly, the founder of Kelly Capital Management, has been actively using ETFs and now specializes in creating individual portfolios based solely on ETFs. The Philadelphia money manager has about US$50 million in assets and 125 clients, most of whom use ETFs. Kelly claims to be the first money manager to come to the market with a managed ETF product.

Kelly uses a proprietary quantitative process to determine the asset mix of his portfolios, which are benchmarked to the S&P 500, and seeks to provide returns above the benchmark. Kelly is proud of his performance record and says, "through March 2005, in the 22 quarters since inception, the ETF strategy has beaten the S&P 500 64 percent of the time. On a rolling quarterly basis, the strategy has beaten the benchmark more than half the time."

C. Michael Carty, the founder of New Millennium Advisors, LLC, a New York City-based investment adviser, uses proprietary quantitative, fundamental, and technical disciplines to manage institutional and individual accounts. Carty manages an ETF-only long/short strategy that seeks absolute returns. He says that "the strategy is conservative and designed to preserve principal. The strategy is designed to build a more efficient portfolio and may trade the ETFs on a daily basis or hold them for several months if they are following a trend." Carty expects the strategy to have a lower standard deviation and higher returns than the S&P 500.

Carty says that "ETFs are flexible enough that they can meet most clients' needs." He believes that "the worst thing about ETFs is that due to their complexity, specifically their unique share creation/redemption process, they need more client education than traditional funds. Also, commission-based professionals do not want to deal with them because ETFs do not provide the compensation available with traditional mutual funds."

Hedge Funds' Use of ETFs

Hedge funds, one of the early adopters of ETFs, quickly realized that they could move in and out of these vehicles to equitize their cash or to go long or short particular sectors. Now, a handful of hedge funds are tailoring their strategies to focus on trading ETFs.

Saddle River Capital Management, of Ridgewood, N.J., manages US$10 million in ETF strategies. In July 2004, the manager opened up The Saddle River ETF Strategy Fund. The fund is SEC registered and invests in the entire spectrum of ETFs. Dick Wolfe, managing director, says that "currently the fund has a core/satellite portfolio whose core is 50 percent invested in the S&P 500 and satellites are invested 50 percent pro rata in the 10 sector SPDRs."

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> **DICK WOLFE**
> Managing Director
> Saddle River Capital Management

To avoid liquidity issues, Wolfe "focuses on ETFs that have at least 100,000 shares traded on a 30-day average and in some cases may go as low as 50,000 shares traded." Once trading volume goes below this level, Wolfe feels that "the liquidity is just not adequate. When you are considering an ETF, liquidity has to be factored in."

Gary Gastineau is a portfolio manager in the Dickerson Division of H.G. Wellington & Co., Inc., as well as the managing director of ETF Consultants. Gastineau, with his partner Michael Dickerson, has put together a valuation model that "values indexes or stock baskets based upon their aggregated fundamentals and appropriately weights the fundamentals so that the indexes can be valued as if they were individual stocks. The model ranks indexes based on their relative value and identifies buy and sell candidates." Since January 2003, the partners have managed money using iShares ETFs based on the S&P BARRA Growth and Value Indexes, primarily for the high-net-worth market. The Skyhawk Market Neutral Hedge Fund, which the partners plan to launch in the first quarter of 2006, uses this same model, as will other hedge funds that they intend to launch.

Integrity and Other Advantages

Robert Kares, a Boynton Beach, Fla., fee-only financial planner, says that "with all of the recent problems and scandals, ETFs are one of the most transparent investments that you can make, and the arbitragers help to keep ETFs fairly priced."

In addition to their transparency, Kares favors ETFs for a number of other reasons and needs no prodding to provide a list of their top features. "It's very difficult to explain to clients in January why they have phantom income from capital gains trades on their mutual funds, especially when the funds have declined in value. With ETFs, I don't have that problem as the ETF in-kind creation/redemption process effectively reduces capital gains taxes to zero or close to it. I also like the low expenses. With the average mutual fund's expenses running above 1.25 percent and ETFs at 10–30 basis points, there's just no comparison."

On the subject of ETF trading, Kares says, "I like the fact that I can trade all day and have the luxury of being able to get out of a position immediately if I want. With most ETFs you can trade options, such as with the QQQQs I can trade puts and calls. By betting on an index like the QQQQ, I avoid the risk that buying an individual security exposes me to. I can even sell short without waiting for an uptick, unlike with stocks."

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>
> **VAIDAS UZGIRIS**
> Vice President
> Timberhill, LLC

From a behavioral perspective, Kares notes that "for many fund managers selling is one of the most difficult things they have to do because they become emotionally invested in a particular stock. When you use an ETF, it's just a basket of stocks, so selling is more logical and unemotional."

Active Managers' Bias

When Kelly is asked why he doesn't have much competition for his active ETF strategies, he says that "it's the psychology of portfolio managers and analysts that biases them against a 'passive' product." As Kelly tells it, "most of the research and money management community don't see ETFs as a security to research."

Kelly maintains that ETFs are worth researching, saying that "in one ETF share I can capture the return of several thousand securities. I don't have to analyze how each individual security is impacted on a daily basis, but I do actively manage the portfolio of ETFs and need to determine whether or not these ETFs are a good value for my clients." For example, if you want exposure to the oil industry, there are about seven ETFs globally from which to select. Whether to use one fund or another would depend upon your preference for the individual stocks that the funds are composed of, dividend collection procedures, weightings, and so forth.

Vaidas Uzgiris, vice president of trading for Greenwich, Conn.-based Timberhill, LLC (the market-maker unit of Interactive Brokers), makes a market in all US ETFs and most others traded around the world. Uzgiris says that "there is a perception that money managers who invest in ETFs are cheating somehow." Because they are being compensated to research stocks, not a stock basket, the analysts are uncomfortable when their level of analysis and due diligence is not down to the individual company level.

Uzgiris argues that investing in ETFs "is a sensible thing to do in order to get generic exposure at a low cost. Money managers' performance is usually measured against a benchmark, and for them to invest in the index through an ETF gives them the exposure that they need. Using ETFs frees up the managers so that they can use their brainpower to add value by finding good stocks to invest in or bad stocks to short."

In 2004, roughly 70 percent of ETFs outperformed the S&P 500, according to data from Lipper and Financial Research Corp. On the active side, there will always be managers who can add value through their management and analysis skills. In the end, though, the focus should be on what's best for clients. As Kelly says, "a lot of ego needs to be put aside on Wall Street, and when ETFs are appropriate for a client they should be used."

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RECOMMENDED RESOURCES

"Traditional Indexing Is Passé"
Points of Inflection: New Directions for Portfolio Management
2004 CFA Institute Conference Proceedings
(cfapubs.org)

"Index Mutual Funds and Exchange-Traded Funds"
Abstracted in the *CFA Digest* (February 2004)
(cfapubs.org)

"European Exchange-Traded Funds: An Overview"
Abstracted in the *CFA Digest* (May 2003)
(cfapubs.org)