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With James V. Kelly of Kelly Capital Management LLC

By David Hoffman
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Exchange traded funds are all the rage, except in retirement accounts.

A major reason is related to dollar cost averaging.

Because of the commissions investors pay to buy ETFs, it makes more sense for dollar-cost-average-oriented investors to buy mutual funds, some industry experts say.

But the industry has been working to solve that problem.

One of the earliest solutions was the development of ETF-only managed accounts for retirement plans.

And one of the earliest purveyors of that solution was James V. Kelly, 60, president and founder of Kelly Capital Management LLC in Philadelphia.

While at Addison Capital Management LLC of Philadelphia, now Walnut Asset Management LLC, he was involved in the creation of what many industry insiders believe to be one of the first ETF-only managed accounts.

Now after founding Kelly Capital in 2004, Mr. Kelly is on his own.

The firm has just $45 million in assets under management, but it is growing at about 12.5% a year, he said.

Some, however, argue that Mr. Kelly's approach already is out of date.

Including an ETF-only managed account within a retirement plan greatly reduces one of the main benefits of ETFs — their relatively low cost, said Darwin Abrahamson, chief executive of Invest n Retire LLC of Portland, Ore. In addition to the fees associated with the underlying ETFs, plan participants would be paying a fee to manage the account, he said.

Invest n Retire has developed a better system that allows employees to own whole and fractional shares of ETFs in their portfolio without forcing them to shoulder the expense of setting up self-directed brokerage accounts, thus eliminating the need to invest in ETFs through separately managed accounts, Mr. Abrahamson said.

Even he, however, said that such an approach can be dangerous, as investors could end up chasing hot ETFs — something that wouldn't be a problem if their exposure to ETFs was through an ETF-only managed account.


Jim Graham

Q. *How has your use of ETFs been accepted by clients?*

A. It's been fine. In fact, I think that the fact that we moved [to ETFs] enhanced our returns, reduced the risk profile for the clients and made our services more desirable to them. Over time they have actually wanted more ETFs, not that our stock picking wasn't good. But they recognize that ETFs make an awful lot of sense.

If you think about it, if I had an unlimited amount of money, I'd buy everything in the market, and I wouldn't be wrong. But if I have a limited amount of money I have to pick and choose what I'm going to buy.

If we are looking at health-care stocks, there might be 15 or 20 drug companies. Trying to determine ahead of time which one was going to be the best performer is a lot harder than picking which five or six [represented in an ETF] might be pretty good performers.

Q. *But don't mutual funds give you the same advantage?*

A. First off, I think we have to define what kinds of mutual funds we're talking about. There are mutual funds that are passive. If you wanted to compare a passive mutual fund to an index-based ETF … ETFs tend to have a lower expense ratio, and they certainly are more tax efficient in the way they operate, versus a mutual fund. I think when it comes to passive versus passive, the ETFs have it all over the mutual fund industry.

When you're talking about small amounts of money being invested over long periods of time à la dollar cost averaging, then we know a no-load mutual fund that's passive would tend to have cost advantages to the client, versus an ETF.

Q. *And your approach overcomes that?*

A. As far as Joe individual plan participant goes, if he's putting money into his own [individual retirement account], then you have the cost of acquiring an ETF and acquiring a small number of shares regularly at some cost.

But if Joe plan participant is part of a group … you're not doing the nickel-and-dime dollar cost averaging for Joe individual participant. You're going in and buying a block of 1,000 or 2,000 or 3,000 shares of an ETF for a particular plan account, so you don't have those issues.

Q. *But if that is the solution, why am I hearing from industry experts that there is a resistance among plan sponsors to ETFs?*

A. I'm not seeing it myself. But I think part of it might be education. Although the people at Barclays Global Investors [of San Francisco], [The Vanguard Group Inc. of Malvern, Pa.], Rydex Investments [of Rockville, Md.] and State Street Global Advisors [of Boston] are certainly working very hard at educating money management firms on how to use ETFs … you still, at the end of the day, have to convince the plan sponsor to use them. It might be just a lack of ability to convey to the plan sponsor why these things make sense.

What I've found from my experience with talking to people who haven't used ETFs but have kind of heard about them is, they tend to think they're passive. They tend to think, 'Oh. you're just coming in to be a passive manager. I could go buy the Vanguard 500 Index Fund for a lot cheaper.'

If that was all there was, that would be correct. But that isn't what's going on. From Day One, back in the mid- to late 1990s, when my partners and I were the pioneers of individual portfolio management using ETFs … it was active management.

Q. *What about mutual funds that invest in ETFs?*

A. A few years ago, I was asked in the press what I thought about it. I thought it was a silly idea. It defeats the purpose of the tax efficiency of ETFs when you take them and stick them in a mutual fund. Unless you want to change the mutual fund diversification rules, unless you want to change some of the taxation rules on mutual funds, to me it makes no sense to construct a mutual fund of ETFs.

The remaining shareholders of that mutual fund are going to get stuck with all the negative consequences [tax consequences] that they would be stuck with in any other mutual fund. No one has been able to show me yet that there's a tax advantage to a mutual fund of ETFs.

I have always been ready to manage — and I made proposals to some of the major sponsors to ETFs about managing — an ETF of ETFs, which I think would make more sense. But there would have to be some changes to some of the rules about how those ETFs are structured.

Q. *And wouldn't cost be an issue?*

A. If you're talking about expense ratios, that may be right. But when you assemble several ETFs together in a portfolio, you have the blended effect of their individual expense ratios, which combine to some number that may be higher than some of the constituent ETFs that make up your pool. If you then compound that by sticking some mutual fund expenses on that, then, yeah, it defeats the lower costs of the ETFs.

Q. *But couldn't the same be said about your approach?*

A. We can show value added. What we have done is show superior return to the benchmark indexes that we're measured against, so we have earned our fee. The mutual funds — it remains to be seen if they will do that.

*Snap*Shot

James V. Kelly, 60, president and founder of Kelly Capital Management LLC in Philadelphia since 2004

Career: 2002-04, executive vice president at Walnut Asset Management LLC of Philadelphia, via the merger of Addison Capital Management LLC of Philadelphia and Walnut; 1990-2002, chairman and chief executive of Addison Capital Management; 1985-89, vice president and chief equity investment officer at Wilmington (Del.) Trust Co.; 1981-85, executive vice president and principal at Ellwood Associates of Chicago; 1974-81, vice president at Prudential Insurance Company of America of Newark, N.J.

Education: Bachelor of Arts degree in speech and drama from the University of Virginia in Charlottesville, 1969; Master of Business Administration degree from the Leonard N. Stern School of Business at New York University, 1978