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# Keeping It Simple

By BRENDAN CONWAY

***Three well-respected advisors sat down with Barron's to discuss how they choose ETFs, which ones they stay away from, and what they see ahead.***

Behavioral finance experts call it the paradox of choice: in short, too many options can cause people to make poor decisions, or no decisions at all.

Financial advisors, of course, are supposed to prevent the daunting choice of investment products and strategies from overwhelming their clients. And their expertise is becoming more and more necessary when tangling with the fast and furious exchange-traded-fund industry.

Now offering more than 1,400 ETFs tracking a wide variety of markets, from the broadest stock indexes to the narrowest niches (Brazilian consumer companies or corn futures, anyone?), the industry provides plenty of choice, and a not insignificant paradox.

*Barron's* sat down with three top advisors to assess their views of the ever-changing ETF landscape, and hear how they evaluate and choose funds, what their best strategies and picks are right now -- and when they think ETFs aren't as useful.

Our panel:

**Dryden Pence,** chief investment officer of Newport Beach, Calif.–based Pence Wealth Management, which oversees $850 million. Pence creates a "personal index" for each client based on the his or her goals, such as the need for yield or capital appreciation, and uses ETFs to meet that individual's goals.

**Richard Saperstein**, of HighTower's Treasury Partners in New York, uses ETFs in managing part of its $10 billion in client assets. The firm uses ETFs in several ways. For instance, opportunistically, to get an immediate presence in a certain market, or as part of "strategic" portfolios, in which the funds serve as both core long-term holdings and shorter-term investments that are rotated.

Our third expert, **Matthew Reiner,** runs all-ETF portfolios with a heavy emphasis on income investing for Atlanta-based Wela Strategies. Wela focuses on clients with less than $500,000 in assets, and was spun out of Capital Investment Advisors, which Reiner's father, Michael Reiner, co-founded.

This lively bunch debated the relative merits of lower fees, the limitations of some exchange-traded funds, and where they see the most opportunity. Read on.

**Barron's:***Let's dive into the biggest ETF news this year: lower expenses. Vanguard Group and BlackRock's iShares, two of the largest providers, appear to be in a fee war, while other firms, such as Charles Schwab, have also lowered their fees. Are you impressed?*

**Richard Saperstein:** Fee compression is pervasive throughout the entire financial-services industry. But returns are more important than fees.

*But aren't fees one of the biggest drivers of returns?*

**Saperstein:** Not necessarily; not when your fees are down to 16, 18, 20, 40 basis points [each equal to 0.01%] on a security that can generate 15% returns. At that level, comparing fees is not as critical as evaluating volatility, or tracking error, or correlation with what you are trying to achieve.

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(From left) Dryden Pence, Richard Saperstein, and Matthew Reiner manage significant amounts of money in exchange-traded funds, but they're quick to point out ETFs' shortcomings.

**Matthew Reiner:** It's going to make investors who only look at fees look more closely at each ETF. We are not going to move to a different ETF today because of a fee cut. But now there are more players [to review] because a fee screen is not going to filter them out.

**Dryden Pence:** Fees are down the list in terms of important criteria—yield, liquidity, and bid-ask spread are all more important. It's great that these firms are all rushing to the bottom. But it doesn't change our decisions. It all comes back to this: Are we really getting access to the returns and the yield we are looking for? That's more important than whether it is the cheapest.

I*s there a downside to the fee-cutting? Vanguard recently said it will swap the well-known MSCI index for indexes from the London-based FTSE Group and a University of Chicago research center, affecting the cost* *and performance of more than $500 billion in those funds.*

**Reiner:** I don't think [the Vanguard switch] was necessarily to track a better index. I think they were just trying to make it lower-cost. You can see that with the flows that have occurred over the past few weeks: They've gone away from **Vanguard Emerging Markets** ETF [ticker: VWO] and into the **iShares MSCI Emerging Markets Index** fund [EEM]. So the switch doesn't seem to have enticed many investors. But not many people know the Footsie [the common appellation for the FTSE index] in the U.S. Nor do many people know the University of Chicago indexes that Vanguard will also be tracking. People like to invest in things that they know. It is a risky move on Vanguard's part.

*So what do you look for in an exchange-traded fund?*

**Pence:**I want to see the top 10 or 15 holdings, and how many holdings comprise the top 50% of an ETF. You have to look at composition first -- everything else is what I call contamination. It comes down to composition and contamination.

*What do you mean by contamination?*

**Pence:** If you are looking at a country-specific ETF, the top 10 or 15 holdings may comprise 25% to 50% of the entire ETF. So you need to really figure out if you want to own those top holdings, because the other 500 positions or 200 positions are nothing more than little bitty one-percenters that contaminate the returns of the big drivers. We like ETFs tight, small, focused, clean, and uncontaminated. We want a better mousetrap, not necessarily a cheaper mousetrap.

*Matt, you run all-ETF portfolios for your clients. How do you narrow the field of more than 1,400 to get what you want?*

**Reiner:** The ETF industry has become like a supermarket. You can't go in and not know what you want -- you'll end up buying all these things that you won't ever eat. You have to go in saying, "What do I need?" For instance, "I need high-yield exposure." OK, so now I can go and look at the **iShares iBoxx $ High Yield Corporate Bond** fund [HYG], the **SPDR Barclays High Yield Bond** ETF [JNK], the **SPDR Barclays Short Term High Yield Bond** ETF [SJNK], or the **Pimco 0-5 Year High Yield Corporate Bond Index** ETF [HYS]. Now I have a feasible task ahead of me; I can analyze the funds and perform due diligence.

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Matthew Reiner

### Matthew Reiner

Reiner's firm manages all-ETF portfolios for investors with less than $500,000 in assets. This one is for someone 10 years from retirement.

| Fund Name | Ticker | % |
|---|---|---|
| iShares Core S&P 500 ETF | IVV | 22.75% |
| iShares Core S&P Mid-Cap ETF | IJH | 6.50 |
| Vanguard REIT ETF | VNQ | 3.25 |
| iShares MSCI EAFE Index Fund | EFA | 6.25 |
| Vanguard MSCI Emerging Markets | VWO | 6.25 |
| Vanguard Total Bond Market ETF | BND | 25.00 |
| Vanguard Long-Term Bond ETF | BLV | 5.00 |
| SPDR Barclays Intl Treasury Bond ETF | BWX | 5.00 |
| iShares iBoxx $ Invt Grade Corp. Bond | LQD | 5.00 |
| iShares Barclays 7-10 Year Treasury Bond | IEF | 5.00 |
| Cash | - | 5.00 |

*Source: Wela Strategies*

Another example is dividends. We want high-dividend payouts, but also an index of companies that have a history of increasing their dividends. We went straight to State Street's **SPDR S&P Dividend** ETF [SDY] and the **iShares Dow Jones Select Dividend Index** fund [DVY].

*But even if you know what you're looking for, there are often dozens of options. There are some 43 dividend ETFs and 18 high-yield ETFs, for instance, but you immediately narrowed it down to the biggest and best-known. Does size matter?*

**Reiner:** We want an ETF to have at least $25 million to $50 million in assets, and to be offered by a firm that we think will be around for a long time. We are looking at one fund now -- **PowerShares Global Coal Portfolio** (PKOL) -- that we like but I don't think we'll use because of its size. [PKOL has $10 million in assets.]

*Dryden, do you also gravitate toward the bigger ETFs and/or those from the top providers?*

**Pence:** Yes. We don't want to wake up some morning and find out our position is 1% or 2% of the ETF. So we have to be in guys above $50 million. All ETFs are easy to get in. But the small ones are like Hotel California -- getting out is difficult.

*Why?*

**Reiner:** There are a lot of investors who don't understand how ETFs work, and how they can use the creation and redemption process to more efficiently trade larger amounts, sometimes even more than the daily volume of the ETF itself.

*OK, so explain to those investors what you mean.*

**Reiner:** Investors, and even a lot of advisors, think, 'I can trade an ETF any time of the day.' But the creation-and-redemption process of an ETF is different than trading a stock. Investors can speak with what's called an authorized participant, which is a firm that can create or redeem shares of an ETF by swapping its own inventory of stocks with ETF shares. That way you don't have to trade the ETF shares themselves on the open market. It's often a more efficient process. Using the capital-markets teams of ETF providers can allow you to go beyond your own screen for price and volume, and trade more efficiently.

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Dryden Pence

**Dryden Pence**

This all-ETF, income-oriented portfolio could be used for investors who want their portfolio to generate at least a 3% yield per year.

| Fund Name | Ticker | % |
|---|---|---|
| iShares JPMorgan USD Emerging Mkt Bond | EMB | 7% |
| iShares iBoxx $ High Yield Corporate Bond | HYG | 7 |
| iShares iBoxx $ Investment Grade Corp Bond | LQD | 7 |
| iShares S&P U.S. Preferred Stock Index | PFF | 7 |
| Pimco Total Return ETF | BOND | 6 |
| iShares Barclays TIPS Bond | TIP | 2 |
| iShares High Dividend Equity | HDV | 6 |
| SPDR S&P Dividend ETF | SDY | 6 |

**Pence:** When it comes to buying shares, everybody says, "Oh, great, if you want to do this, call our trading desk and we'll create the liquidity for you." But getting out is the problem. If you need to get out and you have a lot of clients in [a fund], you may not have time to call that trading desk. Or, if you are trying to call, everybody else is, too. If you get a moment where there is a major market move or a major need for liquidity, that trading desk is not going to be able to help you as much. There are too many people trying to get through that narrow door. That is a risk. You don't want to go into a dark movie theater that doesn't have any exits.

*So the need for a trading desk can be a risk factor?*

**Pence:** We use limit orders when we buy something, which means we'll only buy an ETF at a certain price or lower. When we think we might have to deal with a trading desk on the way out of an ETF, that is a risk factor that figures very prominently in our willingness to use that fund.

*Exchange-traded fund sponsors argue that the liquidity of the underlying securities is what matters, not the size or liquidity of the ETF itself.*

**Pence:** That's a good point. You do have to look at the underlying securities. If they're broadly traded, it is not that big of a deal. But if the underlying securities are thinly traded,

| | | |
|---|---|---|
| iShares Russell 2000 Index | IWM | 4 |
| iShares S&P MidCap 400 Value Index | IJJ | 4 |
| Consumer Staples Select Sector SPDR | XLP | 6 |
| iShares Dow Jones U.S. Industrial Sector Index | IYJ | 3 |
| iShares S&P Global Consumer Staples Sector Index | KXI | 6 |
| SPDR S&P Homebuilders ETF | XHB | 3 |
| iShares Dow Jones U.S. Technology Sector Index | IYW | 3 |
| Vanguard REIT ETF | VNQ | 6 |
| iShares S&P Global Consumer Disc Sector Index | RXI | 5 |
| iShares MSCI Germany Index Fund | EWG | 4 |
| iShares MSCI South Korea Index | EWY | 3 |
| Cash | - | 5 |

*Source: Pence Wealth Management*

you'll have a bid-ask spread that is going to create an issue for you.

**Saperstein:** I answer to my clients, not the fund sponsors. All investors should think about what the liquidity profile of an ETF will be in a replay of 2008. I see very little difference between illiquidity and a superwide bid-offer spread. They both result in a hostile position for my client's money.

*Do you evaluate the ETF provider in any way? If two funds look good, do you opt for the one from a big firm like Vanguard or iShares over a smaller shop's?*

**Reiner:** We look at all funds on an equal playing field, but if it comes down to three nearly exact funds, it becomes a matter of who's going to keep that ETF afloat longer. A Pimco is able to keep a fledgling ETF around because they're making money elsewhere. There's going to be huge consolidation over time. You're not going to have 50 providers; you're going to get five big names and maybe a few niche players.

**Saperstein:** You can look to the tremendous consolidation in the money-market industry to see what will happen with ETFs. This is what happens when you have fee compression. Inefficient providers or high-cost providers have to consolidate to gain economies of scale. This raises a different point, with Fidelity Investments coming to the market.

*It's interesting you mention Fidelity, since it's a big firm that is able to stand behind its fledging products.*

**Saperstein:** Yes, but there are already four providers -- iShares, State Street, Vanguard, PowerShares -- that have 87% of the market. Those top four -- that's the overwhelming majority of what we use. It's confusing to me why Fidelity is coming in. The game is already pretty much determined. Plus, they have a big mutual-fund business -- are they going to cannibalize it to make their ETFs a success? Then their margins will come down. I don't understand it.

*Are there asset classes or strategies for which you don't use ETFs?*

**Saperstein:** We tend to shy away from using ETFs for fixed income. Most indexes are weighted toward companies with the highest amount of debt outstanding. Quite often, those are not the best bonds to hold. A manager of a mutual fund or separately managed account, though, can identify issuers with lower leverage ratios but that offer equivalent yields. We have found that security selection in fixed income is more critical than it is in the equity space.

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Richard Saperstein

When it comes to high yield, we wound up using the **Federated Institutional High Yield Bond** mutual fund [FIHBX], which we found outperforms the ETF space and has a unique strategy in managing high-yield money. We also use the **Lord Abbett High Yield** mutual fund [LHYAX] versus the ETF.

*How complex is too complex for ETFs? Do you use the credit-like instruments known as exchange-traded notes? How far out on the complexity spectrum will you go?*

**Reiner:** We use ETNs a little bit, mostly for investments in master limited partnerships. We used to use the **JPMorgan Alerian MLP Index** ETN [AMJ], but they closed off new share creation. Now it trades more like a closed -end fund, sometimes at a premium or discount to the value of the underlying MLPs. So we moved into the **UBS ETRACS Alerian MLP Infrastructure Index** [MLPI], which is still accepting new money. It is better at tracking the index.

### Richard Saperstein

Saperstein's firm, Treasury Partners, uses ETFs for both long- and short-term strategies. This is a sampling of funds they are currently using.

| Fund Name | Ticker |
|---|---|
| Consumer Staples Select Sector SPDR | XLP |
| Energy Select Sector SPDR | XLE |
| iShares Dow Jones US Pharmaceuticals | IHE |
| iShares Dow Jones US Home Construction | ITB |
| Technology Select Sector SPDR | XLK |
| iShares S&P Global Technology Sector | IXN |

*Source: Treasury Partners*

*You don't want to own something that could trade at a premium over net asset value?*

**Reiner:** Exactly.

**Pence:** We looked at ETNs pretty hard and decided not to use them. We don't want to be an unsecured creditor of a financial institution. That's saved us over the past couple of years. To Matt's point, ETNs are more effective in the master-limited-partnership area. But when we looked at it, we said, let's just buy the MLP.

*Back to complexity: Do you like any of the more exotic or alternative indexing strategies, such as the ones that weight stocks according to earnings or dividend payouts, or international ETFs that are weighted according to country demographics?*

**Pence:** Those are useful in foreign markets. That's where the expertise and the actual access to investments doesn't come as easy. Funds using specific strategies in that area, like **WisdomTree Emerging Markets SmallCap Dividend** fund [DGS], make that kind of investing much more efficient. The ETF is a very good application in that space.

*So you're not troubled by the rising specificity of ETFs?*

**Pence:** We want ETFs to be more thematically pure, to better represent a particular resource or asset class, and not be contaminated by other things. As advisors, we'll figure out the weighting in the client's portfolio. That's our job. Let the provider give us the tools to execute the weighting we think each portfolio should have.

Recently we have liked railroad companies, for instance. There are several transportation ETFs out there, and in smaller accounts, we would own the **iShares Dow Jones Transportation Index** fund [IYT]. But what we really wanted was exposure to rails. When oil is north of $78 a barrel, the cheapest way to move a ton of freight one mile is by train. If half of a transportation ETF is made up of railroads, the stocks in that half will benefit from higher oil prices. But if the other half is made up of planes and trucks, that piece will be hurt. It's when you have these big themes that you really have to look at the composition of an ETF versus its contamination point. If you want to be rails, be just rails. If you want to be planes, be just planes. If you want to be trucks, be just trucks.

*In that case, why not just buy the stocks?*

**Pence:** We do, and most of our portfolios are individual stocks. But in smaller accounts, that's inefficient. So when you are trying to give the most help to the people who need it the most, the guy who needs to go from a $500,000 retirement portfolio to $1.5 million, exchange-traded funds are more efficient.

**Reiner:** I'd like to see the ETF industry create products that better slice and dice the market, rather than come up with exotic strategies or crazy hedge-fund-type things. Exposure to a hedge fund in an ETF? That's just not what we want.

**Pence:** In the final analysis, the best hedge is a sell button.

**Saperstein:** I also question the utility of mimicking a hedge fund through an ETF. Hedge fundshave suitability requirements, designed to keep out unsophisticated investors or investors with a small portfolio.

*One of this year's biggest trends is strong inflows into emerging-market bond funds. Are you partaking?*

**Saperstein**: We think that's an overpriced asset class right now. We don't have any exposure to EM debt.

**Pence:** We chose both a dollar-denominated and a nondollar-denominated ETF, the **iShares JPMorgan USD Emerging Markets Bond** fund [EMB] and the **WisdomTree**

**Emerging Markets Local Debt** fund [ELD]. [For more on emerging-market debt securities, see "A Debt World Turned Upside-Down."] This goes back to the issue of ways to get income. We have to diversify our income stream to provide clients with a constant stream of income in retirement.

**Saperstein:** When you're buying any security outside the U.S. or denominated in a currency other than the dollar, it forces you to be right twice. The first time you have to be right is in the underlying investment; the second is in the relationship of that currency versus the dollar. Assuming our clients, for the most part, are dollar payers for their everyday living, investing outside the U.S. engages a whole other set of currency risks. That affects our decision to go into emerging-markets debt.

**Pence:** Are clients asking you different things now than they were prior to 2008?

**Saperstein:** Clients were more aggressive and had higher-return expectations, precrisis. That makes the current environment really challenging. Historically, you can build lower-risk portfolios using fixed income, and assume a reasonable rate of return, whether it's 3%, 4%, or 5%. Today, you can't do that. That changes the dynamic and the composition of a portfolio, and becomes more challenging for the more risk-averse investor.

**Reiner:** Clients are coming to us, and they don't have any cash flow any more, except for Social Security. Their CDs are maturing -- the ones that pay 5% or 6% -- and they say they want 5% or 6% without risk. We have to figure out what investment mix we can utilize with closed-end funds that will give clients enough yield without putting their net worth at risk. It's a tough environment, and we're having to look outside the box.

**Pence:** You have dividend-paying stocks that are better bets than bonds at this point. They actually have a better yield, which is different from the past 50 years. But if we change the conversation to "what do you really want the money to do?" and focus on generating income, people become more comfortable. Part of our role is to change that dialogue, so that people look at what their money is really doing for them, and what they want it to do. If the income component is fairly stable, they can accept a certain amount of volatility, and they are going to have to in this market.

*Thanks, gentlemen.*