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FA TALKS

HERE'S LOOKING AT YOU, CORE

with Larry Whistler, President and CIO, Nottingham Advisors

FA TALKS IS AN INTERVIEW SERIES WHERE INDUSTRY THINKERS SHARE THEIR THOUGHTS AND PERSPECTIVES ON A VARIETY OF MARKET TRENDS AND THEMES IMPACTING INDEXING.

LARRY WHISTLER
As head of the Investment Policy Committee, Larry leads the investment research and portfolio management team at Nottingham Advisors. He is a Chartered Financial Analyst (CFA).

S&P DJI: How do you define core to clients?

Larry: We define core as efficient, diversified exposure to all of the major, global asset classes. The mix between these asset classes is anchored by a client's overall risk tolerance. A portfolio's core is the key determinant of an investor's overall experience over time, so it's important to make sure that the core asset allocation correctly matches a client's risk appetite.

S&P DJI: In your opinion, why is core so important to the portfolio-building process?

Larry: We believe core is important because it drives the bulk of a portfolio's return. The math is straightforward. The return of an investment portfolio is simply a weighted average of the return of its components. For example, suppose core holdings make up roughly 80% of a portfolio. This means that the core portion is responsible for 80% of that portfolio's return, while tactical holdings account for just 20%. It seems logical that core would then receive considerable focus. In practice, however, we see the exact opposite. Most advisors are spending 80% of their time on the tactical component of a portfolio and only 20% on the strategic, which seems a little backwards to us. Since core is really the driving force behind a portfolio's returns, we believe that it's important to make sure it receives the attention it deserves.

S&P DJI: What approach do you use to construct a core portfolio, and how do you ensure tax and cost efficiencies?

Larry: There are numerous ways to construct a core portfolio, but our bias is towards an index-based approach. Indexing provides both the broad diversification and purity of style required to construct a comprehensive, disciplined core. More specifically, we utilize exchange-traded funds (ETFs) in the strategic portion of our portfolios. We favor ETFs because they're both low-cost and tax-efficient. For example, not only does their passive nature make ETFs inherently low-cost, but the rapid development of the industry has also exerted incredible downward pressure on management fees. There are now over 1,600 ETFs in the U.S. vying for assets, and competition is driving down costs. At the same time, ETFs are also tax-efficient as their structure allows for a process called "in-kind transfer" that minimizes capital gains distributions.

S&P DJI: Some believe that large-cap stocks are synonymous with core portfolio building. What's your view?

Larry: We would have to disagree. To us, a portfolio's core should be as inclusive as possible, providing the greatest opportunity set for our clients. The world is an expansive and diverse place, and we take a global worldview that includes both stocks and bonds from companies of all different sizes and locations in all different parts of the world. By one measure, U.S. equities make up only 49% of all global equities and large-cap stocks are a subset of that bucket. By failing to include international stocks or even smaller-sized domestic stocks, an investor is missing out on opportunities for enhanced diversification, higher returns and lower risk.

S&P DJI: In your view, how much of a client's portfolio should be allocated to core investments?

Larry: In our view, the portion of a portfolio positioned in core investments should really be a function of an investor's risk tolerance. For an investor with a greater appetite for risk, we believe a 60/40 strategic/tactical mix may be appropriate. However, for a conservative investor, we would advocate for a mix closer to 80/20. The reason for this is that, although every investor wants to generate outperformance, it's the more aggressive investors who are better suited to handle the potential for underperformance that comes along with the pursuit of alpha. Aggressive investors have a longer time horizon, while conservative investors do not. A longer time horizon does two things: one, it affords tactical investments a longer period to play out, and secondly, it provides additional opportunity to outperform in the future, potentially offsetting any current performance lag.

S&P DJI: Speaking of alpha, can you share your views on striving for excess returns (alpha) versus achieving market returns for each asset class (beta)?

Larry: We believe that there is room for both beta and alpha in any portfolio, which is why we subscribe to a core-satellite approach. This construct corresponds with our belief that markets are mostly efficient. Most factors are usually priced into the market, but occasionally the behavioral tendencies of market participants lead to opportunities. Under a core-satellite approach, a portfolio's core, or strategic allocation, seeks to efficiently and cost-effectively replicate market risk and return (the beta). At the same time, the portfolio's satellites are designed to generate returns in excess of the overall market (the alpha). It's the best of both worlds; it allows us to pursue outperformance within the tactical portion of the portfolio, while the strategic portion hedges against us taking an incorrect tactical position.

S&P DJI: Has the current low interest rate environment influenced your positioning at all, in terms of the fixed income portion of your core investments?

Larry: The answer to this question largely depends on the type of client. For us, we have two types of clients with fixed income exposure: those seeking total return and those seeking current income. For our clients seeking total return, we are currently focused on short duration, high credit quality bonds. Absolute yields and relative spreads are so low that there is not much opportunity cost to shunning risk at the moment; the incremental yield is just not there. On the other hand, for our clients seeking current income, we've had to take on a whole new set of risks since their required income needs cannot be met in the current rate environment. For example, more and more conservative income investors are including things like dividend-paying equities, MLPs and REITs to boost portfolio yields.

S&P DJI: Let's talk a little bit more about indexing. When it comes to implementing core and achieving exposure, is indexing effective across asset classes?

Larry: A majority of the time, we believe indexing is the way to go as it provides broadly diversified exposure at a reasonable cost. With that said, we do think there are some less efficient areas of the investing universe where an argument can be made for active management—think asset classes like bank loans or small-cap emerging market equities. However, even in these areas, it is important to remember that, with the added costs of active management, the hurdle to outperform gets even higher and that manager outperformance can be awfully fleeting.

S&P DJI: What makes a good index, in your opinion?

Larry: In our opinion, a good index should first have a straightforward methodology. That allows us to understand the exposure it represents and where it might fit in our portfolios. We also like to see a reasonably long track record, typically five years or longer, to make sure that an index really captures the exposure it's designed to capture. Beyond that, an index must have a transparent and replicable process and its underlying securities must be liquid—that's what makes the index investable. Lastly, it should avoid excessive turnover to limit implicit trading costs. Frictional costs matter to us and in our book, a basis point saved is a basis point earned.

S&P DJI: How important is an index's methodology to your ETF selection process?

Larry: An index's methodology is very important to our ETF selection process. In our eyes, an ETF is really only as good as its index. Sure, it's important to analyze how well an ETF tracks its index and what it charges to do so, but by and large, the largest contributor to how a particular ETF acts, or how it fits in a given portfolio, is the methodology of its underlying index.

S&P DJI: At one point, VWO was your ETF of choice for exposure to emerging markets. You've since switched to IEMG. Can you explain why?

Larry: Our exposure to emerging markets has seen quite an evolution. We started with EEM, which at the time, was the cheapest and most liquid way to access emerging markets. In 2005, however, VWO launched and quickly gained critical mass. It tracked the same index as EEM, but at a much lower cost. At that point, we decided to use it to replace EEM. In 2012, Vanguard decided to make a switch to VWO's underlying index, which ultimately altered its fit in the overall portfolio. Fortunately for us, iShares launched its "core" series, including IEMG, right around the same time. In our opinion, IEMG provided even better exposure and at a similar cost, so it replaced VWO as a core holding. The moral of the story here is that managing the core of a portfolio is not a passive proposition. Investors clearly benefit from changes in the ETF industry, but they must adapt their portfolios over time in order to take advantage of them.

S&P DJI: What does your core portfolio currently look like?

Larry: Our core portfolio is currently made up of 13 ETFs, encompassing seven asset classes and 14,000 individual securities. It has a weighted expense ratio of 16 basis points and 2013 capital gains of ostensibly zero (2 basis points). We think that's pretty good.