

## BUILDING A BETTER CORE WITH ETFs



Determining where to invest a client's money is a complicated process that demands time, expert knowledge and resources. So the question many advisers will ask themselves is: Am I prepared to undertake asset allocation and construct bespoke portfolios for my clients? If the answer is yes, then it's worthwhile considering how and where exchange traded fund (ETF) building blocks can be used.

### Beyond shares and bonds

For years investors relied on equities and/or bonds to provide most of their desired investment returns. However, as the investment universe has widened advisers have been able to take advantage of a broader set of opportunities and build more dynamic portfolios with diversified sources of return.

An increasingly popular way of doing this is through core satellite portfolio construction. This is based on the concept of splitting a portfolio into two segments; the 'core' forms the foundation of the strategy around which the more specialised 'satellite' investments are added.

ETFs, being low-cost, diversified investments, can form an ideal 'core'.

### Core competencies

The rationale behind core satellite investing is the ability to combine the most effective characteristics of index and alpha-generating strategies, while offering flexibility and lower costs.

Using index funds such as ETFs in the core can reduce overall costs and deliver the market return element of the portfolio. This leaves the satellite open for more specialised investments an adviser believes will deliver active outperformance (*however, may also have higher fees*).

Theoretically the core should account for 50% or more of the portfolio.

### Building a balanced portfolio

So what does a core satellite portfolio actually look like? Let's imagine a client who wants a balanced portfolio, 50% equities and 50% fixed income, focused on growth with only moderate risk. And let's say the adviser/portfolio manager specialises in small-mid cap equities. The resulting portfolio could be a 70% core comprised of government bonds, corporate bonds, inflation linked bonds and large cap equities - implemented through pure beta investments in ETFs. In the 30% satellite could be small and mid-cap equity active funds, or even some sector ETFs for tactical bets.

The result is a broadly diversified portfolio across fixed income and equities that focuses on the advisers key competencies. The use of ETFs in the core reduces overall costs for the client, and in the satellite, allows for more tactical overlay.

Depending on client and the adviser preference, portfolios can also be implemented in reverse, with active funds at the core, and predominantly index funds in the satellite. This model offers greater alpha potential, but potentially at a higher overall cost.

### Active risk control

Another advantage of core satellite investing is its modular approach to portfolio construction which allows specific risk and return targets to be set for each investment. If any part of the portfolio isn't meeting its target, swift action can be taken without necessarily disturbing other elements of the strategy. This gives the portfolio manager more flexibility and enhances transparency of risks taken and the return contribution of each investment.

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Many institutional investors use an approach to core satellite investing called “active risk budgeting”. In this strategy, you “back into” a prescribed active risk (*tracking error*) target. Because the core of the portfolio comprised of ETFs tracks an index, it should closely mirror the intended asset allocation model, allowing for better control for active risk. Actively managed satellite investments are then used to dial up/down active risk. Active risk budgeting can help advisers clearly articulate an expected range of relative performance, and illustrate a risk management system aimed at reducing wide swings in active manager performance

### Growing trend

The past five years have seen huge growth in the availability and AUM of ETFs across Europe. There are now over 2000 exchange traded products (ETPs) on offer with total assets over US\$400 billion (*as at 31 February 2014, Source: BlackRock*). This growth has been underpinned by the increasing recognition of the importance of asset allocation in constructing portfolios. In a famous 2000 study ‘Does Asset Allocation Policy Explain 40, 90 or 100 Percent of Performance?’, Roger Ibbotson and Paul Kaplan found that, on average, asset allocation accounts for

more than 90% of portfolio returns (*Financial Analyst Journal, 2000*).

With this in mind, we believe more investors are using ETFs as the building blocks of a core satellite portfolio. ETFs offer an efficient entry point to the traditional investments of equities and bonds, as well as additional asset classes such as corporate debt, government bonds, property, commodities and infrastructure. Previously hard-to-access markets like real estate and private equity can also be accessed through ETFs. Because these asset classes have different historical correlations to the more traditional asset classes they provide a unique way to manage risk at the asset class level. Additionally, ETFs that track a narrow index, such as an individual country or industry sector, can be used as satellites since they are less diversified than the broader indexes and can be used more tactically to improve a portfolio's overall performance.

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Prior to assuming his current role in 2010, Mr. Gast was with UBS Global Asset management, where he had worked since 1999 heading up the ETF business. Additionally, Christian was also Head Product Development and Management UBS Equity Funds. Prior to this, he worked with the St. Galler Kantonalbank as Senior Portfolio Manager responsible for managing private and institutional assets. Christian Gast earned a PhD degree from the University of Zurich in 1998 and an M.B.A. from the University of Saarbruecken in 1994.

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- ▶ Trading ideas.
- ▶ Strategic and tactical investment research.
- ▶ BlackRock Investment Institute (BII) white papers.
- ▶ Asset allocation advice (model portfolio solutions).
- ▶ ETP flows.
- ▶ Global ETP overview of all providers.
- ▶ Monthly iShares newsletter.



## Product analysis support

- ▶ Product analysis (performance difference, liquidity, etc.).
- ▶ Benchmark comparisons (index methodology, liquidity of the underlying market, performance, etc.).
- ▶ Product tax efficiency analysis based on withholding tax and tax reporting status.



## Tailored fund information

- ▶ Tailored fund reporting (factsheet mailings, fund breakdowns, distribution reporting, etc.).
- ▶ Customised product data files, RfPs, etc.
- ▶ Conference calls or 1-to-1 meetings with PM teams and investment strategists.



## Trade execution support

- ▶ Guidance on the best trade execution:
  - Pre- and post-trade transaction cost analysis.
  - Provide limit order guidance.
  - Provide information on brokers to help you achieve best execution.
- ▶ Help source liquidity through relationships with more than 50 market makers.
- ▶ Market insight and product expertise.



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