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Fast-growing managed portfolios extend ETF market

The spectacular growth of the exchange traded fund market has been one of the major stories in the U.S. asset management industry this century. In 2000, the products, with just $70 billion in assets, barely registered with investors. But in the decade that followed, 30% annual average growth created a major industry with assets in the U.S. that now top $1.4 trillion. By comparison, traditional active and passive fund assets grew by an average of 5% to 6% a year between 2000 and 2010, according to McKinsey & Co., with passive equity index funds enjoying far stronger demand (based on net inflows) than actively managed equity funds since the financial crisis.

As the U.S. ETF industry has grown to incorporate 1,200 products, it has naturally evolved: The early plain-vanilla index funds have been joined by leveraged ETFs, active ETFs and an increasing number of finely drawn and even exotic offerings. This year, for example, the **FLAG Forensic Accounting ETF** was launched, employing "forensic accounting analysis focused on 'earnings quality.'" The **Global X Nigeria Index ETF** is another new option for investors who want "exposure to the largest and most liquid companies in Nigeria." New York's **Emerging Global Advisors** manages specialized emerging market ETFs that offer investors alternatives to the broad-based MSCI Emerging Markets Index. For example, the **EGShares Emerging Markets Consumer** ETF invests in the constituent securities of the Dow Jones Emerging Markets Consumer Titans 30 Index.

Since the market meltdown of 2008, a less heralded trend has also picked up steam: The rise of ETF managed portfolios. From a small base prior to the financial crisis, these investment products, comprising ETF funds that for the most part are tactically managed, have accumulated $73 billion in assets. According to the most recent data from Morningstar, in the six months through March 2013, assets climbed 22%. Global tactical asset allocation strategies define the market, accounting for 64% of assets, with strictly U.S.-focused strategies comprising 33%.

In its latest 2013 estimates, Morningstar — which defines ETF managed portfolios as those with more than 50% of assets in ETFs — estimates that 140 firms offer such products, with boutiques predominating. In January 2012, the research firm calculated a universe of around 100 firms. While still small and young enough to be fluid, the market has quickly assumed a pecking order, with the top five firms accounting for 55% of assets and capturing the lion's share of the growth in the six-months through March 2013.

Portfolio managers earn their spurs by making broad tactical decisions about markets, sectors and nations based on their readings of a variety of trends, with a keen eye on risk management. This focus contrasts with the individual stock- or bond-picking prowess demanded of active fund managers. Although an ETF managed portfolio may hold a 60-40 equity to fixed income allocation, for example, managers are free to shift that weighting based on their reading of the market's prevailing winds.

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They can also employ such tactical allocation strategies to alter sector and country weightings, with the liquidity and low cost of trading ETFs facilitating that process.

Although this element of "active" management adds a layer of fees to the low-cost ETF products comprising the portfolios, the total cost to investors, generally below 1%, compares favorably with the fees charged by active fund managers. For example, the leading provider of ETF managed portfolios, **Windhaven Investment Management**, charges fees ranging from 95 basis points for the first $500,000 to 70 basis points for more than $5 million.

Primarily a retail-oriented vehicle, ETF managed portfolios play into several trends. One is the greater emphasis on risk management following the market crashes of 2000 and 2008. Among affluent baby boomer investors, risk management is a particularly critical demand as they enter the wealth preservation phase. The products, like the ETF market in general, also benefit from the jaundiced view many investors hold these days of active fund managers, including an aversion to paying the hefty fees many of these managers command unrelated to performance.

From the financial advisor perspective, the products can also be a good fit: As these advisors increasingly place portfolio management in the hands of external specialists so they can concentrate on expanding their businesses and servicing their clients, an individual ETF managed portfolio may provide either the core equity component of a retail client's portfolio or a "satellite" investment option for a high net worth client.

As the industry seeks expansion, it does face some questions, however. A major one is whether the market will expand beyond its retail base to incorporate the institutional and 401(k) markets, thereby providing significant new avenues for growth. A second is the possibility that active fund managers could recover their mojo in more volatile markets and steal some of the momentum from indexers. A third question impacting the growth and development of the market revolves around the enthusiasm and intentions of major asset managers, which have the distribution and marketing muscle to drive product awareness and sales. As they consider the market, do asset managers build from within, act as conduits for existing products (as **Fidelity Investments** has done with **BlackRock**), or make acquisitions? Or, do some asset managers dismiss the products altogether as being inconsistent with their overall investment philosophy?

Andrew Gogerty, who follows the market for Morningstar, believes the industry giants will eventually jump in. "As the fiduciary standard moves forward, [a] low-cost, broad-based focus on asset allocation is really going to be the standard for managing client money," he said in a 2012 company interview. "And as the flows have shown, ETFs are definitely gaining traction, are here to stay, and I think as more and more advisors want these types of portfolios, I think the heavyweights are going to have to get in to have a presence."

Charles Schwab has been the only heavyweight to buy its way into the market so far, acquiring Windhaven Investment Management (Windward Investment Management at the time of the deal) in 2010. As is the case with other deals in this sector, the Schwab-Windhaven transaction was a classic infrastructure-for-product swap. The deal did raise eyebrows on pricing, however. Schwab paid $150 million in shares and cash for just $4 billion in AUM. The broker for everyman sweetened the pot with another $100 million in incentive payments to employees over nine years. The rich valuation, while a risk for Schwab, was not without merit, given Windhaven's five-year track record of 56% compound annual growth in AUM. The two companies also had an existing distribution agreement and so were familiar with one another.

Boston-based Windhaven managed three global ETF portfolios with varying risk profiles at the time of purchase. "Among independent advisers and retail investors there is a growing interest in the kind of value [Windhaven] can provide — portfolio construction which puts risk management at its core," Schwab said in announcing the deal. In discussing the transaction, Stephen Cucchiaro, then Windhaven's president and chief investment officer (and current CIO), said "Schwab's vibrant brand coupled with its unrivaled leadership with RIAs and individual investors" would allow his firm to extend its footprint. He also noted that a larger parent would allow him to focus on investment research rather than "business management."

Schwab's bet has paid off so far, with Windhaven's AUM soaring fourfold to more than $16 billion in the three years since the deal. Windhaven continues to offer the same three portfolios that provide conservative, growth or aggressive strategies. **Windhaven Diversified Growth**, an equities and fixed income product that mixes in commodities and real estate investment trusts (REITs), is the leading ETF managed portfolio (AUM: $8 billion) and continues to grow rapidly. The Windhaven business also neatly rounds out Schwab's overall ETF business, which includes a broad menu of some 100 commission-free products for self-directed investors as well as a "Select List" for those who want assistance in pruning the choices.

To date, Schwab has been the only major retail distribution player to make an acquisition, with private equity players and one securities firm accounting for the other transactions. In 2011, private equity firm **TA Associates** bought a 54% stake in **Stadion Money Management**. Stadion, an established asset manager based in Georgia, utilizes ETF managed portfolios in a range of products, including risk-based collective investment trusts (CITs), target date CITs, managed accounts and within its 401(k) line. In a statement, Stadion said ETFs are "an excellent tool" with which to gain exposure to "specific areas of the equity markets" that managers can also recalibrate "very quickly and efficiently." According to Morningstar, the firm had $1.6 billion in AUM in those ETF managed portfolios as of March 2013, with assets having declined slightly in the prior six months.

The second private equity deal saw a consortium of firms led by **FTV Capital** make a $75 million investment this past April in **Good Harbor Financial** (AUM: $5 billion), one of the larger providers of ETF managed portfolios. The two other investors were **LLR Partners** and **CJM Ventures**. FTV said the investment is designed "to further enhance Good Harbor's product, client service and distribution capabilities through both organic growth and acquisition." FTV, which targets financial services firms as one of four "sector focus areas," has been an investor in several ETF providers, including three that remain in its portfolio: **ETF Securities**, a commodities specialist with $23 billion in AUM; and **IndexIQ** and **VelocityShares**, both of which provide liquid alternative strategies (IndexIQ also offers ETF managed portfolios).

Good Harbor said FTV's track record for assisting the development of other asset managers played a role in its decision to team up, noting that FTV "will contribute significantly to our product expansion" while its "industry relationships" would help with distribution. Good Harbor, established in 2003 and based in Chicago, manages three tactical funds employing ETFs in part or whole. These include **Tactical Core**, a U.S. long-only balanced fund that shifts its asset allocation based on prevailing or anticipated market conditions.

The fourth transaction took place in 2010 and involved **Knight Capital Group**'s $18 million stock-and-cash purchase of **Astor Asset Management**, which had $560 million in AUM at the time — a number that had topped $1 billion less than a year later. Knight, a global securities firm, praised Astor's "rapid growth" and "relatively low expense ratio using ETFs" while saying it could "help Astor get to the next level" and create "a foundation for asset management that contributes stable, recurring revenues to Knight." For Astor, the deal provided resources for new products and access to Knight's network of broker-dealers. Founded in 2001 and based in Chicago, Astor uses macro-economic models in building ETF managed portfolios for separately managed accounts and mutual funds, including income-generating and long/short portfolios. ▲

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