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The Rise and...Continued Rise...of the ETF Strategist

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Written by: Bryan Novak, Senior Managing Director & Portfolio Manager

ETF STRATEGIST PRIMER

- The Exchange-Traded Fund is a dynamic asset allocation tool, allowing managers to implement changes quickly & efficiently across multiple asset classes
- Managers who employ ETF-based strategies (using a minimum of 50% ETFs) are NOT a new asset class. They offer solutions that are an expansion of time-tested strategies (i.e. tactical or strategic)
- Although the past 1.5 years have been challenging for growth, the space has grown quickly over the last 5 years, post-financial crisis
- The recent challenges for the ETF strategist space have been idiosyncratic rather than systematic
- Empirical analysis suggests that these managers offer equivalent, and often better, value propositions compared to managers of similar, non-ETF strategies

The advent of the Exchange-Traded Fund (ETF) has permeated all levels of the investment management landscape as a (relatively) new and efficient tool for the implementation of asset allocation strategies. These tools have allowed investors and traders to access various markets in one fund, in one trade, intraday. These features, combined with general tax efficiency (compared to mutual funds), make ETFs one of the ultimate tools for active, as well as passive, asset allocation strategies.

A subset of asset managers that have accepted these tools has evolved into a group called ETF Portfolio Managers (EPM) or ETF Strategists. It is generally understood that in order to be considered an ETF strategist, 50% of your investment allocation must be in ETFs. This investment categorization is defined and tracked by a number of consultants, platforms, and other data-collecting firms catering to all facets of the investment management industry.

The formation of this space began in earnest in 2008 as the bull market came to a halt. Strategies outside of the standard benchmarked asset allocation (ie: 60/40 stock/bond) demonstrated risk management capabilities. They either avoided much of the market drawdowns through tactical asset allocation or adjusted enough to change the risk/return profile versus standard passive allocations. A number of the prominent, early pioneers of ETF strategists displayed these characteristics during the period and gained notoriety by offering value added solutions to investors.

While the philosophy of allocating part of a portfolio to active strategies was not new, the timing was right for the space to gain recognition. The accelerating use of ETFs in the mainstream combined with investor concern prompted by the Great Recession, created an opportunity for ETF managers to implement asset allocation strategies. As a result, advisors and platforms alike began to view the ETF strategist space as offering legitimate and promising solutions.

RECENT DISTRACTIONS

While still a young segment only a few years ago (maybe still), the asset growth rate in the ETF managed portfolio space was substantially higher than traditional managers, pushing total AUM up near $100B by the end of 2013 (as noted in the Q4 2013 Morningstar ETF Managed Portfolio Landscape Report). Prior to recent issues, ETF strategists were still growing significantly and far from exhibiting traits of a mature market segment.

In 2014 and early 2015, the ETF strategist space encountered substantial headwinds which began to attract attention. For what was recently the fastest growing space in the industry, this resulted in an unfavorable PR perception. The above reference is significant within the scope of this paper as the issues encountered were idiosyncratic in nature. Nonetheless, concern and negative attention created a narrative that threatened to muddle the overall efficacy of the value being offered by ETF strategists as a whole.

Before we continue, let's address a common misconception: neither the ETF nor the ETF strategist is or has created a new asset class.

DEFINITION:
An asset class is a group of securities that have similar characteristics, behave similarly in the marketplace and are subject to the same laws and regulations. The three main asset classes are:

- *Equities (stocks)*
- *Fixed-income (bonds)*
- *Cash equivalents (money market instruments)*

An ETF is a vehicle that creates access to specific asset classes (equity, fixed income, real estate, commodities, etc). An ETF strategist, just like any other asset manager, seeks access to one or more of these asset classes to implement a strategy but utilizes ETFs instead of individual stocks or bonds. They offer an extension, or an option, of existing strategy applications that have been employed in the asset management space for years. The vehicle used to implement the strategy, the ETF, is just different. Managers across the investment landscape employ similar strategies such as tactical allocation, strategic asset allocation, or a hybrid approach.

With the space under scrutiny, our inclination was to examine investment profiles and outcomes to discern how ETF manager solutions were different from the broader, comparable universe of managers. Although we can't blindly dismiss the skeptics, there has been a lack of evidence (actual data) comparing the two options (ETF managed portfolios and traditional mutual funds) and,therefore, chose to investigate. After all, we are biased. What if the skeptics are wrong?

THE STUDY

The primary evaluation method for this test was to identify a comparable sample group to one from the ETF strategist sub-categories. Fortunately, we didn't have to look far. Morningstar maintains the SACIT Database which contains performance of many of the ETF strategists broken into three categories: tactical, strategic and hybrid. The reported performance is based on separately managed account composite performance for each listed strategy.

111 S. WACKER DRIVE SUITE 3950, CHICAGO, IL 60606
312.228.5900 | INFO@ASTORIM.COM

Morningstar also tracks thousands of public mutual funds, categorized by strategy. One category happens to be tactical allocation. A handful of managers occupy both lists but, by and large, the Morningstar mutual fund category represents a broad and diverse group of tactical strategies utilizing various tools (stocks, bonds, ETFs, funds, futures) for implementation.

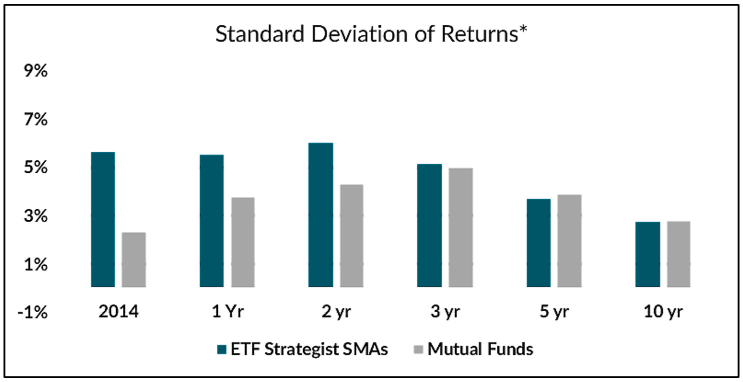
Criteria for inclusion:

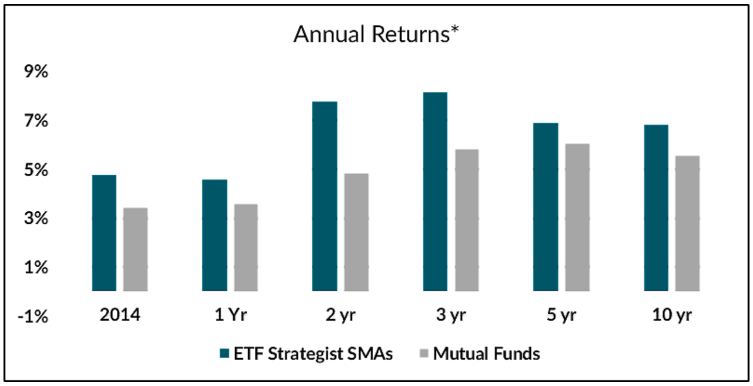
After identifying the sample group, the next step was to screen the constituents of each group. The strategies were screened on the below criteria:

- *Morningstar Mutual Fund Category*: 3-year track record, $25M in assets
- *Morningstar ETF Strategist Group*: 3-year track record, $25M in assets, GIPS compliant

The thought process was to allow strategies with enough history to contribute meaningfully to the study as well as set a minimal yet critical asset level. It was important that the performance was verifiable. Mutual funds are audited and publicly recorded, so that was sufficient. For the ETF strategist group, each strategy had to be listed as GIPS (Global Investment Performance Standard) compliant. These criteria set a level playing field for comparison.

The main point of the comparison was to draw parallels between the two and compare performance from the ETF strategist tactical segment to a broader implementation group. Are there similarities in return profile, risk, etc?





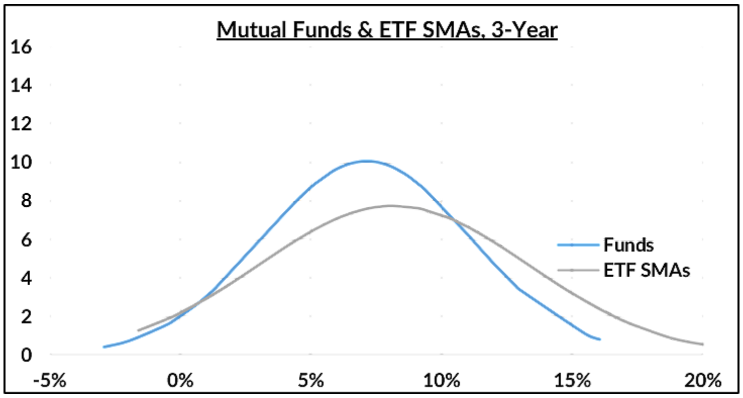
**ETF strategist SMA data retrieved from the Morningstar SACIT Database.*
**Mutual funds data is retrieved from Morningstar.com and Bloomberg.*

RESULTS FAVOR THE ETF STRATEGIST

While exhibiting a moderately higher volatility profile overall, risk-adjusted returns/sharpe ratios were comparable to better over the various study periods.

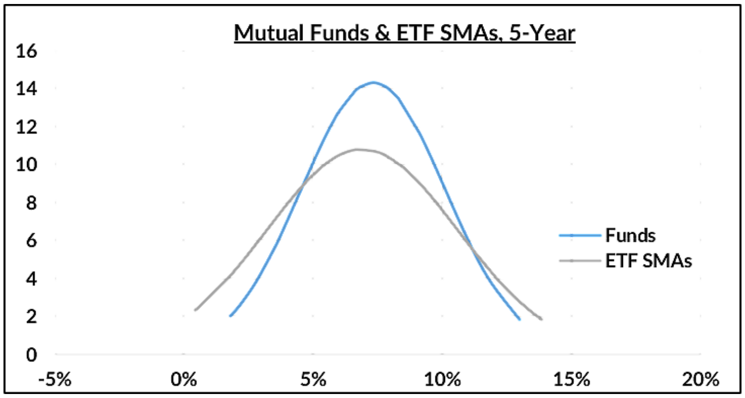
The mutual fund sample exhibited a more central tendency and negligible skew in the distribution curve for 2014 (standard deviation of returns and Kurtosis levels) as the ETF strategist had outliers illustrated by the curve (Exhibit 2). Removing the top and bottom 3 returns from the sequence for 2014 results in an almost identical skew and kurtosis profile.

Over the 3 and 5 year periods, ETF strategists continued to demonstrate a wider deviation in returns but with a more positive skew than the mutual fund sample group.



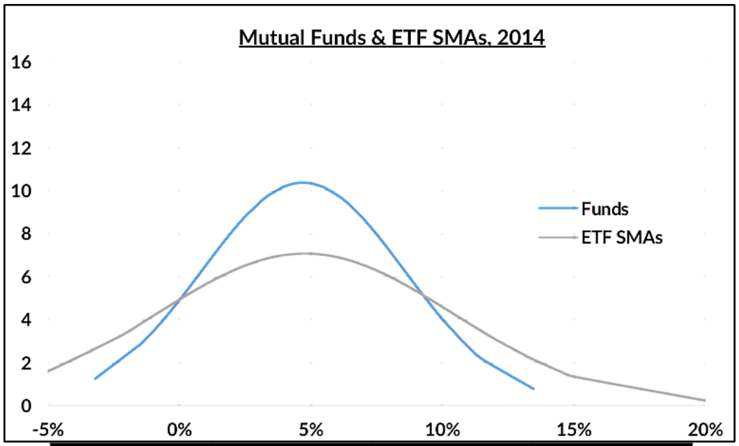
Strategy	n=	Kurtosis	Skew
Mutual Funds	55	0.69	-0.43
ETF SMAs	81	-0.07	0.46

*3-year time period 3/2012-3/2015



Strategy	n=	Kurtosis	Skew
Mutual Funds	31	-0.18	-0.44
ETF SMAs	65	-1.09	0.21

*5-year time period 3/2010-3/2015



Strategy	n=	Kurtosis	Skew
Mutual Funds	55	-0.75	0.12
ETF SMAs	81	5.27	-0.93

*ETF strategist SMA data retrieved from the Morningstar SACIT Database.
*Mutual funds data is retrieved from Morningstar.com and Bloomberg.

The results support the ETF strategist group as a laudable representation of tactical strategies compared to the broader group. This was demonstrated on an absolute return basis but also on a risk-adjusted basis. While not statistically significant in all cases, the favorable results were visually consistent over multiple time sequences (Exhibit 1), which included the 2008 recession, but also in more recent years when the integrity of the group was in question.

This result is in line with our philosophy that the significant majority of long-term strategy returns are explained by asset allocation, rather than timing or security selection. Choosing ETFs as the security selection tool lets the ETF portfolio manager pay more attention to the asset class allocation decision and overall portfolio strategy. The use of ETFs has consistently produced results that are at least equivalent, if not better, than traditional funds.

DISCLOSURE

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The performance presented is publicly available on Morningstar.com and should not be viewed as the performance of Astor's strategies or as an indication of the performance of Astor's strategies. The performance shown for ETF Strategists represents composite performance reported by investment managers to the Morningstar SACIT Database following the criteria listed. Astor makes no representation of the accuracy or completeness of the performance record of these managers. Additionally, the fee structure and method of composite creation will vary across the different managers. The performance shown is represented to be GIPS compliant by the reporting parties. Astor makes no representation as to whether the reporting parties are GIPS compliant or not. The performance shown for the mutual fund category represents performance reported to Morningstar by individual registered investment companies organized under the 1940 Investment Companies Act. Astor makes no representation of the accuracy of this performance. Similar to the ETF Strategists, the fees of these funds will vary according to the underlying structure and share class of each fund.

A complete list of the constituents for each category is available upon request.

Tactical Allocation: Tactical Allocation portfolios seek to provide capital appreciation and income by actively shifting allocations between asset classes. These portfolios have material shifts across equity regions and bond sectors on a frequent basis. To qualify for the Tactical Allocation category, the fund must first meet the requirements to be considered in an allocation category. Next, the fund must historically demonstrate material shifts within the primary asset classes either through a gradual shift over three years or through a series of material shifts on a quarterly basis. The cumulative asset class exposure changes must exceed 10% over the measurement period. Source: Morningstar.com

GIPS: The Global Investment Performance Standards is a set of principles designed to provide a standardized, industry-wide guideline for the calculation and presentation of investment performance.

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111 S. WACKER DRIVE SUITE 3950, CHICAGO, IL 60606
312.228.5900 | INFO@ASTORIM.COM