DISCUSSING PORTFOLIO MANAGEMENT WITH TWO ETF STRATEGISTS

Jeremy Schwartz – Global Chief Investment Officer
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Last week on our podcast we had the pleasure of speaking with two exchange traded fund (ETF) strategists live in our studio for the hour—Steve Blumenthal, founder of CMG Capital Management, and Corey Hoffstein, Founder and Chief Investment Officer of Newfound Research.

Both Steve and Corey are quantitative investment managers and both incorporate elements of tactical portfolio management within their investment programs servicing primarily other financial advisors.

Momentum and trend following are key determinants of tactical portfolio rotation for both firms – but Hoffstein's firm also incorporates ETF portfolio solutions that incorporate value investing, 'carry' as a factor and even defensive investing.

Markets priced for 2-4% Returns?

We discussed the market environment and the case for equities today. One thing that differentiates CMG and Newfound – Blumenthal commented that while he expects forward equity returns over the longer- run to be between 2-4% per year, he does not think valuations can be used as a guidepost for short-run decisions. Hoffstein's firm, on other hand, incorporates capital market assumptions and valuations to adjust their expected returns in building certain long-run oriented portfolios.

Hoffstein's firm was founded in 2008 and everyone was looking for risk management strategies when, certainly with hindsight, investors should have been embracing equity market risk. Today, Hoffstein believes investors are more complacent with the strong gains in equities we have witnessed since the bottoming of the crisis in '09, and most investors are just moving away from active portfolio management to passive, low cost, 'beta' solutions.

Building Trending Global Portfolios

Blumenthal describes his firm's core offering, a global product that evaluates 11 different portfolio sleeves – each with 8-10 different possible holdings—with higher beta exposures to lower beta exposures. Each of the 11 models are run using a relative strength model to evaluate the winning in each of 11 portfolio sleeves. They rotate this trading strategy as a way to achieve strong returns in the market. This portfolio is often used as an alternative allocation to traditional stocks and bonds and often in the role of 10-15% of a portfolio.

Building Optimized Portfolio from Valuations

Hoffstein described a model that does something very opposite – utilizing expected returns which is more mean reversion in nature due to its valuation sensitivity in driving expected returns. This portfolio –if it was done unconstrained – would have very little exposure to U.S. equities, and would be much heavier in emerging market equities, debt, local currency debt, and almost no traditional fixed income exposure. Many investors would not be comfortable with these net exposures, so Hoffstein constrains the optimizer to get a more well-rounded global portfolio.

Alternatives to Traditional Fixed Income Allocations

Hoffstein discussed how equities are harder to forecast future returns but bond returns are a bit more predictable and reliant upon the initial starting portfolio yield—which we know today are near historically low levels, particularly on an after-inflation basis (the 10-year TIPS yield today is around 0.40%).[1]

Steve talks about his tactical exposures for fixed income incorporates 9 different fixed income asset classes –evaluating the 9 different exposures and holding the top 2. He evaluates this weekly and will change it weekly – right now this is in emerging market local debt and municipals.

Hoffstein wants to unbundle fixed income portfolio attributes and then try to re-assemble a portfolio to its properties: different exposures for safety, income, hedging, and diversification. Hoffstein also believes with a skeptical yes one can even time duration using momentum signals –although 'highly skeptical' because models developed over the last 35-years have experienced a nearly one-way market with rates moving down so it is hard to know how robust it will be if the market environment changes in the future.

Other Alternatives for the 'Great Reset'

Blumenthal is one of 4 ETF strategists that are being included in a John Mauldin portfolio solution that is the assembly of four ETF strategists doing independent trading strategies. With low rates, large amounts of debt outstanding, and pensions being under-funded, Mauldin believes these ETF strategists have a unique offering for portfolios and believes his team can serve as the core allocation for people—with Mauldin suggesting up to 60% of a wealth anchored to this team of ETF strategists. Watching this 'all-star' ETF team will be interesting, as one of the new places active management is taking place is with advisors who can go deep and narrow in utilizing ETF strategies.

This was a great discussion with two very thoughtful ETF strategists. I encourage you to listen and I thank-both guests for participating in our show.

[1]Bloomberg, 8/28/17.

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DEFINITIONS

Momentum : Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Treasury Inflation-Protected Securities (TIPS) : Bonds issued by the U.S. government. TIPS provide protection against inflation. The principal of a TIPS increases with inflation and decreases with deflation, as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.