Discerning Quality in the Increasingly Crowded Landscape of ETF Managed Portfolios

MRM GROUP

MRM's Dynamic Overlay Strategy and Other Top Performers, as Tracked by Morningstar

by Stephanie Charitonenko, 28 October 2016

I. What are ETF Managed Portfolios?

In recent years, professionally managed portfolios that have more than 50% of portfolio assets invested in exchange-traded funds (ETFs) have become one of the fastest growing segments in U.S. retail investment space.[1] In 2008, only about two dozen ETF managed strategies were offered by fewer than 10 firms with aggregate assets of 5.8 billion.[2] As of mid-2016, there are 787 strategies offered by 151 firms with total assets[3] of $84 billion on a combined basis.[4]

Why the rapid growth? Morningstar and academic research have shown that asset allocation is as important as security selection in determining portfolio total returns.[5] A prudently constructed portfolio of ETFs can provide wide asset allocation options and relatively low cost diversification, which is especially important since 2008, given increased market volatility[6] and the heightened correlation between sectors and even asset classes.[7]

II. How to Judge Quality?

As the number of ETF managed strategies has exploded, so too has the variability of their performance. For example, Morningstar reports[8] that returns over just the last one-year period ranged from a stellar 22.5% (iSector Precious Metals Allocation) to a dismal -8.9% (Keystone Wealth Commodity Alpha Rotation). With such wide disparity in performance, selecting "winners" among the growing field has become increasingly difficult.

To help separate the wheat from the chaff, Morningstar has created a portfolio attribute classification system that can make performance comparisons more meaningful. Segmenting the ETF managed funds by four primary portfolio attributes with secondary classifications within each attribute. This classification system allows advisors or investors to narrow or widen the ETF managed fund field as needed to conduct "apples to apples" performance analysis (Table 1).

Table 1:
Morningstar's ETF Managed Portfolio Attribute System

Universe	Asset Breadth	Portfolio Implementation	Primary ETF Exposure Type
Global	All-Asset	Strategic	All-Inclusive
International	Alternative	Tactical	Broad Market
United States	Balanced	Hybrd	Country/Region
	Equity		Sector
	Fixed Income		

Source: "Q2 2016 ETF Managed Portfolios Landscape," Morningstar.com, accessed 28 October 2016.

As Table 1 shows, "Universe" captures the geographic exposure of the securities within the ETFs used, "Asset Breadth" indicates a strategy's primary asset class exposure or returns driver, "Portfolio Implementation" gives insight into the investment manager's process for implementing a investment management strategy across asset classes and "Primary ETF Exposure Type" identifies the type of ETFs typically used to gain exposure.

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Importantly, Morningstar also notes which ETF managed funds are compliant with the Global Investment Performance Standards (GIPS) promulgated by the Investment Performance Council of the CFA Institute. GIPS compliant ETF managed portfolios go beyond regulatory requirements to employ the globally accepted methodology for calculating and presenting their performance history. Some of the alternatives to GIPS compliance are "cherry picking" only good years for performance reporting or presenting returns based purely on back-testing, not actual investor performance. Almost two-thirds of ETF managed funds tracked by Morningstar are now GIPS compliant.[9] The increasing adherence to GIPS helps level the playing field for firms and promotes comparability of ETF managed portfolios.[10]

MRM's Dynamic Overlay Strategy has captured over two-thirds of the upside of market booms over the last five years while suffering only about 28% of the 2008 market bust.

III. Which Strategies are Consistent Top Performers?

Given that some of the advantages of ETF managed portfolios are their potential to provide wide asset allocation options and relatively low cost diversification, this analysis of top performers considers only those strategies that offer the widest possible geographic exposure (selecting the "Global" classification within Morningstar's "Universe" attribute), have the broadest possible asset allocations (Asset Breadth: All-Asset), are tactical in their investment selection, include all types of ETFs and are GIPS compliant. This analysis excludes ETF managed portfolios that allow leveraged ETF, inverse ETFs, shorting or use options.

Morningstar tracks 34 ETF managed strategies with combined assets of $7.5 billion that fit this description but, indicative of the high growth in this investment space, only 15 of them report at least a five-year return. Of these, MRM's Dynamic Overlay Strategy reports the third highest five-year return of 9.7%. SSGA Aggressive Tactical comes in first with a 10.6% return and Maryland Capital Management (MCM) Apto comes in second with a 10.3% return.[11] Although comparison to the most relevant market index would have to be done strategy by strategy, we can place these returns in some context by comparing them to a blended benchmark return of 14.5%, comprised 75% of S&P Total Return and 25% MSCI EAFE Gross (rebalanced monthly).[12]

Table 2:
MRM's Dynamic Overlay Strategy Returns

Period	Portfolio Return	Benchmark Return 75% S&P / 25% EAFE*
Seven Year	6.3%	14.0%
Five Year	9.7%	14.5%
Three Year	2.6%	8.8%
One Year	2.0%	13.3%

MRM Group claims compliance with the Global Investment Performance Standards (GIPS®). Returns are net of fees. For more information visit www.mrminv.com or call (800) 233-1944.

* The benchmark is a blend of 75% S&P Total Return and 25% MSCI EAFE Gross (rebalanced monthly).

In other words, MRM's Dynamic Overlay Strategy has captured over two thirds of the gain in the relevant market index over the last five years.

The number of ETF managed strategies reporting three-year results rises from 15 to 28 and MRM's Dynamic Overlay Strategy is in the top 25% of strategies with a 2.6% return vs. 8.8% for the blended index. For the one-year results, 34 strategies report a wide disparity of returns (given the relative "youth" of many of the strategies) ranging from -7.6% to 17.0%. MRM's Dynamic Overlay places roughly in the middle of this pack with a 2.0% return through 30 September 2016 while the blended index returned 13.3% over the same period.

MRM's Dynamic Overlay strategy has managed to be near the top of its peer group[13] for the last three year and five year periods under review. How? MRM explains that its Dynamic Overlay strategy "actively invests in ETFs in an attempt to generate above-market returns, protect principal and reduce volatility."[14] The portfolio can be fully invested when investments rank positively and may hold up to 70% in cash when potential investments look unattractive.

This ability to take advantage of a wide range of alternative investment options (such as commodity or micro-cap ETFs) and go to cash is especially important in market downturns like 2008, when the S&P 500 index (and the blended index) decreased 38.5% yet MRM's Dynamic Overlay strategy declined only 10.8% that year. This downside risk management may be an even more important performance indicator than the portfolio's ability to capture growth given increased market volatility and heightened correlation between sectors and even asset classes since 2008. Not many advisors or investors need a reminder that more than 66.6% growth is needed to bring a portfolio that loses 40% back to neutral. The average management fee of 0.75% for MRM's Dynamic Overlay portfolio seems relatively inexpensive when compared to the historical growth and risk management the strategy offers.

MRM GROUP
12444 Powerscourt Dr., Suite 350
St. Louis, MO 63131
(800) 233-1944
www.mrminv.com

SOURCES

[1] "An Introduction to ETF Managed Portfolios," Morningstar.com, accessed 28 October 2016, http://www.morningstar.com/advisor/etf-managed-portfolios.htm.

[2] "ETF Investment Strategists," iShares by BlackRock, accessed 28 October 2016, http://www.ishares.com/us/investment-professionals/etf-strategists.

[3] Includes assets under advisement (AUM) and assets under management (AUM).

[4] "Q2 2016 ETF Managed Portfolios Landscape," Morningstar.com, accessed 28 October 2016, http://news.morningstar.com/im/ETFMP_Landscape_2015_Q1.pdf.

[5] See for example, the following often cited publications on the topic:
Gary P., L. Randolph Hood, and Gilbert L. Beebower. 1986. "Determinants of Portfolio Performance." Financial Analysts Journal, vol. 42, no. 4 (July/August):39–44 Hensel, Chris R., D. Don Ezra, and John H. Ilkiw. 1991. "The Importance of the Asset Allocation Decision." Financial Analysts Journal, vol. 47, no. 4 (July/August):65–72 Ibbotson, Roger G., and Paul D. Kaplan. 2000. "Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?" Financial Analysts Journal, vol. 56, no. 1 (January/February):26–33. Kritzman, Mark. 2006. "'Determinants of Portfolio Performance— 20 Years Later': A Comment." Financial Analysts Journal, vol. 62, no. 1 (January/February):10–11.

[6] The CBOE Volatility Index (VIX) is a widely used measure of investor sentiment and equity market volatility. The VIX is based on real-time prices of options on the S&P 500 Index (SPX) and is designed to reflect investors' consensus view of future 30-day expected stock market volatility. The VIX averaged19.6% over the period 2004-2014. A VIX over 25.0% is generally considered an indicator of high market volatility. For the period 2004 - 2007, the VIX exceeded 25% only 3% of the time compared to 28% for the period 2008-2014. For information is available at: http://www.cboe.com.

[7] Correlations Climb in Wake of Crisis," Morningstar.com, accessed 28 October 2016, https://sg.morningstar.com/ap/news/115603/Correlations-Climb-in-Wake-of-Crisis.aspx.

[8] As of 28 October 2016.

[9] "ETF Managed Portfolios Screener," http://advisor.morningstar.com/etf-managed-portfolio, accessed 28 October 2016.

[10] "Becoming Compliant," GIPSstandards.org, accessed 28 October 2016, http://www.gipsstandards.org/compliance/Pages/index.aspx.

[11] MRM Group is working with Morningstar to correct the classifications assigned to MRM's Dynamic Overlay strategy to accurately reflect the portfolio's strategy, process and exposures.

[12] Historical performance data for the two components of the blended index can be found at "SPX," Morningstar.com, accessed 28 October 2016, http://performance.morningstar.com/Performance/index-c/performance-return.action?ops=p&t=SPX&region=usa&culture=en-US and "MSCI EAFE," MSCI.com, accessed 28 October 2016, https://www.msci.com/end-of-day-data-search.

[13] Even if MRM's Dynamic Overlay Strategy is compared with all 485 GIPS-compliant ETF managed portfolios tracked by Morningstar, it scores in the top 20% for five-year returns and in the top 30% for three-year returns ("ETF Managed Portfolio Screener," Morningstar.com, accessed 28 October 2016, http://advisor.morning-star.com/etf-managed-portfolio.

[14] "Dynamic Overlay Fact Sheet: Q2 2016," MRMinv.com, accessed 28 October 2016, http://www.mrminv.com/files/Fact_Sheets/Fact_Sheet_Dynamic_Overlay.pdf.

DISCLOSURES

MRM GROUP

12444 Powerscourt Dr., Suite 350
St. Louis, MO 63131

(800) 233-1944
www.mrminv.com