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ETF INVESTMENT STRATEGIES

**Best Practices from Leading
Experts on Constructing a**

WINNING ETF PORTFOLIO

ANIKET ULLAL
FOUNDER OF FIRST BRIDGE DATA

ETF INVESTMENT STRATEGIES

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Experts on Constructing a
Winning ETF Portfolio**

ANIKET ULLAL



New York Chicago San Francisco Athens
London Madrid Mexico City Milan
New Delhi Singapore Sydney Toronto



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CONTENTS

Acknowledgments	xi
Introduction	xiii
1. The Emerging Mindset: Tradable Beta	1
2. The Emerging Tools: The Targetization of Investing	9
3. The Emerging Industry Model: Fee-Based Advice	23
4. Future Gazing: The ETF Landscape in 2025	29
5. Megatrends: Practical Implications for Investors	35
6. Key Features of an ETF	41
7. Differences Between an ETF and ETN	51
8. Case Study: Kal Salama, CIO, The Headlands Group	57
9. Fundamentally Weighted ETFs	67
10. Case Study: David Hultstrom, Founder and CIO, Financial Architects LLC	75
11. Growth and Value Investing with ETFs	81

CONTENTS

12. Case Study: John O'Connor, President and CIO, 3D Asset Management	89
13. Case Study: King Lip, CIO, Baker Avenue	97
14. Sector- and Industry-Based ETF Investing	105
15. Case Study: Kim Arthur, CEO, Main Management	109
16. Active ETFs Versus Active Investing Using Index-Linked ETFs	117
17. Case Study: John Lunt, President and CIO, Lunt Capital Management, Inc.	123
18. Case Study: Rich Bernstein, CEO, Richard Bernstein Advisors	131
19. Low-Volatility and High-Beta ETFs	137
20. VIX Futures-Based ETPs	143
21. Case Study: Christian Wagner, CEO, Longview Capital	149
22. Alternative and Commodity ETPs	157
23. Case Study: Vern Sumnicht, CEO, iSectors	163
24. Leveraged and Inverse ETFs	171
25. Best Practices from Case Studies	175
26. Summary of ETF Product Insights	183
27. ETF Tax Strategies: Robert Gordon, CEO, Twenty-First Securities	191

CONTENTS

Appendix A. Industry Classification Systems	197
Appendix B. Traditional ETF Classification Dimensions	203
Appendix C. Comparison of Style (Growth/Value) Index Methodologies	215
Appendix D. Table Comparing ETFs with Traditional Mutual Funds	217
References	219
Important Disclaimer	223
Index	225

CASE STUDY: KAL SALAMA, CIO, THE HEADLANDS GROUP

In the first few chapters of the book, we looked at how the wealth management industry is evolving, with the emergence of a new mindset focused on asset allocation particularly through the use of ETFs. Kal Salama, the CIO of The Headlands Group, has been at the forefront of that change, first investing in ETFs in 1997 when they were still very nascent products.

The Headlands Group is a RIA firm located in the San Francisco Bay Area that advises high-net-worth clients. Founded in 1985, it was one of the early adopters of ETFs when it invested in World Equity Benchmark Shares (WEBS) country ETFs (which later became iShares country ETFs). The WEBS allowed The Headlands Group to design global equity portfolios using custom individual country allocations based on its investment analysis.

The core investment philosophy of The Headlands Group states that to grow wealth over time, investors need investment strategies that have a high probability of success. Certain investment strategies have a high probability of being rewarded by markets over the long term, yet they are often uncertain and difficult to execute in the near term:

- Capture full-cycle risk premiums:
 - Establish enough long-term equity ownership to reach wealth goals

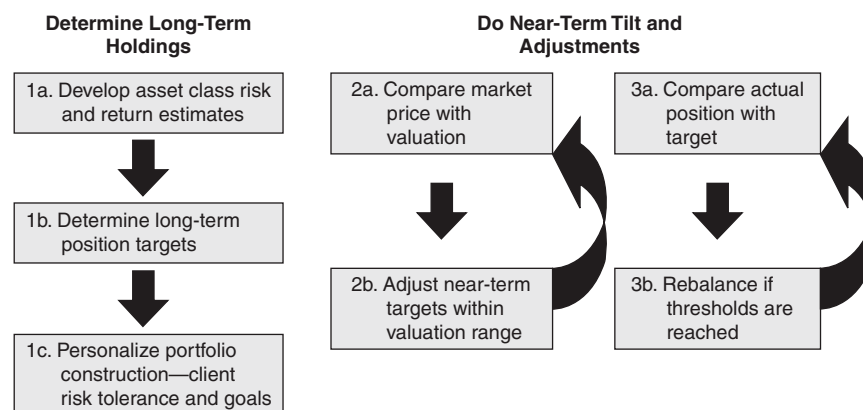
- Maintain allocations to core and noncore assets throughout their cycles
- Capture premiums from well-researched and reliable techniques:
 - Tilt toward undervalued assets and away from overvalued assets
 - Dynamically rebalance by cutting back winners and adding to those likely to win

The Headlands Group does this by building its single best bond portfolio and its single best equity portfolio. It then combines the two to reflect a client's specific risk tolerance, risk capacity, and financial goals.

Investment Process

Figure 8-1 provides an overview of the firm's investment process. Each step is then explained in detail, providing insight into its process for using ETFs to construct portfolios.

Figure 8-1 The Headlands Group—Investment Process



1a. Develop Asset Class Risk and Return Estimates

Each asset class has unique risk characteristics and a corresponding risk premium that investors could earn for taking on the inherent risk of that asset class. The foundation of The Headlands Group's methodology is analyzing the historical behavior of each asset class and making assumptions about its likely forward-looking long-term risk and risk premium.

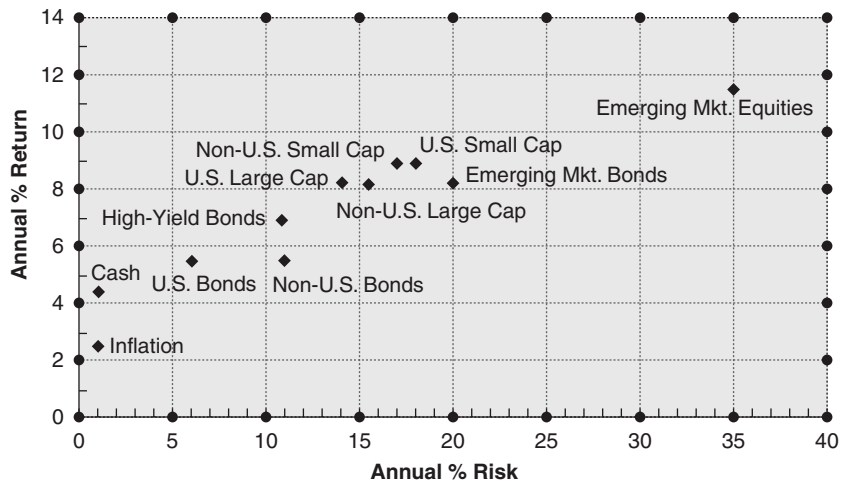
Each asset class is analyzed by studying the historical risk and return characteristics of an index that best represents that asset class. The asset classes analyzed by The Headlands Group and their corresponding benchmarks are shown in Table 8-1.

The forward-looking characteristics of each asset class are estimated using several decades of data and are meant to be market cycle independent. They are not designed to be cyclical projections. For example, in The Headlands Group's view, U.S. large-cap equities can be expected to deliver a risk premium of 6 percent above inflation over the long term. Figure 8-2 shows The Headlands Group's expectations for each asset class.

Table 8-1

Asset Class	Representative Index Benchmark
Equities	
U.S. large cap	S&P 500 Index
U.S. small cap	Russell 2000 Index
Non-U.S. large cap	Individual MSCI country indexes
Non-U.S. small cap	MSCI country and regional small-cap indexes
Emerging market	MSCI EM
Bonds	
Investment-grade bonds	Barclays (formerly Lehman) indexes
High-yield bonds	First Boston and Merrill Lynch indexes
Non-U.S. developed market bonds	Salomon/Citigroup indexes
Emerging market	JP Morgan EMBI indexes

Figure 8-2 The Headlands Group—Risk and Return Projections by Asset Class



1b. Determine Long-Term Position Targets

The long-term asset class risk and return estimates are then used to determine the long-term position targets within equity and bond portfolios. The Headlands Group's preferred approach is to get the desired exposure most efficiently by allocating to index-based vehicles where possible rather than to active funds or individual securities (see Figure 8-3). Exposure to each asset class is obtained through an ETF that tracks the desired underlying index, or another fund product if an appropriate ETF is not available.

1c. Personalize Portfolio Construction

With the long-term position targets in place, client portfolios are designed by combining equity and bond components to reflect their individual risk tolerance, risk capacity, and financial needs (see Figure 8-4).

Figure 8-3 The Headlands Group—Sample Asset Allocation

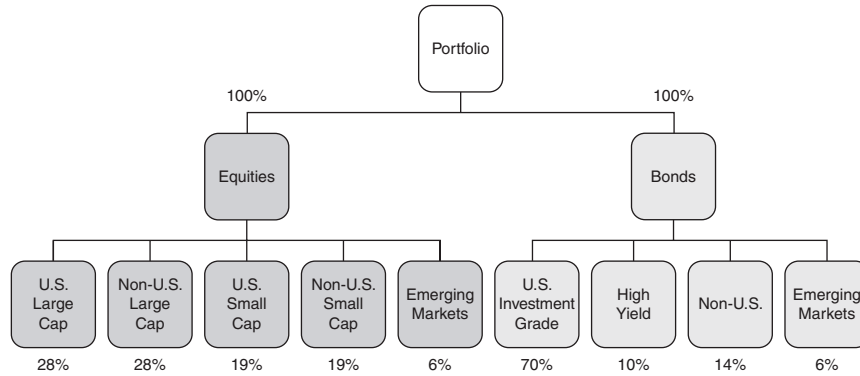
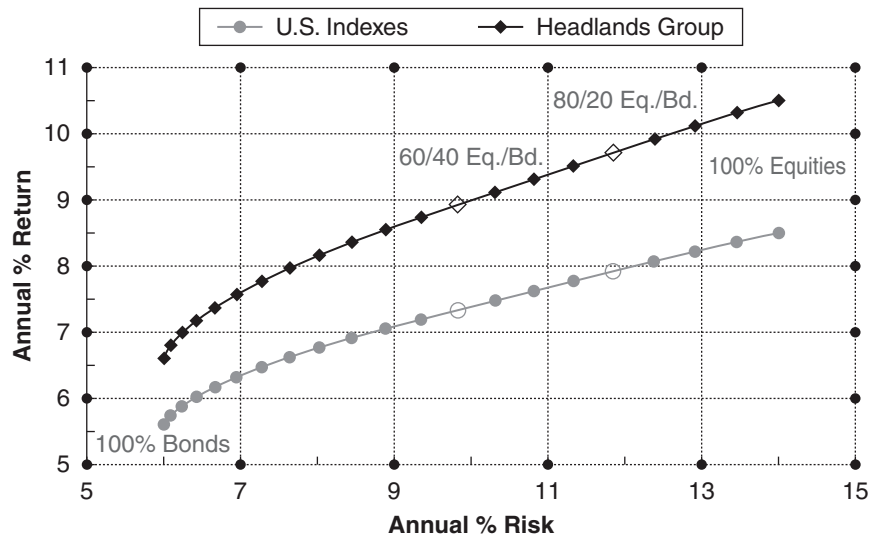
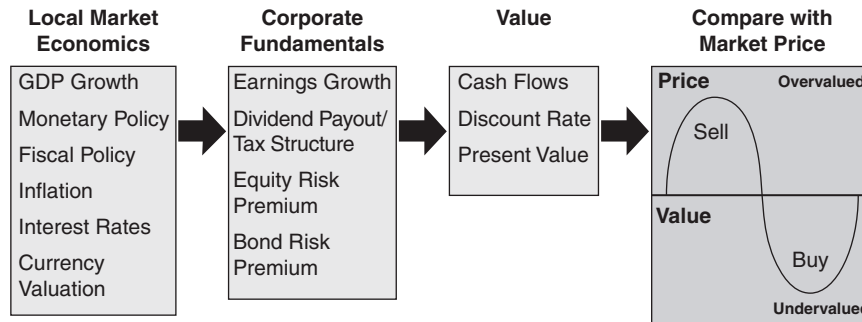


Figure 8-4 The Headlands Group—Determining Equity and Bond Mix



2a. Do a Proprietary Valuation Analysis

In addition to the long-term asset class analysis described above, The Headlands Group does proprietary valuation analysis on specific markets, and asset classes (see Figure 8-5).

Figure 8-5 The Headlands Group—Valuation Process

In the near term, the goal is to tilt portfolios toward markets and asset classes that are undervalued and away from those that are overvalued. A range is determined for each position within which the tilts can be made.

Note that this is very different from active stock selection. The Headlands Group focuses on macroanalysis at the market level. The Headlands Group's view is that markets are generally efficient. They are kept that way by a limited number of investors who have a competitive advantage that allows them to consistently beat the market. The Headlands Group believes that its competitive advantage is identifying major discrepancies between price and value across markets.

2b. Adjust Portfolio Within Valuation Ranges

Based on its valuation analysis, The Headlands Group determines near-term holdings targets. If a market is at its most overvalued, the exposure in the portfolio will be moved to the low point or minimum of its range. Conversely, the most undervalued market is moved to the upper end of its range. (See Figure 8-6.)

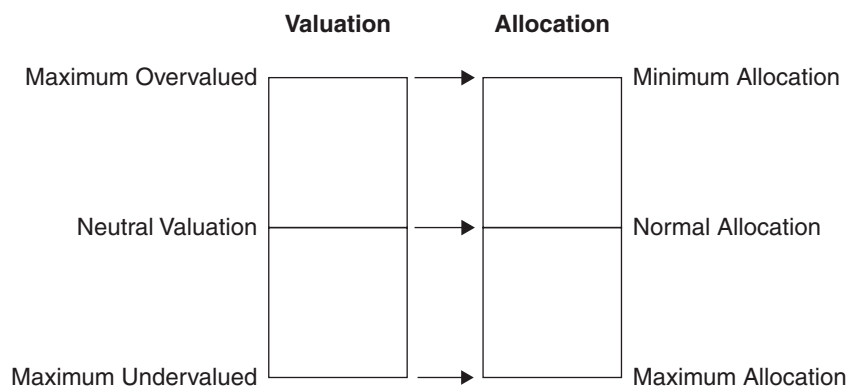
Valuation is mapped directly to valuation ranges for each position (see Figure 8-7). The greater the overvaluation or undervaluation of a market, the further it is moved away from its long-term target or "normal" allocation and toward the boundary of its valuation range.

Figure 8-6 The Headlands Group—Valuation Ranges

Large-Cap Equity Strategy			
	Normal	Low	High
U.S.	50.0%	40.0%	60.0%
Non-U.S.			
Australia	2.5%	0.0%	5.0%
Austria	2.0%	0.0%	5.0%
Belgium	2.5%	0.0%	5.0%
Canada	0.0%	0.0%	3.0%
France	2.0%	0.0%	5.0%
Germany	2.0%	0.0%	5.0%
Hong Kong	4.0%	0.0%	8.0%
Ireland	0.0%	0.0%	3.0%
Italy	3.0%	0.0%	6.0%
Japan	16.0%	6.0%	26.0%
Malaysia	2.5%	0.0%	5.0%
Netherlands	1.5%	0.0%	4.0%
New Zealand	0.0%	0.0%	3.0%
Singapore	2.5%	0.0%	5.0%
Spain	3.0%	0.0%	6.0%
Sweden	0.0%	0.0%	3.0%
Switzerland	1.5%	0.0%	4.0%
U.K.	5.0%	0.0%	10.0%
TOTAL LARGE CAP	100%		

Bond Strategy			
	Normal	Low	High
U.S.			
Investment Grade			
ST Federal	6.0%	2.0%	15.0%
IT Treas.	11.0%	5.0%	20.0%
LT Treas.	7.0%	2.0%	15.0%
ST Corp.	3.0%	0.0%	20.0%
IT Corp.	13.0%	5.0%	20.0%
LT Corp.	5.0%	0.0%	10.0%
Mortgage	25.0%	15.0%	35.0%
High Yield	10.0%	5.0%	15.0%
Non-U.S.			
Developed	14.0%	5.0%	25.0%
Emerging	6.0%	2.0%	10.0%
TOTAL BOND POSITIONS	100.0%		

Figure 8-7 The Headlands Group—Mapping Valuation to Allocation



3a. Conduct Proprietary Dynamic Rebalancing

The Headlands Group uses a proprietary process to dynamically rebalance positions to their target weights. Rebalancing is done in response to changes in market prices. It is distinct

from the valuation-driven tilts described in Section 2b, which reflect prices relative to underlying valuations and determine near-term targets. Markets will always move actual positions away from targets. If deviations from target weights are within rebalancing ranges from target weights, no rebalancing is required. Portfolio positions are designed to absorb a certain amount of market movements, as shown in Figure 8-8.

3b. Use Rebalancing Triggers

When an actual position deviates from target by a specified trigger amount, the end point of its rebalancing range, the position is rebalanced to target (see Figure 8-9). Rebalancing triggers are customized based on position volatility, size, and transaction costs. When used properly, these triggers help the portfolio regularly capture market gains arising from position volatility and correlation properties. Rebalancing triggers are also very useful for guiding client additions and withdrawals.

Figure 8-8 The Headlands Group—How the Portfolio Absorbs Market Movements

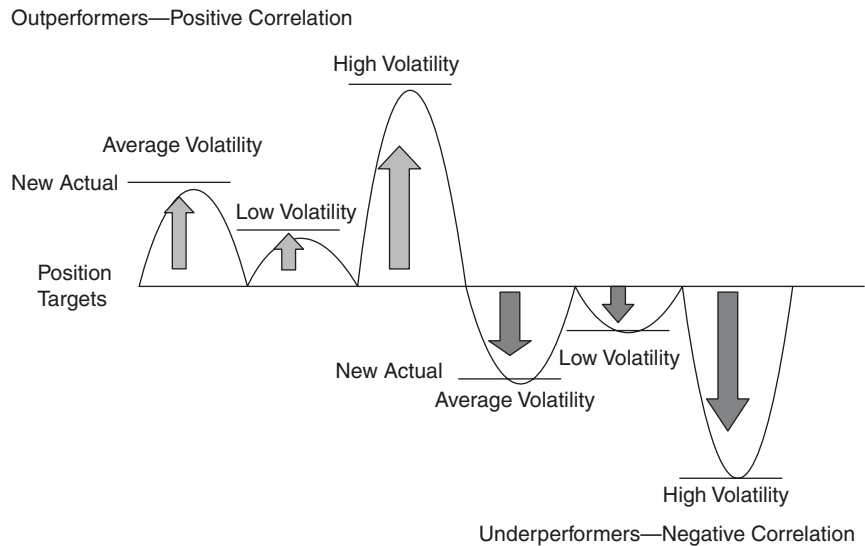


Figure 8-9 The Headlands Group—Rebalancing Triggers

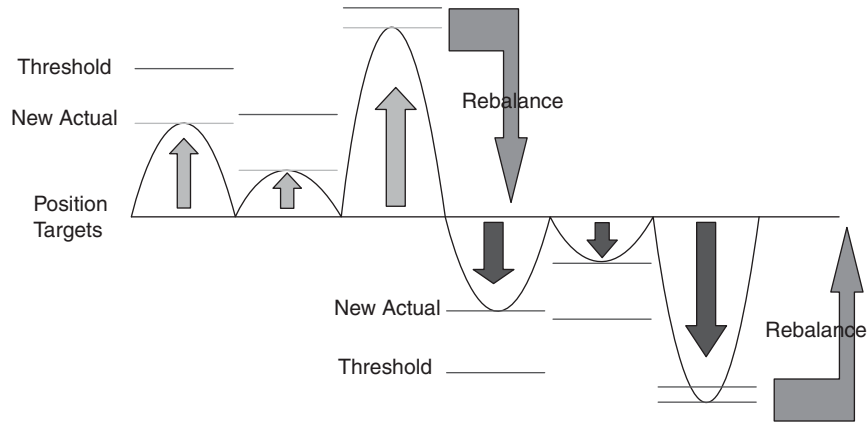


Figure 8-10 shows a specific example when a rebalancing was triggered, requiring The Headlands Group to bring a position back to its target. In 2012, iShares MSCI Spain ETF (EWP) dropped significantly relative to other markets, breaching its

Figure 8-10 The Headlands Group—Rebalancing Example



rebalancing trigger in early June. The Headlands Group promptly added to client positions, and the positions appreciated by 30 percent over the subsequent months, capturing incremental gains for client portfolios.

In a Headlands Group portfolio, ETFs are used for both long-term and near-term position targets. Long-term targets serve as underpinnings or anchors to the portfolio structure; they provide stability and capture long-term risk premiums. Near-term targets allow for responsiveness to market conditions, using market movements to add incremental returns from both valuation and rebalancing opportunities.

Through its process, The Headlands Group is able to construct globally diversified, multiasset, ETF-based portfolios that can successfully grow wealth for its clients over time.