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FA Talks

How Can Indexing and ETFs Change Adviser Practice Management?

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FA Talks is an interview series where industry thinkers share their thoughts and perspectives on a variety of market trends and themes impacting indexing.

Tell us about indexing and ETFs as a set of tools for advisers to use and master. What are some of your best ideas for use? And what are some potential benefits of use?

Terence: We use indexing and ETFs in order to focus on the key component of portfolio performance – asset allocation. Indexing and ETFs enable us to allocate funds in the various asset classes consistent with a clients' circumstance or stage in life. We believe the potential advantage of this approach is that it helps eliminate risks to the portfolio associated with manager selection. Furthermore, portfolios can be constructed where there is a lower cost, comprehensive asset exposure and transparency. Our preference is to use indexes and ETFs for the core of the portfolio and then add various satellites for exposure to themes and/or managers with a particular style.

Jon: I think it is not done as often as it should be, but anyone who is going to manage a portfolio, whether it is their own or someone else's, should complete a thorough process of articulating their investment philosophy and core beliefs. In the process that we followed, we determined that getting asset allocation right was the most important aspect, closely followed by the ability to allocate dynamically between assets over time, based on our long-term forecasts. It was then simple to identify how the historical advantages of ETFs would allow us to manage portfolios more efficiently. Using ETFs means our investment committee can spend its time on the most consequential decisions where we will have the most impact on long-term portfolio outcomes.

Andrew: Our business has always had a niche bias towards listed Australian equities. Whilst we have delivered consistently strong income returns, the capital (and therefore total return) has been volatile. In a macro environment where volatility is heightened, we are using ETFs as a tool to diversify client portfolios and to smooth out total return.

How do you position your ETF use to your clients?

Jon: We're comfortable saying we don't think we can pick stocks and beat an index consistently, or that we can identify managers who are able to do that reliably. To an adviser audience, which is who we work with primarily, we will always use your SPIVA® (S&P Indices vs. Active) reports and your Persistence Scorecard to show the simple reality of the data on this topic. We also do think it is important to push back against some of the myths and false criticisms that ETFs may attract, and that clients are likely to be exposed to from time to time.

To a retail investor we would say something like, we think the combination of income and valuations in the Financials sector is attractive and likely to provide good long-term returns. However, rather than favoring one bank over another, we use these effective tools called ETFs, that are cheap, transparent and tax efficient to build your portfolio and give you the same benefits of owning all the underlying companies individually.

Andrew: Introducing ETFs into our practice has been a multi-step process. Firstly starting with adviser education, then ensuring we had the research capability to support our recommendations and, most importantly, client education and acceptance of the use of ETFs in their portfolios.

Terence: ETFs are positioned as a tool used to gain comprehensive exposure to chosen asset classes. We highlight their features such as lower costs, transparency, liquidity and tax effectiveness. We focus on eliminating performance risk for the core part of a client's portfolio and highlighting this in our discussions with clients.

Have indexing and ETF use changed your investing behavior or your clients' behavior?

Andrew: Absolutely. Whereas meetings in the past with the direct equities were, say, 80% individual stock commentary and only 20% "big picture," that has now inverted so we are spending around 20% monitoring performance and adjusting weightings to the benchmark, but 80% focused on other areas that we simply would not have had time to discuss in the past. Further, clients are always "hiding money on you" so by offering a broader range of options and showing you are delivering better risk-adjusted returns, we've found clients more open to sharing their full financial position rather than just telling you what they think you need to know!

Jon: I have to agree with Andrew because, anecdotally, we hear from the advisers we work with that it fundamentally changes their review conversations. As we provide an Individually Managed Account structure there is a lot of transparency about the holdings and transactions in a client's portfolio. Therefore, communication is critical, and we spend a lot of time assisting advisers in that regard. The experience has been that the adviser and client review conversations become much more focused on what they should be; how have the client's circumstances changed, do their objectives need updating after review and are they on track to meet their lifestyle goals. For the client that is keenly interested in their portfolio and maybe even logs on to check their portfolio daily, they get the information they need from our regularly written commentaries and presentations.

Terence: Instead of being focused on manager performance and style we now focus on the appropriate asset allocation for the clients' stage in life and their attitude to risk. More time can be spent educating clients on the performance and behavioral attributes of various asset classes. Less time is spent considering manager performance or portfolio performance. Clients are now more focused on talking about the other aspects in their lives and progress/milestones on the journey ahead. Client relationships can become broader and have a greater depth. You move beyond being regarded as a stock or fund picker.

How do the relatively lower fees of ETFs work with regard to your fees that you charge and your profitability as a firm?

Terence: The lower fees on ETFs reduce margin pressure as the costs associated with managing the client's portfolio can be contained. I believe that clients gain from the reduction in investment management fees and we gain as some of the cost savings can be taken as an increased advice fee, without having to escalate the costs to the client.

Andrew: We are still early in our ETF journey but have been working on a tiered model whereby the first $1 million under advice is a 1% fee per annum (including ETF MERs). This is quite a cultural shift for clients who in the past may have only paid brokerage as they need to buy/sell shares. We are confident that by having a more holistic offering and delivering less volatile returns due to exposure to other assets, we can demonstrate value to the client.

Jon: Everyone is focused on costs and that is a trend that is not going to change. Expensive active managers who don't beat an index over time should be feeling cost pressure. The cumulative flows in the trillions of dollars from active to index-based funds in overseas markets, particularly those that are more advanced in their adoption of ETFs, is all the proof anyone should need that costs are critical, and that investors are voting with their feet.

The topic comes up in practice management conversations that each of you are active managers using passive tools. How do you describe this blend of capabilities and what is the mix of active and passive you favor?

Jon: We would absolutely describe ourselves as being active, but in the areas where we think we can make a difference, that is active on asset allocation. By this, I mean not just in terms of the traditional asset classes but down to regional, country and sector decisions where appropriate. We do challenge ourselves to make sure we always have a reasonable basis for our decisions, and that works best in quite broadly diversified exposures. With the popularity of the ETF sector, there is a proliferation of new funds, many of which are quite narrowly focused or even a bit esoteric in the index constituents they are targeting. Whilst ETFs are a great portfolio construction tool, they do not absolve the investor, or their adviser or portfolio manager for that matter, of doing the work to understand what they own and why they own it.

Terence: Using indexes and ETFs is not a "set and forget" approach to portfolio management. Asset allocations must be reviewed to ensure they are still appropriate for the client. An index or ETF enables you to increase or decrease asset allocations in a precise manner (i.e. increase exposure to the UK or China), and have targeted exposure to technology or a particular theme (i.e. the Health Care sector). These are examples of active management using passive tools. We favour a passive core of 70% and active satellites of 30%.

Andrew: Whilst we are still perfecting our offering, we expect portfolios will likely be around 80% passive using index ETFs and 20% active using either active ETFs or direct equities should the opportunity present itself.

How are you using SPIVA and other index provider research? What tools are most helpful to you in evaluating and using ETFs to construct portfolios?

Andrew: As part of our education offering, aside from pointing clients to the ASX and MoneySmart websites for ETF education, we are also using SPIVA research when discussing with clients the returns of active managers versus the index. We have found this to be powerful in demonstrating to clients the long-term difficulties that most active managers (including ourselves!) have in beating the market.

Terence: We use SPIVA in conversations with clients as part of the education process. SPIVA is great for highlighting the historical risks associated with manager selection. These risks include underperformance over various timeframes and the issue of lack of persistence in manager outperformance. We find this information is well-received by clients and assists with dispelling myths and false understandings regarding performance.

We use index provider white papers and research regularly in our discussions with clients. We use the Morningstar Portfolio Construction Tool for portfolio modelling. This is supplemented by information and research from ETF issuers and the various research houses (i.e. Lonsec, Zenith and Morningstar). This enables us to gain an understanding of how an index or ETF is constructed and its component parts.

Jon: As mentioned, we use these reports in all our presentations with advisers who are being introduced to our portfolio management service. Your SPIVA data is very comprehensive and ultimately compelling, and of course begs the question of the sceptic, what basis do you have to believe you are going to be in the tiny minority that can pick stocks and beat an index consistently over time?

To conclude, you were all panelists at our 9th Annual Australian Indexing and ETF Masterclass in 2019. What were your goals in participating in this program and what were your key takeaways from attending?

Andrew: My main goals in participating were to say thank you to Shaun, Stuart, and the rest of the S&P Dow Jones Indices' team for the truly career-changing experience they gave me as part of the 2018 U.S. study tour. A strong secondary reason was to share with Australian advisers as to what I saw in the U.S. and Canada in 2018 and to highlight the potential range of opportunities for both clients (better risk-adjusted returns, lower fees) and advisers (more engaged conversations, more asset choice) by using ETFs.

Jon: We have been early adopters and supporters of ETFs in Australia and were really pleased to contribute to the ongoing development of ETFs in Australia. ETF assets as a percentage of the broad Australian equities' market capitalisation and the huge pool of retirement assets we have is still tiny, and so there are, potentially, huge benefits to investors in seeing a much broader uptake in Australia.

Terence: My goals in participating in this program were to share my experience and insights into adopting ETFs and indexing as a central theme in the client investment process. My key takeaways from attending the Masterclass were that many other advisers are also moving down the same path and they recognize the value of adopting this approach in their businesses.

For more information about the topics discussed in the Australian market, visit http://www.indexologyblog.com/tag/australia/.