Tactical asset allocation using exchange traded funds

In recent years, we have seen a dramatic expansion in the number of indexes, styles and asset classes covered by exchange traded funds or ETFs – index-based open-ended funds that can be bought and sold as quickly and easily as any share. This strong growth is underpinned by the core benefits of ETFs, whereby they can also be useful tools for investors looking for tactical asset allocation (TAA) exposure, particularly as one of the key strengths of ETFs as investment tools is the wide range of products available and the sheer breadth of equity- and fixed-income benchmarks they track.

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ETFs combine the advantages of index funds and stocks. They are liquid, easy to use and can be traded in any quantity just like stocks. At the same time an ETF provides the diversification, market coverage and low expenses of an index fund. These characteristics combine to create an investment tool that provides investors with the broad exposure they require, at the level they want, at the moment they need it.

As Barclays Global Investors (BGI) reported in its Industry review[1] in November 2008, during the first ten months of 2008 investors were expressing concerns over counterparty risk, transparency and liquidity when using structured products, swaps, certificates and notes. Consequently, they were showing a preference for exchange traded funds, where the structure is a fund and, more specifically, for ETFs which invest exclusively in specie in securities. As at the end of October 2008, the ETF landscape key figures were:

- Globally, at the end of October 2008, there were 1502 ETFs managed by 85 managers on 43 exchanges with assets of US$ 642.95 billion.
- According to the SIX Swiss Exchange, ETF trading reached an all-time high with a turnover of 7.6 billion francs (+95.42% versus the prior-month reading and +183.65% compared to October 2007) on the SIX Swiss Exchange, SWX Europe and Scoach Switzerland.
- The number of ETFs increased year to date: 381 new ETFs have been launched. There are plans to launch a further 571 ETFs: 42 in Europe, 470 in the U.S. and 59 in the rest of the world. In addition, there were 269 ETPs with 522 listings and assets of US$ 46.21 billion managed by 26 managers on 14 exchanges.
- Although ETF assets under management (AUM) worldwide decreased by 19.3% YTD, this is significantly less than the decline in the "market", which, using the MSCI World Index as a proxy, is down 39.75% in US dollar terms YTD.
- Total assets under management encompassing both ETFs and ETPs equal US$ 689.16 billion in 1771 products with 3050 total listings.
- The U.S. has the largest number of products and assets under management: 663 ETFs and US$ 454.38 billion, followed by Europe with 587 ETFs and US$ 125.76 billion.

Many private and institutional investors have embraced the idea that ETFs are tools that can help them to equitise cash, establish a core holding and implement tactical asset allocation and that they can be a substitute for a program trade or for using futures. They can be used to gain exposure to equity sectors, styles, country, regional, international and emerging-market indexes, government, corporate bond and money-market indexes as well as commodity indexes at real-time prices during the trading day. Hence, this exceptional growth is underpinned by the core benefits of exchange traded funds, whereby investors can use these relatively simple investment tools for both strategic and tactical exposure.

How ETFs can be used for TAA

When making a strategic asset allocation, it will broadly be made between bonds and equities, based on a long-term view of market opportunities and the risk profile of the investor. The decision on how a portfolio's investments are allocated between stocks, bonds and cash has shown to have a considerable impact on the performance and risk profile of a portfolio. Over the long run, a strategic asset allocation may be constrained by its rigidity. Therefore, the process of tactical asset allocation using ETFs may be used to engage in short-term tactical deviations from the mix in order to capitalize on unusual or exceptional investment opportunities. TAA can be described as a moderately active strategy which can be used for a couple of purposes:

Value creation / capturing: This is where the investor wants to take advantage of certain situations in the markets, temporary stock undervaluation for example. To achieve this, a typical approach used could be tilting with equity income, sector or country specific ETFs. So, for example, an investor has a diversified portfolio consisting of broad-based European equity and fixed-income ETFs. By adding or by tilting the portfolio with equity-income ETFs, the investor can gain specific exposure to companies that historically generate high dividends. By doing this, the new portfolio may generate higher returns with lower risk.

As a result, tilting with a broad range of ETFs allows the investor to have specific exposure to different asset classes and provides effective diversification, which can be particularly valuable during periods of volatility. In addition, tilting with ETFs can help to diversify single-investment specific risk and significantly improve the risk-adjusted return of the portfolio. It is also an excellent method of concentrating exposure in a favourite sector while reducing the risk of being exposed to the fortunes of a few companies.

Risk alteration: This is where the investor would like to take the opportunity to alter or decrease his risk exposure (via changing the overall asset class mix or adjusting the exposure within a particular asset class). A typical example of this approach could be the active management of fixed-income ETFs, where the investor can change both weights and exposure within the fixed-income allocation of the overall portfolio to decrease the temporary risk of the fixed-income holdings and possibly achieve higher returns.

This can be done while maintaining a stable overall allocation to fixed income. For example, an investor may decide to use index-based fixed-income ETFs, which can be used for TAA and can optimise portfolio allocation, providing a rebalanced portfolio depending on the stage of the business cycle. If the investor adjusts the allocation within the fixed-income allocation of the portfolio (tactically moving from one type of fixed-income exposure to another; for example from short-term bonds to long-term bonds), this may benefit the investor by providing an opportunity to actively use fixed-income ETFs, enhance the portfolio return / risk profile and generate excess return with beta products such as ETFs.

Beneficial tool requiring discipline

Real-life evidence of ETFs being used tactically can be seen by referring back to the secondary market trading volumes for equity- and fixed-income ETFs in the month of September 2008. In September, iShares experienced exceptionally large gross trading volumes, reaching more than 25 billion € in trading of its European-listed ETFs versus 15 billion € in September 2007.

Average global daily trading volumes for all ETF providers combined were 96.1 billion € in September 2008 compared to 42 billion € in September 2007, representing an increase of 128.8%. High ETF trading volumes demonstrate how easily investors can implement investment decisions during any period and despite difficult market conditions in a liquid and transparent way.

During these types of market conditions, which were considered far from normal, investors were more likely to adopt a TAA approach, and the key features of ETFs allowed them to do this quickly and efficiently. Those key features include transparency, cost efficiency, flexibility and liquidity equipped with a range of exposures.

ETFs can be useful tools in TAA, particularly as one of the key strengths of ETFs as investment tools is the wide range of products available and the sheer breadth of equity- and fixed-income benchmarks they track. It must be noted that, like all asset allocation strategies, TAA demands some discipline, as the investor must first be able to recognise when short-term opportunities have run their course and then rebalance the portfolio to the long-term asset position.

ETFs in turbulent market conditions

ETFs have become important bellwethers to gauge shifts in investor sentiment between asset classes. During the first ten months of 2008, fixed-income and commodity-based ETFs enjoyed heavy inflows as some investors switched capital out of equity ETFs. Given rising levels of risk aversion, equity markets perceived as higher risk have suffered much of the capital outflow, notably emerging markets as well as Asian and global (excluding U.S.) equities. Yet, while the challenging market backdrop has hit demand for some other investment products, BGI forecasts the ETF industry to grow in Europe to US$ 200 billion and globally to US$ 1 trillion in 2009, reaching US$ 2 trillion in 2011.

1) "ETF Landscape", Industry review from the exchange traded funds research and implementation strategy team, Barclays Global Investors, November 2008.

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