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FINANCIAL POST

How millionaires use ETFs to build 'core and satellite' portfolios

Michael Nairne, Serious Money

A satellite above the Earth. Satellite investments offer exposure to asset classes that lack the liquidity needed for an effective indexed solution. Handout/AFP/Getty Images

A recent survey by Millionaire Corner in the U.S. found that millionaires are more likely to buy exchange-traded funds (ETFs) than less affluent investors. The advantages cited included lower costs, broad diversification and immediate liquidity.

Other surveys have also found more and more U.S. high net-worth investors are adopting a passive approach to equity investing by favouring ETFs and index mutual funds. This should come as no surprise.

Indeed, some four decades of research now make a compelling case for the advantages of index over active investing.

Why? First, active managers as a group underperform the market over time because of their higher fees and costs. Second, this underperformance is even worse after-tax due to their higher investment turnover.

Third, statistically, it can take up to several decades to separate skill from chance so it's hard to know if the latest hot manager is super savvy or simply lucky. Finally, good past performance is, at best, a very weak predictor of future performance.

This evidence is finally working its way into the investment mindset of affluent investors.

However, this is not the whole story. Many high net-worth investors are also adopting what is called a "core and satellite" portfolio structure.

Suite 700, 90 Adelaide Street West, Toronto, Ontario M5H 3V9
Phone: 416-964-8535 | Email: info@tacitacapital.com

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The core is comprised of index funds such as ETFs that seek to replicate the returns of an index that reflects the performance of a particular investment market. In essence, the core provides low-cost and transparent exposure to a range of asset classes. A satellite ring of managers with investment mandates that seek higher returns and/or enhanced diversification is then built around the core.

Broad-market ETFs that replicate well-diversified indices such as the DEX Universe Bond index, S&P/TSX Capped Composite index, S&P 500 index and the MSCI EAFE index are often the core's foundation. These four simple ETFs provide an investor with a globally diversified core that contains nearly 2,400 bonds and stocks for a fraction of the cost of most active managers.

To add to the attraction, there is now a dizzying array of ETFs available to further customize the core. According to ETFGI LLP, an independent research and consultancy firm, there were 258 and 1,439 exchange-traded products available at the end of October in Canada and the U.S., respectively.

The myriad ETFs permit investors to really fine-tune their portfolios. For those concerned about foreign-exchange risk, currency-hedged versions are often available. Investors pursuing the higher long-term return potential associated with value and small-cap strategies can find a range of ETFs that focus on these market dimensions.

Concerned about low government bond yields? There is a plethora of corporate bond ETFs from which to choose. Worried interest rates are going to rise? An ETF that focuses on short-term bonds may be just the ticket.

Loading up on ETFs is not a complete solution, which is where a portfolio's satellite components come in.

Satellite investments offer exposure to asset classes that lack the liquidity needed for an effective indexed solution. Canadian high-yield bonds and micro-cap stocks are two examples. It can also contain tax-effective vehicles such as corporate-class mutual funds that are simply not available in an index fund.

Private equity, direct real estate and infrastructure investments are additional satellite components. Private equity, in particular, has a history of providing higher returns than publicly traded stocks. Carefully selected hedge funds can also add potential diversification benefits.

A word of caution: None of this is a free lunch. These satellite investments typically have leverage and idiosyncratic risk in addition to lacking liquidity.

The advantages of a core and satellite structure have been well-known in the institutional investment community for years. Wealthy investors are finally taking note.

Michael Nairne, CFP, RFP, CFA, is the president of Tacita Capital Inc., a private family office in Toronto.
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