MONEY management executive

THE PREMIER NEWS SOURCE FOR ASSET MANAGEMENT LEADERS

January 27, 2014 | Volume 22 • Number 4 | mmexecutive.com | feedback-mme@sourcemedia.com

# Mutual Fund Fears Drive ETF Growth

**Q&A**
**BY PAULA VASAN**

TRADITIONAL LONG-ONLY MUTUAL fund managers certainly aim to differ from their benchmarks so they can justify their fees. But many are also afraid to manage portfolios that appear *too* different from their indexes because if they underperform, they'll be fired, says John Lunt, president of Salt Lake City-based money management firm Lunt Capital Management.

The result: many mutual fund managers are hugging their benchmarks too closely and are failing to overperform, pushing more money to ETFs. Lunt speaks with *Money Management Executive* about how the perception of career risk among mutual fund managers are giving ETF managers leg up and what that means for the industry.

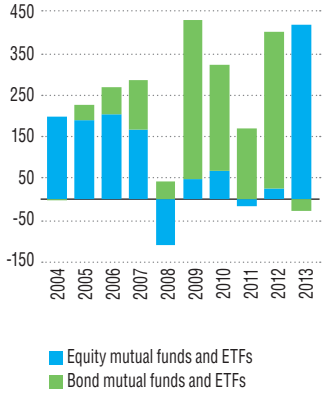
**Q. What is the biggest challenge for mutual fund managers right now?**

The perception among mutual fund managers that they'll be fired for dramatic underperformance and rewarded for even slight outperformance creates a situation where many mutual fund managers became the benchmark, or "beta with a higher fee." ETFs not only made benchmarks investable, but ETFs offer more transparency at a lower cost. Many mutual fund managers feel threatened by ETFs, because they are attempting to offer the same value proposi-

**BENCHMARKS** *cont. on page 6*

**Estimated Flows to Equity and Bond Funds ($B)**

Excludes money market funds




*Source: Morningstar*

# Hedge Fund Replicators

**OPERATIONS**
**BY MARGO EPPRECHT**

A NEW FAMILY OF FUNDS AND ETFs STRIVE to package the benefits of hedge funds for a broader market.

But for some managers, these investments have frequently been too risky or pricey. Until recently, only "qualified investors" and institutions could invest in hedge funds and even for a qualified investor, a hedge fund investment hasn't always been ideal: the minimums are high, usually over $1 million and commonly over $3 million, and the funds often charge a 1.5%-

**REPLICATORS** *cont. on page 8*

# Rethinking Risk

**OPERATIONS**
**BY AYE M. SOE**

LAST YEAR WAS A TERRIFIC ONE FOR equity fund managers as most of the global equity markets posted superb returns. In the U.S., the S&P 500 returned a record breaking 32.39% and the average large cap core manager, based on the Lipper category average, posted 31.63%. Overseas, the international developed markets returned 21.44%, by no means a small feat. Given the impressive gains, volatility and downside protection, on every manager's mind following the 2008 financial

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tion as the ETF. This will become increasingly difficult for this type of manager.

**Q. How will ETFs fare if active mutual fund managers don't beat their benchmarks?**

We believe that ETFs will continue to grow for a variety of reasons. Many traditional, long-only mutual fund managers will continue to struggle to beat their benchmarks, which will continue to push the marginal dollar to ETFs. This will contribute to the rise of the ETF strategist and ETF model portfolios, where value is added through asset allocation and the tactical management of various asset classes.


JOHN LUNT

**Q. How should mutual fund managers avoid falling too far behind?**

Mutual fund manager that simply provide exposure similar to that or their benchmarks will find it difficult to compete with lower cost, transparent ETFs. We believe that mutual fund managers either should embrace the role of providing efficient market exposure and focus on scale and lower fees or stake out a different value proposition associated with a risk/return profile that is different from efficient beta. This will require mutual fund managers to change the way that they communicate with investors, and talk more about solutions, outcomes, and portfolio characteristics. Looking different will result in times of meaningful outperformance and underperformance against traditional market benchmarks. We believe that more mutual fund and ETF managers will talk more about combining their strategies with other active managers or with other passive asset classes.

**Q. BlackRock Chief Executive Officer Larry Fink said in mid-January that ETFs may eventually make up 25% of the mutual-fund industry. Do you agree with that prediction?**

Absolutely. We anticipate continued growth and use of ETFs by ETF strategists and by mutual fund managers. ETFs are allowing both types of managers to provide granular exposures as they attempt to deliver returns by targeting sectors, geographies, and factors across asset classes.

**Q. What should fund managers keep in mind on the topic of risk management?**

Ultimately, risk is defined as the permanent loss of capital. The potential for behavioral risk by a money manager and/or an underlying investor becomes a relevant, qualitative risk factor. Behavioral mistakes can turn transitory, temporary losses into permanent losses of capital. Money managers recognize that risk is rarely eliminated, but instead, risk simply changes form based on the strategy employed. While there are many ways for professionals to dissect risk, most types of risks originate from a form of "market" risk or from a form of "active" risk. In order to effectively manage risk, a manager should attempt to correctly diagnose the sources of "market" or "active" risk within a portfolio or strategy. When more "active" risk is taken within a portfolio, the longer the horizon needed for benchmarking the strategy to both peers and market benchmarks. However, time should not be used as a shield in all cases.

**Q. More specifically, do mutual fund/ETF managers properly understand where currency risk is coming from?**

We believe that currency exposure is often underappreciated as a source of return and risk within a portfolio. Currency is sometimes ignored given the variety of return drivers. Interest rate differentials may seem to drive currency rates for a time, only to be overwhelmed by growth factors or changing central bank policy. Currencies behave as a "top down" risk and return factor, and many traditional managers take a very "bottom up" approach to security selection. Macro currency factors do not easily lend themselves to bottom up analysis.

**Q. Currency risk is a primary challenge for fund managers. What are some top operational challenges?**

Liquidity is always a top operational challenge for portfolio managers. Mutual fund and ETF managers are becoming adept at recognizing that liquidity is not defined simply by what appears on the screen. Liquidity can be sourced if a manager has built the appropriate connections and infrastructure. Some investors confuse ETF liquidity with average daily volume. For ETFs, it is the liquidity of the underlying components of the ETFs that is relevant. An ETF with wide screen spreads and low volume can be trade very efficient by a professional that uses the ETF providers or ETF liquidity providers.

**Q. Smart beta is just one example of where investors poured money into ETFs in 2013. Why is that area gaining traction among fund managers?**

Smart beta is attractive because these strategies typically follow quantitative, repeatable processes. These strategies are allowing managers to access additional return factors (for example, low volatility, momentum or high quality) within their passive exposure.

**Q. How should mutual fund/ETF managers view performance?**

In our view, relative performance benchmarking (risk and return) is more appropriate when comparing mandates with similar, high constraints. It makes less sense to benchmark unconstrained, multi-asset managers to peers or to the market over shorter periods of time. Fewer investment constraints are creating the potential for better absolute outcomes, but it is also creating havoc in evaluating shorter-term performance.

Money managers have always viewed performance as a combination of risk and return. We increasingly see the benefit of evaluating performance in terms of return and maximum drawdown. Volatility is less relevant on its own than understanding the drawdown required to capture an asset class', strategy's or manager's return over a period of time. MME