FROM THE DESK OF THE CIO

Unleashing Asset Allocation Benefits

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ETFs have revolutionized the ability for the main street investor to achieve benefits previously confined within the walls of large institutions. However, an ETF portfolio constructed without careful attention paid to the profile of issuers comprising it, or the numerous factors impacting its overall quality, can dramatically blunt the efficacy of their deployment. The whole premise of selecting ETFs is rooted in the benefits of asset allocation that they offer, yet certain selection pitfalls can occur when sifting through the hundreds of available offerings. Before delving into how we specifically attempt to navigate this for the benefit of our clients, let's first explore the merits of institutional asset allocation.

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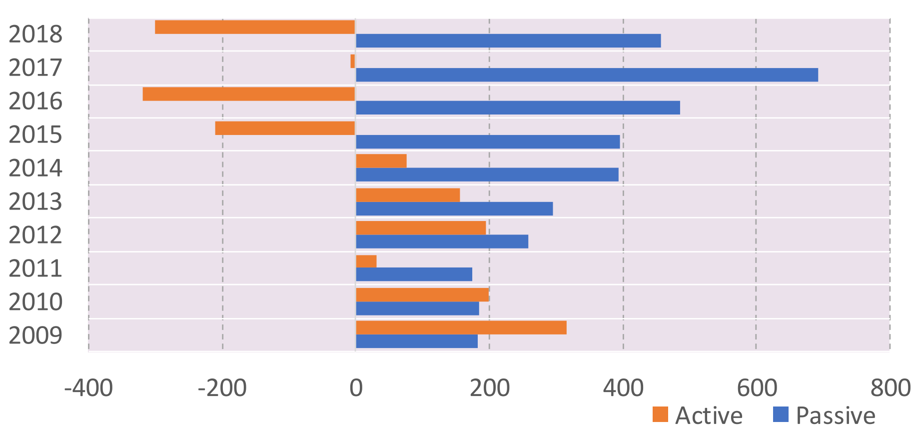
Institutional asset managers have long leveraged asset allocation as a powerful tool for return variability management, i.e. attempting to mitigate performance impacts from anything but price movements of their underlying indices. Asset allocation also can have a greater impact on the variability of your overall return than any individual security within your portfolio. For long term investors, the key is to have a sound, clear execution plan in harnessing all of the rewards that a prudent asset allocation strategy can deliver. Our diversified ETF-based strategies have been designed to achieve precisely that, bringing the tools traditionally deployed within a large institution to the individual investor.

The first step to asset allocation design is categorizing the opportunity set of an

US Fund Flows: 2018 Continues Passive Dominance Over Active ($Bs)

2018 continued the trend experienced across the prior decade, with $3.5 trillion in aggregate invested across passive-based ETFs and mutual funds, compared to just $139 billion in flows to active funds over the same period. In other words, Investors continue to utilize the benefits of ETF-based approaches in droves.



Source: Morningstar

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investable universe. The core variable here is the universal feature behind every security: the cash flow that it either generates or expects to generate. In newly issued equities, the presence of sustainable cash flow may indeed be years away. However, investors invariably attempt to factor all potential variables impacting the path to profitability into their assessment of that security's present value. In fixed income, the exercise is no different, but the nature of a face value repayment, regular coupon payments, and capital structure nuances—to name a few—carry different implications on the security owner's return variability. Hence, a fixed income security's price volatility reacts differently than cash flow streams accruing to the equity holder. These differences are typically what drive higher percentages of fixed income-based allocations, all else equal, for investors skewing to the more conservative end of the risk/reward spectrum.

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Even within equities, cash flow variability can be derived from differences pertaining to the sector, geographic exposure, market capitalization, or go-to-market actions of a given company. For example, the pace of innovation, and the incessant need to translate it into products and services is fastest within the technology sector. The core driver to this cadence is humanity's insatiable computing needs, where we attempt to squeeze smaller and smaller features onto silicon wafers with every passing day. Place the wrong bets on the wrong set of features, and you'll find yourself suffering the fate of the Palm Pilot, a product that was forced into capitulation by the iPhone. The business of competing within technology runs at a faster rate than that of a beer distributor or cigarette producer, for instance. The latter companies face the task of attempting to appeal to demographic demand shifts toward craft beer and e-cigarettes, respectively, along with preparations for when/if cannabis becomes legalized within the US.

Sector differences aside, resource scarcity can vary greatly among companies of differing sizes, which ultimately impacts cash flow variability, as the resources available to a $100 billion+ market capitalization company are vastly different than a $1 billion company. Generally speaking, a smaller company has to make smaller, concentrated bets with much less room for error. Even though tools at the disposal of the startup today are vastly superior to those from a decade ago—enabled by the likes of Amazon Web Services and Google Cloud Platform—an issuer's market capitalization undoubtably has an impact upon its cash flow variability.

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How a company sells its products, the lifeblood to revenue generation, also has drastic implications on cash that flows through the P&L and drops to the bottom line. Companies capable of locking customers into multi-year subscription contracts entail very different cash flow variability profiles than ones selling as much of what they manufacture every given quarter in efforts to maximize revenue. Examples of these differences can be seen in analyzing a software-as-a-service company, such as

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Salesforce.com, relative to a semiconductor company, such as Intel. The former sells software subscriptions with billing terms that can extend multiple years, whereas the latter has to spend billions of dollars a year on expensive equipment to manufacture silicon chips and sell everything it manufactures in order to generate revenue. These operating differences have dramatic impacts on one quarter's cash flow profile relative to another's, which impacts the price volatility of their respective share prices.

The point behind highlighting numerous factors that influence an underlying security's ability to generate cash flow is simple: it's imperative to take them into consideration in order to harness the benefits of asset allocation. A portfolio comprised of ETFs that were selected without close attention paid to these dynamics can cause unintended overexposure to a specific factor. For example, geographic boundaries can intersect when a US-based fund is held alongside a global-based fund that may include some level of domestic exposure. This can cause actual diversification to vary from perceived diversification, in turn weakening the implementation of asset allocation. There are also numerous important considerations in performing ETF selection due diligence, including the fund's size, its efficiency in tracking its defined benchmark, liquidity, and operating expenses.

Our managed ETF strategies distill the universe down to align investors with their desired outcomes. Embedded in this approach is an effort to minimize costs and harness the explanatory power that asset allocation can have on portfolio returns.

All of these considerations can be daunting to execute in portfolio construction for most investors, especially among a universe of hundreds of ETFs. However, our managed ETF strategies distill the universe down to align investors with their desired outcomes. Embedded in this approach is an effort to minimize costs and harness the explanatory power that asset allocation can have on portfolio returns. We have implemented this institutional approach in developing allocations for our Multi-Asset Income strategy, with enhancements made as of March 1st. For more information, please contact us.

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SWS Partners is a registered investment advisor that focuses on using technology to deliver contemporary asset management and financial planning solutions to high net worth individuals, family offices, endowments, foundations, and other institutions. We believe that by emphasizing the application of modern technologies, we can create broad efficiencies and deliver better outcomes to clients.

About the Author

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Mike joined SWS in 2017 as its CIO and leads portfolio management, risk management and research for the firm. Before joining SWS, Mike was a portfolio manager on $4 billion of long-only equity portfolios at the Ohio Public Employees Retirement System (OPERS). He leverages over sixteen years of experience on both the buy-side and the sell-side to bring an institutional research and portfolio management framework for SWS investors today.

Prior to OPERS Mike was responsible for investment bank equity research at FBR Capital Markets. He received his Bachelor of Science in Economics, Finance concentration, from the Wharton School at the University of Pennsylvania and is a CFA® charterholder.

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