Partnering with ETF Strategists

ENHANCE YOUR ADVISORY BUSINESS

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Overview

For those in the advisory business, today's market conditions present a unique set of opportunities. Demand for financial advisors' services is growing at a robust pace, thanks in no small part to the ongoing transition of some 76 million baby boomers into retirement. And the pace of innovation in investment products and services is also accelerating. Nowhere is this more evident than in the booming market for exchange-traded funds, where more than 1,500 ETFs are now listed in the United States — 10 times the number available just a decade ago.

But along with those opportunities, advisors are now facing more challenges than ever before. Badly shaken by two stock market collapses over the course of 10 years, investors are seeking out new investment solutions to help avoid a repeat of another "lost decade" of equity returns. And the needs of retirees and pre-retirees are shifting dramatically, from an almost exclusive focus on savings and accumulation, to a much heavier emphasis on income generation and principal protection. Meanwhile, global markets are more interconnected than ever, adding another layer of complexity to the investment process. And increasing client demands for service and a greater regulatory burden are weighing on most advisory practices.

To meet the growing needs of clients in this rapidly changing environment, leading advisors are embracing innovative approaches to investment management. ETF strategists — who research, design and manage ETF portfolios and have more than half of their managed assets in ETF portfolios — are offering many of these cutting-edge advisors access to institutional-caliber portfolios, with better transparency and daily liquidity. And strategists have gained significant traction in the advisory world: Assets in ETF managed portfolios hit $80 billion as of mid-2015, up from just $6 billion in 2008.

As part of an ongoing commitment to help advisors succeed in today's rapidly evolving investment landscape, State Street Global Advisors | SPDR and Invesco PowerShares have jointly produced this guide to navigating the thriving — but still relatively new — market for ETF strategists. Advisors are forming partnerships with ETF strategists to enhance their practices along the following dimensions:

- By outsourcing a portion of investment strategy implementation to an ETF strategist, advisors are freeing up more time to manage client relationships and attract new business.
- By partnering with ETF strategists, advisors are gaining access to wide range strategic and tactical investment expertise.
- Advisors are keeping their clients invested during periods of market turmoil, by using ETF managed portfolios to help dampen volatility and limit downside risk in client accounts.
- With the help of ETF strategists, advisors are embracing a flexible framework for portfolio construction that helps them deliver the "personal performance" that investors are demanding.

A growing number of advisors are discovering that the top-down, macro approach to asset-allocation made possible by ETFs can be a highly effective method for addressing their clients' most pressing needs. For many, partnering with ETF strategists is an efficient, cost-effective avenue for incorporating this type of investment management into their practices. Advisory firms would be well served to investigate the potential opportunities that might stem from partnering with a strategist as this burgeoning market continues to take flight.

The Market for ETF Strategists

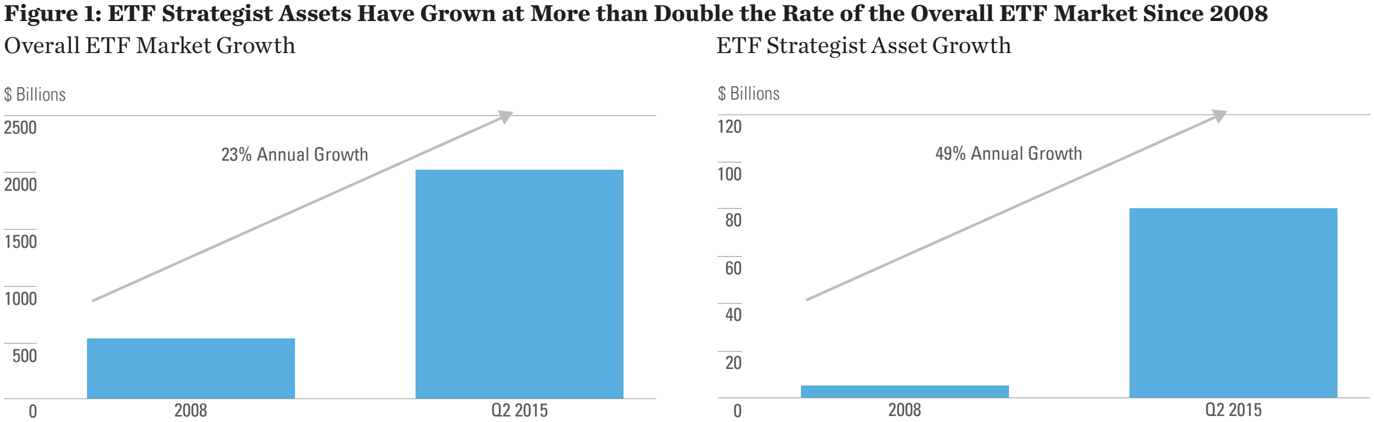
Robust Demand, Fueled by a Transformative Product

ETFs have revolutionized the way in which investors, both large and small, access asset classes. In addition to offering inexpensive, transparent and highly liquid exposure to domestic equities and fixed income, they have democratized access to such strategies as commodities, currencies, and foreign bonds that were once too expensive and impractical for retail and small institutional investors to own. And investors of all stripes are also discovering that the top-down, macro approach to asset allocation made possible by ETFs can be a highly effective, cost-efficient method for implementing their investment strategies.

Specialized Expertise

Fueled by the rapid growth of the overall ETF market, ETF strategists — who research, design and manage ETF portfolios — are likewise seeing robust demand for their specialized expertise. Strategists are giving advisors and their clients access to institutional-caliber portfolios with daily liquidity and better transparency than most mutual fund offerings. The ability of professionals to monitor the markets daily and make adjustments to a portfolio when necessary is of enormous value to many advisors, especially those who do not have sufficient time to do their own research or monitor underlying investments. It is largely for that reason that ETF managed portfolios have gained significant traction in advisory channels over the past seven years. Indeed, ETF strategist assets have grown at more than double the rate of the broader ETF market since 2008 (Figure 1). As of mid-2015, ETF strategist assets totaled $80 billion, up from just $6 billion in 2008.

Figure 1: ETF Strategist Assets Have Grown at More than Double the Rate of the Overall ETF Market Since 2008



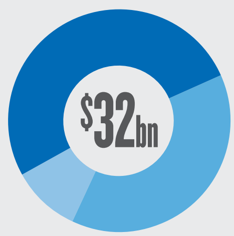
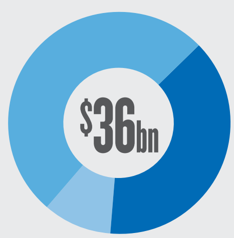
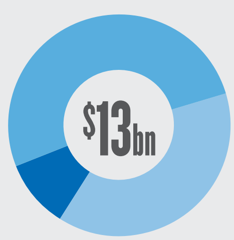
Source: Investment Company Institute, Morningstar.

A Wide Spectrum of Strategies

With the assistance of ETF strategists, advisors can embrace a flexible framework for portfolio construction that incorporates long-term strategic, core-satellite and more tactical investment solutions. Of the 770 managed ETF portfolio strategies tracked by Morningstar as of mid-2015, 38% fall under the tactical category, 33% are managed with a strategic approach, and the remaining 29% are in hybrid designs (Figure 2).

In addition to the rapidly increasing adoption of ETF managed portfolios among financial advisors, institutions and endowments, defined benefit pension plans, 401(k) plans and defined contribution plans have also begun to place assets with ETF strategists. Still, the vast majority of ETF strategist assets (about 90%, according to most industry estimates) currently reside with retail financial advisers. And as we'll discuss in the next section of this paper, advisors have compelling reasons for continuing to adopt them.

Figure 2: Strategists Offer Managed Portfolios Across Three Major Categories

		TOTAL ASSETS*	# OF STRATEGIES OFFERED
TACTICAL	Engages in short-term and potentially large changes in the asset mix of a portfolio to capitalize on identified investment opportunitites Typically employs a combination of tactical and strategic elements in asset allocation	 $32bn	294
HYBRID	Utilizes a combination of tactical and strategic elements in asset allocation Often starts with a stated asset allocation, but allows for significant deviations of exposure, similar to "core and satellite" operating models	 $36bn	225
STRATEGIC	Establishes and maintains a long-term allocation plan across asset classes and/or sectors May deviate from the plan in short-term periods based on identified opportunities, but typically only to a very limited degree	 $13bn	251

Source: Morningstar.

*As of June 30, 2015.

Using ETF Strategists to Enhance Your Advisory Business

For advisory firms, ETF strategists can represent a compelling value proposition. As they look to grow their businesses in an increasingly complex and volatile market, advisors are forming partnerships with ETF strategists and reaping a host of benefits.

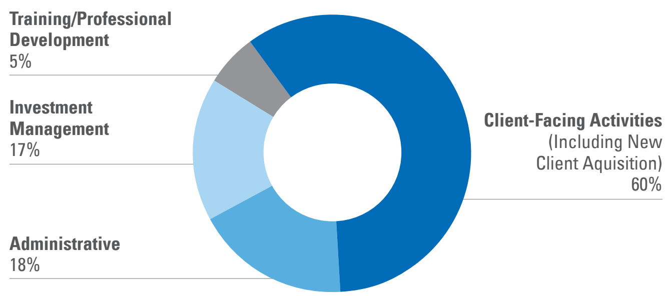
Freeing Up More Time to Manage Client Relationships and Attract New Business

Guiding clients' financial lives — understanding their goals and risk tolerances, defining their investment objectives, assisting with tax, education and estate planning, and navigating a host of personal and family issues — requires significant time and resources. And as their assets under management grow, advisors typically find themselves devoting an increasing share of their time to serving existing clients and attracting new business. Indeed, advisors spend an average of 60% of their time on client-facing activities, including meeting with current clients and new client acquisition, according to Cerulli Associates (Figure 3). Administrative functions and training/professional development take up another 23%. That leaves just 17% of their time for investment management.

At the same time, the rapid pace of new product innovation throughout the asset management industry has introduced a new element of complexity for advisors. Nowhere is this more evident than in the booming market for ETFs, where new products continue to come to market every year at a swift rate. More than 1,500 ETFs are now listed in the United States — 12 times the number available just over a decade ago (Figure 4).

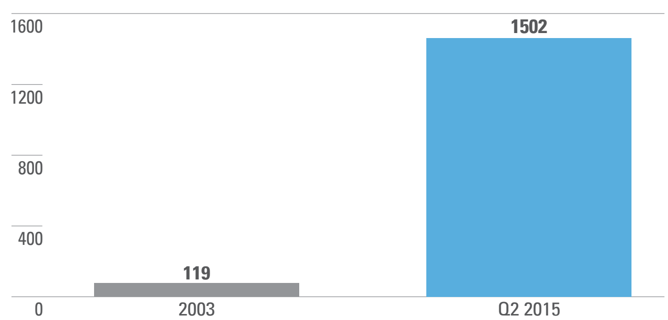
As a result, advisors are tapping into the expertise of ETF strategists to help them implement their investment strategies. When partnering with strategists, advisors continue to control and manage all aspects of the client relationship, including financial planning and the setting of investment objectives. But by outsourcing a portion of the investment strategy implementation to an ETF strategist, advisors can free up more time for the client-facing aspects of their business. ETF strategists generally follow clearly-defined processes, giving advisors comfort that their client assets are being managed consistently. They generally provide high-touch client service to their advisor clients, including making their investment professionals readily available to provide market insights and field questions. Many also provide advisors with research perspectives and market commentary to share with clients.

Figure 3: Advisors' Client-Related Activities Often Leave Insufficient Time for Investment Management



Source: Cerulli Associates, The Cerulli Report: Advisor Metrics 2014.

Figure 4: The Number of ETFs has Exploded Over the Past Decade, Making the Tracking and Evaluation of Products More Challenging for Advisors

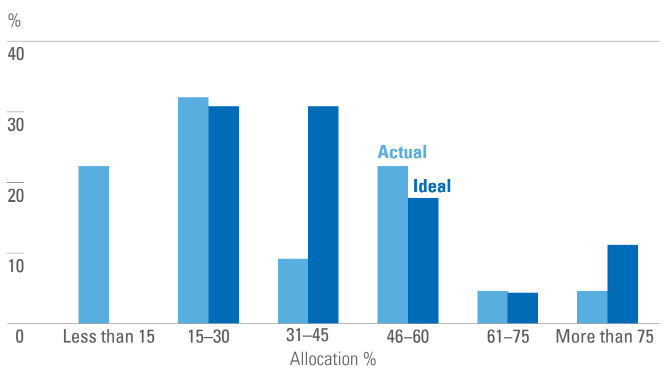


Source: Investment Company Institute.

Gaining Access to Wide Range Strategic and Tactical Investment Expertise

The market meltdown caused by the global financial crisis, coupled with the extended period of volatility that followed, has led advisors to seek more flexible programs for moving clients' money among asset classes like stocks, fixed income, commodities and cash. More than three-quarters of all advisors incorporate at least some degree of tactical management into client portfolios, according to Cerulli. But employing tactical considerations across accounts can be an onerous task and many advisors do not consider this an area of expertise. To obtain flexible, best-in-breed investment expertise, many advisors are now outsourcing a portion of their client portfolios to an ETF strategist (Figure 5). ETF strategists give advisors access to a wide variety of both strategic and tactical portfolios and the proliferation of liquid ETF products that go beyond broad asset classes has given tactical strategies even greater potential to outperform. Strategists can quickly adjust investment strategies as market conditions warrant; most employ "rules-based" processes based on a variety of technical and quantitative factors.

Figure 5: Advisors' Actual Allocation to ETF Strategist Models vs. ETF Strategists Ideal Allocation in Advisors' Portfolios, 2015



Source: Cerulli Associates, Exchange-Traded Fund Markets, 2015.

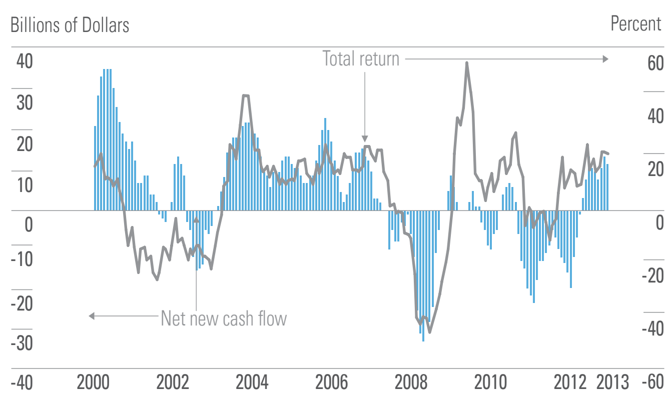
Keeping Clients Invested in Volatile Markets

Volatile markets can make individual investors do dangerous things. The flows into equity funds since 2000 provide ample evidence of this highly destructive investment behavior (Figure 6). The massive inflows to equity funds just prior to the bursting of the dotcom bubble in 2000, for instance, demonstrated retail investors' impulse to chase performance. At the other extreme, investors pulled record amounts out of equity funds during the depths of the financial crisis in 2008 — illustrating the well-documented tendency of individuals to respond far more strongly to losses than to gains. That same loss-aversion tendency also caused many retail investors to stay out of the market and miss the most rewarding part of the historic market rebound that started in early 2009.

Advisors today are partnering with ETF strategists to help dampen the volatility of long-term strategic portfolios — incorporating, for instance, more dynamic strategies that can quickly adjust allocations as market conditions change. ETF strategists can assist advisors in keeping their clients invested during periods of market turmoil.

Figure 6: When Confronted with Market Volatility, Investors Often Run for the Exits

Net new cash flow to equity funds and equity returns*



Sources: Investment Company Institute and Morgan Stanley Capital International.

*Equity returns are for MSCI Global Equity Index.

Past performance is not a guarantee of future results.

Delivering The "Personal Performance" That Investors are Demanding

Many leading advisors are shifting away from the concept of relative performance against a benchmark and embracing strategies aimed at helping clients achieve highly personal and specific goals (such as not outliving their money in retirement.) This "personal performance" focus is in stark contrast to the approach taken by most active mutual fund managers, who are concerned with relative performance against a benchmark, such as the S&P 500 index.

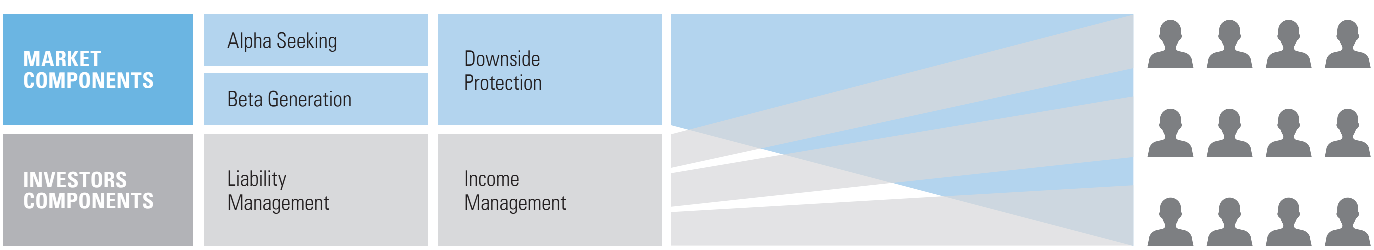
State Street's Center for Applied Research recently surveyed[1] more than 2,600 individual investors to find out which capabilities are most important when it comes to selecting financial advisors and other investment providers. The research revealed that discerning investors are looking for value across four key components: alpha seeking/beta generation, downside protection, liability management and income management (Figure 7). The two market-related components — alpha seeking/ beta generation and downside protection — are common to most investors. But the two investor-specific components — liability management and income management — are risk exposures that are highly unique to each individual. Increasingly, advisors are utilizing ETF managed portfolios as tools for delivering on the building blocks of "personal performance." With the help of ETF strategists, advisors can embrace a flexible framework for portfolio construction that incorporates long-term strategic, core-satellite and more tactical investment solutions to address the needs of investor goals across a wide spectrum of risk tolerances.

Better Managing Compliance Risk

For platform gatekeepers, the increasing demand among advisors for tactical strategies is cause for some concern. Thanks to a host of regulatory and compliance issues, home-office executives would prefer that advisors utilize packaged solutions from third parties instead of constructing their own tactical portfolios. ETF strategists, with their clearly defined strategies and investment processes, can provide gatekeepers with institutional-quality portfolio management that addresses their compliance concerns.

Figure 7: ETF Strategists are Partnering with Advisors to Deliver the Four Building Blocks of "Personal Performance" for Clients

These four components of value — from the investors' perspective — will be the building blocks of "personal" performance



Source: EDHEC, "Asset-Liability Management Decisions for Sovereign Welth Funds" (2010); Center for Applied Research analysis.
Alpha seeking: outperforming an index. Beta generation: tracking an index.

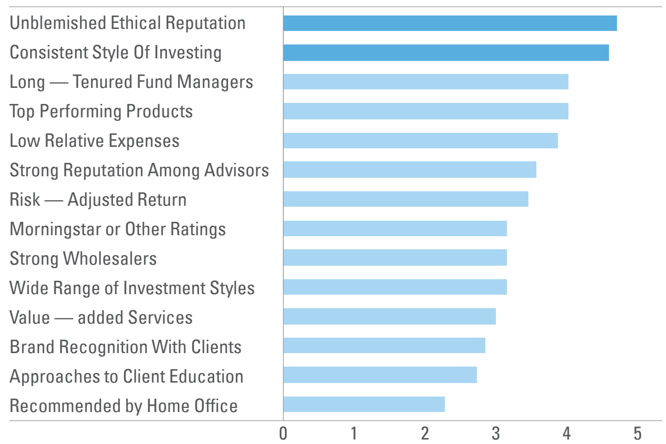
The Need For Due Diligence

ETF strategists can vary significantly in terms of size, history and investment philosophy, so advisors should always conduct due diligence before selecting a strategist firm. Key considerations include the strategist's financial stability and GIPS (Global Investment Performance Standards, which ensure fair representation and full disclosure of investment performance results) compliant track record.

In addition to offering strategies that fit the specific needs of advisors and their clients, strategists should also have a clearly-defined and consistent investment process, along with substantial expertise in ETFs. This is especially important in a rapidly growing industry like the market for ETF strategists. For example, some strategist firms that relied heavily on marketing back-tested theories, which test a trading strategy based on past data, (in lieu of an actual track record) have since faltered. But strategists with sound investment processes and reputable, professional staffs will be far more likely to provide results that are consistent with advisors' expectations.

In fact, according to a recent survey of advisors, an unblemished ethical reputation and a consistent investing style are the two most important factors in choosing an asset manager (Figure 8). Strategists should also have the processes and operational capabilities in place to provide a high level of customer service to their advisory clients.

Figure 8: The Most Important Factors Advisors Consider when Selecting an Asset Manager



Average rating (1=least important, 5=most important)
Source: Cerulli Associates, The Cerulli Report: Advisor Metrics 2014

Case Study

How Use of ETF Strategists Enhanced One Firm's Business

John Murphy, a financial advisor with Addison Avenue Investment Services, first began working with an ETF strategist in 2005. Aware that an ongoing wave of new ETFs was coming to market, he could readily envision the potential benefits of using ETFs within his clients' portfolios. But time was a major constraint: While financial and investment planning are at the core of Murphy's value proposition to clients, he still has to balance the time spent between day to day investment management and building client relationships. With the myriad of investment products available today, having professional help to assist with some of the day to day investment selection allows Murphy to devote more time to developing existing relationships and gathering new assets. "My focus is on what my clients need to do to accomplish their goals. Are their kids going to college? Are they getting married? Are they trying to retire? That is where most of my time is spent."

Murphy started out by incorporating the ETF managed portfolios of Sage Advisory into his client portfolios — gradually, at first. Today, he allocates about 50% of client assets to the strategist's tactically managed ETF portfolios. These offer the potential for upside participation while helping to manage against downside risk — a crucial consideration considering that the bulk of Murphy's clients are pre-retirees or retirees. "You're getting more tailored performance with the client's best interest in mind, as opposed to performance relative to an index," he says.

Transparency was also a key consideration that spurred Murphy to gravitate from mutual funds to ETF managed portfolios. By law, mutual funds are only required to disclose their portfolios on a quarterly basis. In between reporting periods, Murphy had no idea if they had strayed from their stated objectives. "We had no control over that," he says. By contrast, ETF portfolios allow Murphy to easily ascertain what his client portfolios contain at any given point in time. "If a client calls me and asks, 'Do I have exposure to X, Y or Z right now?' I can answer the question."

Murphy has also found that partnering with an ETF strategist has helped him to scale his business profitably. He's been able to decrease the time he spends on daily portfolio maintenance, while increasing the time he allocates towards building client relationships. "We're able to help the smaller client and we're also able to take on more clients," says Murphy, adding that his average account size is about $225,000. "It frees me up from micro-managing and allows me to do macro- management for my clients."

This case study may not be representative of the experience of other customers and is no guarantee of future success.

Setting the Stage for Success

To fully capitalize on the opportunities available through partnership with an ETF strategist, advisory firms must first consider what it will take to establish a productive working relationship. At a minimum, advisors and platform gatekeepers should expect the following from an ETF strategist:

- **Recognizes your firm's unique needs** and how the strategist's products fit into your broader strategy for growth.
- **Has a well-defined approach.** The strategist should have a clearly understood strategy that fits a particular set of needs for advisors or addresses a specific set of solutions for client portfolios (e.g., tactical allocation, inflation-protected income).
- **Articulates a clear value proposition.** The strategist should be able to articulate their advantage and explain why that advantage is sustainable over time.
- **Offers distribution support** that combines access to investment expertise and assistance in client marketing / education.

For a growing number of advisors, partnering with ETF strategists can be the most efficient, cost-effective avenue for incorporating the top-down, macro approach to asset-allocation that best addresses their clients' most pressing needs. Advisory firms would be well served to investigate the potential opportunities that might stem from partnering with a strategist in this burgeoning market.

[1] State Street Center for Applied Research survey of 2,623 retail investors, ending November 2012, as detailed in The Influential Investor: How Investor Behavior is Redefining Performance.

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* Assets under management were $2.2 trillion as of September 30, 2015. This AUM total reflects approximately $25 billion (as of 9/30/15) with respect to which State Street Global Markets, LLC (SSGM) serves as marketing agent; SSGM and State Street Global Advisors are affiliated.

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Frequent trading of ETFs could significantly increase commissions and other costs such that they may offset any savings from low fees or costs.

Diversification does not ensure a profit or guarantee against loss.

Correlation is defined as a statistical measure of how two securities move in relation to each other.

There can be no assurance that a liquid market will be maintained for ETF shares.

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