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Kim Arthur: How To Manage ETF Portfolios

By Matt Hougan | December 11, 2009

An important change is taking place in the world of wealth management. In the past, investors looking to outperform the market would turn to actively managed mutual funds or even hedge fund managers looking for that performance.

But with the advent of exchange-traded funds, a new cadre of sophisticated financial advisers have emerged that are using passive instruments like ETFs to implement active portfolio management strategies that search out strong returns while managing risk.

Kim Arthur is part of this new group of advisers. As the founder and CEO of Main Management LLC *in San Francisco, Arthur manages more than $325 million in sophisticated ETF-only strategies. He spoke recently with IndexUniverse.com to explain how he does it, and what areas of the market are attractive right now.*

IndexUniverse.com (IU.com): Tell me a bit about your firm.

Kim Arthur, CEO, Main Management LLC (Arthur): The firm was founded seven years ago, with the prevailing philosophy that we wanted to be a fiduciary for our clients and provide them with a liquid, transparent, diversified wealth management solution.

When we looked around to see what products were available to help us achieve that end goal, we found ETFs [exchange-traded funds]. There were about 100 ETFs available at that time, and now there are about 900, and more are being added all the time.

We started out in 2002 with $25 million in assets, and we're now at $325 million. Along the way, the embedded fees in the ETFs have come down, and the liquidity has increased dramatically. We have been able to pass those savings on to our clients.

IU.com: What attracted you to ETFs?

They were liquid, transparent and diversified, and they had the additional benefits of being low cost and tax aware.

IU.com: What strategies do you offer?

Arthur: We started with a single strategy focused on sector rotation domestically. But today, we have six strategies, including a global portfolio allocation strategy, which we see as a one-stop solution for wealth on our portfolios to manage risk and create cash flow streams.

IU.com: How do you approach building an ETF portfolio? How do you decide how much to allocate to what and where to place your bets?

Arthur: We have an institutional-grade advisory board, half of whom are former Wall Street strategists or economists, and we work with them to look at the markets from 30,000 feet. We dig into interest rate forecasts, spreads, currency movements and a great deal more.

Based on the input from our advisory board and from trusted sources we've built up over the years on Wall Street, we decide where we are in the economic cycle and where we are going, and we use that to put a strategic allocation in place.

We then switch to a bottoms-up approach, testing various hypotheses and looking back to see how different asset classes have responded to various market conditions in the past.

We also believe in reversion to the mean in sector valuations, so we'll look at the 10 sectors and compare their valuation today vs. historical valuations at different points in the business cycle. If a sector is attractive on both valuation and timing, we will make an allocation.

The final check we do is from the bottom up. Everyone in the company comes from a single-stock background, so we will talk to C-level people at businesses to find out how things are looking for them: Are they seeing lean inventories, where are things in the product cycle, etc. We realize that sectors and markets can stay cheap a lot longer than you expect, unless you have a catalyst that will drive investors back to a theme. We look for that catalyst, and we also make intra-year changes as market conditions evolve.

The last piece we do is an options overlay. We sell covered calls against a portion of the equity allocation, giving some downside protection while forfeiting some of the upside exposure. We use options overlays as a volatility damper and a way to manage risk in the portfolio.

IU.com: A covered call strategy; it sounds like you're essentially running a hedge fund for your clients.

Arthur: We think it's a better solution for most investors.

Imagine you are an investor with $10 million to invest. You go to a traditional wealth manager, who may put you in 25 different hedge funds (50 percent of their portfolio), 15 different active managers (25 percent of the portfolio) and 10 beta plays (25 percent of the portfolio). That gives you 50 different positions, half of which are individually papered positions that deliver a K-1 [partnership distribution]. It's very complex; there may be liquidity constraints and gates, and your fees are significantly higher—maybe 2x what we're charging. Often, the investments are also illiquid, so you can never know the true saleable value of a position.

In our strategy, we've got liquidity, transparency and diversification. We think that over time, given the cost advantage we have, we're going to be able to deliver you a better total return.

IU.com: How do you decide where to place your covered call bets? Are they in the money, out of the money or what?

Arthur: I like to call it part art, part science. For the science part, we always look at one-month options, as you For us, it depends on where the market or the ETF has come from in the preceding 30 days and where we think it will go.

For instance, in the small-cap space, we've been decreasing our exposure and selling a lot of in-the-money calls, because we have decided that we want to exit part of our small-cap strategy.

On average, in any given year, we think we can generate 70-100 bps from this strategy. Some people say that seems like a lot of work for 70 basis points, but if I'm charging you 65 bps in fees and I can rebate that fee through this strategy, we think it's a good value proposition and that it's doing the right thing for the client.

IU.com: How do you decide which ETFs to use?

Arthur: We use the tools that the product providers offer—State Street Global Advisers, Barclays, etc.—and we also do internal analysis.

What it really comes down to is sector exposure. We look at things like the liquidity, optionability, tracking error, embedded fees and other factors, but really I'm making sector bets. If I decided I want an overweight in technology and there are four similar ETFs, I'll gravitate to the one with higher exposure to technology. If I like growth and large cap and want a tech bent and a health care bent, I'll screen through and find the one that gives you the greatest exposure to those factors. It's all about sector exposure under the hood.

IU.com: What is attractive right now?

Arthur: Tech, telecom, health care and utilities are all attractive to us. It's a combination of high and stable cash flows. For technology, there is an overseas bent, playing on the theme of global reflation.

We have been de-emphasizing the early cyclical sectors recently: semiconductors, energy names. In fact, we have been out of energy for some time. One of the best predictors of energy stock performance is whether the oil futures market is in backwardation or contango. When it's in contango, energy stocks typically underperform the market. That's where it is today.

Globally, we are very big on the thesis that things are growing faster outside of the developed markets than inside. But I think that in 2010 we will scale back the risk in that area because they have had a good run. As we see rolling debt fears move from Dubai to Greece to wherever is next—there will be some Eastern European countries that have to stand up and face the music soon—we want to take down some of the risk profile in that area.

At the beginning of this year, for instance, people were scared to death of Austria. But then Austria had a huge run. It's corrected a tiny bit, but not much, and my guess is that a lot of the risky exposure is still there.

IU.com: What about commodities? Any exposure there?

Arthur: We do have some commodities and currency exposure in our portfolios. Gold we sold a little too early: We bought it around $840 and sold near $1,000. Gold has become a speculative play on dollar debasement.

If there is going to be moderation in 2010, then commodities probably will slow down slightly. The agricultural commodities still offer some interesting risk/reward opportunities, so we have been tilting more towards the ag

IU.com: What ETFs do we still need to see develop?

Arthur: We'd like a further build-out of fixed income, particularly in sovereign debt for the developed and emerging markets. Anything that offers broad exposure to the developed and sovereign credits we would embrace. Eventually, you'd love to see corporate available in varying durations for the developed and emerging markets as well. There is some activity there but it is pretty thin.

The other area we are starting to see action is in emerging market sector strategies. I think we'll see more guys coming up with emerging market sector funds, so you can take rifle-shot approaches into those areas.

Finally, in the frontier markets, we see room for better funds. Barclays has an institutional frontier strategy and I hope they'll stick a wrapper on it. They do things like place a cap on Kuwait exposure at 15 percent, so the fund isn't dominated by Kuwait. They also eliminate exposure to Nigeria, where it is easy to get your money in but difficult to get it out.

Many of the existing frontier market ETFs are either dominated by Kuwait or have countries like Chile in them which are really emerging markets.

IU.com: Any interest in the new active ETFs that have launched recently?

Arthur: Our philosophy, in general, is that we want to make the active decisions. We want to actively manage passive indexes. If someone else is making an active decision under the covers, it will step on top of us. If someone is actively trying to beat a benchmark, they can just as easily miss it.

IU.com: Thanks for your time.

You can visit Main Management LLC's Web site here.