Institutional Investor

An emissary for ETFs

Former U.S. ambassador J. Richard Fredericks has taken up a new mission: pushing actively managed ETF portfolios. • **By Charles Keenan**

After serving from 1999 to 2001 as U.S. ambassador to Switzerland and Liechtenstein, where he helped forge an agreement between Holocaust victims and Swiss banks, J. Richard Fredericks thought about retiring to pursue his passion for collecting American Indian art. Instead, the former star banking analyst, now 59, decided to jump back into finance.

In August 2002, Fredericks, who appeared 17 times as a member of Institutional Investor's All-America Research Team, accepted a proposal from an old friend, James Concidine, to launch an asset management firm. Concidine, who is also 59, a former head of international institutional sales at Montgomery Securities, where Fredericks worked for 17 years, and the current CIO of a family office, would act as portfolio manager; Fredericks would handle clients and marketing. They would both set strategy. The firm would offer one product — an actively managed portfolio of exchange-traded funds, or ETFs. These are baskets of securities that track various indexes — everything from the Standard & Poor's 500 index to the Dow Jones U.S. health care index to the FTSE/Xinhua (starting this month) — and are bought and sold like stocks.

Unlike index funds, ETFs, which trade on the major exchanges, allow real-time pricing and tax efficiency. Institutional investors appreciate the liquidity that allows them to rejigger their holdings quickly. And ETF shareholders pay capital gains taxes only when they sell, whereas investors in index funds pay them every year. They have proved so popular that such large brokerages as Smith Barney Citigroup, Morgan Stanley and Merrill Lynch & Co. are increasingly offering ETFs to both their institutional and retail investor clients.

Jeffery Newbury

Main Management's Fredericks: "This wave is coming our way"

San Francisco–based Main Management debuted in August 2002 with a modest $28 million under management, raised entirely from the Silicon Valley family office where Concidine worked. Main, whose assets have grown to $116 million, is still one of just a handful of money managers, including Mench Financial in Cincinnati and Walnut Asset Management in Philadelphia, that run actively managed portfolios of ETFs.

"This wave is coming our way," says Fredericks. "ETFs provide an effective way to rebalance portfolios while maintaining diversification. They are going to be a big-time delivery mechanism over time."

The sector's recent growth has been dramatic: As of July 31, 160 U.S. registered ETFs reported $185 billion in total assets, up from 29 ETFs with $34 billion in assets in 1998, according to Leuthold Group, the research division of Connecticut-based brokerage Weeden & Co. The two biggest ETFs are SPDR, or Spider, which is indexed to the S&P 500 and has amassed $45 billion in assets, and the Nasdaq 100 Trust Shares, also known as QQQs or Cubes, which has accumulated $21 billion.

Main aims to beat the S&P 500 index by 200 to 400 basis points each year, making targeted bets that certain ETFs will outperform the benchmark. In its first portfolio, launched in August 2002, Main invests in three categories of ETFs: broad index funds like SPDR, sector ETFs such as Merrill Lynch's Holdrs Pharmaceutical

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and State Street Global Advisor's Energy Select Sector SPDR, and international ETFs such as Barclay Global Investors' iShares. Main picks about a dozen ETFs, looking for undervalued sectors poised for a rebound. The firm likes to buy and hold ETFs for 12 to 18 months to keep down capital gains expenses. This year through early September, the portfolio was up 2.47 percent, versus 2.05 percent for the S&P 500.

Last month Concidine, working with three analysts, introduced a second product for Main: a portfolio of ETFs that uses covered-call options, allowing the manager to sell options on the ETFs at higher strike prices.

Main's fees are higher than those of a single index fund or ETF but comparable to those of large, actively managed equity portfolios. Institutional and high-net-worth investors pay annual expenses of about 50 basis points, that compare to 49 basis points for actively managed $100 million institutional equity portfolios, according to Connecticut consulting firm Casey, Quirk & Acito.

Main Management got its start when Concidine became frustrated by the performance of active managers used by his family office. "They owned Enron Corp. and Tyco International," says Concidine. "I said: 'God, you're supposed to have all this research capability. How is it that you got bagged along with everybody else?'" He set out to sell a new investing model to the family office that employed him: a basket of ETFs in which a single bad stock pick wouldn't destroy a portfolio. The family office gave Concidine the $28 million to get started, and Main Management was born.

Jane Mauer, president of Tartan Investment Co., a family office in Minneapolis that invests with Main, likes the buy-and-hold approach. "The ETFs and Main Management have allowed me to retain the core of the index but also trade around it with the sectors they believe will do better," she says. "They are able to add value."

Concidine begins by establishing a macroeconomic view. Then he focuses on quantitative measures for the ETF's ten largest stock holdings, such as price to book, price to sales, price to earnings and cash flow over trailing ten-year periods. In sector ETFs the top-ten stocks generally make up 50 to 75 percent of the market value of the ETF's assets. For instance, in August 2002, Main bought shares of Semiconductors Holders Trust, an ETF that tracks the leading 20 semiconductor companies. At the time, semiconductor stocks were beaten down, trading at about 1.5 times book value, versus a ten-year trailing average of four times book. Main expected a turnaround and started buying the ETF's shares at an average cost of $20. It sold its position in this year's first quarter for $40 a share.

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Main's portfolio of a dozen funds gives investors access to 2,000 stocks, significantly minimizing the impact of any one blowup, Fredericks argues. When Merck & Co. announced on September 30 that it would stop selling Vioxx, a blockbuster pain and arthritis medication, because a study found it increased patients' risk of heart attack and stroke, Merck shares plunged 27 percent. But Holdrs Pharmaceutical, an ETF that includes Merck, lost 4 percent.

"Wall Street's focus is so short term," Fredericks says. "If you miss earnings by a penny, you can be off 20 percent in an hour."

Always, he adds, "we are trying to find those baskets that outperform."

In January 2004, Main bought Energy Select, a basket of 27 stocks, at an average cost of $28.05 a share. Main figured investors were underestimating the value of oil company reserves. The ETF was trading at $33.06 in early September.

ETFs got off to a slow start when they first hit the market in 1993. State Street created the market with the launch of its SPDR. It took three years for ETF assets to reach $1 billion. The five largest ETFs — two of which track the S&P 500, and one each that mirror the Nasdaq 100, the S&P 400 index and the Dow Jones industrials index — accounted for more than 95 percent of all ETF assets in January 2000, according to Leuthold Group. By April 2004 the share of the top-five ETFs had fallen to 60 percent, reflecting the fact that the ETFs cover an ever-growing roster of market sectors.

This year alone Vanguard Group has launched 14 new Vipers (Vanguard index participation equity receipts) that are tied to MSCI U.S. indexes, including growth and value categories in large, mid- and small capitalizations. BGI launched ETFs linked to nine Morningstar market sectors in July.

Main isn't the first money manager to specialize in ETFs. Mench Financial, a Cincinnati, Ohio–based money management firm, started using them eight years ago, with the instruments making up an increasing part of its portfolio. ETFs now comprise about 80 percent of its $150 million in assets, up from 40 percent in 1998. "The new buzzwords out there in the investment community are 'allocation' and 'diversification,'" says Thomas Mench, chairman and chief investment officer at the firm. "How do I do it readily, easily and at low cost? The answer is ETFs."

For the moment, large money managers like Barclays and Vanguard are aggressively selling ETFs, but they are not yet selling portfolios of ETFs to their retail or institutional clients. They earn much higher management fees on their active portfolios, of course. And institutional investors, ever sensitive to fees, can find diversification by simply investing in index futures or by buying a basket of stocks themselves.

"If you are a large investor, futures are cheaper," says Kelly Haughton, strategic director at Russell Indexes at Russell Investment Group in Tacoma, Washington. However, mutual funds, many of which have bylaws restricting them from using futures, have become big ETF buyers.

Fredericks, for one, argues that any investor can be well served by owning shares in a portfolio of ETFs. "It's an elegant solution to diversification," he says. i

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