TOP ETF THEMES FOR 2018

Jeremy Schwartz — Global Chief Investment Officer
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Last week on our podcast, I spoke with Bruce Lavine, my former boss and colleague and current member of the WisdomTree Investments board of directors, along with his current colleague John Davi, founder and CIO of Astoria Portfolio Advisors. We had a great conversation on Lavine's background and history, going back to his early days at WisdomTree and the founding of the iShares business. The discussion with Davi touched on portfolio themes Astoria has worked into clients' exchange-traded fund (ETF) portfolios for 2018.

In March of this year, Davi saw a dream scenario for stocks: earnings were inflecting higher globally, liquidity was tremendous and inflation was muted. This led him to invest in emerging market equities, emerging market currencies, U.S. cyclicals, Europe and Japan. As he looks ahead, this bullish outlook has become more of the consensus. Davi now is looking for ideas that are out of consensus that he can time and size right for his portfolio in order to outperform. He still is constructive on the market for the next quarter, with over-weights in U.S. cyclicals, global ex-U.S. equities and international small caps.

Liquidity Declining: Due to the Fed's planned rate hikes, quantitative tightening and a likely pullback in liquidity from other central banks such as the European Central Bank, Davi expects liquidity to decline on the margin. Davi said that markets trade on the margin and the rate of change is everything, so this decline in liquidity will have significant portfolio implications. As a result, Davi suggested holding portfolio-diversifying assets such as liquid alternatives, gold and long dated duration in order to lower portfolio volatility.

Fixed Income out of Benchmark Exposures: We also discussed whether the negative correlation between equities and bonds will persist over time, and Davi commented that the bond market over the last 30 years was like Christmas for his kids—bonds provided income, carry, diversification and hedging properties. But with the more than $2 trillion of inflow into bonds over last seven or eight years, he no longer sees bonds as a risk-reduction tool or high income. Davi does not like making a bet on the belly of the bond curve; instead, he uses municipal bonds, senior loans, emerging market debt and preferred equity for their income, where they each provide two times the yield of the traditional Bloomberg Barclays U.S. Aggregate Bond Index. Davi mentioned that neither of these provides the opportunity they did years ago, but there is a small margin of safety compared with traditional bond indexes.

Assets for a Curve-Flattening Environment: During the latter stages of the economic cycle, the yield curve tends to flatten. In Davi's research, he sees a case for energy stocks, emerging markets, European equities and some commodities during a flattening yield curve environment. Research shows that a recession typically hits one to two years after the curve inverts.

The Case for International Small Caps: Davi described the liquidity environment we have today as still supporting international small caps. Further, Davi said that international small caps are an asset class that has surprisingly lower volatility than international large caps when you consider how much more volatility U.S. small caps possess over U.S. large caps. Davi described international small caps as call options on global growth, as they are more plays on domestic economies. Moreover, international small caps have varying sector and factor exposures that diversify most traditional large-cap ETF portfolios.

Our Discussion with Bruce Lavine

Lavine joined Astoria through a connection with Davi, but also because the firm was in a sweet spot for asset management. He sees Astoria as providing active portfolio management that uses largely passive building blocks and harnessing the power of ETFs. Because these are early days for the firm, Lavine sees Astoria carrying less entrenched baggage compared with more well-established firms.

I described Lavine as being one of the godfathers of the ETF industry, given that he discovered the power of indexing back in the 1990s when he worked at Bristol-Myers Squibb in its pension plan group and utilized beta exposures. In 1994, Lavine went to work for Wells Fargo Nikko, the predecessor firm to Barclays Global Investors. Wells Fargo was an early proponent of indexing for pension funds, but it was completely unknown at the retail level. Barclays bought this Wells Fargo Nikko division, and Lavine became a member of the internal SWAT team that was formulating the retail and ETF plan in 1998. Lee Kranefuss was the head of the business, and Lavine was the CFO.

Lavine shared an interesting story about how the acronym ETF came to be. It was being used on Barclays' internal project memos and people working there didn't know what to call them, so when it was time to file with regulators, they expanded ETF out to be "exchange-traded fund" instead of the traditional naming of SPDRs and cubes and diamonds that some of the trust products had at the time.

Structuring Stronger ETF Portfolios

We discussed how the world could change in the future. Building an ETF portfolio to cover global markets can be done as simply as using two ETFs for global stocks and global bonds. Yet Lavine thinks that in the world we have ahead of us, this simple diversification may not be adequate. Fixed income, which historically has provided reduced volatility, could be the spark that creates more volatility in portfolios.

Current ETF Marketplace and Potential Consolidation

We discussed all the new entrants to the ETF space in recent years. Lavine counted more than 100 ETF issuers, 33 of which have more than $1 billion in assets and 18 of which have more than $5 billion in assets. There were only 15 firms even trying to do ETFs until about seven or eight years ago, and now you have all these firms jumping in at a time Lavine considers pretty late in the game for the development of new ETF companies. He clearly sees a number of unprofitable business models out there and believes there will be consolidation in the future.

About Nate Most: Father of SPDR

I asked Lavine to name some of the biggest influencers on his career, and one of the first he described was Nate Most, who was an 85-year-old when Lavine met him. There are many people who take credit for being the "father of the SPDR" franchise, but Lavine gives Most as much credit as anyone, and the intellectual curiosity he showed for developing new ideas shaped Lavine's career as a product developer at iShares.

Jonathan ("Jono") Steinberg, CEO of WisdomTree

Lavine described how inspirational a leader Jono Steinberg has been and how impressive the accomplishments of the firm have been to date. Most of the other big ETF start-ups all developed as a division of a larger asset management firm. WisdomTree started from scratch with just a great idea and the right people, and Lavine gives Steinberg all the credit for what he accomplished.

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DEFINITIONS

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Inflation : Characterized by rising price levels.

Cyclical sectors : Consumer Discretionary, Energy, Industrials, Materials, Financials and Information Technology sectors.

Bullish : a position that benefits when asset prices rise.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Liquid alternative : An alternative investment, one that is not one of the three traditional asset types (stocks, bonds and cash), that can be bought and sold on a daily basis.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Fixed income : An investment security that provides a return in the form of fixed periodic payments and the eventual return of principal at maturity.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

Preferred stock : A class of ownership in a corporation that has a higher claim on the assets and earnings than common stock. Preferred stock generally has a dividend that must be paid out before dividends to common stockholders and the shares usually do not have voting rights.

Bloomberg U.S. Aggregate Bond Index : Represents the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, as well as mortgage and asset backed securities.

Flatten : to effect a zero positio.

Recession : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

Active : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

Passive : Indexes that take a rules-based approach with regular rebalancing schedules that are not changed due to market conditions.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.