

Why a Monkey Managing Your ETF Portfolio Could Boost Returns

By Gil Weinreich | July 15, 2014 at 01:36 PM

How does an untrained monkey add value to a portfolio that trained professionals can't match?



A monkey throwing darts at a stock board would outperform active fund managers and market-cap weighted index funds.

Like a mighty river, assets continue to flow into exchange traded funds, [approaching the \\$2 trillion high-water mark](#) earlier this month.

Add in ex-U.S. ETF assets and the year-to-date total is \$2.6 trillion.

The flexibility, transparency, tax benefits and low costs of ETFs continue to draw the interest of advisors, who can use them to implement the most sophisticated strategies on behalf of their clients — but only if they have the most up-to-date knowledge.

That education gap was the key purpose behind ThinkAdvisor's live virtual conference on July 24: "[ETFs: From Alpha to Omega and Everything in Between](#)."

The keynote speaker, Rob Arnott, is something of a gadfly in an industry crowded with highly competitive, smart people.

To Burton Malkiel's famous claim that a blindfolded monkey throwing darts could select stocks as well as investment experts, Arnott boldly showed the monkey would actually [outperform](#) active fund managers and market-cap weighted index funds.

How does an untrained monkey add this kind of value? By breaking the link between weight and price that handicaps professionals who tend to buy the largest, most popular stocks whose prices exceed their value.

In other words, most listed stocks are small and neglected, precisely those whose risk and return characteristics are most apt to outperform over time. So the blindfolded monkey is bound to capture more of that risk and return than the trained professional operating under constraints such as the need to deploy large hordes of investor cash.

But what makes smart beta smart is human, not simian, intelligence, and Arnott and his team of highly trained analysts have tested a large number of smart beta strategies aimed at helping advisors add a [2% or greater return premium](#) over cap-weighted index funds.

Another luminary noted for his investment strategy smarts is Mebane Faber, the head of Cambria Asset Management and a veteran investment blogger especially known for a quantitative approach aimed at eliminating the heartache of the volatility-exposed buy-and-hold investor.

Faber's latest push is to quantify "blood on the streets," and load up on it in his Cambria Global Value ETF ([GVAL](#)).

Faber uses forecasting of Robert Shiller's cyclically adjusted price-to-earnings ratio (Shiller CAPE) to rank the cheapest countries, the ones he says are getting the worst current headlines and whose stocks consequently reside in the bargain basement.

It took a certain kind of courage, or quantitative confidence, to buy Greek stocks in the summer of 2012, when the nation's financial woes generated apocalyptic headlines and drove its CAPE ratio to 2. But investors who did so have seen their holdings rise 200% since that time.

Faber explains his investing approach and current favorite markets in the [July 24 event](#), in a session with ETFguide and ThinkAdvisor contributor Ron DeLegge.

An ETF analyst from the category's infancy, DeLegge is also a highly opinionated and clear-eyed market observer, who recently chastised bearish investors with this comment about the market's historic 5-year, 155% gain from 2009:

“My instincts say the stock market needs way more Kool-Aid drinkers to join it. There still aren’t enough barbers, babysitters and taxicab drivers that own an undiversified portfolio of Twitter, Weibo and GrubHub. We need them to join the party ASAP.”

For all the talk about smart beta and dumb beta, the subject of alpha will doubtless be discussed on a [panel on actively managed ETFs](#). Some groundbreaking recent research has found that active managers *do* beat their benchmarks — once you remove the large number of closet indexers.

Another key question sure to come up is how ETF transparency might impact active ETF portfolios, which cannot conceal managers’ favorite trades in the way that mutual funds can.

A list of the current top performing ETFs is heavily skewed toward leveraged and inverse ETFs, such as leveraged long junior miners ETFs up over 60% year to date.

But something as innocuous as comments by Fed Chairwoman Janet Yellen having no inherent bearing on mining can trigger a selloff in momentum-oriented stocks. Consequently, our [ETF event](#) will include a panel helping advisors weigh the risks and rewards of these 2x and 3x bull and bear funds.

Perhaps the opposite of the high-risk approach of leveraged ETFs is the uber-cautious strategy employed by liquid alts, which use managed futures and other derivatives to hedge against market movements.

These funds, which seemed like the ultimate answer to the 2007-’08 market crash, where no category offered investors safety, have paradoxically offered the latest opportunity for investors to lose money for years on end, as they have “successfully” zagged while the market has been zigging upwards.

ThinkAdvisor’s [panel discussion](#) of this topic will aim to help advisors think about how to relate strategy and fund selection to clients’ risk tolerance rather than following shifting market trends.