Richard Bernstein Advisors

The Leaders In Pactive® Management

ETF Insights

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Richard Bernstein Advisors

Richard Bernstein Advisors LLC (RBA) is an independent investment adviser focusing on longer-term investment strategies that combine top-down, macroeconomic analysis and quantitatively-driven portfolio construction. We strive to be the leading provider of innovative investment solutions for investors, and our competitive edge is our research-driven macro style of investing.

Our top-down macro approach differentiates our firm from the more common, traditional bottom-up approach of most asset managers. Our extensive array of macro indicators allows us to construct portfolios for clients that are innovative, risk-controlled, and focused on overall portfolio construction instead of individual stock selection.

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X-raying ETFs

WHAT WE MEAN:

We look-through (or "X-ray") an ETF to examine its underlying portfolio of constituents instead of treating an ETF like a single security. This more sophisticated method for choosing ETFs allows for a total portfolio view of risk and exposures.

HOW WE DO IT:

We dissect and analyze ETF holdings using state-of-the-art 3rd party risk analysis tools.

WHY WE DO IT:

X-raying ETFs is critical in understanding the risk of an ETF-based portfolio. It seems naïve not to treat ETFs as portfolios and ETF portfolios as portfolios of portfolios.

RBA is one of the largest and fastest growing ETF model managers in the United States[1]. Investors are increasingly accepting the use of ETFs and now realize asset allocation decisions have a greater influence on returns compared with stock selection in a low concentration portfolio.

RBA is a macro firm, but unlike other macro firms we are not event-driven and have longer investment time horizons. We translate our fundamental macro views into our Pactive® strategies. The term "Pactive®" refers to an actively managed portfolio that invests in passive instruments. RBA is a unique investment manager because we combine fundamentals with a mix of active ***AND*** passive strategies.

What we mean:

X-raying ETFs means treating an ETF like a portfolio. We look at an ETF's underlying constituents rather than invest in an ETF as a single security. For example, the largest ETF with S&P 500® exposure is SPY US (SPDR® S&P 500 ETF TRUST). Most investors treat SPY like a single security, but RBA considers the interactions by all 506 constituents (500 companies plus cash). Rather than paint with a roller, we're able to use a finer brush to more accurately target exposures within our portfolios. Understanding how the risks embedded into an ETF could impact our overall strategy guides RBA to select the most appropriate ETF.

[1]Morningstar ETF Managed Portfolios Landscape Report Q1 2018, https://www.morningstar.com/research/trending

How we do it:

ETF issuers publish their holdings daily and RBA examines an ETF's individual components using state-of-the-art 3rd party tools. We look-through (or "X-ray") the parent level of an ETF to shape and mold our desired solution just as a studio artist might sculpt pottery from a piece of clay.

Why we do it:

Why is X-raying ETFs critical? Can't we just read the ETF's description? Isn't it simpler to look at one ETF rather than potentially thousands of constituents? Let's rewind the clock to my high school football days. During a tackling drill I stuffed the running back, tackling and sending him airborne. As he made his way back to earth, he landed on my leg. Cursory inspections seemed to indicate everything was fine. I could still walk with a slight hobble, so I just took some ibuprofen. The next morning, I collapsed on the floor getting out of bed. X-rays of my leg revealed multiple fractures. Without X-raying ETFs to see what's beneath the surface, you could get tripped up due to unforeseen exposures.

Tripped up – sector exposure:

Recently our clients heard we increased our defensive positioning, increasing Health Care exposure. But when some looked at their portfolio, they recognized only two Health Care ETFs summing to 13% as of 1/31/2019. These clients didn't X-ray ETFs. The equity portion of the portfolio had a 30% exposure to Health Care, almost 20% overweight the benchmark's Health Care weight.

Tripped up – factor exposure:

Another oversight some investors make occurs when they buy a "Smart Beta" ETF that emphasizes a factor or multiple factors. RBA's 2017 paper, "***What's in your ETF portfolio?***," highlighted that investors may think they have a value or growth ETF, but, in reality, a larger contributor to the ETFs' risk was derived from industry and stock specific risk.

Tripped up – industry exposure:

The homebuilding industry dominated headlines a decade ago because homeowners hadn't experienced price declines since the Great Depression. Several homebuilding ETFs were launched including ITB US (iShares U.S. Home Construction ETF) and XHB US (SPDR S&P Homebuilders ETF). However, investors had no idea whether home builders were the largest positions. In XHB as of 1/31/2019, homebuilding wasn't even the largest sub-industry held despite the ETF's name!

Tripped up – yield exposure:

Home prices eventually fell and the Federal Reserve lowered rates to historical lows of between 0 and 25bps. VIG US (Vanguard Dividend Appreciation ETF) appealed to investors who may have been seeking yield and grew from <$1b at the end of 2008 to over $30b during 2018. Without X-raying, many investors thought this "Dividend Appreciation" ETF should have a high dividend yield. Yet, the yield for VIG was lower than that of another Vanguard ETF based on the S&P 500: VOO US (Vanguard S&P 500 ETF). The 30 Day SEC yield as of 12/31/2018 for VIG was 2.20% whereas it was 2.23%, 3 bp higher, for VOO!

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Tripped up – outdated theme exposure:

The future seems quite different from a decade ago. One of the largest companies in the world today is AAPL US (Apple Inc.)[2]. A large part of its success stems from launching the iPhone in 2007. Today, Apple is the 3rd largest manufacturer of smartphones behind Samsung and Huawei. However, the largest constituent in FONE US (First Trust Nasdaq Smartphone Index Fund) as of 1/31/2019 was Nokia Oyj. In fact, Nokia doesn't even make phones anymore.

Tripped up – commodity exposure:

According to the Weather Channel, at least 160 cold temperature records were set by the end of January 2019. Natural gas closed October 2018 below $3/mmBTU and rose 50% during November. One might think that natural gas exposure could be achieved via an ETF like FCG US (First Trust Natural Gas ETF). However, 7 of the 35 companies in this ETF produced more oil than natural gas. With this natural gas ETF, you're getting exposure to natural gas ***AND*** oil. However UNG US (United States Natural Gas Fund, LP®) invests purely in natural gas futures (though contango and K-1 impacts should be considered). On the flip side, a company that still has oil in its name COG US (Cabot Oil & Gas Corporation) as of year-end 2018 has 100% exposure to natural gas, 0% exposure to oil!

X-raying ETFs is a critical component of RBA's investment process. Simply looking at a group of ETFs isn't enough to fully understand the exposures and potential risks within a portfolio. Our process isn't fool proof, of course, but does provide a better insight than relying on ETF names or thinking of ETFs as individual securities.

[2]At the time of this publication, Apple Inc. is currently held in several portfolios managed by Richard Bernstein Advisors.

To learn more about RBA's disciplined approach to macro investing, please contact your local RBA representative.
www.rbadvisors.com/images/pdfs/Portfolio_Specialist_Map.pdf

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About Richard Bernstein Advisors

Richard Bernstein Advisors LLC is an independent investment adviser. RBA partners with several firms including Eaton Vance Corporation and First Trust Portfolios LP, and currently has $9 billion collectively under management and advisement as of January 31st, 2019. RBA acts as sub-advisor for the Eaton Vance Richard Bernstein Equity Strategy Fund, the Eaton Vance Richard Bernstein All-Asset Strategy Fund and also offers income and unique theme-oriented unit trusts through First Trust. RBA is also the index provider for the First Trust RBA American Industrial Renaissance® ETF. Additionally, RBA runs ETF asset allocation SMA portfolios at UBS, Merrill Lynch, Morgan Stanley Smith Barney and on select RIA platforms. RBA's investment insights as well as further information about the firm and products can be found at **www.RBAdvisors.com**.

RBA Investment Process:

- → Quantitative indicators and macro-economic analysis are used to establish views on major secular and cyclical trends in the market.
- → Investment themes focus on disparities between fundamentals and sentiment.
- → Market mis-pricings are identified relative to changes in the global economy, geopolitics and corporate profits.

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