



Kreinces: ETFs Work Best With Absolute Return Strategies

Written by IndexUniverse Staff

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David Kreinces is a portfolio manager with ETF Portfolio Management. Before founding the Newbury Park, Calif.-based firm in 2007, he was a portfolio manager in Merrill Lynch's global private client group, specializing in absolute return strategies using exchange-traded funds.

Kreinces is one of a growing number of independent portfolio advisers offering all-ETF portfolios that implement hedging strategies. To find out more about his unique quantitative-based methodology, IndexUniverse.com's Managing Editor Murray Coleman recently caught up with him at ETF Portfolio Management's southern California headquarters.

IU.com: How do you implement ETFs in absolute return strategies?

Kreinces: Our strategies are built around quantitative, rules-based models. And they don't use leverage at all. That's an important point. By not using leverage, we feel like our ability to limit volatility and control portfolio risk is greatly enhanced. But this has been an unusual period. In the past 18 months, we've had record activity in terms of shifting positions. During this time, it has been rare for us to hold funds for more than a few weeks at a time. But this isn't designed as a short-term trading strategy.

IU.com: What's your fee structure for your various strategies?

Kreinces: Our core passive portfolios have no advisory fees. We offer three of these. One follows the basic recommendations for an all-ETF portfolio created by David Swensen, the manager of Yale University's endowment program. It basically follows the strategy described in his book, "Unconventional Success."

The second passive core portfolio is designed for novice investors and takes a more basic approach to diversification. A third passive portfolio takes a more diversified approach by not discriminating as much against emerging markets and commodities. Again, all three are passively managed buy-and-hold strategies using ETFs where our clients don't pay advisory fees.

IU.com: How do you make money then?

Kreinces: We make money because most clients, after seeing the results of our absolute return strategies, put at least a portion of their assets into those portfolios. After 2008, when the buy-and-hold strategy hit a pothole, about 90% of our client assets have moved into absolute return strategies.

IU.com: How much do you charge for those strategies?

Kreinces: Last year, we charged 50 basis points for our global growth model and 100 basis points for our long-short strategy and aggressive growth strategy. This year, they're all charging 200 basis points. That's because all of the strategies outperformed strongly in 2008. And we don't charge a performance fee.

IU.com: Can you provide a recent example of how you achieve positive returns in a down market?

Kreinces: Our global growth model in 2008 went into cash and stayed in cash for a large part of the year. When the model moved into equities, it was very selective about which ETFs it picked. Probably the broadly diversified ETFs we traded most often last year were the iShares MSCI Emerging Markets Index (NYSE: EEM), the iShares Russell 2000 Value Index (NYSE: IWN) and the iShares MidCap 400 Index (NYSE: IJH).

IU.com: What are you doing this year?

Kreinces: The global growth model is a long-only strategy. This year, it's long in large-cap growth. And what is driving that part of the market is technology. We use ETFs such as the PowerShares QQQ (Nasdaq: QQQQ) to capture large-growth with a tilt towards technology. We're also investing in emerging markets through EEM and the Vanguard Emerging Markets ETF (NYSE: VWO). But we continue to be very greatly invested in cash in the diversified global growth strategy.

IU.com: What are you doing in your aggressive growth strategy?

Kreinces: It's also a long-only absolute return strategy and rotates between sectors. Right now, it still has about a third of total assets in cash. In this model, we do have the ability to use more broad ETFs when the environment calls for it. That's the case now. We're using EEM with a heavy weighting on Brazil through the iShares MSCI Brazil Index (NYSE: EWZ). In this portfolio, we've also traded the Internet HOLDERS (NYSE: HHH). We don't hold them now, but our theme currently is to emphasize emerging markets and technology. We've traded SPDR Gold Shares (NYSE: GLD) and the iShares Silver Trust (NYSE: SLV) in this model as well. But we don't hold either of those right now.

IU.com: What about your long-short portfolio?

Kreinces: It invests in concentrated countries and sectors as well as commodities. It also

has the capacity to step back and go into broader ETFs. This model can go 100% long or 100% short. Right now, it's 100% long. We're not holding any individual commodity ETFs right now, preferring to gain that exposure through Brazil and other emerging markets that are strongly influenced by natural resources.

IU.com: What has made you turn so bullish in that strategy?

Kreinces: When the market is trending upward as strongly as it has been, we try to capture as much of that as possible. So our long-short model hasn't been in cash during the past five weeks. We're very much trying to listen to what the market is telling us. The nature of our long-short model—along with the other models—is that it doesn't try to outguess markets. We're clearly in an uptrend and that pattern hasn't broken enough to send us back to cash yet.

IU.com: You also have an overlay for your models based on your own views, don't you?

Kreinces: Yes, but that overlay is implemented only when markets are at extreme levels. Right now, our more subjective judgments are being used to override our objective, rules-based quantitative processes only to a very limited degree.

IU.com: Why is that?

Kreinces: Our goal is to follow our rules-based methodology as much as possible. But when the markets shock our models, we don't want to get whipsawed around—that's expensive. So part of our risk controls are to allow for some sort of logical override to prevent severe losses of capital. We've got limitations on our threshold for pain. If our models aren't able to keep risks within a certain range, then we'll step in. Lately, we've been overriding the models in our core alpha strategy to try to stay out of the markets.

IU.com: How defensive are you in those types of composite portfolios?

Kreinces: Right now, we're about 85% long in our core alpha model, which equal-weights the other three strategies into a single, blended portfolio. The effort to fight the current rally reflects the fact that we were down in the mid-single digits in the first quarter in the core alpha strategy. That's a big drawdown for us. So as markets started rallying, we've participated in a very conservative fashion. The core alpha strategy is down slightly for the year. So we've eaten away at the drawdown, which is giving us a progressively bigger risk appetite.