ETFS' AND PASSIVE FUNDS FOR PRIVATE CLIENT ALLOCATIONS

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Agenda

- ETFs' and Passive Funds for Private Client Allocations
  - Core Allocation
  - Tactical tilts and Satellite Portfolios
- Smart Beta

CORE ALLOCATIONS

customised Mandates and Private Banking

Private Client Portfolios - Challenges

- Very customised requirements
- Skewed Towards Fixed Income and Equity
  - During periods of stress are highly correlated
- Require Portfolios with Low correlations between asset classes
  - benefit from the reduction in volatility
  - ensure performance in parts of the portfolio
- Diversification reduces nonsystematic risk
- Selection across a number of asset classes that exhibit modest or low correlations with each other
- The expected and realized long-term returns and volatility vary by asset class

ETFs' are best suited for creating Private Client Portfolios

- Single Transactions
- Cost-Effectiveness
- Flexibility
- Accountability
- Passive Management
- Simplicity
- Inexpensive rebalancing – Small denominations and pure exposure
- Consistent Risk – No cash calls or allocation changes

Contd..

Single transactions possible, on an exchange which makes it possible to target a certain price - traditional MF have entry / exit ***blind pricing***

No loads and managing fees tend to be lower for ETFs as opposed to regular mutual funds

ETFs trade throughout market hours – prices are known and ETFs can be sold short (SLB) or on margin allowing for creation of customised strategies

Designer / Creator / Manufacturer publish the list of assets (and weights) on a daily basis – **you know what you are buying into**

ETFs are not meant to outperform indices - smaller portfolio churn **lowers risk and expenses**

ETFs are **simple** in structure and easy to understand for investors.

MOSt Diversified Baskets (MDB)

- Most broad market indices are available
  - But not all
- Sector ETFs' , while available, have concentrated portfolios
  - Expose the investor to company specific risk
  - Lower constituent diversification benefit
- MOSt Diversified Baskets (MDBs')
  - Provide a diversified access to sectors, themes, smart beta and non-ETF index investment
  - Easy to switch from basket to ETF when appropriate ETF is available
  - Suitable for HNI investment tickets
  - Ideal for low cost asset allocation

Myths about ETFs'

- Not good for commercials
  - 60-70% rebate is available for asset allocators
  - Buying and selling brokerage off terminal
  - 2.5% MF is at odds with charging an advisory fee
  - Direct Plan is a threat to the manager selection business
- Liquidity
- Impact Cost: iNAV v/s Last Traded Price
- Alpha Generation – From the Right Beta
  - If you are in the wrong asset, or absent from critical asset classes, fund manager / alpha doesn't count

Commercials a Win:Win

Scheme	Expense	Your Annual Share	Client Benefits	Your Benefits
Regular MF	250 bps	100-125 bps	=	=
Direct MF	175 bps	0 bps	☑	☒
ETF	100 bps	60 bps + Brokerage + Fees	☑	☑

Example Portfolio

- CNX Nifty
  - Well diversified 50 stock index accounting for 24 sectors of the of the market in India with stocks representing about 63.55% of the Free Float Market Capitalization
- CNX Midcap
  - Free float capitalization-weighted index designed to represent the midcap segment of the market in India
- NASDAQ 100
  - Index includes 100 of the largest domestic and international non-financial securities listed on the Nasdaq Stock Market of US based on market capitalization
- Passive Mid-Duration Gsec
- Gold
- MOSt Diversified Bank Basket

Illustration

Allocation	14.29%	14.29%	14.29%	14.29%	14.29%	14.29%	14.29%	**100.00%**

Asset Class	Liquid	CRISIL G10	Nifty	CNXMCAP	Hang Seng	NASDAQ100	GOLD	Equal Weight
Compounded Annual Growth Rate (CAGR)								
1 Year	5.37%	11.42%	10.14%	-0.13%	13.31%	17.17%	-19.24%	5.11%
2 Year	5.76%	9.57%	1.71%	-4.03%	11.27%	28.95%	4.42%	7.78%
3 year	5.40%	6.91%	3.22%	-3.34%	9.87%	28.85%	8.33%	8.09%
4 Year	4.66%	6.03%	8.02%	7.85%	8.82%	25.01%	13.26%	10.60%
5 Year	4.58%	8.08%	7.65%	6.98%	5.47%	16.92%	13.02%	9.43%
7 Year	4.65%	7.45%	9.33%	9.28%	7.43%	13.21%	14.59%	10.25%
10 Year	4.33%	5.50%	17.81%	19.01%	10.82%	11.95%	16.37%	12.91%
Volatility (Assuming 250 working days in a year)								
1 Year	0.01%	3.11%	13.55%	15.04%	14.76%	15.35%	17.92%	6.07%
2 Year	0.02%	4.05%	17.30%	17.11%	19.35%	20.10%	19.38%	7.47%
3 year	0.04%	3.97%	17.18%	16.92%	17.63%	18.71%	17.76%	7.12%
4 Year	0.09%	4.52%	18.24%	17.83%	18.01%	18.71%	17.42%	7.53%
5 Year	0.10%	7.09%	26.27%	23.21%	26.01%	25.33%	21.23%	9.94%
7 Year	0.13%	6.49%	26.66%	24.65%	25.99%	24.08%	20.68%	10.44%
10 Year	0.12%	6.06%	26.09%	25.04%	23.06%	22.28%	19.51%	10.39%

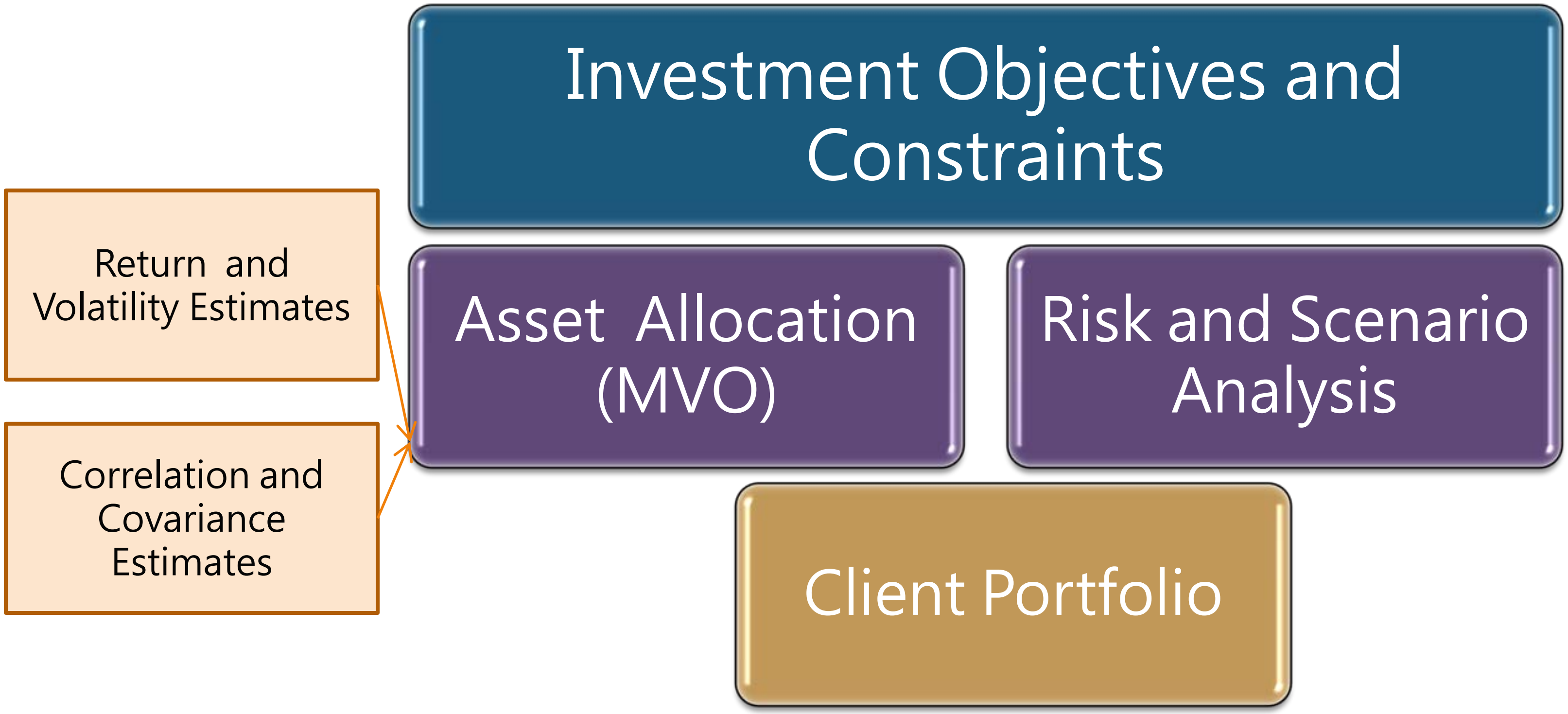
Example Portfolio Risk Characteristics

- Allocation Tailored to Client Risk
- Alpha generation from the right beta
- Significantly reduced draw downs
- Lower volatility (than constituent asset classes)
- Better Sharpe
- Better expense pass through to clients and similar pay out to Distributors and Asset Allocators

The “How to”

- First and foremost: Initial planning to determine
  - Liquidity - what sort of short notice cash does the client need?
  - Bullet requirements – specific outflows e.g. business loan repayments
  - Balloon fund requirement or other objectives
- Investments in different asset classes
  - Derisk market stress and spike
  - Align Cash Availability with Investment Plan
- Determine Rebalancing - subject to asset class volatility and currency movements
- Determine Exceptional rebalancing criteria

ETF based Asset Allocation Review Process



All investment via investment pools such as ETFs or Single Asset Class Portfoli

Tactical Tilts – Satellite Portfolios

Short Term Opportunities

Satellite Portfolios

Traditional View

Core

- Large Cap Broad Market
- Fixed Income

Satellite

- Midcap
- Small Cap
- Foreign Equity

Alternative View

Core

- Right Beta - Exposure to Broad Markets

Satellite

- Midcap
- Foreign Equity
- Focused and Disciplined Alpha Strategies

Alternative View - Satellite Portfolios

- Fools rush In
  - Always develop a disciplined framework to manage the interaction ***between*** satellite investments.
- Most tactical allocations have two main purposes: alpha enhancement and volatility reduction
- Always complementary to your core portfolios
  - Alternative and thematic strategies are designed to have distinctive risk levels to mirror the risk parameters of our core portfolios
  - Evaluating process to determine the optimal implementation strategies

Advantages - Satellite Portfolios

- Better-than-average performance
- Limited volatility & cost with flexible packaging
- Tailored specifically to each clients needs
- Advisor driven short term objectives possible without altering risk attributes

Smart Beta

The Next Level

Some Needs

Market Cap Weighted Indices do not satisfy all investor needs

Sometimes concentrating risk on a limited number of components, cap-weighted indexing may contribute to the volatility

New methods designed to capture the market risk premium is complimentary

Types of Smart Beta

Equal-weighted indices

- Minimises portfolio' s weight concentration
- Does not take into account each component' s respective level of risk
- Used as a component in different enhancement strategies

Fundamental indexing

- Scrap market cap weighting
- Replace with new market measures (PER, Dividend Yield, etc.) for weighting
- Objective: to generate outperformance relative to the market index, regardless of any specific risk or bias created by this methodology

Types of Smart Beta - 2

Basic Risk Based Smart Beta	Advanced Risk Based Smart Beta
• Drastically reduce some risk measures • Improve Diversification • Improve Market Capitalisation based indices by adequately capturing market risk premiums	• Maximize or minimize given ratios or risk indicators • E.g Minimum Variance Index: limit ex-ante volatility • E.g Maximum diversification portfolio / Maximum Sharpe Portfolio

Beta v/s Smart Beta: Should you replace Beta?

- Market Cap Indices are a common representation of the market shared by all investors with certain practical advantages.
  - They require very little rebalancing since the weighting of their components adjusts automatically.
  - Turnover is very limited, generating fewer trading costs.
  - The weighting of components depends on their size, which allows for investment mainly in the most liquid stocks, thus avoiding excessive impact cost or fee.
- Larger purpose of Smart Beta to enhance market cap weights investment pools.
  - Smart Beta allows investors, including institutional investors, to select the beta which best suits them,
  - Vary betas when they would prefer to maintain exposure to traditional cap-weighted indices.

Parting thoughts

- Basic Tenets
  - Core Portfolios - investor must initially select a strategic asset allocation commensurate with his or her investment objectives using broad beta-based investments (i.e., exchange-traded funds [ETFs])
  - Tactical tilts - then selectively add Smart Beta and narrower ETFs' order to add positive alpha to the baseline portfolio
- The results of our analysis have three key observations for investors
  - Manager Selection rather than the skill to isolate particular segments of the market deemed inefficient, that drives the success of a core-satellite portfolio.
    - An investor's ability to identify low-cost, successful managers should determine the portfolio's satellite weighting.
  - Given the favourable risk-return profile of ETFs', all investors benefit from having an index in their portfolio.
    - Unless an advisor has perfect skill—the ability to select funds that **survive and outperform**—the investor is better off with a majority of his or her portfolio an index.
  - Constructing the diversified portfolio
  - An advisor should begin using ETFs' and then consider substituting Smart Beta / active funds for index funds to the extent there is conviction in particular managers or in case of Smart Beta – Product Design.

THANK YOU

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