
So Happy Together: Using ETFs in Combination with Active Managers

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Agenda

- ▶ Defining active and passive
- ▶ Active managers vs ETFs
- ▶ Blending ETFs and active managers together
 - ▶ Core and explore
 - ▶ Portable Alpha
 - ▶ Portfolio completion
 - ▶ What the star ratings tell us
 - ▶ Other specialized examples
 - ▶ How to choose ETFs – A brief guide

Defining Active and Passive

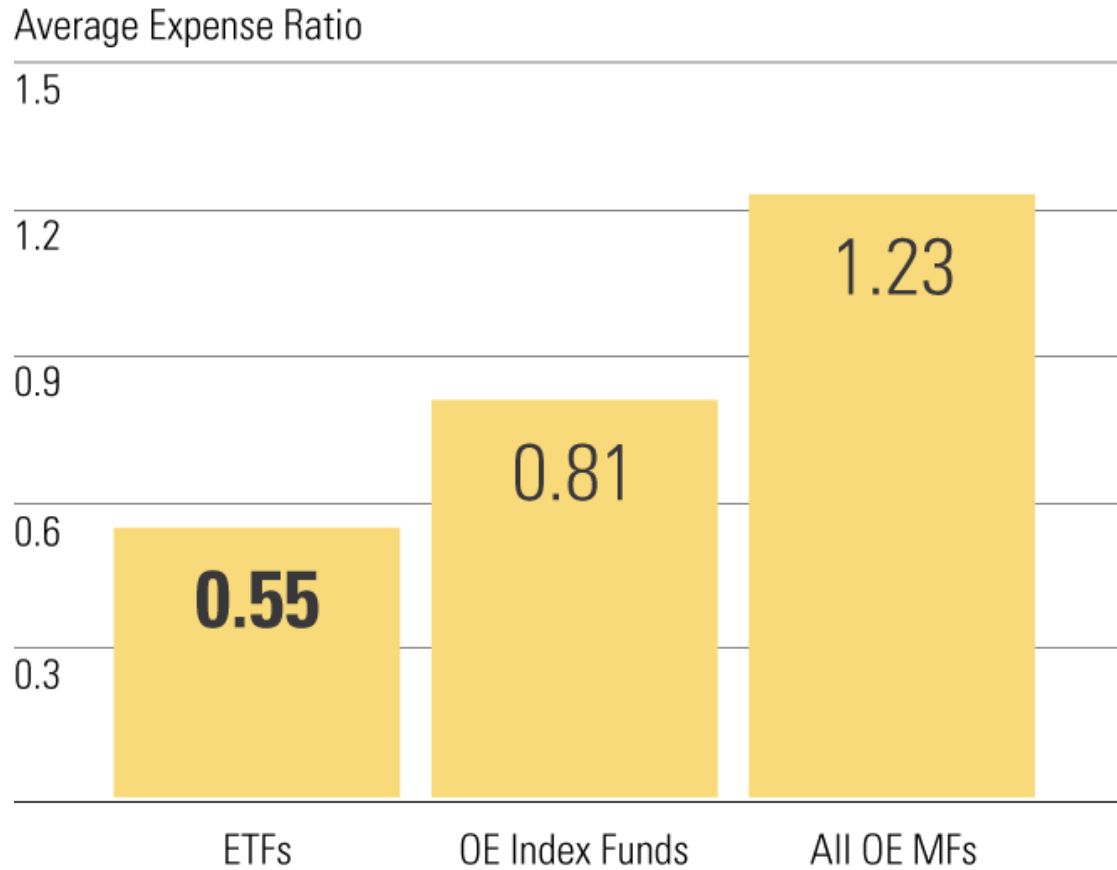
	Active	Passive
Approach Definition	Making specific investments with the goals of outperforming a benchmark	Invest in accordance with a pre-determined strategy that does not entail any forecasting. E.g. mimic an index
Investment Vehicles	E.g. Active mutual funds	E.g. Index ETFs

- ▶ All investing decisions are inherently active, regardless of vehicle

Active Managers vs ETFs

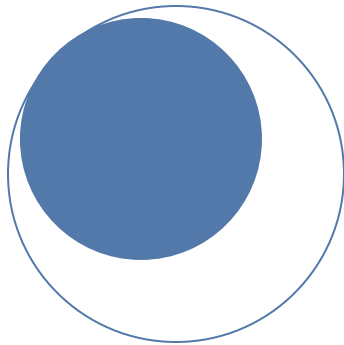
- ▶ Active Managers (Actively managed mutual funds)
 - ▶ Opportunity for outperformance
 - ▶ Potential to reduce risk in uncertain markets
- ▶ Exchange Traded Funds (ETFs)
 - ▶ Lower costs
 - ▶ Trading Flexibility
 - ▶ Consistency of exposure and adherence to guidelines
- ▶ Blended approach ~ attempting to use active and passive investment approaches and vehicles opportunistically to exploit the advantages of both

Key Advantage of ETFs – Low Cost



Using Active Strategies & Index ETFs Together - Core & Explore

Core



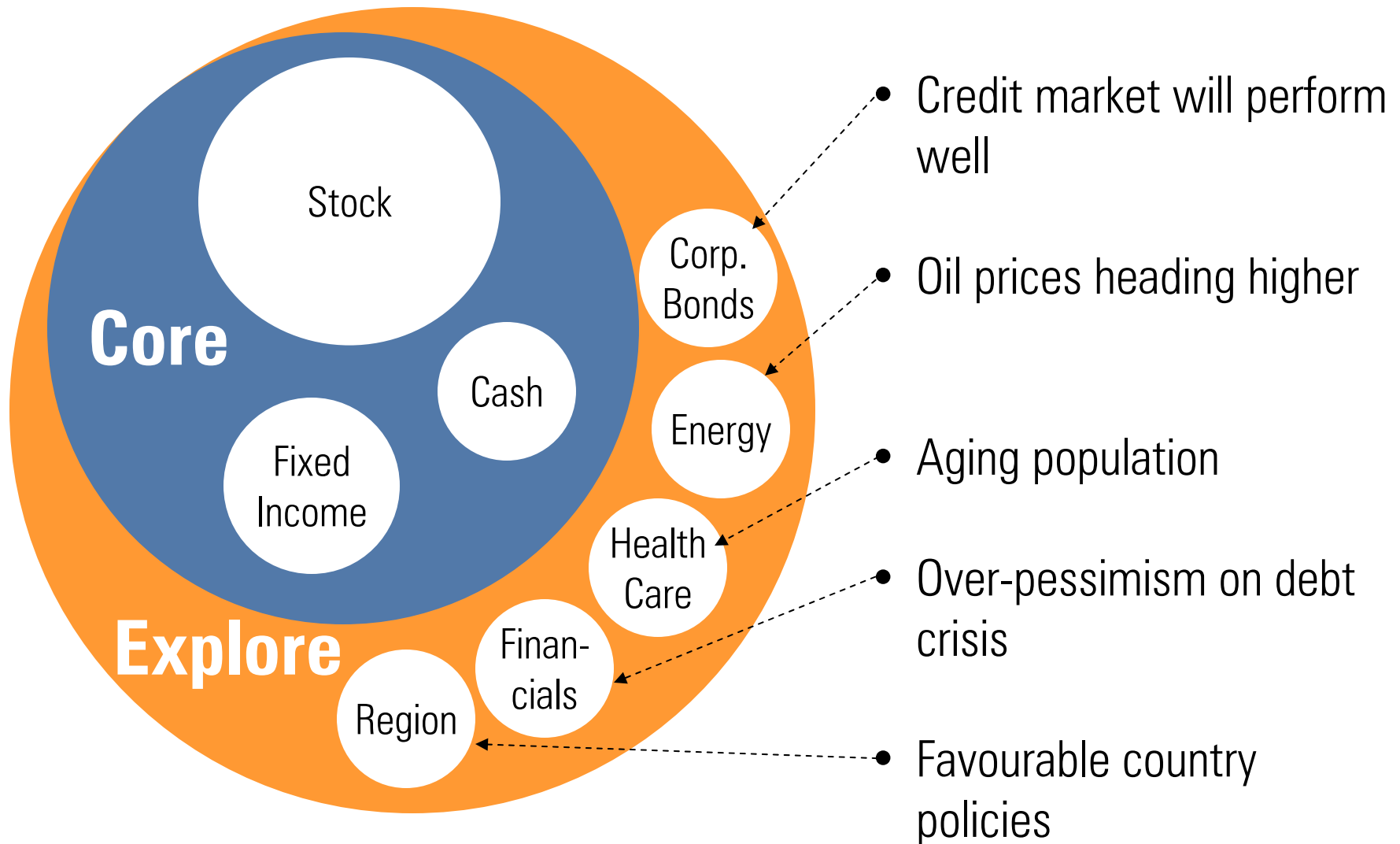
- ▶ Low cost, broadly diversified passive ETFs cover a variety of indexes, making them ideal building blocks for the core of a portfolio

Explore



- ▶ Active mutual funds managers that seek alpha can form an “explore” sleeve to a portfolio
- ▶ Focused, niche ETFs can also be used by a portfolio manager seeking alpha by making tactical tilts

Core & Explore – If you have a tactical view...



Core & Explore Example

Fund	Weight	TER
Core		
Tracker Fund of Hong Kong (2800 HK)	25	0.15
iShares FTSE A50 China Index ETF (2823 HK)	25	0.99
ABF Pan Asia Bond Index ETF (2821 HK)	20	0.19
Explore Equity		
First State Asian Growth Fund	10	1.74
Value Partners China Convergence Fund	10	1.25
Explore Fixed Income		
BlackRock Global Funds – Asian Tiger Bond Fund	10	1.22

Use ETFs to capture performance of overall market at low cost

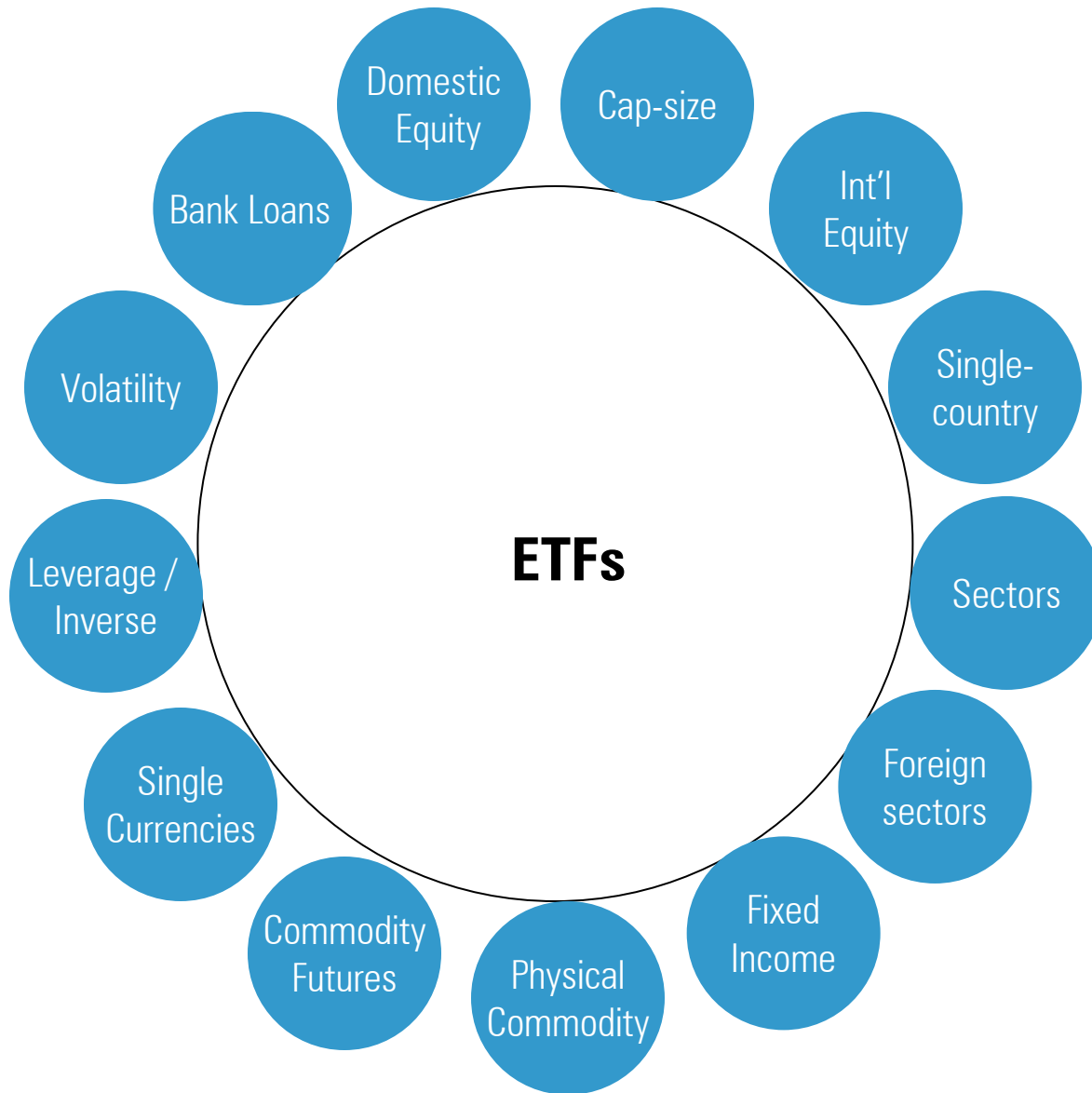
Using active managers to seek out alpha. We used 2010 Fund Award winners as example

* These examples are for illustration purpose only and does not constitute an advice to buy/sell the mentioned funds/ ETFs

Portable Alpha

- ▶ ETFs trade like stocks – you can short-sell
- ▶ “Our best manager and highest conviction bet are in the China A-share market. We now have a 15% weight in China A-share market while our asset allocation plan calls for 10%. We want to keep our exposure to this manager but without throwing off our entire asset allocation.”
- ▶ Sell short 5% in iShares FTSE A50 China Index (2823 HK)
 - ▶ Reduces beta exposure to 10% target without sacrificing alpha

Portfolio Completion - Wide variety of ETFs available



- ▶ ETFs, on a global perspective, covers a broad range of asset classes
- ▶ In Asia, this is growing – more ETFs launched covering more asset classes
- ▶ In January 2012, 13 new ETFs listed on the HKEx; 5 on the Korea Exchange
- ▶ Australian Dollar interest rate, Indonesia, Thailand and Malaysia exposure now available in Hong Kong listed ETFs

Portfolio Completion Example

“We like the active managers that we use but the portfolio’s sector weightings might not be optimal. We’d like to make sure there aren’t any holes in our asset allocation without adding another manager to the mix.”

Say we have a portfolio of Asian funds - Using winners of 2010 Morningstar Hong Kong Fund Awards as an example:

	% Weighting
1 Value Partners China Convergence	40.00
2 First State Asian Growth	30.00
3 Fidelity Asian Special Sits A-USD	30.00

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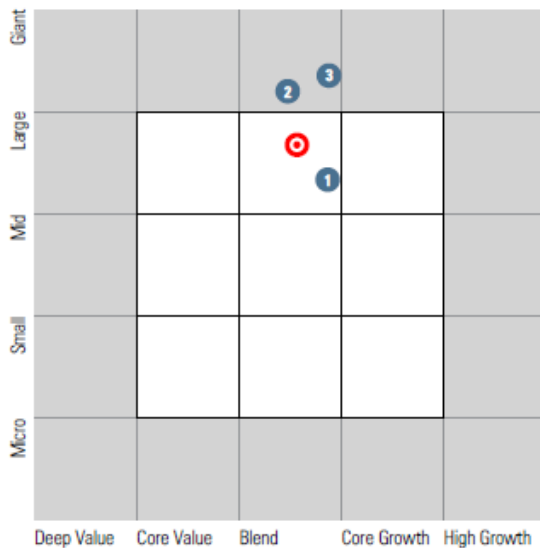
Portfolio Completion Example (cont.)

“...the portfolio’s sector weightings might not be optimal.”

- ▶ In addition to the active funds we like, we want:
 - ▶ ~10% in Asia/China consumer
 - ▶ ~10% in India
 - ▶ But we don’t have active funds that we like in the sector/country

Portfolio Completion Example (cont.)

	% Weighting
1 Value Partners China Convergence	40.00
2 First State Asian Growth	30.00
3 Fidelity Asian Special Sits A-USD	30.00



Equity Sector Breakdown	Portfolio %	Top 10 Country Breakdown	Portfolio %
Cyclical	49.14	China	37.31
Basic Mats	13.21	Hong Kong	21.54
Cons Cyclical	7.67	South Korea	10.98
Financial Svcs	16.32	Taiwan	8.57
Real Estate	11.94	Singapore	5.95
Sensitive	39.67	Australia	3.90
Comm Svcs	9.31	India	3.66
Energy	6.51	Thailand	3.48
Industrials	9.60	Indonesia	1.30
Technology	14.25	Malaysia	0.95
Defensive	11.20		
Cons Defensive	5.80		
Healthcare	2.83		
Utilities	2.57		

Source: Morningstar Direct

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Portfolio Completion Example (cont.)

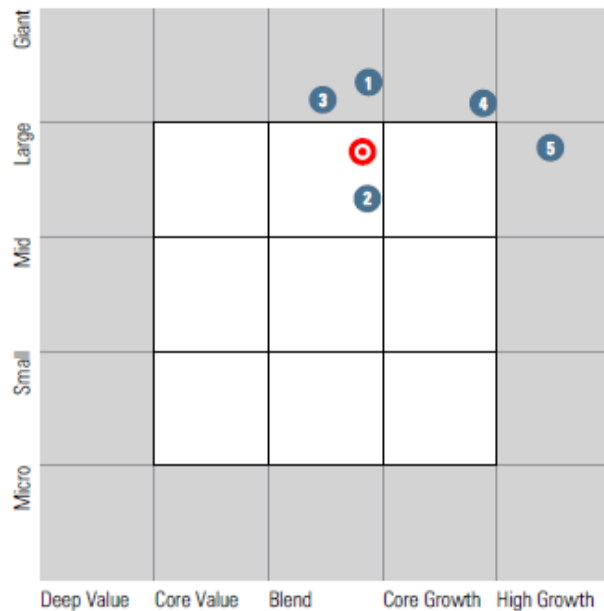
“We’d like to plug those holes, but without adding another manager to the mix”

- ▶ Sell 10% of Value Partners China Convergence
- ▶ Buy 6% of an India index ETF
- ▶ Buy 4% of an ETF that tracks the China consumer sector

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Portfolio Completion Example (cont.)

	% Weighting	% Weighting
1 Value Partners China Convergence	40.00	30.00
2 First State Asian Growth	30.00	30.00
3 Fidelity Asian Special Sits A-USD	30.00	30.00
4 iShares BSE SENSEX India Index ETF (2836 HK)		6.00
5 iShares CSI A-Share Consmr Stpls Idx ETF (2841 HK)		4.00



Source: Morningstar Direct

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Equity Sector Breakdown	Portfolio %	Portfolio %
Cyclical	49.14	45.87
Basic Matls	13.21	11.54
Cons Cyclical	7.67	7.09
Financial Svcs	16.32	16.83
Real Estate	11.94	10.40
Sensitive	39.67	38.44
Comm Svcs	9.31	9.09
Energy	6.51	6.57
Industrials	9.60	8.22
Technology	14.25	14.55
Defensive	11.20	15.69
Cons Defensive	5.80	10.66
Healthcare	2.83	2.33
Utilities	2.57	2.70

Top 10 Country Breakdown	Portfolio %	Portfolio %
China	37.31	34.98
Hong Kong	21.54	18.66
South Korea	10.98	10.61
Taiwan	8.57	8.28
Singapore	5.95	5.75
Australia	3.90	3.77
India	3.66	10.36
Thailand	3.48	3.36
Indonesia	1.30	1.26
Malaysia	0.95	0.82

Risk Management Tools

- ▶ Many new ETFs provide liquid, transparent alternatives to tools that formerly were available as structured product
- ▶ The “slicing and dicing” of the ETF market has provided many precision tools for a host of risks in the portfolio
 - ▶ Duration
 - ▶ Style
 - ▶ Sector
 - ▶ Factor
 - ▶ Credit
 - ▶ Currency
- ▶ Foreseeing more ETF products available in Asia – stay tuned!
 - ▶ RMB quoted ETF to be launched
 - ▶ RMB bond ETF to come?

What can the Stars tell us about ETFs vs. Active Managers?



Average US ETF star rating by style box category

	Value	Blend	Growth
Large	3.1	3.4	3.3
Mid	2.7	3.0	2.9
Small	2.2	2.3	3.2

- ▶ ETFs have done well in growth segments and across large cap, less so in mid and small styles

Source: Morningstar Direct

What can the Stars tell us about using ETFs or active?

- ▶ While ETFs have done well in some niche categories, ETFs have not done as well in other categories

Category	Average star rating
US Financials	2.4
Global Real Estate*	2.0
China Region*	2.8

* Less than 5 ETFs with star ratings

Source: Morningstar Direct

Additional ETF applications

▶ Equitizing Cash

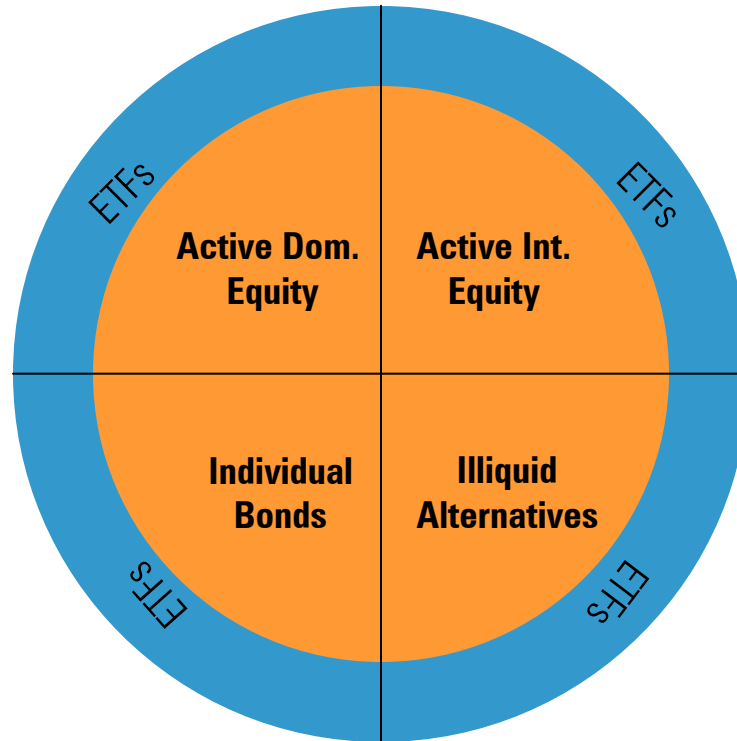
- ▶ Managing cash flows while reducing cash drag
- ▶ Client account not fully funded, yet want to have “beta” exposure in the interim with the available assets – use ETF
- ▶ Portfolio manager keeps ~10% of assets in a diversified and liquid ETF, which he can buy/sell to manage inflows/redemptions
- ▶ Portfolio remains fully invested, despite potentially volatile cash flows into and /or out of the fund

▶ Transition management

- ▶ Portfolio manager leaves or loses capacity
- ▶ ETFs are effective stop-gap solutions in these situations

Additional ETF applications (cont.)

- ▶ Liquidity management
 - ▶ ETFs can offer price improvement over trading the basket of underlying securities, particularly for credit bonds or international stocks



How to Choose ETFs – A Brief Guide

- ▶ Suitability
 - ▶ The best uses of the product in an investor's portfolio depending on economic circumstances, portfolio focus, and investment outlook
- ▶ Fundamental View
 - ▶ Underlying macroeconomic fundamentals that will affect the product's performance
- ▶ Index Construction
 - ▶ Examine the nuances of the underlying index
 - ▶ E.g. weighting methodologies, caps, free float adjustments, re-balancing and review periods, dividend treatment, and eligibility criteria, etc.

How to Choose ETFs – A Brief Guide

- ▶ Product Construction
 - ▶ How the product is built to replicate or otherwise provide the performance of its reference index or asset
- ▶ Costs
 - ▶ Total cost of ownership – including fees, transaction costs and holding costs
 - ▶ Examine the all-in expense ratio and how that compares to peers
- ▶ Or... an easier way – Morningstar Direct
 - ▶ Morningstar ETF Analyst Reports
 - ▶ Portfolio X-rays of ETFs and mutual funds
 - ▶ And a lot more features...

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