What is the Alternative? Using ETFs to Diversify Portfolios

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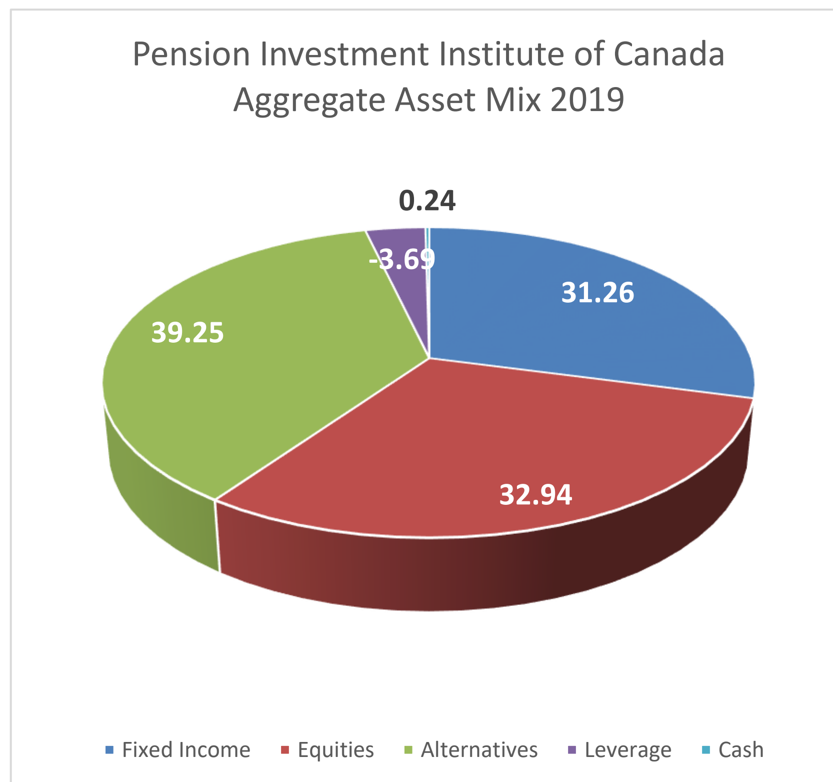
The traditional 60/40 asset mix was conceived in the 1980s when interest rates were higher and life expectancy was shorter. Current low interest rates, however, have changed portfolio construction assumptions for all investors. Today's portfolios have reduced allocations to bonds and increased allocations to equities.

More sophisticated investors like Institutions have extoled the virtues of Alternatives as essential portfolio diversifiers. But what are Alternatives, are they suitable for investors and what investment or operational risks do they pose?

The most recent Pension and Investment Institute of Canada (PIAC) Asset Mix Report shows the degree to which Institutions have reshaped the traditional 60/40 portfolio:



The largest allocations in the Alternative categories are as follows:

Asset	Allocation
REAL ESTATE	11.97%
INFRASTRUCTURE	7.52%
PRIVATE EQUITY	12.82%
PRIVATE DEBT	1.78%

Source: (Pension and Investment Institute of Canada (PIAC) Asset Mix Report Dec 31 2019)

There are several attractions to Alternative assets, not the least of which is that they do not mark-to-market, and thus should not show some of the dramatic swings which may afflict publicly traded assets during market corrections.
In addition, Real Estate, Infrastructure and Private Debt may provide higher yield than publicly traded Investment Grade Debt, and thus help to diversify some of the traditional Fixed Income risk in a portfolio.

It is little surprise that many Family Offices and Investment Counselling firms, as well as traditional brokers, are aching to use Alternatives too.

It is important to recognize the structural difference between asset owners like pensions and endowments, on the one hand, and Investment Counselling / Family Offices on the other. Asset owners have very long investment horizons, often stretching several decades, and their decisions are based on sophisticated Asset-Liability models.
Family Offices and Investment Counselling firms, however, have clients with shorter investment horizons and whose decisions may be motivated as much by emotions as by long-term considerations.

Acknowledging these fundamental differences, it is important to ask how Alternative investments, and their intended benefits, can be integrated into portfolios for individual investors. Are there ways to capture the essence of the Alternative intended exposures through Exchange Traded Funds?

Goldilocks Choices

It is important to state from the outset that the Alternatives game is not played on a level playing field. What is accessible to large Institutions like CPP, la Caisse de Depot or AIMCo is beyond the scope of most Institutional investors. Direct holdings, with in-house capabilities to structure arrangements and to administer holdings, are not possible for smaller Institutional investors.

As a result, smaller Institutions use Pools to access Alterative assets, resulting in manager risk, liquidity risk and scalability constraints. The larger Institutions have the expertise and the Capital to identify the most desirable targets; the rest are available for investment Pools. Returns in Alternatives are highly idiosyncratic.

Capturing the Intent

Investment Counselling and Family Office firms can achieve the same objectives as Institutions, but with greater flexibility and potentially at lower cost, through ETFs. ETFs may have practical advantages to achieve similar diversification, growth and yield objectives, such as scalability, tradability and transparency, important considerations which may not be available when examining Alterative Pooled investments for Physical Real Estate, Physical Infrastructure and Private Debt or Private Equity.

Exchange Traded Funds can capture the liquidity or risk premia associated with Alternative investments without any operational restrictions.

Physical Real Estate:

This asset class has grown exponentially in recent years, with many Physical Real Estate investment Pools having been launched. Real Estate has had a lower volatility than equities, over time, but there have been a few difficult episodes.

Not so long ago, in Autumn 2008, one of Canada's largest physical Real Estate funds had to institute a freeze because they could not sell buildings fast enough to meet redemptions. There are several other periods when Real Estate has experienced noticeable corrections, so it makes sense to be prudent about the liquidity risk in physical exposures.
Publicly traded REITs provide the attractive yield associated with the asset class, with opportunities for growth through an economic cycle, but with transparency, scalability and liquidity which is vital for smaller Institutions like Investment Counsellors and Family Offices.

ZRE (BMO Equal Weight Canadian REIT Index ETF), holds 22 REITs, equally weighted, diversified across Residential, Retail, Industrial and other sectors to ensure broad exposures. The equal weight index is an important consideration for several reasons:

- Equal weighting avoids concentration risk which occurs in Market Capitalization indices, forcing diversification equally across all constituents;
- The Equal Weight exposure captures the Size Factor, which has been shown to provide outperformance across business and economic cycles;
- An Equal Weight Index tends to have a higher dividend Yield because higher yields are associated with lower priced companies. Providing equal exposure to all constituents has the desirable by product of generating higher Yield than a Market Cap exposure.

Infrastructure:

Physical Infrastructure presents some of the same dilemmas as physical Real Estate, though with less volatility. On the flip side, Infrastructure's inherent stability, its main attraction, means that it does not have the same long-term return potential as Real Estate.

ZGI (BMO Global Infrastructure Index ETF), uses the Dow Jones Brookfield Index to gain exposure to 47 publicly traded Infrastructure companies. The Index displays very low correlation to core Canadian and US equities and provides admirable yield.

In addition, ZGI scores in the 95th percentile for ESG scores, so it would also be suitable on that basis. (Source: MSCI, Mar 31 2021)

Private Equity:

Private Equity is a growth asset which should deliver superior returns to compensate for its liquidity constraints (the liquidity premium). Pooled exposures often have explicit holding periods which may not always be suitable for all investors, but the growth potential Private Equity presents may be captured in several equity exposures which are readily available in Exchange Traded Funds, without capacity or liquidity limitations, and potentially at a much lower cost.

The S&P 600 Small Cap Index has outperformed the Russell 2000, its rival Small Cap benchmark, by a significant margin over the long-term (Bloomberg, Dec 31 2020). It doesn't require a complicated attribution to understand why – the S&P 600 has an explicit profitability screen which insists all constituents must have positive earning for the preceding four Quarters. This captures the Quality Factor and eliminates laggards which would otherwise be a drag on long-term performance.

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Small Cap can deliver the growth aspirations investors seek in Private Equity, but without any lockup periods or capacity issues. Significantly, and rather surprisingly, this exposure displays a lower *Beta* than its large Cap counterpart – the S&P 500 (see below).

Similarly, S&P 400 US Mid Cap provides the same diversification properties found in the Small Cap realm and may be implemented through ZMID. An important distinction, however, is that Mid Cap companies have moved up in the capitalization range, displaying a resilience and providing greater market depth, so enhancing liquidity and tradability.
Another Private Equity proxy is ZEM (BMO MSCI Emerging Market Equities). With a Yield approximately 1/3 higher than the S&P 500 and with strengthening demographic and fiscal foundations, Emerging Market equities provide scalability and liquidity while measuring up to the growth potential investors seek in Private Equity.

Private Debt:

Private Debt metrics may be recreated using ZEF (BMO Emerging Markets Bond Hedged to CAD Index ETF), or ZFH (BMO Floating Rate High Yield ETF).

ZEF uses a Debt-to-GDP Weighted index which favours countries with low debt but high economic productivity to support their indentures. This weighting methodology creates an exposure which is, surprisingly, 72% Investment Grade. The Index is limited to US-Pay bonds, so they are more stable than local currency issues.

ZFH is unique because it sells a Markit CDX to earn the risk premium on Floating Rate and High Yield issuers. Because it does not hold physical bonds, it does not have the liquidity risks associated with High Yield or Floating Rate debt, yet still captures the credit premium investor seek in the asset. Given that the instrument provides default coverage through a Clearinghouse, there is ample capacity to provide scalability.

Conclusion

Traditional 60/40 portfolios may be archaic reference points in a low interest rate environment, so Alternatives are very attractive additions to portfolio construction. Large Investment Counselling firms or Family Offices may want to consider Exchange Traded Funds to achieve the same diversification benefits Alternatives provide because some ETFs provide similar diversification benefits, fully liquid, without prescribed holding periods, at competitive cost.
Faced with Goldilocks choices, a middle decision which captures the intent Alternative promise may be just right.

APPENDIX

Ticker	Asset	Correlation to S&P/TSX	Correlation to S&P 500	*Beta / Duration*	Yield
ZRE	Equal Weight Canadian REITs	0.72	0.54	0.94	4.58%
ZGI	Global Infrastructure	0.44	0.33	1.01	3.48%
ZSML	US Small Cap Equity			0.75	1.05%
ZMID	US Mid Cap Equity			0.70	1.12%
ZEM	MSCI Emerging Markets	0.64	0.64	0.96	2.09%
ZEF	Emerging Market Sovereign Bonds	0.59	0.48	4.93	5.75%
ZFH	Floating Rate High Yield	n/a	n/a	0.23	4.55%

Source: BMO Global Asset Management, 5 April 2021

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	25-Year Return	25-Year Std Deviation
S&P Midcap 400 Index	11.45%	16.96%
S&P SmallCap 600 Index	10.52%	16.36%
S&P 500 Index	9.56%	17.71%

Annual % Returns (best return each year highlighted in yellow)	S&P 500 Index	S&P Midcap 400 Index	S&P SmallCap 600 Index
1996	22.96	19.25	21.32
1997	33.36	32.25	25.58
1998	28.58	19.12	-1.31
1999	21.04	14.72	12.4
2000	-9.1	17.51	11.8
2001	-11.89	-0.61	6.54
2002	-22.1	-14.53	-14.63
2003	28.68	35.62	38.79
2004	10.88	16.48	22.65
2005	4.91	12.56	7.68
2006	15.79	10.32	15.12
2007	5.49	7.98	-0.3
2008	-37	-36.23	-31.07
2009	26.46	37.38	25.57
2010	15.06	26.64	26.31
2011	2.11	-1.73	1.02
2012	16	17.88	16.33
2013	32.39	33.5	41.31
2014	13.69	9.77	5.75
2015	1.38	-2.18	-1.97
2016	11.96	20.74	26.56
2017	21.83	16.24	13.23
2018	-4.38	-11.08	-8.48
2019	31.49	26.2	22.78
2020	18.4	13.66	11.29
% of Time Best Annual Performer	**44%**	**28%**	**28%**
25-Year Annualized Return	**9.56%**	**11.45%**	**10.52%**
25-Year Standard Deviation	**17.71%**	**16.96%**	**16.36%**

Source: **Mighty Midcap ETFs** March 29, 2021Craig Israelsen, ETF.com

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