ETF Portfolio Optimization
A Fresh Approach for Meeting Investor Needs
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What are the optimal ways to build portfolios? Which investment vehicles should investors use? With both individual and institutional investors increasingly turning to ETFs as solutions, are there still ways to capture excess returns? We sat down with three of the ETF industry’s thought leaders, to sort out some answers to these questions.

“Portfolio optimization has three aspects,” observes Shundrawn Thomas, Managing Director and Head of Exchange Traded Funds Group at Northern Trust. According to Thomas, the starting point of the optimization process is to make sure the portfolio has defined investment objectives. Any investment strategy must align with these goals. The second element concerns risks: are investors being adequately compensated for the risks they are assuming? Moreover, what is the investor’s risk tolerance, and what risks is the portfolio exposed to? The third and final element concerns implementation: is the investment strategy being applied efficiently in terms of cost and execution?

Creating a Framework
“Creating a Framework” Thomas adds. This framework acknowledges that virtually all investors share a handful of common concerns: growing their assets, managing risk, managing liquidity, and finding ways to generate income. “It doesn’t matter if they are institutions or individuals or their advisors, investors are focused on these topics,” says Thomas.

And all these topics relate to ETFs: there are reasons investors are turning to these vehicles in an effort to advance their investment objectives. ETFs may offer unparalleled diversification, transparency, liquidity, cost efficiency, and in most cases, tax efficiency. However, there are nuances to these basic principles, and they are evolving fast. As the number of benchmarks and types of ETFs grows, a deeper understanding of the structures and products can help investors to identify the most appropriate ETFs to pursue their objectives.

Evolution of ETFs
“ETFs were originally a trading tool, and a way to gain market exposure where investors had limited access and knowledge,” explains Deborah A. Fuhr, Managing Partner & Co-founder, ETFGI. Today, ETFs are being used differently, such as for long-term strategic purposes including portfolio completion and rebalancing. According to Fuhr, the average holding period is much longer and the universe of investors much broader than in the past. Additionally, ETFs were predominately based on traditional indexes; today there are new types of ETFs that reflect new asset classes and investment approaches. These innovations include ETFs based on alternatively weighted indexes, as well as actively managed products. “These open up a wide set of options to investors building portfolios using ETFs,” says Thomas.

Accessibility, Liquidity
All ETFs—new or traditional—share a common characteristic that makes them attractive to investors: they are among the few products in which the same tool box is offered to institutional and individual investors and advisors alike, and at the same minimal cost. “ETFs are accessible in nature. And having many investors enter at the same price point impacts the liquidity of the product in a positive way,” Thomas says.
“An ETF is only as liquid as its underlying securities,” explains Reginald M. Browne, Managing Director, KCG Holdings. An ETF based on U.S. large caps will therefore be much more liquid than an ETF representing frontier market debt. Hence, Browne advises that it is important to understand the characteristics of the underlying holdings, the asset classes they represent, and the depth of those markets, when formulating expectations about the liquidity of a particular ETF.

**Capturing Excess Returns Using ETFs**

When building portfolios, investors historically thought in terms of active versus passive investments. A parallel discussion was alpha (simply defined as excess returns), versus beta or market returns. Because they were based on market indexes, ETFs were traditionally classified as passive or beta products, with investors turning to active investments in search of alpha. However, this classification is less relevant today, particularly given the evolution of ETFs.

“Investors aren’t concerned about jargon, what they care about is clear and defined market exposure at an efficient price,” says Thomas. ETFs can meet this aim. Investors also care about capturing excess returns, and being appropriately compensated for risks. Newer types of ETFs can pursue these objectives as well.

**Specific and Composite Risk**

As Thomas points out, a portfolio faces two types of risks, which he terms as specific risk and composite risk. Specific risks include currency, credit and interest rate risks; investors demand to be compensated for these exposures. Composite risks are those investors wish to mitigate or avoid, such as tail risk or liquidity risk. For example, our FlexShares ETFs attempt to compensate investors attractively for specific risks, while at the same time seeking to mitigate composite risks.

“We use the term ‘flexible indexing’ to describe our approach,” says Thomas. These are products engineered to provide targeted portfolio exposure while capturing excess returns. FlexShares ETFs, managed by Northern Trust, offer alternatively weighted index strategies that seek to address real world investor needs, such as generating income.

**New Ways of Thinking**

“We find that investors’ views on income are evolving,” says Thomas. For instance, investors traditionally looked at income generation through the lens of fixed income. Today, the focus is on what Thomas terms “reliable income.” High dividend-paying stocks, can be a source of reliable income. FlexShares engineered ETFs attempt to meet income needs in an otherwise demanding interest rate environment, while simultaneously pursuing investors’ desire for growth.

ETFs are playing an increasingly prominent role in portfolio construction and optimization. Thomas expects even greater utilization of alternatively weighted ETF strategies that are designed to meet changing investor needs.

The success and continuing growth in enhanced index strategies is driven by the accessible nature of ETFs, allowing investors to gain entry to a variety of asset classes in a liquid and low-cost format. The potential for excess returns offered by these products is another key driver.

*Before investing, visit [http://www.flexshares.com/prospectus](http://www.flexshares.com/prospectus) to obtain a prospectus that includes the investment objectives, risks, fees, expenses and other information you should read carefully and consider carefully. Foreside Fund Services, LLC, distributor.*
Investment in FlexShares Quality Dividend Index Fund, FlexShares Quality Dividend Defensive Index Fund, FlexShares Quality Dividend Dynamic Index Fund, FlexShares International Quality Dividend Index Fund, FlexShares International Quality Dividend Defensive Index Fund, and FlexShares International Quality Dividend Dynamic Index Fund is subject to numerous risks including loss of principal. Highlighted risks: dividend (issuers of underlying stock might not declare a dividend, or dividend rate may not remain at current levels); concentration (more than 25% of assets in a single industry); currency (foreign currencies may fluctuate in value relative to the U.S. dollar, adversely affecting IQDE, IQDF & IQDY investments); emerging markets (countries potentially less liquid and subject to greater volatility); foreign securities (IQDE, IQDF & IQDY typically invest at least 80% of assets in ADRs and GDRs); small cap stock (smaller company stock may be subject to more abrupt/erratic market movement than larger companies); and volatility (volatility may not equal target of Underlying Index). See prospectus for full description of risks.

Definition of Beta
A statistical measure of the volatility, or sensitivity, of rates of return on a portfolio or security compared to a market index. The beta for an ETF measures the expected change in return of the ETF relative to the return of a designated index. By definition, the beta of the Standard & Poor’s (S&P) 500 Index is 1.00. Accordingly, a fund with a 1.10 beta is expected to perform 10% better than the S&P 500 Index in rising markets and 10% worse in falling markets.