19thAnnual Real Property, Trust & Estate Symposia of the American Bar Association

The Insurance and Financial Planning Committee Presents:

The Ins, Outs and Basics of ETF Investing for Individuals and Fiduciaries

May 1, 2008, Washington, DC

The Ins, Outs and Basics of ETF Investing for Individuals and Fiduciaries

Moderator:
Susan M. Harmon
Susan M. Harmon & Associates
Bala Cynwyd, PA

Panel:

Lara Roman	**Alison S. Wood**	**Mark R. Parthemer**
iShares Barclays	**Merrill Lynch Trust Co.**	**Bessemer Trust**
New York, NY	Wilmington, DE	Palm Beach, FL

The Ins, Outs and Basics of ETF Investing for Individuals and Fiduciaries

I. ETF Basics – Lara Roman

II. Modern Portfolio Theory and the Prudent Investor – Mark R. Parthemer

III. Portfolio Construction with ETFs – Alison S. Wood

IV. Case Studies – Three Thoughtful Uses of EFTs - Panel

I. ETF Basics – Lara Roman

II. Modern Portfolio Theory and the Prudent Investor – Mark R. Parthemer

The Wisdom Behind the Adage: Concentration to make wealth; diversification to preserve it.

Understanding the Prudent Investor Act

- **As adopted in 44 states and DC, there are four fundamental tenets:**
  - **Entire investment portfolio considered when determining the prudence of an individual investment. Individual investment losses not a breach so long as the investment was consistent with overall portfolio objectives.**
  - **Diversification required for prudent fiduciary investing.**
  - **No category or type of investment is deemed inherently imprudent. Instead, suitability to the trust account's purposes and beneficiaries' needs is the determinant. Fiduciaries are permitted/encouraged to develop greater flexibility in overall portfolio management, but speculation and outright risk taking are not sanctioned.**
  - **Fiduciary may delegate investment management and other functions to third parties.**

Understanding Modern Portfolio Theory

- **Rational investors will use diversification to optimize their portfolios, as markets do not reward for financial risks that can be managed.**
- **The model assumes that investors are risk averse, thus:**
  - **Given two assets that offer the same expected return, investors will prefer the less risky one.**
  - **An investor will take on increased risk only if compensated by higher expected returns. Conversely, an investor who wants higher returns must accept more risk.**
  - **The implication is that a rational investor will not invest in a portfolio if a second portfolio exists with a more favorable risk-return profile.**

Understanding Modern Portfolio Theory

- **Risk, in this model, is the standard deviation of the portfolio's return.**
- **Managing risk is not elimination of risk.**
- **The efficient frontier is a collection of portfolios, each one optimal for a given amount of risk. A quantity known as the Sharpe ratio represents a measure of the amount of additional return a portfolio provides compared to the risk it carries.**
- **The Steve Akers theory of golf:**
  - **manage risk (volatility), not return (expectation of future).**

Understanding Modern Portfolio Theory

- **Company specific risk**
  - **Managed by exposure to among securities in the same asset class**
  - **Think Enron**
- **Market risk**
  - **Managed by exposure among several uncorrelated asset classes or sectors**
  - **Think "tech bubble"**

Employing "hedge" strategies that protect against market volatility also may reduce both types of risk.

5 Key Financial Terms

1. Alpha - **a measure of residual risk of an investment relative to some market index.**

2. Beta - **the sensitivity of a stock's returns to the returns on some market index (1 = index).**

3. Correlation - **the interdependence between pairs of variables.**

4. Volatility - **standard deviation.**

5. Reversion to mean - **the statistical phenomenon stating that the greater the deviation of a random variate from its mean, the greater the probability that the next measured variate will deviate less far.**

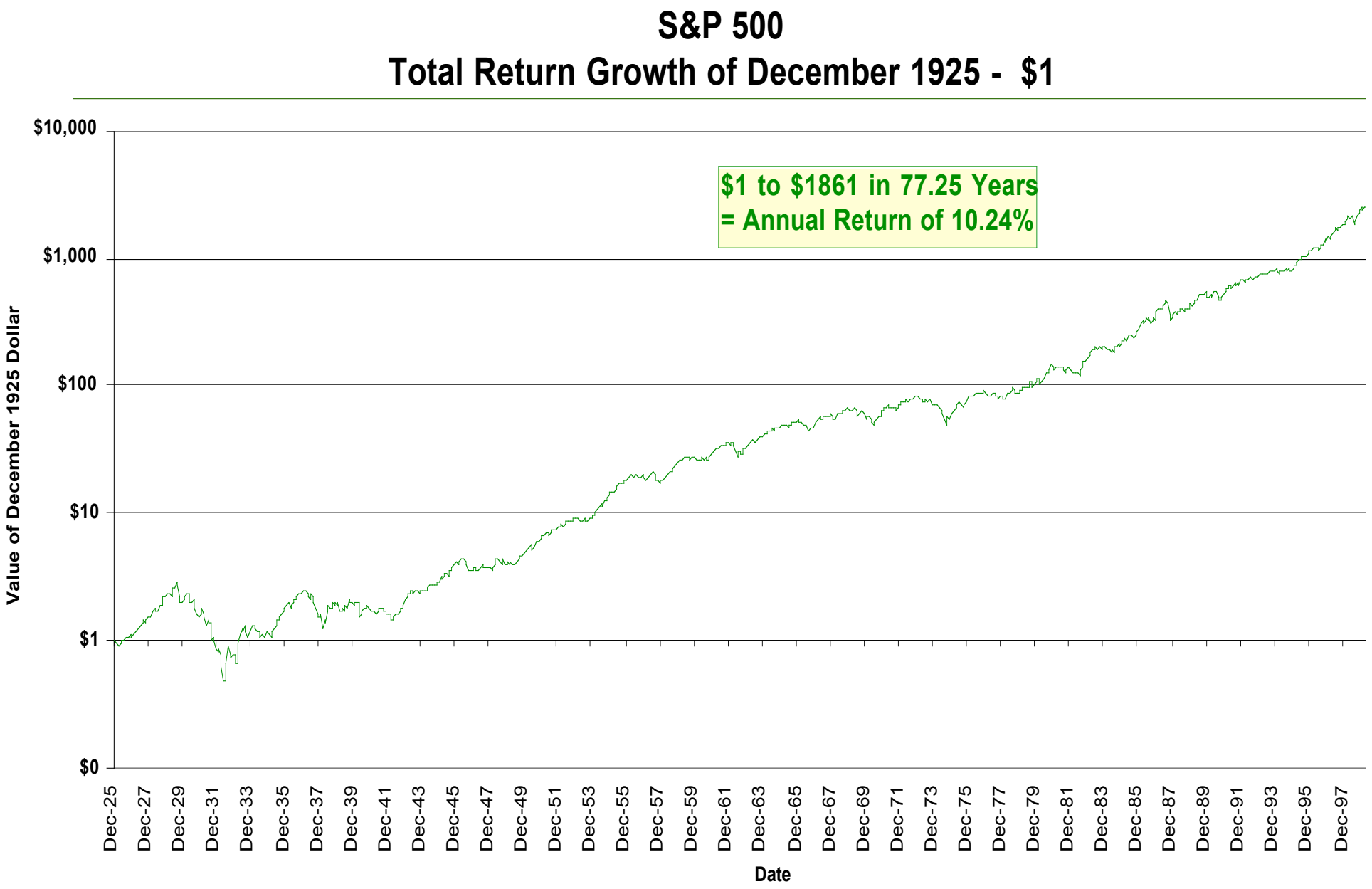
Reversion To Mean

- **Although this phenomenon appears to violate the definition of independent events, it simply reflects the fact that the probability function of any random variable, by definition, is nonnegative over every interval and integrates to one over the interval:**

$$\int_{\mu-i}^{\mu+i} P(x)\,dx > \int_{\mu-j}^{\mu+j} P(x)\,dx$$

- **Example: Shaquille O'Neal, 52.4% NBA career free throw average, shoots and makes 1 free throw a day for 99 consecutive days. Does he have a better than 52.4% chance of making the shot on day 100?**
- **Better chance than Rick Barry (90% NBA career FT avg) assuming he missed the shot on each of the 99 days?**

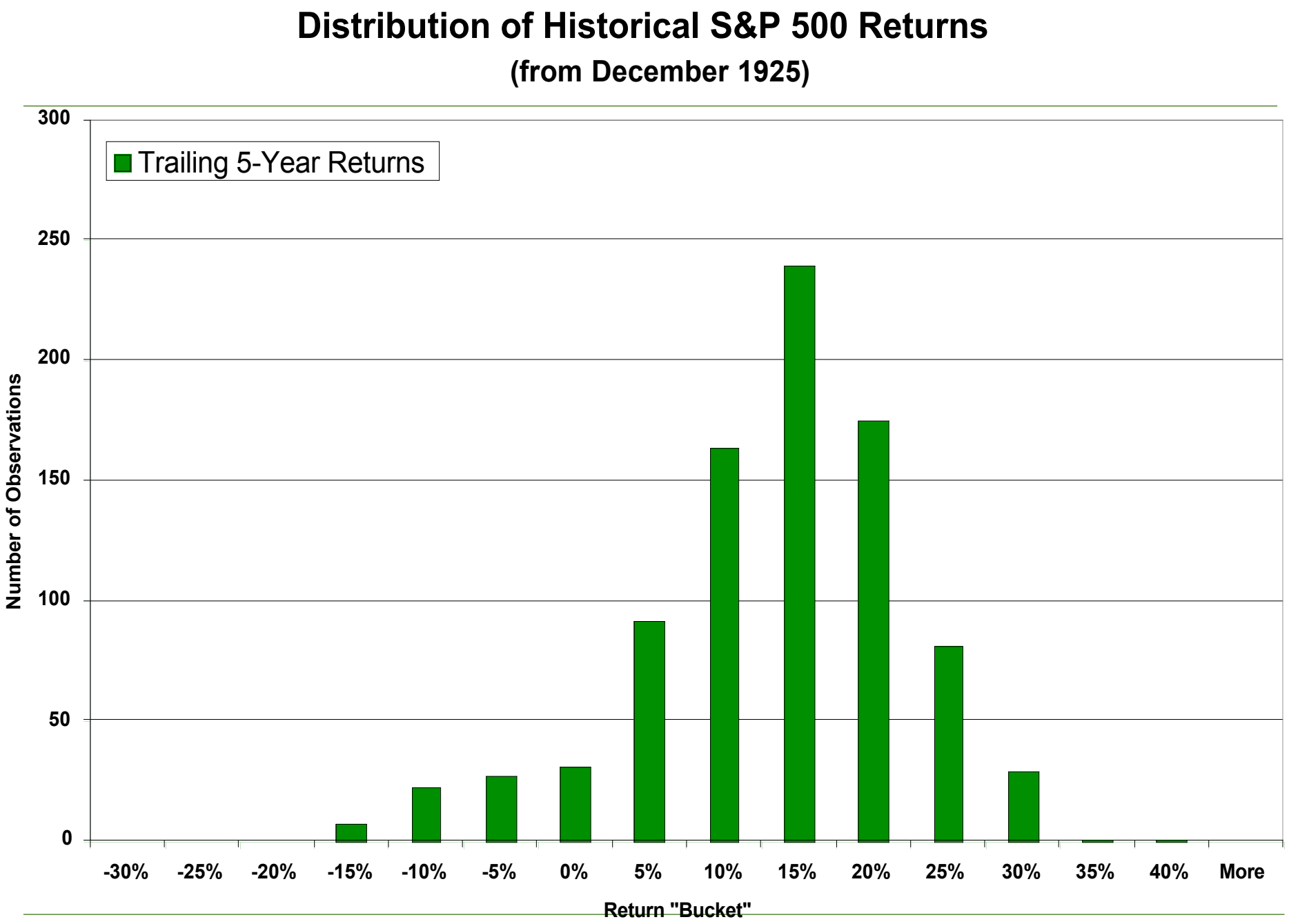
Assets are generally described in terms of long term return expectations



The metric to measure this variability is standard deviation or "volatility"

Trailing 5 Year Annualized Volatility

But.. these returns can vary significantly depending upon the time period



Satisfying the Obligation to Manage Risk with ETFs

- **Many ETFs, and the ETF (SPR), are cap weighted.**
  - **Problem can be that as stock price surges or wanes beyond standard deviation, one buys when would rather sell (or hold) and one sells when it may be better to buy.**
  - **Reconciliation when value reverts to mean.**
- **ETFs currently are passive only. SEC now considering whether to permit actively managed ETFs.**

Indexing – Passive vs. Active Management

- **Indexing can be a sound strategy, in certain cases for certain purposes…**
- **… but its drawbacks mean it is not a panacea.**
- **The key question: Can active managers add value?**

Annualized Returns 10 Years Ended December 31, 2006	
Average U.S. Large Cap Fund	+7.2%
S&P 500 Index	+8.4%

Based on Lipper Large Cap Universe consisting of more than 2,100 funds.
Source: Lipper, Standard & Poor's

Changing Constituents Of S&P 500 Index

Of the 500 companies in S&P 500 Index as of 1997, only 269 are still in the index today.

- **Various factors lead to deletion, including:**
  - **Acquisitions** (e.g., First Chicago, Georgia Pacific, Grumman, GTE, Household International, Lotus, Nynex, Quaker Oats, Scientific Atlanta, Texaco, Unocal, Upjohn, Warner-Lambert)
  - **Financial difficulty** (e.g., Bethlehem Steel, Delta Airlines, Enron, Kmart, MCI, Nortel, Pan Am, Polaroid, US Airways, Wang Labs, Winn-Dixie, WR Grace, Zenith)

Source: FactSet, Standard & Poor's, Bessemer Trust

Academic Study Regarding Active Management

- **Professors from Yale School of Management studied performance of 2,650 U.S. equity mutual funds from 1990 to 2003.**

- **Research reached three notable conclusions.**

Study by Martijn Cremers and Antti Petajisto published August 7, 2006
Source: Yale School of Management

Yale School of Management Study: Conclusions

- **Portfolios closely tracking index weightings generally underperform.**
  - "Closet indexing tends to destroy value."
  - Described 7% of non-index fund assets in 1995 and 32% in 2003.

- **On the other hand, high tracking error hurts performance too.**
  - Generally achieved through sector rotation strategies.
  - "Factor bets tend to destroy value."

- **To win, portfolio managers must develop convictions and emphasize those holdings**.
  - "Active stock pickers tend to create value for investors."
  - "The funds with the highest Active Share significantly outperform their benchmark indexes, while the funds with the lowest Active Share underperform."

Study by Martijn Cremers and Antti Petajisto published August 7, 2006
Source: Yale School of Management

A Summary:

1. ETFs are viable vehicles to assist the passive investor achieve diversification.

2. Frequently less expensive and more tax efficient than mutual funds.

3. Not necessarily a "safe harbor" as one must expend diligence in selecting one or more ETFs. Consider if the fund itself properly diversified. Two examples: a Russia ETF is 44% in 3 stocks – concentration issue? A China ETF is 42% financials – is this China's strength?

III. Portfolio Construction with ETFs – Alison S. Wood

IV. Case Studies – Three Thoughtful Uses of ETFs

1. **Income Tax Loss Harvesting – Planning around wash sale rules without losing asset class exposure.**

2. Single or Correlated Asset GRATs – Coordinated investment and estate tax planning for mid-net worth individuals and clients whose portfolios are already diversified.

3. Core/Satellite strategy and individual security risk reduction.

19thAnnual Real Property, Trust & Estate Symposia of the American Bar Association

The Insurance and Financial Planning Committee Presents:

The Ins, Outs and Basics of ETF Investing for Individuals and Fiduciaries

May 1, 2008, Washington, DC