EXCHANGE-TRADED FUNDS

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Experts aim to catch ETFs on the way up, not down

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It used to be relatively easy to buy exchange-traded funds. No doubt the wild market drops over the past month are complicating that decision at some portfolio management firms.

Ordinarily, determining the optimal time to buy a specific ETF requires sophisticated, global-oriented strategies, approximating a fine science.

"We look around the world for the best risk-return tradeoffs," says Tyler Mordy, the president and chief investment officer of Forstrong Global Asset Management Inc. in Toronto. Mr. Mordy is widely recognized as a leading independent ETF expert.

Mr. Mordy, who described the current market gyrations as "a normal correction in an ongoing bull market," explains that his company's strategies for determining when to buy an ETF involve analyzing global economic, political and other factors impacting various countries and industries.

"The winner in all this is the individual investor, who is the end client for us. The ones who are winning for clients, so to speak in portfolio management, are those portfolio managers who have a good macro investment process to know where to place the money," he adds.

Forstrong takes two approaches to ETF selection and timing that it views as symbiotic.

1) Assess macro fundamentals

The first approach studies the underlying macro-economics affecting an ETF, and the countries, companies, sectors and themes that comprise that ETF.

To determine whether investors should commit to an ETF of a particular country, for example, "we're looking at factors like the commodity intensity of the economy. Are they a net commodity importer or a commodity exporter? We're looking at demographics. How young is the population? We're looking at levels of credit. There's a whole swath of data points that we're researching," Mr. Mordy explains.

Also scrutinized are economic output, including manufacturing and production, price level stability, leading economic indicators, such as capital flows, liquidity conditions, and sector and industry supply and demand.

"I'll give you a quick example. For some time, we've been hearing that China is supposed to crash – both economically and from a financial perspective. So what our team does is dig through the research. The market consensus is often wrong, so we're looking to uncover a different perspective," he explains.

In this instance, Forstrong concluded that China is in the process of rebalancing away from cheap exports and instead focusing on stimulating its consumer economy. Reaching this conclusion involved analyzing the makeup of that country's debt, as well as taking a detailed look at the overall balance sheet of the Chinese economy, including a mix of government, corporate and household data.

"The Chinese have a whole lot of savings. When you look at it from an overall balance sheet perspective, the debt doesn't look as ominous," explains Mr. Mordy.

The makeup of China's stock market is also rapidly changing, and January of 2017 saw the most initial public offerings for any month in the market's history, he adds. As a result of such developments, the Chinese stock market will come to more closely resemble the underlying economy as a whole, rather than being dominated by state-owned enterprises.

Chinese equities, including ETFs, have much room to be revalued upward, he elaborates in explaining why this could be a good time to buy.

At the corporate and sector level, Forstrong studies earnings, profitability, productivity and capacity utilization rates, and inventory levels, among other factors, of corporations and industries within an ETF.

"We're assessing our view of the industry versus the global business cycle, including the sectors that do better at particular points in the cycle. So we're doing the same broad approach as when assessing national factors, but weighting the factors differently," Mr. Mordy explains.

2) Assess behaviour

Forstrong's second approach focuses on behavioural outlook.

"We look at market perceptions of a certain country or sector or theme. And we look at the investor psychology and general sentiment toward that asset class. In general, we're looking for extreme situations where either the sentiment is depressed or overly exuberant, in order to take advantage of opportunities where ETFs might be undervalued or overvalued," says Mr. Mordy.

Other behavioural factors examined include capital flows, activity on the futures market to see where speculators are making their biggest allocations, and historical precedents, including analyzing any patterns or templates that may repeat themselves and impact a certain ETF today.

"We've been schooled to think that markets are rational. That's a very rigid perspective, and practitioners quickly realize that markets do not always behave rationally. But the neat thing about macro-analysis is that you can go beyond financial and economic factors, and analyze factors like behavioural psychology and even culture, which are perhaps even more important in driving investment themes in the markets," explains Mr. Mordy.

Rating the assessment results

Once both the fundamental and behavioural analysis is complete, Forstrong relies on a five-point factor rating to determine whether an appropriate buy point has been reached for an ETF.

The first factor Forstrong takes into account is the expected return. The second factor is diversification.

"When you're constructing an ETF portfolio, or any portfolio, one has to be extremely cognizant that the world has become quite globalized and interconnected, and therefore the correlations between many of these assets are quite high. So we're looking to find assets that can increase diversification," he says.

The third factor involves taking a closer look at the behavioural side of the analysis. "We want to see a low-risk entry point for investment, as defined by retail and institutional investor sentiment and historical precedence," Mr. Mordy elaborates.

The fourth factor Forstrong considers is the ETF's valuation. The fifth factor involves looking for what Forstrong refers to as a macro lever or catalyst.

"We look for assets with a macro event or trend with a high probability attached to it, that would significantly revalue the target asset upward. For example, if the market suddenly realized that China wasn't going to crash after the anticipation had been depressing the market for China-themed ETFs, that could be a strong indication that the price of such ETFs are about to recover, and that may be a good time for investors to buy," he explains.

Extreme sentiment moods, whereby investors are either too down, or on the flip side, too euphoric about a market event**,** can lead to good times to buy or sell, respectively, Mr. Mordy adds.

ETF purchase still an art

Determining when to purchase an ETF, and what ETFs might fit into an individual portfolio, has traditionally been more art than science, and some firms still take what might be considered a more traditional approach.

Adrian Mastracci, a senior portfolio manager with Lycos Asset Management Inc. in Vancouver, believes that asset allocation is the biggest determinant of portfolio performance, and should therefore be the top priority.

Second is proper diversification. He notes that one advantage of an ETF is that it contains a diversity of investments.

After those priorities have been dealt with, "it's not about trying to pick the best stock, or the best ETF. It's really about rebalancing back to the original targets that you had," Mr. Mastracci says, emphasizing that he seeks consistency of return wherever possible.

Following an analysis of which ETFs to purchase, the timing for that purchase could be positively impacted if, for example, several major companies represented within that ETF have rising earnings and/or rising dividends, Mr. Mastracci notes.

"What I also try to do is to pony up when the prices are low. If all a sudden an ETF's price drops dramatically and prices are much lower than they were yesterday, I would be buying unless there were extenuating circumstances," he adds.

"That applies fully to today, where the prices have been reduced, and I've got a chance to buy at less than I would have paid one month ago," says Mr. Mastracci, referencing the current market drop.