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ERIC BALCHUNAS

# THE INSTITUTIONAL ETF TOOLBOX

HOW INSTITUTIONS CAN  
UNDERSTAND AND UTILIZE THE

**FAST-GROWING WORLD OF ETFs**

# THE INSTITUTIONAL ETF TOOLBOX

How Institutions Can Understand and Utilize  
the Fast-Growing World of ETFs

**Eric Balchunas**

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*For Trang, Gabriel, Elliott, and Mom and Dad.*

# Acknowledgments

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I realize I'm not winning an Oscar here, but I feel some people need a shout-out. This book wouldn't have been written without both direct and indirect help from the following people.

In terms of direct help, I owe a huge thanks to Suzanne Woolley, my amazing editor at Bloomberg. She not only taught me a lot about writing, but also connected me to Stephen Isaacs of Bloomberg Press. If not for Suzanne's stamp of approval—and Stephen's guidance—this book would not exist. Second, I would like to thank Matt Kelly and Doug Kenney in Bloomberg Global Data. They have been supportive of me for years now—not only in this book project but also encouraging me to take opportunities necessary to turn my job into a career.

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I also have to give a special thanks to David Abner, who is a friend and a mentor within the industry. Dave has written two books on ETFs, which I've

read multiple times. While this book is largely a different topic, his work and his attitude has influenced me and inspired me in subtle ways.

This book also would not exist if not for some folks in Bloomberg's media operation, namely, Catherine Cowdery of Bloomberg Radio, as well as the folks over at Bloomberg TV—namely, Ted Fine and Jonah Davis who first let me on the air to talk ETFs. Every Friday for five years now I've traveled up to New York City to do a weekly segment on ETFs for radio and TV. This consistent deadline was a huge motivating force for me; it sent me into every nook and cranny of the ETF world. All told, I've done over 500 segments, and all of the notes from those deep dives provided a solid resource for me in writing this book—especially in the “toolbox” half of the book.

Like any writer, I have influences. My biggest influences come from my favorite ETF trade publications, starting with Dave Nadig and Matt Hougan of ETF.com. When I was first developing myself as an analyst, their articles and podcasts were a major source of knowledge and inspiration. If ETF analysis has a cutting edge, it's those guys. I've also found enlightenment from fellow ETF analysts such as Todd Shriber, Victor Reklaitis, Chris Dieterich, Brendan Conway, Michael Rawson, Tom Lydon and Deborah Fuhr.

Every book I read, the author inevitably apologizes to his family for being so pre-occupied with writing their book. Now I know what they mean. It really does demand a lot of precious time. So to my wife and kids, thank you so much for all your support and patience during this book writing process. Daddy is as happy to be done writing it as you are!

# Introduction: Institutions and ETFs

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It is widely known that exchange-traded funds (ETFs) have democratized investing by giving the little guy (retail) the same access as the big guy (institutions). While that is very true, the less told story is that many institutions have also turned to ETFs for a wide variety of purposes. While retail investors and the advisors serving them largely see ETFs as a cheaper, more tax-efficient version of a mutual fund, many institutions see them as a versatile, liquid tool to help them deliver exposures within their portfolios.

This book explores how those institutions use ETFs as well as how they—or any investor—can use them better.

Institutions such as pension plans, foundations, endowments, hedge funds, insurance companies, asset managers, and foreign institutions are slowly increasing their usage of ETFs. “Slowly” is the key word here, though, because getting an institution to change its habits is a bit like turning around a battleship, as one endowment manager told me.

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*“My history with institutions is they are naturally skeptical and they are going to be slow to move. And they will probably leg in. Not too much different than what financial advisors did ten years ago.”*

James Ross, State Street Global Advisors

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While ETFs tend to compete in terms of benefits when stacked up against the mutual funds used by retail investors and advisors, it is a different story for folks running pensions or endowments. ETFs are in competition with some of the cheapest and most efficient investment vehicles Wall Street has to offer, such as separately managed accounts, total return swaps, and futures contracts.



When an institution puts money to work, it isn't \$200,000 or even \$2 million; it can be \$200 million or \$2 billion. When you are putting that kind of money to work, the world opens up to you and gives you many more options at insanely cheap prices. In short, institutions get the royal treatment from asset managers and Wall Street banks via a broader array of investment vehicles.

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*"The goal of any investment vehicle or product is to get you to some type of investment strategy or purpose. Whether or not you have access to a conventional index fund, an institutional separate account, a futures contract or you have a swap desk you can trade with. At the end of the day, you care about what's my trade-off between the best possible tracking instrument at a cost that you find reasonable. The ETF is a new item in that discussion, but all of those things are on the table."*

Jim Rowley, Vanguard

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So while ETFs have earned a seat at the institutional product table, they are still the new kid on the block and are mostly used in small portions, for very specific needs. At this level, they are typically though not explicitly used more as tools to adjust the portfolio exposures or manage cash or stay liquid. We will explore all of these usages in full.

Many surveys have touted these usages and hyped up how institutions are adopting ETFs right and left. While usage is increasing, the actual percentage of institutions' assets that hold ETFs is still pretty minuscule, as seen in Table I.1. Using a collection of sources; I estimate generally that institutions are using ETFs for 1 percent of their assets on average. Of course, when you are talking about a combined \$75 trillion or so in assets, that's nearly a trillion dollars and close to half of total ETF assets (advisors and retail make up the rest). And if that number inches up to even just 4 or 5 percent—which is not that that hard to imagine—that's trillions of new assets into ETFs.

**TABLE I.1** Institutional Ownership (Estimated and Generalized) of ETFs

Institutions	Total Assets (billions)	ETF Assets (billions)	% of Their Assets in ETFs
Pensions	5,500	30	0.55%
Insurance companies (Gen Accts)	5,000	15	0.30%
Endowments	516	5	0.78%

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Institutions	Total Assets (billions)	ETF Assets (billions)	% of Their Assets in ETFs
Asset managers	41,000	400	0.95%
Hedge funds	3,000	34	1.13%
Foreign institutions	20,000	200	1.00%

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Sources: Pensions & Investments, NAIC, Bloomberg, Towers Watson, HFR, Sovereign Wealth Funds, Blackrock, Deutsche Bank

Historically speaking, institutions have used ETFs only in a limited fashion. Perhaps they bought some of the SPDR S&P 500 Trust (SPY) with some new cash to keep market exposure until they give it to an active manager. Many of them look at ETFs more as a retail product, in the same boat as an index mutual fund. How could some generic emerging markets ETF be better than the hot active manager they just hired who was picked after months of scrutiny by a consultant?

What's interesting about that is ETFs were originally designed specifically for big institutions in the early 1990s. And until around 2000, those were the *only* investors that used them. In fact, the first two major issuers—State Street and Barclays—were big institutional managers, and the ETF in some ways was a natural extension of what they were already doing. All that changed when Barclays launched iShares and saw the value of ETFs for retail investors and advisors.

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*"I think there has been a transition. Initially, it was institutional, and then the advisor market grabbed it. Then about five to six years ago the institutions really began to awaken to ETFs. We've come full circle."*

Anthony Rochte, Fidelity Investments

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Institutions have a lot at stake and a lot of pressure to deliver performance. This is why, as an outsider like myself, it was baffling to see how dedicated they still are to spending so much money on consultants, active managers, hedge funds, and so on.

It begs the question: why do institutions think they can outperform given the shaky track record and high costs of active management and hedge funds and private equity? Why not just make it easy and keep costs low and stay liquid by using an all-ETF portfolio like some asset managers and advisors now do? Have they ever used ETFs? Which ones and for what purpose? How do they choose them? When does an ETF not make sense? Do ETFs pose a

threat to their very existence? These are some of the questions I asked many institutions directly as well as people in the ETF industry. I will share what I learned in the book.

Besides cost and a love of active management, another big reason institutions don't use ETFs is lack of understanding. In fact, in almost every institutional study and survey I reviewed, initial concerns around ETFs melted away as they learned more about the structure and got some hands-on experience with them.

But what is interesting is most institutions and their consultants apply such rigorous due diligence when picking an active manager, yet barely any when picking an ETF. That's a big mistake as the difference in returns between similar sounding ETFs can be just as wide as or wider than that of active managers

This brings me to the point of the book: to help an institution—or any investor—understand, utilize, and perform due diligence on the vast array of ETFs available to them. I will show examples of how other institutions were able to do this as well. We will also look at new perspectives on liquidity and trading that will unlock the full ETF toolbox.

One thing you will notice with institutional investors and their ETF usage is those who do use ETFs may be using inferior products and probably don't realize it. Sometimes the first ETF to come out in a category becomes the most liquid and everyone uses it, even though many new ones have come out that offer better exposures with fewer total costs. This is the ETF equivalent of using an iPhone 1. This book will help you feel comfortable going deeper into the toolbox in order to find the best ETF for you.

This toolbox is growing faster than anyone can keep up with. ETFs have evolved so much in only the last couple years. There are now over 1,800 ETFs for virtually every category of equities, fixed income, international, and alternatives with more flavors than Baskin-Robbins. Today, you can build a solid global allocation with using only ETFs for less than 0.10 percent. This was not possible 10 years ago as 98 percent of the ETFs were developed for market equity.

This product influx and innovation is why the ETF industry is like the tech sector of the financial world. There is definitely a Silicon Valley, gold rush vibe. But the pace of innovation and new products has outrun the education by a mile. And it has created more noise. This is why ETF due diligence is going to be very important going forward. This is why we work to make the best functions on Bloomberg. This is why we do ETF events all over the country. This is why I'm writing this book.

The tricky thing with ETFs is that they wrap up everything under the sun, including futures contracts, options, and swap agreements on top of stocks, bonds, or commodities. This is also one of the reasons it is so intellectually satisfying to be an ETF analyst. They take you to every nook and cranny of the financial markets and the world. You have to be a mile deep and a mile wide.

Now, as useful as ETFs can be, there can be some nasty surprises underneath some of them. Some ETFs hold pretty illiquid stuff, not to mention derivatives. Also, some ETFs are much more volatile than they look. Some ETFs have hidden fees or unusual tax treatment. I will share how to spot those things and how a “nasty surprise” rating system for ETFs may be useful.

This book is about tools, not theory. I’m not going to teach you about portfolio management techniques or how to do asset allocation or what will go up or down or what model works best. I’m not that guy. There are literally hundreds of books on investing written by more appropriate people than I.

I am an ETF analyst, or guru, or geek—whatever you want to call it. I have spent the past decade managing ETF data and developing new ETF functions on the Bloomberg terminal, as well as writing articles for Bloomberg .com and Bloomberg Intelligence. This is in addition to my weekly segments on Bloomberg Radio and TV. While I don’t manage money or work at an ETF issuer, I’ve been eating, sleeping, and breathing ETFs for nearly a decade now. As such, I can offer an objective view and unique analysis.

I’m also not a fan of textbooks. I like reading books with a more conversational and informal tone. So that’s how I wrote this book. Financial analysis and humanity are not mutually exclusive! So while this book is chock-full of substance for institutional investors to learn from, it is written in a language that both novice and expert investors can understand. At least that’s my hope.

A few things before we start. First, there are simply too many ETFs to cover all of them in this book. That’s probably a good thing, or else this would read like an encyclopedia instead of a book. I purposely tried to hone in on stories and case studies to make larger points that can be applied to other areas of the ETF landscape. I also did my best to highlight both the popular ones and the up-and-coming innovative ETFs. With that said, the ETFs covered in this book represent over 80 percent of the assets and trends.

I also use a lot of numbers in this book, such as assets, returns, fees, and trading figures. By the time you read this, some of those will have changed. It’s like trying to hit a moving target. However, they won’t change that much and the figures are key in showing relativity and providing case studies.

Now, because I’m not a money manager or an ETF issuer, I wanted to bring in outside voices to accompany my data analysis. This is why I

conducted more than 50 interviews for this book with institutional fund managers, ETF issuers, ETF strategists, market makers, advisors, and others. Their quotes are peppered throughout the book to give it a documentary feel with me as the narrator. Also, every single quote in the book, unless otherwise stated, is from an interview I did specifically for the book. In other words, all the material is fresh and original and it has not been used anywhere else.

I also purposely didn't include their titles with their quotes in the name of brevity and informality. Suffice it to say though, I only interviewed people that I felt would help readers understand the topic better. You will see from the quality of their quotes that they know what they are talking about.

I spent a lot of time researching institution types, which was a bit like visiting different planets. You could spend years learning about them. For example, you could write an entire book on what is going on with state pensions right now, or how smaller endowments are faring with their alternative-heavy strategies. When you start asking questions and doing research, you end up seeing some loose threads here and there—more questions that pop up out of your original questions. I pulled some of these threads, but given that this is a book on ETFs, I left many of those threads alone in the name of brevity. However, a few of those threads could make for an interesting follow-up book!

And if researching each type of institution is like visiting a planet, getting information on what they invest in, and why, well, that's like solving a murder mystery. You have a tiny bit of data available from public filings, but it is largely sketchy and opaque. Let's just say researching this book taught me a lot about how little documents like 13F forms really tell you.

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*"Part of the challenge of all the reporting out there is it is incomplete. We all think if we look at what someone reports, we know what they are doing. But you really have no idea what they are doing."*

Mark Yusko, Morgan Creek Capital Management

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While surveys of institutional investors' usage are pretty good measures of how those institutions use ETFs, they are not really good measures of how *much* institutions are using ETFs or use specific examples or anecdotes. In addition, most of the surveys are sponsored by an issuer, so they tend to just focus on how ETF usage is increasing amongst certain institutions, but the fact is, wider adoption is still in the very early innings as noted in the asset figures above.

As a result, it took a lot of detective work, which involved researching a wide variety of sources, but mostly talking to people. One group of investors whose interviews I thought were especially useful was ETF strategists, which are asset managers who run all-ETF portfolios. I use them so much in the book is because they are master ETF users and their knowledge of the toolbox is unparalleled. I thought some of their insight and hard-won experience using ETFs would be beneficial to all investors.

The book includes all of this in an arrangement that I thought was natural to the topic. Just like an old-school vinyl album has two sides, with several songs on each side, this book will be laid out in a similar fashion, with two distinct sections and several chapters within each section.

The first section will be a dive into the “ETF phenomenon.” We will look at the advantages that make ETFs so popular. We will then look at their growth, not just assets, but in volume and product count. Then, we will learn about ETF mechanics via the story of how the first ETF was invented, followed by an examination of the myriad ways different institutions are using ETFs. The section will end with a thorough look at how to vet and select ETFs including a look at trading. All this will arm you for Section Two.

Section Two is a tour through the “ETF toolbox” with me as your tour guide. We will look at each asset class including equities, fixed income, and alternatives. We will spend some extra time in hot areas such as smart beta, currency hedging, China, gold, and liquid alts. The book will end with some parting thoughts from me as well as some resources for additional and ongoing education.

Now that we got that out of the way, let’s get started!

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