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ADVISOR PLAYBOOK

2019 INVESTMENT STRATEGIES

CONTENTS

2 Howard Marks: Advisors Should Focus on Client Risk
4 The Fossil Fuel-Free
6 How Advisors Are Fielding Client Questions on Cryptocurrency
8 Municipal Tax Loss Harvesting to Decrease Capital Gains Tax
10 The Benefits of Owning Municipal Bonds
15 Falling Angels and the Threat to Bond ETFs
18 Enthusiasm and Investment Dollars for Smart Beta Funds Waning
20 The Paradox of (ETF) Choice

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Howard Marks: Advisors Should Focus on Client Risk

THE CO-FOUNDER OF OAKTREE CAPITAL MANAGEMENT ON HOW ADVISORS CAN STAY COMPETITIVE, THE TYRANNY OF BENCHMARKS AND WHY CASH IS NOT THE BEST WAY TO DE-RISK A PORTFOLIO. BY DAN WEIL

Howard Marks, co-founder of Oaktree Capital Management, is known for his often contrarian market commentaries—and for making his investors a lot of money. In his new book, *Mastering the Market Cycle*, he focuses on the importance of figuring out where we are in the cycle to determine investment strategy.

He's cautious, given all the signs of excess in financial markets. In an interview with *WealthManagement,* he added his voice to the chorus of those who point out that financial advisors risk obliteration by automated competitors if they don't find a way to add value beyond investment performance, and given the markets today that means helping clients manage their risk.

***WealthManagement*:** Does the continuing automation of the investment business spell doom for retail investment advisors?

Howard Marks: In all parts of the investment industry—as in the rest of the business world—the key question will be, "Can humans do something that machines can't?" If so, I believe humans will stay in demand and be able to charge appropriate fees. If not, machines will take over.

Much equity management has transitioned to index/passive funds, not because passive performs so well, but because active managers have produced inferior results and charged high fees. Better results and/or lower fees will make advisors viable and successful. Anything else assumes the clients are naive.

I think advisors can do a better job than machines [on helping their clients manage risk]. A skillful advisor who reflects the client's preferences and knows how to implement them should always be a valuable resource.

WM: Given that we seem to be late in the investment/economic cycle, how should financial advisors guide their clients now?

HM: There are times for aggressiveness and times for caution, and I believe the choice between the two is the most important decision for the intermediate term of two to five years. Aggressiveness is in order when news has been negative, recent performance has been poor, investors are depressed, and thus little optimism is embodied in security prices. When the reverse is true, it's time for caution.

Today, I observe the advanced age of the economic recovery and bull market, the fact that low interest rates have pushed people into risk assets, and the risk tolerance many people are exhibiting as a result. Consequently, I think this is time for somewhat more caution than aggressiveness.

WM: Are there investment areas that you find attractive or unattractive in this environment?

HM: Most of my observations are market-wide because, for the reasons listed above, I think most assets are priced on the high side of fair or the beginning of rich. My main preference is for a cautious approach in all asset classes.

Long bonds should be avoided because of the likely rise in interest rates. Stocks aren't priced too badly, with the exception of the top tech and social media names, where considerable optimism is incorporated in prices. Emerging market equities have taken quite a hit and might have appeal for investors with a strong appetite for risk.

WM: How should financial advisors help clients

> "Not every cyclical episode is a bubble/crash. Rather, there can be more moderate bull markets followed by bear markets."

adjust their asset allocations in different market environments?

HM: First, advisors should help every client establish an explicit normal risk posture. Second, based on the thinking that I mentioned earlier, they should decide whether the risk in their portfolio today should be above, below or at the normal level.

After doing that, risk can be adjusted. There are many ways to do so, by moving both between asset classes and within asset classes. Raising or lowering cash is binary—either right or wrong, with no gray area—and it's difficult to do right. Fortunately, there are many ways to adjust risk without manipulating cash.

WM: What economic/financial/market trends worry you the most now?

HM: Rising interest rates will make it harder for companies to service their debts, increase the federal deficit, retard economic growth, and increase the competition that cash and fixed income instruments provide relative to stocks.

Rates should be expected to continue to rise. The 2017 tax bill will increase economic growth and the likelihood of inflation. It also will increase the annual deficit and national debt. Thus, in order to keep the economy from overheating and inflation from rising, the Fed may have to increase rates more than it might otherwise. The result could be slower economic growth or recession.

WM: Do you worry at all that we could fall back into financial crisis like in the late 1930s?

HM: Anything's possible, but the Great Depression of the 1930s was a very extreme outcome and not one that should be expected to repeat often. In the last 20 years we've seen two bubbles and resulting crashes: tech/internet in 1999 and 2000 and subprime mortgages in 2007 and 2008.

But not every cyclical episode is a bubble/crash. Rather, there can be more moderate bull markets followed by bear markets. Today we don't have the excesses—especially in terms of leverage in investment products and the financial sector—that produced the global financial crisis in 2007 and 2008. Thus, I don't feel a replay of the 1930s or 2007 and 2008 is in the cards at this time.

WM: Has investing changed in fundamental ways over the past 30 years?

HM: The changes have been massive. For the better. There's a greater variety of investment options available today. More importantly, people no longer think good investing consists of buying top-quality assets. The introduction of high-yield bonds 40 years ago led to a mentality wherein risky investments are acceptable as well, as long as the risk is understood and compensated by the potential return. Further, [Nobel Laureate economist] Harry Markowitz introduced the notion, now widely accepted, that by adding risky but uncorrelated assets to a portfolio of safe assets, you can reduce the portfolio's riskiness. These changes revolutionized the investment world. Finally, there is clearly a movement afoot to pay high management fees only to managers who add value.

WM: What are the negative changes?

HM: The introduction of derivatives, levered structures and financial engineering has increased the complexity of investing: the difficulty of understanding and gauging risk and the potential for financial system-wide risk.

Another change for the worse is the growing shortsightedness of most investors. Who will ignore quarterly performance to wait to see what happens in the long run? But, isn't long-run performance the only thing that counts?

Then there's the increasing tyranny of benchmarks. Investment managers are generally evaluated on the basis of their performance versus the benchmarks, but that comparison considers only return, not risk. In times in which the highest returns go to the person who takes the most risk, like the last five years generally, keeping up with the benchmark may be an indicator of pro-risk behavior. ■

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The Fossil Fuel-Free Opportunity

AS THE RISKS OF INVESTING IN CARBON-BASED COMPANIES ESCALATE, FIRMS IN THE TRANSPORTATION AND ENERGY SECTORS ARE LEADING THE WAY TOWARD A FOSSIL FUEL-FREE PORTFOLIO. BY BETSY MOSZETER

Photo: Jens Schlueter/Getting Images

To be fossil fuel-free or not to be?

That is a question clients will increasingly ask their financial advisors, as interest in sustainable and impact investing continues to grow and the financial risks presented by fossil fuels become more apparent.

For advisors, the answer may even boil down to a fiduciary obligation to clients.

In his *Huffington Post* article, former SEC Commissioner Bevis Longstreth wrote that, “At some point down the road towards the red light of 2 Degrees Centigrade … it is entirely plausible, even predictable, that continuing to hold equities in fossil fuel companies will be ruled negligence.”

The clearest economic signals favoring a fossil fuel-free future come from transportation and energy generation, both of which trend toward increasing renewable energy demand and decreasing fossil fuel demand.

EVs Everywhere

There were more than 2 million electric vehicles on the world’s roads in 2016, according to the International Energy Agency. With EV sales expanding at a pace that’s similar to the growth rate that pushed Ford’s Model T past the horse and buggy in the 1910s, car makers are pouring research and development into new EV production.

- Beginning in 2019, Volvo will no longer make gas-powered cars, and will launch five new EVs or plug-in hybrids.
- BMW, which launched the i3 electric car in 2013 and sold more than 78,000 electric cars and plug-in hybrids in the first 10 months of 2017, will mass produce electric cars by 2020.
- Daimler is investing $11 billion in electric vehicles over the next five years, including $1 billion to convert a factory in Tuscaloosa, Ala. to produce EV SUVs and build batteries.
- Porsche announced in September 2017 that its first all-electric vehicle will be released a year ahead of schedule in 2019, in order to avoid being last to market, as demand undeniably swells.
- General Motors, which makes the popular Chevrolet Bolt, says they will not make any internal combustion engines “at some point in the future,” delivering “another critical blow to the future of gasoline and diesel cars,” according to *USA Today.*

EVs are dramatically less expensive to fuel than their internal combustion engine counterparts—the current U.S. average is $1.16 for an EV compared to $2.32 for regular gas, according to the U.S. Department of Energy’s eGallon calculator.

EVs also are cheaper to maintain than ICE vehicles, which makes sense when you consider

that the average internal combustion engine has 2,000 moving parts and an EV has about 20. As the initial purchase price of EVs comes down and more options come online, it's a no-brainer that EVs will continue to be the fastest-growing portion of the personal transportation segment.

Expanding demand for and production of EVs means that demand for transportation-fueling gasoline is on the decline. Not only is this trend driven by consumers, but global regulations are playing their part too.

Norway, Germany and France are banning the sale of all fossil fuel-based cars over the next two decades, and ING Bank expects to see "battery-powered vehicles accounting for 100 percent of registrations in 2035 across the [European] continent." India, one of the world's fastest-growing economies, has set goals for transitions away from ICEs to EVs, proposing a ban on ICE sales by 2030. China is also developing plans to phase out vehicles powered by fossil fuels.

Electrified Portfolios

The other major driver of fossil fuel consumption is our electrical energy grid. There's an exciting race on in the world of renewable energy generation, with wind and solar jockeying for the leading position. Wind energy was the fastest-growing source of electricity in the U.S. in 2015, while solar took to the top spot in 2016, contributing 39 percent of the grid's capacity additions, according to GTM Research and the Solar Energy Industries Association. And renewables will capture most of the estimated $10.2 trillion that will be invested in new power generation globally by 2040, according to projections by Bloomberg New Energy Finance.

Solar and wind are already less expensive on a price per kWh basis, without subsidies, than new natural gas, coal or nuclear power plants. And renewables will get cheaper as wind, solar and battery storage technologies race each other down the cost curve, according to a 2017 National Renewable Energy Lab report. "Solar photovoltaic (PV) capital costs have declined recently and are projected to continue to decline. Similarly, land-based wind capital costs have fallen while capacity factors have increased. These are trends that are both projected to continue and make wind increasingly competitive with new generation from natural gas combined cycle plants in the near term."

Unlike commodity-based fossil fuels that become more expensive as demand for them increases, renewables are tech-driven and follow both Moore's and Wright's laws, meaning they become more efficient and cheaper as more are produced (as do many technologies; think about the last two or three televisions you bought), so cost competitiveness will only continue to improve.

As demand for fossil fuels shrinks due to the shift toward EVs and renewables, it's important for investors to understand how incredibly sensitive oil and gas prices are to marginal changes in the balance between supply and demand balance.

In the transportation sector, 2 million barrels per day of demand will be displaced by 2023 by electric passenger cars alone, notes Bloomberg New Energy Finance. Recall that it was a 2-million barrel per day imbalance that led to steep oil price declines between 2014 and 2017.

Given the rapid rise of EVs, the 2-million barrel per day displacement by 2023 will be only the beginning of much larger demand reductions. Consequently, investments in companies whose primary source of revenues is tied to fossil fuel extraction, transportation, and/or refining will soon be in peril.

Companies innovating around renewable energy are gaining market share and becoming more competitive. They are investments that will help clients preserve and create wealth, rather than risky investments in fossil fuel companies that have begun their decline. ■

Betsy Moszeter is the chief operating officer and an investment committee member at Green Alpha Advisors, LLC.

Solar and wind are already less expensive on a price per kWh basis, without subsidies, than new natural gas, coal or nuclear power plants.

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How Advisors Are Fielding Client Questions on Cryptocurrency

THEIR FUTURE IS UNKNOWN AND THAT REQUIRES MORE EDUCATION FOR BOTH ADVISORS AND CLIENTS, ACCORDING TO PANELISTS AT TD AMERITRADE INSTITUTIONAL'S CONFERENCE FOR ADVISORS.

BY MICHAEL THRASHER

It was expected that an advisory conference panel on technology and innovation in wealth management—at one of the largest annual gatherings for financial advisors, no less—talk would eventually turn to cryptocurrencies.

"I'm willing to bet that the vast majority of clients have asked about [cryptocurrencies], how could you not?" Ric Edelman, executive chairman of Edelman Financial Services, said at TD Ameritrade's National LINC conference last month.

TD Ameritrade President and CEO Tim Hockey, a panelist alongside Edelman at his company's conference, acknowledged that the future of cryptocurrencies is unknown and evolving.

"Everyone is struggling" with how to define cryptocurrencies, he said, but "like anything else, it will sort itself out over time, it will mature."

Roughly 3,200 registered investment advisors attended the conference this year and nearly all of them stuck around for the technology discussion panel following the kickoff opening remarks by TD Ameritrade Institutional President Thomas Nally.

Edelman called the cryptocurrency market the "wild west" where extreme volatility is normal and fraud and theft are rampant. As a result, the Securities and Exchange Commission is paying more attention to the new asset class, although the Internal Revenue Service is currently treating cryptocurrencies as property, rather than securities, he said. But that could change.

For those reasons, Edelman said no portfolio should allocate more than 1 percent of a client's assets in cryptocurrencies. "Treat it like a lottery ticket," he said. The price of bitcoin fell 15 percent over the first two full days of the advisor conference.

"The words investing and Bitcoin shouldn't be used in the same sentence," said Carol Schleif, the deputy chief investment officer at Abbot Downing, who said in December that buying cryptocurrencies was like gambling.

Meanwhile, Wells Fargo Advisors, Merrill Lynch, UBS, Morgan Stanley and RBC all confirmed their brokers are not allowed to offer the new asset class to clients, including Grayscale's **Bitcoin Investment Trust Fund** (OTC:GBTC), citing concerns over suitability.

However, Edelman said there is legitimacy in cryptocurrencies, and if clients are asking, advisors can't "stick their heads in the sand." They need to educate themselves and be able to help clients make informed decisions if they're interested in it.

That's the approach taken by Erika Safran, founder of Safran Wealth Advisors, a fee-only financial planning and investment firm in New York City. She doesn't present cryptocurrencies as an asset class like she would stocks or even alterna-

Illustration: Maksim Karlione/Thinkstock

tive investments because it "requires a tremendous amount of client education and expectation management." However, if a client expresses interest, Safran advises them on whether they should buy cryptocurrency, walks them through the decision and ensures they understand the risks.

Safran was aware that Merrill Lynch and other brokerages had barred their advisors from pitching cryptocurrency and said she understood why. Valuing cryptocurrencies is difficult—cryptocurrencies are not tied to any other asset—and the wild swings in price could wreak havoc on a portion of a portfolio that a client has sole control over.

Bitcoin, for example, began 2017 below $1,000 and reached a high of nearly $20,000 in mid-December. Since then, the cryptocurrency sawed down to about $10,000 near the end of February, according to Coinbase, one of the most popular cryptocurrency exchanges.

Unlike more traditional investments, there is no easy (and compliant) way for an advisor to open accounts on cryptocurrency exchanges, transfer funds to them and execute trades on a client's behalf. The most an advisor can do is give advice and hope a client listens.

One of the benefits of having an advisor is that they serve as a layer of defense against panicked trading and other potentially harmful, knee-jerk client actions. Relinquishing that control is a risk in itself, especially with a highly volatile asset.

"I think it's challenging for advisors," Safran said about cryptocurrencies, "until there is less volatility."

Safran said it's easier for the advisor and clients interested in cryptocurrencies to invest in new derivative products, like Grayscale's Bitcoin Investment Trust Fund and bitcoin futures contracts recently launched by CME Group and Cboe Global Markets. But the future of cryptocurrencies and their prices in the long run is still unknown, and Safran is keeping an open mind.

"I have no patience for black and white solutions to something that is not fully understood," Safran said. "Don't say everyone should or no one should [buy cryptocurrencies]."

A few advisors, who attended the panel discussion Edelman participated in, told *WealthManagement.com* they agreed with his approach to cryptocurrencies and had taken similar steps to field client questions.

Another advisor, who didn't want to share his name, admitted he had done little research on cryptocurrencies and wouldn't feel comfortable advising clients on them, beyond telling them they're volatile and risky. The same advisor said he could only name a few cryptocurrency exchanges—only because their names were in the media for having paused trading or had cryptocurrencies stolen from them.

"I'm willing to bet that the vast majority of clients have asked about [cryptocurrencies], how could you not?"
—Ric Edelman

Liquidity and trading costs are lesser issues that advisors bring up with clients when it comes to cryptocurrencies. During the run-up in bitcoin's price last year, exchanges frequently paused trading, preventing account holders from both executing trades and converting their holdings into cash, and some are no longer allowing new accounts.

None of the advisors *WealthManagement.com* spoke to had clients with enormous cryptocurrency holdings, that is, in the millions of dollars. But the cost to trade even modestly large positions could be more expensive on some exchanges. Coinbase, for example, charges U.S. account holders a 1.49 percent fee to convert holdings into cash and transfer them to a U.S. bank account.

Unlike a client with a large stock position, there's no way for an advisor to help save on the cost of a high-volume transaction. ■

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Photo: © LILA PHOTO for TD Ameritrade Institutional

Municipal Tax Loss Harvesting to Decrease Capital Gains Tax

LEARN HOW AN INVESTMENT PRACTICE CALLED TAX LOSS HARVESTING CAN HELP OFFSET CAPITAL GAIN TAXES FROM OTHER, RISKIER ASSET CLASSES, SUCH AS EQUITIES, TO DECREASE YOUR TAX LIABILITY. THIS IS ESPECIALLY IMPORTANT GIVEN THE CAP ON STATE AND LOCAL TAX DEDUCTIONS INSTITUTED IN 2017, WHICH MAY HAVE CAUSED YOUR TAX BURDEN TO INCREASE. By Alex Etzkowitz, Vice President, Investment Research & Strategy at Gurtin Municipal Bond Management

Given the nearly decade-long equity bull market that we've been experiencing—and continue to experience today—you might be realizing substantial capital gains from your equity investments. And, while you are likely enjoying any capital gains, your consequent tax liabilities might not seem as attractive. You may also have experienced an additional increase in your tax burden due to the limit on state and local tax (SALT) deductions[1] that the Tax Cuts and Jobs Act mandates.

In light of these considerations, the investment practice of tax loss harvesting can be used to help offset, and thereby decrease, your tax liability from capital gains in other investments. Furthermore, by executing tax loss harvesting in municipal bond portfolios, you don't simply defer taxes like you would in equities. Instead, you capture the actual tax value of a capital loss without experiencing a decrease in the value of your municipal portfolio holdings.

What Is Tax Loss Harvesting?

As you realize capital gains and earn income on your investments, tax liabilities accrue. Your ultimate tax bill can be substantial, especially when your assets have appreciated over a long period of time. Tax loss harvesting is a practice that allows you to partially reduce, or entirely eliminate accrued tax liabilities by selling securities that have depreciated in value, thereby netting out realized losses from gains.[2] Industry professionals have extensively studied the general practice of tax-efficient investing, and tax loss harvesting in particular, and have reported on the added value for taxable investors who execute the process appropriately.[3]

Why Harvest Losses in Municipal Bonds?

Tax loss harvesting in the municipal bond asset class can potentially be extremely efficient. Unlike tax loss harvesting with equities, exchange traded funds (ETFs), and mutual funds—which simply defers the payment of taxes into the future, generating value solely from a net present value perspective[4]—tax loss harvesting with municipal bonds can permanently eliminate tax liabilities.

Example No. 1: ETF Tax Loss Harvesting

Consider the example of

harvesting losses on an ETF tracking the S&P 500, and swapping into a second ETF tracking the same underlying index. Let's assume the original S&P 500 ETF you purchased has a cost basis of $100, and the market price of the original S&P 500 ETF has declined from $100 to $90, allowing you to realize a $10 loss that you can offset against your overall gains when you sell your original S&P 500 ETF at the lower market price. However, when you finish executing the swap by purchasing the second S&P 500 ETF, your cost basis on your S&P 500 ETF investment resets to the purchase price paid for the second S&P 500 ETF.

For simplicity, let's assume that the two ETFs track each other perfectly, and therefore, you're purchasing the second ETF at a price of $90, or $10 less than the original cost basis of the first ETF. Ultimately, when you liquidate the second ETF (no matter what the price is at time of liquidation), you will realize $10 more in gains relative to an alternative scenario in which you decide not to tax loss harvest by simply holding the original S&P 500 ETF investment until final liquidation.[5]

Example No. 2: Municipal Bond Tax Loss Harvesting
Municipal bonds, and other fixed income securities with finite lives, operate quite differently than riskier asset classes from a tax loss harvesting perspective. Assuming you are planning to hold bonds to maturity, tax loss harvesting allows you to reduce or eliminate current tax liabilities—*without creating future tax liabilities.*

For example, imagine you purchase a bond at $120, which is now priced in the marketplace at $110. You realize a $10 loss on the sale, and reinvest into a similar security with an identical maturity date, priced at $110. When the bonds mature, you have no capital gains because your purchases were executed above par. However, you have locked in a valuable $10 capital loss, which can be used to offset other gains realized through other investments. If you had simply held the original bond to maturity, no such realized loss would exist.

This process works best when there are bonds available in the marketplace that you can purchase at a premium. Fortunately, municipalities typically issue high-coupon bonds at significant premiums above par precisely because they are highly tax-efficient structures.[6]

One other reason municipal bonds represent an attractive vehicle for tax loss harvesting is that there is an abundance of issuers in the municipal marketplace—and multiple issuances per issuer.[7] This allows for timely re-investment while avoiding triggering a wash sale, thereby minimizing the impact on portfolio construction.

Benefits of a Tech-Driven Approach to Tax Loss Harvesting

We believe our systematic, technology-driven process for tax loss harvesting enables our firm to:

• Efficiently identify securities across eligible municipal bond accounts that may be appropriate for tax loss harvesting

• Perform a thorough analysis of the liquidity, yield, and structure of identified securities on a bond-by-bond basis, to help ensure that we add value for you on an after-tax basis

• Aggregate blocks of identical CUSIPs held across multiple eligible accounts, in an effort to deliver superior execution

• Avoid triggering wash sales, which can negate the potential benefits of tax loss harvesting

If you have any questions about how we believe our algorithm- and technology-driven process for tax loss harvesting allows our firm to identify opportunities in the municipal bond market in real time and appropriately manage risk, to deliver tangible benefits, please contact us by calling 858-436-2200 or by emailing AdvisoryServices@gurtin.com today. ■

SIDEBAR SUMMARY: Given the ongoing equity bull market that we've been experiencing for nearly a decade, you may be experiencing increased capital gains taxes. In addition, the limit on state and local tax deductions that is mandated in the Tax Cuts and Jobs Act may compound your tax burden. Learn about tax loss harvesting in your municipal bond portfolio as a way to truly decrease your tax liability—not simply defer your bill into the future, as often happens when investors tax loss harvest in other asset classes.

See related disclosures at https://www.gurtin.com/disclosures/

[1] https://www.congress.gov/bill/115th-congress/senate-bill/2254.

[2] If capital losses exceed gains, they can also be used as a deduction subject to limitation, and can be carried forward onto future tax returns and netted off of future capital gains. For a summary see: https://www.irs.gov/newsroom/capital-gains-and-losses-10-helpful-facts-to-know, or for more in-depth information see IRS Publication 550, Ch. 4, https://www.irs.gov/pub/irs-pdf/p550.pdf.

[3] Arnott, Berkin & Ye (2001); Wilcox & Fabozzi (2013), Ch. 8; Bergstresser & Pontiff (2013); Kalotay & Howard (2014).

[4] For more on tax loss harvesting ETFs, see Betterment White Paper: Tax Loss Harvesting+, https://www.betterment.com/resources/research/tax-loss-harvesting-white-paper/.

[5] Or, in the event that the market continues to decline and shares are liquidated at less than $90, the investor will realize $10 less in losses than the scenario in which tax loss harvesting is not undertaken.

[6] Landoni (2017).

[7] Kalotay (2016). As of 2011, there were over 1 million distinct municipal bonds outstanding according to U.S. Securities and Exchange Commission (2012).

The Benefits of Owning Municipal Bonds

MUNICIPAL BONDS ALLOW FOR STATE AND LOCAL GOVERNMENTS, AS WELL AS NONPROFIT ENTITIES, TO FINANCE CAPITAL EXPENDITURES AND IMPROVEMENTS. IN SOME CASES, MUNICIPAL BOND INVESTMENTS CAN ADVANCE POSITIVE SOCIAL OR ENVIRONMENTAL GOALS.

FIGURE 1: MUNI VS. TREASURY YIELD CURVES

In general, municipal bonds offer federally tax-exempt income for most U.S. federal taxpayers as well as state tax-exempt income for most investors when bonds are issued in an investor's state of residence (See Figure 1).

Note: Not every state provides state-level tax exemptions. In addition, in most cases, to qualify for the state-level tax exemption, the municipal bonds must be issued in an investor's state of residence.

About Taxable-Equivalent Yields

In certain states, a single person with a taxable income of more than $500,000 would fall in the 37% federal tax bracket, and would need to earn 7.94% on a taxable security to match a 5% yield on a tax-exempt security.

Source: Thomson Reuters as of 12/31/2018. The taxable-equivalent AAA municipal yield assumes the maximum federal tax of 40.8% (37% income tax + 3.8% Medicare). Note: Not every state provides state-level tax exemptions. In addition, in most cases, to qualify for the state-level tax exemption, the municipal bonds must be issued in an investor's state of residence.

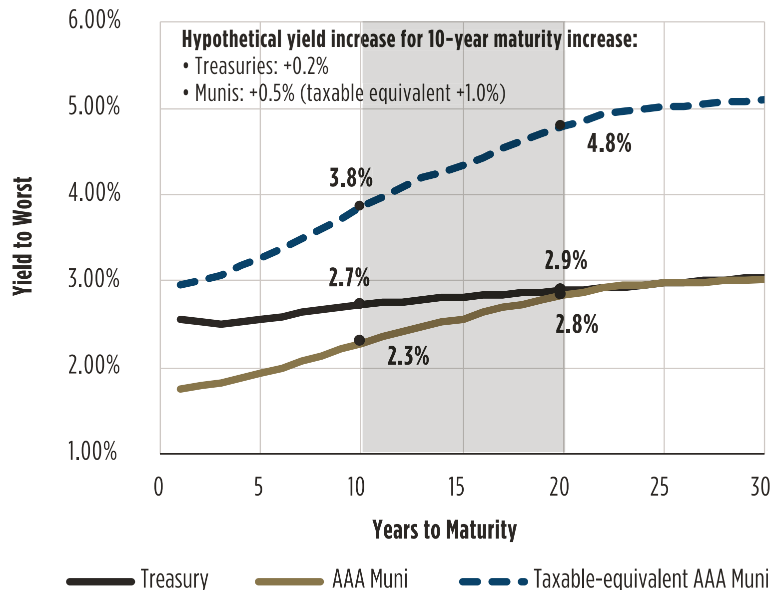
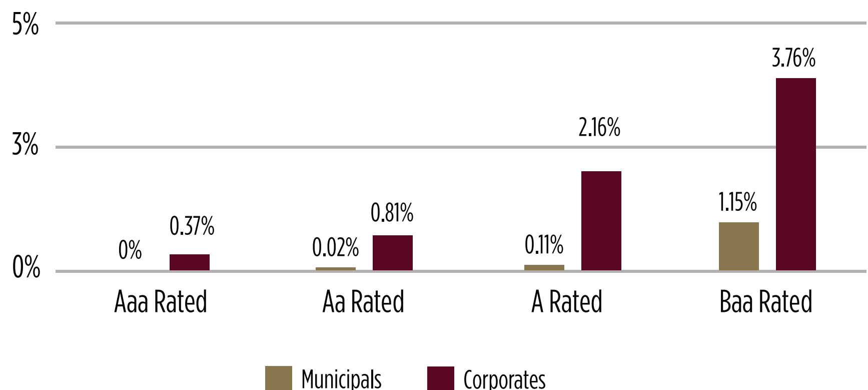


FIGURE 2: U.S. MUNICIPAL AND GLOBAL CORPORATE BOND DEFAULTS, 1970 – 2017

Investment-grade municipal bonds have historically defaulted at low rates (See Figure 2). This makes municipal bonds an attractive vehicle to balance out risk in an investor's portfolio.

Source: Moody's Investors Service, "U.S. Municipal Bond Defaults and Recoveries, 1970-2017," 31 July 2018.



Muni Bond Key Terms & Conventions

KEY TERMS

- A **municipal bond** is a debt issued by local government entities, a state, or a non-profit issuer to finance day-to-day operations or large infrastructure projects.
- A bond's **CUSIP** is its unique, 9-digit identifier.
- A bond's **issuer** is the entity that issues the bond and whose name is on the statement.
- A bond's **obligor** is the entity ultimately responsible for the debt service and principal repayment.
- A bond's **par/face value** is the amount that will be paid to the bondholder at the time of the bond's maturity and is typically equal to $100 per bond.
- **Coupons** (i.e., the interest paid on municipal bonds), are expressed as a percentage of face value and are typically paid semi-annually.
- Many municipal bonds are issued with a **call feature,** meaning they may be redeemed by the issuer during a specified period prior to maturity.
- A bond's **yield*** measures the total annualized return an investor will receive over the lifetime of the bond, with the bond either being redeemed early (if it is callable) or staying outstanding until maturity.
- A bond's **yield to maturity*** is the total return an investor will earn if the bond is held to maturity.
- Portfolio yields can be quoted **at market,** using current market prices to determine the yield if a bond were purchased today, or **at cost,** to calculate yield using the historical prices at which a specific investor purchased the bonds.
- A bond's **total return** over a specified time period includes the impact of fluctuations in a bond's market price (price return) and the coupon income earned over a given period (income return).
- When a bond offers a coupon rate that is higher than the prevailing interest rate relative to its credit quality, it will trade at a premium; whereas it will trade at a **discount** when its coupon rate is lower than market rates.
- The premium decreases as the price of the bond moves toward par in a process called **amortization.**

*Note: Yield definitions assume all coupon payments are immediately reinvested at a rate equal to the yield.

MUNICIPAL BOND CONVENTIONS

Structural Mispricing

The municipal bond market spreads bonds to the AAA MMD curve, assuming a 5% coupon and 10-year call for bonds beyond 10 years to maturity. Gurtin aims to exploit what we see as a market inefficiency by calculating spread based on each bond's unique characteristics, extrapolating option-free yields from the AAA MMD curve, and accounting for all maturity, call, and coupon combinations.

Call Options

Typically, municipal bonds issued with a call feature are called back when interest rates have decreased, and issuers/obligors can effectively refinance their debt at a lower rate.

For a non-callable bond, the yield to maturity and yield to worst are equal, as the maturity date is fixed. However, a callable bond bought at a discount will have a yield to worst equal to its yield to maturity while a callable bond bought at a premium will have a yield to worst equal to its yield to call. For instance, a 5%, $100 bond paying back par at call and maturity with 10 years to the first call date and 15 years to final maturity would exhibit the following yield characteristics, as illustrated in Figure 3 below:

FIGURE 3: HYPOTHETICAL EXAMPLE OF PURCHASE PRICE AND RELATED YIELDS

Purchase Date	Purchase Price	1st Call	Yield to Call	Maturity	Yield to Maturity	**Yield to Worst**
1/1/2015	$95	1/1/2025	5.67%	1/1/2030	5.50%	**5.50%**
1/1/2015	$105	1/1/2025	4.37%	1/1/2030	4.53%	**4.37%**

Note: Example based on Gurtin's internal calculations. (Yield calculations are also available via Bloomberg or a similar source.)

Gurtin has historically viewed callable bonds as a **great source of value** given our view that such bonds are generally mispriced and can provide "yield kick" should they stay outstanding past their first call date.

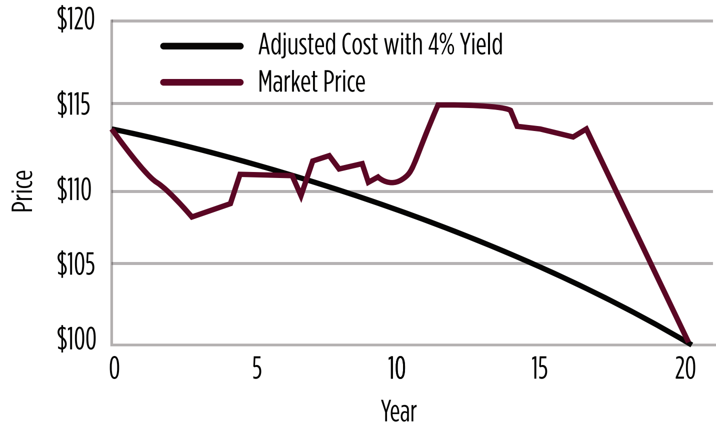
About Municipal Bonds

MEASURING PORTFOLIO PERFORMANCE

Return and Yield Comparison

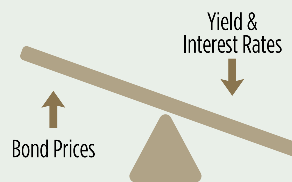
Performance in a municipal bond portfolio is typically measured using a portfolio's return. However, for a long-term investor planning to hold to maturity, yield may be a better measure of performance over the life of the bond, as it ignores changes in bond price caused by interest rate movements. Figure 4 is a hypothetical example of how the market price of a bond can fluctuate dramatically depending on the path of interest rates; however, assuming no default, a hold-to-maturity investor will realize the original yield at cost no matter how rates move.

Figure 4: Hypothetical Example of Amortized Cost and Market Price for a 20-Year Bond



THE RELATIONSHIP BETWEEN INTEREST RATES AND BOND PRICES

A bond's value prior to maturity is determined by current market interest rates, with interest rates and bond prices having an inverse relationship.



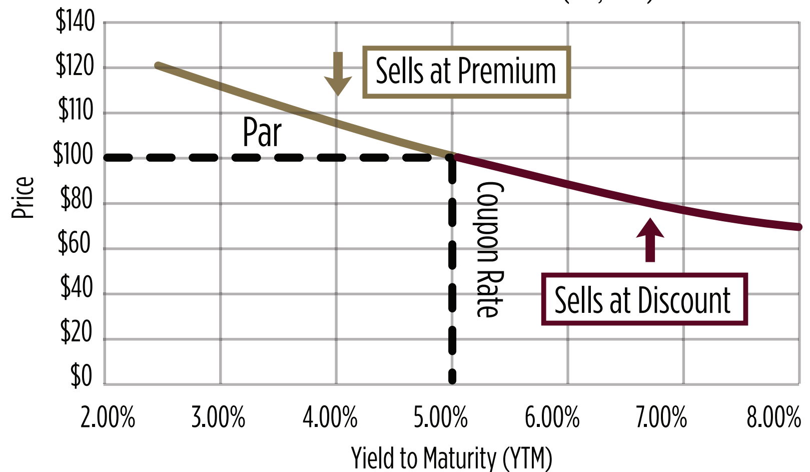
Premium vs. Discount

To compensate issuers for paying bondholders high coupon payments above prevailing market interest rates, bonds are typically purchased at a price above par value, or at a premium. A bond will trade at a premium or a discount when it is trading above or below its par value, respectively, as shown in Figure 5.

Amortization and Accretion

In today's markets, coupon rates tend to be higher than prevailing interest rates. The **premium** that bondholders pay decreases as the price of the bond moves toward par, known as **amortization.** When the opposite occurs, the process is called **accretion,** and each year the accreted value would be *added* to the coupon to calculate earned income and account for the initial discount price.

Figure 5: Hypothetical Examples of Bond Prices vs. Interest Rates (i.e., YTM)



Hypothetical Example: Amortizing a 5-year bond bought at a premium of $105 with a coupon of 5%

Adjusted Cost	$105	$104.08	$103.11	$102.12	$101.08	$100
Coupon Income		$5.00	$5.00	$5.00	$5.00	$5.00
Amortization		$0.92	$0.97	$0.99	$1.04	$1.08
Earned Income		$4.08	$4.03	$4.01	$3.96	$3.92
Year	0	1	2	3	4	5

Accessing the Municipal Bond Market: The Need for a Municipal Bond Manager

DECENTRALIZED NATURE

Municipal bonds do not trade on a centralized exchange. Instead, municipal bonds trade over the counter between dealers. The market is heavily retail dominated and lacks institutional resources to make information or research widely available, emphasizing the importance of in-depth credit research in seeking to protect principal.

Vehicles for Investment: mutual funds, ETFs, individual bonds

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As of December 31, 2018, Gurtin has $14.1 billion in assets under management.

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Gurtin Municipal Bond Management

Falling Angels and the Threat to Bond ETFs

HALF OF THE DEBT IN INVESTMENT GRADE CORPORATE BOND FUNDS TEETERS JUST ABOVE JUNK. IF THE ECONOMY SLOWS AND DOWNGRADES FORCE PASSIVE FIXED INCOME MANAGERS TO SELL, WILL ETF INVESTORS FEEL THE PINCH? BY DIANA BRITTON

The fixed income market is starting to look a little bleaker. U.S. corporate debt is at a record high as many corporations took advantage of low interest rates to fund a record number of mergers and acquisitions last year. But analysts say we're near the end of the credit cycle, and credit quality is diminishing.

In fact, half of the Bloomberg Barclays investment-grade bond index comprises BBB-rated bonds, one step away from junk; that's nearly double the level of the 1990s. The **iShares iBoxx $ Investment Grade Corporate Bond ETF (LQD)**, based on the Markit iBoxx USD Liquid Investment Grade Index, with 48 percent of its bond portfolio at a BBB rating, saw one-year outflows of nearly $7 billion, according to Morningstar data ending November 2018.

As the economy and markets slow, some analysts say we could see a wave of so-called "fallen angels," bonds originally issued at investment grade but downgraded to junk. (To be sure, there are a few ETFs that exist to catch the angels on their way down.)

The concern among some is that the ETF managers of widely held, investment grade corporate debt funds will be forced to sell the junk bonds, and the price of the funds will fall.

According to Moody's, the number of potential fallen angels, Baa3-rated companies with either a negative outlook or that are on review for downgrade, increased to 47 at the end of the third quarter last year, compared with 42 in the second quarter. (Baa3 is the lowest investment grade rating on the Moody's scale.) In addition, the debt of potential fallen angels in the U.S. rose to $102 billion in the third quarter, the highest it's been since Moody's first started collecting that data in 2014.

"The border between investment grade and high yield has been recognized in the marketplace

ETF watchers say the fear of fallen angels among corporate bond ETFs is misplaced.

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as a weak spot for passive managers, because they're really obliged to sell something that's had a downgrade," says Elisabeth Kashner, vice president and director of ETF research at FactSet. "In any market when you've got a whole bunch of forced sellers, what's going to happen to the price?"

Five of the biggest ETFs that could be affected by a downgrade of BBB-rated bonds, according to *ETFTrends.com*, include LQD, the **Vanguard Short-Term Corporate Bond ETF (VCSH)**, the **Vanguard Intermediate-Term Corporate Bond ETF (VCIT)**, the **iShares Short-Term Corporate Bond ETF (IGSB)** and **iShares Intermediate-Term Corporate Bond ETF (IGIB)**.

An Overblown Fear

But ETF watchers say the fear of fallen angels among corporate bond ETFs is misplaced. Asset managers have been through periods of heightened downgrades before, with fairly minimal impact on most investors.

Despite the perception of an indexed bond fund being rules-based and relatively static, taking bonds in and out of a portfolio is par for the course for many managers who have leeway to deal with downgrades without the forced sale of bonds at a depressed price.

"If you are a fixed income portfolio manager, just on a routine, run-rate basis, you expect adjustments to the index, which you are obliged to track; you expect those adjustments pretty much on a monthly basis," Kashner says.

"There is a narrative out there that, if a downgrade happens, the index manager must sell that bond on the very last day of the month, robotically without consideration for execution … because the last day of the month is rebalancing," says Steve Laipply, head of U.S. iShares fixed income strategy at BlackRock. "That is not, strictly speaking, true."

Asset managers don't have to wait until the end of the month to rebalance, Laipply says. "Part of the role of the portfolio manager is to understand market conditions and to make a decision on what would be the most optimal time to sell."

"Particularly within fixed income, investing is never passive," says Matthew Bartolini, head of SPDR Americas Research at State Street Global Advisors. "An index manager will make relative value active decisions. But those active decisions are not to seek alpha. Rather, it is to minimize beta degradation due to high trading costs."

SPDR may look to trade a bond on a day of the month when that issue is more liquid, as the price can change when trading is thinner, Bartolini says.

"If there's a significant amount of downgrades, we're going to be using those really flexible techniques that we have as index managers, such as optimization or sampling, to make sure that the portfolios will have the necessary data exposure to track their indexes and mitigate any sort of high transaction costs."

Bond Funds Are Different

"It's easy for investors to think, 'These are passive; these are indexed; they've got to just do whatever happens to the index,'" says Todd Rosenbluth, director of ETF and mutual fund research at CFRA. "It's not as clear as that."

While equity ETF managers will fully replicate an index, bond managers buy just a sample of the market to replicate the underlying risk factors of the index, such as the duration exposure, credit spreads, and sector and industry exposures. That gives the manager leeway to build samples that will have the least amount of downgrades, says Josh Barrickman, head of fixed income indexing Americas at Vanguard.

"We do have a team of senior analysts that will opine on different credits, give us some sort of their take on the direction of a lot of different credits, and we can factor that into how we build the samples in our portfolios."

VCIT, for example, has about 1,900 securities, while the index, the Bloomberg Barclays U.S. 5-10 Year Corporate Bond Index, has close to 2,000 securities in it. A number of the securities in the index but not the ETF

are either illiquid or too expensive to transact in.

If an analyst expects a bond to be downgraded in the next three to six months, good managers may start to build in an underweight to that name ahead of a downgrade or simply won't add to that name.

"We are going to use our technique that we've honed over the last 30 years as index managers to precisely deliver that beta exposure to clients they've hired us for," SPDR's Bartolini says. "If that means holding less bonds in the index because those smaller bonds may not be additive to the portfolio but they'll be destructive from a cost perspective, the cost to purchase those outweighs the beta afforded by them."

ETFs Have Weathered Downgrades Before

There is historical precedent for this pace of downgrades. In 2002, 17.7 percent of BBB bonds were downgraded; it was 13.6 percent in 2009, according to a Moody's study. Managers also experienced a heightened volume of fallen angels in 2015 when energy prices collapsed. (There were just 14 actual fallen angels in the first three quarters of 2018, Moody's says, similar to the 12 for the full-year 2017 and much lower than the 63 in 2016. Moody's attributes that high volume in 2016 to weakness in commodity-linked industries and the downgrade of Brazil.)

"[In 2015 and 2016], I think the performance of the investment grade ETF actually was fairly good," said Francis Rodilosso, head of fixed income ETF portfolio management at Van Eck, which runs the **Fallen Angel High Yield Bond ETF (ANGL)**. "I think they continued to track their indexes fairly well, and there were some pretty large issuers in those spaces that moved down to high yield."

Rodilosso says the recent volumes of fallen angels are not significantly higher than in the past. He says the BBB universe is currently over $800 billion, and about one-eighth of that, a little over $100 billion, is on negative watch by the ratings agencies.

But there is potential for higher downgrade volume in the next 12 months, and it can be a technical buying opportunity, he says. Historically, bonds in the ICE BofAML US Fallen Angel High Yield Index—which buys original investment grade bonds that have fallen to junk status—see an 8 percent price decline in the six months prior to index entry and almost a full recovery in the six months after. "But the dispersion of actual results around that average is quite high."

"From a day-to-day risk management perspective, there's virtually no difference in terms of the actual cumulative probability of default between a bond that's at the bottom of investment grade and that's at the top of junk," says Dave Nadig, managing director of research firm *ETF.com*. "This is where discussions about active management often end up, which is if you were an active manager who was managing a fund that otherwise had a mandate for investment grade corporate bond exposure, chances are you have the flexibility in your mandate to still hang on to something that may have just gotten downgraded."

Many corporate bond mutual funds have a buffer of about 10 to 15 percent that can be below investment grade, he says. It's reasonable to say these active managers can take advantage of some of these structural issues. Yet recently, active managers of bond funds haven't outperformed. During the one-year period ending June 30, the majority of active bond managers investing in long-term government and long-term investment grade bonds underperformed their benchmarks, according to the U.S. SPIVA Scorecard.

Nadig believes the BBB problem is overblown, and the impact of increased downgrades on bond ETFs to be minimal.

"The bond market is pretty good at pricing risk," he says. "As things get downgraded, they get a little bit oversold. They get a little cheaper. Their yields come up. Now all of a sudden they're attractive high-yield bonds that don't really have any additional risk, so people buy them up. It tends to self-regulate pretty well." ■

The recent volumes of fallen angels are not significantly higher than in the past.

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Enthusiasm and Investment Dollars for Smart Beta Funds Waning

EXPERTS SAY IT WILL BE DIFFICULT TO MAKE A DEFINITIVE JUDGMENT ON SMART BETA FUNDS, MANY OF WHICH ARE LESS THAN 10 YEARS OLD, UNTIL THEY ARE TESTED BY A BEAR MARKET.

BY DAN WEIL

Photo: Mario Tama/Getty Images

Investors seem to have lost some of their desire for smart beta, judging by money flows.

Smart beta exchange traded funds and open-end mutual funds took in a net $32.67 billion this year through Aug. 30. That was less than a third of the $109.21 billion they garnered in the same period of 2017.

To be sure, the percentage drop was even bigger for other ETFs and mutual funds, as investors have shunned risk in general. But smart beta funds aren't supposed to be like other funds; used correctly, they're meant to improve risk-adjusted returns over traditional index funds by tilting the weight of their portfolios according to various factors, including value, size, price momentum and volatility. So-called smart beta funds have attracted some $1 trillion in total assets. But mediocre performance has recently dampened the enthusiasm.

"Over the last few years, there was a lot of optimism that this is the holy grail," says Karim Ahamed, an investment advisor at HPM Partners. But now, "people are starting to ask questions." His firm is testing the smart beta strategy with limited allocations, in case it doesn't work out.

Indeed, their performance hasn't exactly shot the lights out. Investment research firm Morningstar counted 804 smart beta funds (711 ETFs and 93 open-end mutual funds) as of Aug. 30. Their average annualized return was 14.19

percent over one year, 11.20 percent for three years, 9.14 percent for five years and 8.08 percent for 10 years. That lagged the S&P 500 for each of those time periods—20.32 percent, 15.78 percent, 14.52 percent and 10.86 percent, respectively.

One could argue that it's unfair to compare returns to the S&P 500, because many smart beta funds are based on other indexes. But some studies show that smart beta hasn't performed so well on that score either.

According to research from UBS Group, only 32 to 39 percent of the 560 smart beta funds it tracked beat the performance of each fund's closest capitalization-weighted index during the 10 years ended April 30, 2017. The numbers were even worse on a risk-adjusted basis, with smart beta outperforming only 25 to 32 percent of the time.

"Lagging performance is the primary problem for smart beta," says Jack Ablin, chief investment officer for Cresset Wealth Management. "I've been skeptical of small-beta strategies because they tend to optimistically back-test and present their returns in that context. My first reaction is that's yesterday's news and not tomorrow's."

Smart beta defenders say much of the poor performance of smart beta stems from the fact that a large portion of the funds are tilted toward value stocks, and value has underperformed growth for more than 10 years.

That has to turn around eventually, some argue. "You can't expect growth to continue outperforming," says Tom Fredrickson, a New York City financial advisor who's part of the Garrett Planning Network. He and others note that studies show value ultimately outperforms in the very long term.

Many experts say using a combination of factors produces better risk-adjusted returns, helping to dampen volatility. "Individual factors have unique investment cycles," says Ben Johnson, director of ETF research at Morningstar. "Using them in combination will increase the likelihood of investors putting them to good use. Factors go better together."

He puts an interesting classification on smart beta. "At its core, smart beta is just a new form of active management," he says. "In many ways, it's a potential improvement upon the prior version of active stock selection. But it won't defy the laws of gravity that limit active managers overall."

On the plus side, smart beta's index approach often means lower expenses compared to traditional active management, Johnson points out. Smart beta, open-end mutual funds and ETFs have an average expense ratio of 0.53 percent, exactly half the ratio for open-end mutual funds and ETFs as a whole, according to Morningstar.

"Smart-beta funds also eliminate an important source of risk that's present when you have a flesh and blood stock picker: management risk," Johnson says. "You are outsourcing management to a set of rules that define an index, as opposed to people that have touch, lose touch or fall out of touch. Managers can pick up their marbles and go down the street or lose their marbles entirely."

But there's obviously no guarantee of success for smart beta, as the lagging returns show. "At the end of the day, it's still active management," Johnson says. "Whether it's U.S. stocks or large caps or small caps, it's not enough to be different, you have to be good. Some strategies have proven their mettle, and others haven't."

Advisors can provide a tilt to clients' portfolios without the use of smart beta funds, Fredrickson explains. He uses the **Vanguard Small-Cap Value Index Fund (VISVX)** and the **Vanguard Small-Cap Value ETF (VBR)** to give clients exposure in that area.

If you're looking for a smart beta ETF, HPM has clients in the **iShares Edge MSCI Multifactor USA ETF (LRGF)**.

But experts say it will be difficult to make a definitive judgment on smart beta funds, many of which are less than 10 years old, until they are tested by a bear market. "Having been a Wall Street customer for 30 years, I always approach new products with suspicion of whether it's science or marketing," Ablin says. "With smart beta, it's hard to tell." ■

"Lagging performance is the primary problem for smart beta."

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The Paradox of (ETF) Choice

THE EXPLOSION OF ETFS IS GOOD NEWS FOR INVESTORS, ISN'T IT? BY DAN WEIL

The explosion of exchange traded funds in recent years is not news; the total fund population now approaches some 2,200 and shows little sign of slowing down.

That is arguably good news for ETF investors—or is it? After all, more choice doesn't always lead to better decisions. In fact, too many options can often lead to paralysis. Does the proliferation of ETFs lead to more investor options, or more confusion? Is it possible to have too many ETFs?

"I'm not worried about a particular corner of the market," says Ben Johnson, director of global ETF research for Morningstar. "My concern is that the market transitioned long ago from innovation to a period of proliferation for all types, including niche and in some cases gimmicky funds. It's evolved to a lot of spaghetti being thrown at the wall over the past few years, and few of the strands have managed to stick."

For instance, in recent weeks the market has seen the disappearance of a whiskey-themed ETF and a multifactor water infrastructure ETF, recently launched market "solutions" that went searching for a problem to solve.

Not everyone shares that idea. "Throwing spaghetti against the wall? I'm fine with it," says Eric Balchunas, senior ETF analyst for Bloomberg Intelligence. "For every five duds, you get a ROBO," referring to the Robo Global Robotics and Automation Index ETF, which launched in 2013. It has $2.1 billion in assets and a three-year annualized return of 14.3 percent as of June 28, according to Morningstar.

"People vote with their feet," Balchunas says. "Only

Illustration: matejmo/iStock/Getty Images

1 percent of apps make it, and no one complains about that."

Johnson says, however, that even the more successful of recent products largely fall into "sexy themes," a kind of "hot take" on the markets and the economy, and it's not always clear that's the best way for individuals to invest. He mentions robotics, blockchain technology and the launch of blockchain in China as examples. "They're all somewhat interrelated," he says. "It's less being launched on the basis of lasting investment merit, and more opportunists trying to gather assets based on a theme that at any time captures investors' imagination."

Todd Rosenbluth, director of ETF and mutual fund research at CFRA research firm, sees a particular danger zone in the explosion of so-called "smart beta" funds, or funds that apply a non-traditional weighting to an index based on various financial factors. "You have 700 or 800 smart beta ETFs essentially fighting over 20 percent of ETF flows," Balchunas says. "They have such different strategies. Some take magnifying glasses to go through, and I don't know who has time."

These funds tend to be less straightforward for investors and advisors, require a lot more education and a lot of free time to rummage around in the fine print to compare and contrast options. Their expense ratios are similar, with many at less than 25 basis points, so it's difficult to just screen by cost.

"There are so many factors used in so many ways in these funds," Rosenbluth says. "You need to look inside the portfolio and understand the individual and collective exposure you get. The devil is in the details with these products. They can get quite complicated." It's a challenge for advisors to select funds simply and on their own, he says.

Meanwhile, Dave Nadig, managing director of ETF.com, a unit of Cboe Global Markets, has a completely different take from Balchunas and Rosenbluth on smart beta. The most crowded area is in low-cost vanilla beta funds, where meaningful differentiation is next to impossible beyond cost, he says. "Part of the reason there is so much activity in products like smart beta is that this is where there's more greenfield."

When it comes to the vanilla beta ETF, "the chance that there could be a successful launch of another one is zero, unless there's some incredible distribution and brand advantage, such as Google or Amazon," Nadig says.

Nadig says the whole market has become confusing for advisors and investors as a result of its massive growth, and for that, he offers a simple remedy: "I would stick to a traditional beta fund—a boring fund in Morningstar-style boxes."

"The market will only get more complicated," Nadig says. "So due diligence will only get harder. Continuing education is a requirement."

Balchunas sees possible overcrowding in some other sectors too. Environmental, social and governance funds are one. There's already some 60 ESG funds competing for only $5 billion in assets. "Compare that to robotics, which has almost $10 billion in just three funds," Balchunas says.

In addition, there are technology ETFs with $160 billion in 63 funds. "It's sort of like there's so much to choose from, you can't even order," Balchunas says.

Emerging markets	$200 billion in 110 funds.
Dividends	$160 billion in 70 funds.
Value stocks	$180 billion in 70 funds.

Source: Bloomberg

The key question is how much potential any particular area has, Balchunas says. "There are 2,170 ETFs, but about 7,500 mutual funds. If you think many mutual funds investors will switch over, ETFs are right where they should be."

As for why there may be excess ETFs, "any number of actors are trying to jump on the bandwagon to benefit from the halo effect of the category," Johnson says.

Then there's the flip side to that. "The vast majority of investor money continues to flow to seasoned ETFs, the most broadly diversified, vanilla exposure at rock-bottom costs," he says. "Most investors are still keeping it simple and cheap." ■

"There's so much to choose from, you can't even order"

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