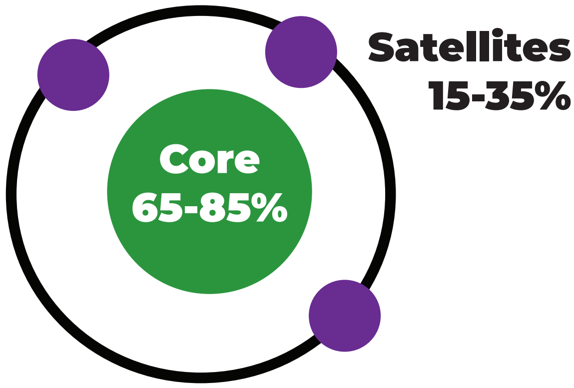
Investing to meet your financial goals. How to use ETFs in your investment portfolio: enhanced core-satellite portfolio construction

The unpredictable nature of markets means that investors need to be pragmatic and measured in their approach to meeting their goals, ranging from building a house deposit and paying for education to generating a consistent retirement income while maintaining enough capital for aged care deposits. Whatever their goals, most investors typically need to be able to preserve a certain level of capital, while also investing for long term growth or for stable income.

An enhanced core-satellite approach to portfolio construction can offer a cost-efficient and measured way to target investment goals and manage market volatility.

The new version of core-satellite investing

Core-satellite investing is a two-pronged approach to portfolio construction, where the core is made up of broad passive exposures to major asset classes (mainly equities and fixed income) and the satellite investments are more opportunistic and designed to seek specific growth outcomes, sometimes at higher levels of risk. These might typically be actively managed funds, but could also be investments in individual companies, real estate or one of a growing number of more-targeted ETFs. Generally, the core might be 65-85% of the portfolio, depending on the investor's goals, investment horizon and risk tolerance, while satellites tend to represent 15-35%[1].



A traditional core investment would be a broad-based index fund – perhaps the entire S&P/ASX 200 or S&P 500 – with the view of providing exposure to the performance of the entire market. The advantages of this approach are typically lower fees, ease of use and the ability to offer instant diversification. There are also challenges to this approach. A common criticism of older types of ETFs which cover broad market indices was that they exposed investors to the full extent of losses in the market, meaning capital might be less protected in market volatility. Another criticism was the blanket approach – you might have the best companies, but you also have the worst companies. As a result, investors often looked to more expensive satellite investments like actively managed funds as defensive plays and less as targeted growth opportunities. Newer generations of ETFs have allowed more tailored construction in the form of an enhanced core-satellite approach.

While still using passive investments at the core, the investments use 'smart beta' or alternative asset selection and weighting schemes. Where traditional index investing, also called passive investing, aims to use rules or a methodology to 'match the market', smart beta investments aim to outperform in certain scenarios using rules-based investing. These rules incorporate tailored filters in the form of fixed selection and eligibility criteria such as performance or sector, as well as how to weight investments. An investor choosing to use a smart beta investment in the core might choose an ETF that could be considered a broad market replacement. For example, an ETF that identifies companies from the S&P/ASX 300 based on quality and yield criteria every 6 months, such as the ETFS S&P/ASX 300 High Yield Plus ETF (**ZYAU**), might be considered a replacement for Australian equities. Or ETFS EURO STOXX 50 ETF (**ESTX**) might be considered a representation of European equities as it identifies 50 of the largest companies across 12 countries in the eurozone.

Or investors looking at alternative assets in the core to perform in different ways to equities or fixed income assets during periods of market volatility might look at assets such as gold through an investment like the ETFS Physical Gold (**GOLD**).

Investors looking for growth above market returns might use satellite investments in an opportunistic way in the enhanced model to incorporate specific themes or tilts. The newer generation of thematic ETFs means these are equally likely to be used as satellite investments, as actively managed funds.

How this might look in practice is as follows: an investor with a goal for high growth in the long term and a higher risk tolerance may wish to use the satellite component of their portfolio to create a tilt towards riskier and higher growth areas. For example, they might have a strong view on the potential of the technology sector and use an investment like ETFS Morningstar Global Technology ETF (**TECH**) as a satellite. Or perhaps they wish to access a particular theme as a satellite like the growing middle class in Asia by including an investment like the ETFS Reliance India Nifty 50 ETF (**NDIA**).

Alternatively, investors focused on income might use the satellite components for yield or proactively switch to defensive or growth tilts to bolster their core investments, depending on market conditions. For example, current market conditions might see income-focused investors include foreign currencies, like ETFS Enhanced USD Cash ETF (**ZUSD**) given its higher yield compared to Australian dollar cash, or foreign fixed income ETFs. They might also consider including sectors like infrastructure which tend to be less vulnerable to market cycles and can generate income through ETFs like the ETFS Global Core Infrastructure ETF (**CORE**). Pending their market view, these types of investments could also form part of the enhanced core portion of the portfolio instead of the satellite.

Since ETFs are typically highly liquid and can be traded on stock exchanges, this can allow investors to move quickly to adjust their portfolios when needed while still remaining cost conscious.

Adjusting the core to the investment strategy

Core-satellite investing is a flexible approach and the core will look different according to the individual investor. A high growth strategy might have a core with a higher proportion of 'riskier' assets like equities, while a defensive strategy might focus more on assets like gold or fixed income. Investors should consider the core as where they set their strategic asset allocation where the long-term targets are set for the investment composition to meet your goals, needs and views. By contrast, the satellite is for tactical asset allocation for shorter-term investments based on market and world conditions that are likely to be more temporary.

Whether a particular investment classifies as core or satellite is also down to the individual investor. For example, an investor with a focus on high growth and a long term view on incorporating consumer and technology trends may use an investment like ETFS FANG+ ETF (**FANG**) within their core, whereas an investor with a focus on balanced returns but still a desire for some exposure to these trends might use the same ETF as part of an opportunistic tilt in their satellite investments instead.

The theory behind the practice

Core-satellite portfolio construction and its enhanced version are based on modern views of efficient market theory. Efficient market theory assumes that companies are correctly priced based on all known information at all times, which means that it's not possible to consistently outperform the market using fundamental research[2].

Research indicates efficient market theory is true to an extent - the true value of investments does typically win out in the long term – but it's still possible to find short term patterns and opportunities to help generate higher returns[2].

An example of short-term patterns is how companies may move away from their fair value for short periods during times of market volatility. An investor might seek to 'beat' the market by avoiding cyclical or volatile companies in their holdings by using an investment like ETFS Global Core Infrastructure ETF (**CORE**) which uses volatility measures to identify 75 listed infrastructure companies. Or they might try to offset the volatility by holding an investment like ETFS Physical Gold (**GOLD**) to take a defensive tilt to their portfolios, either over the long term as part of their core investments or as a satellite tactical play.

An example of an opportunity in the form of a longer-term trend is the changing demographics and growth of the middle class across Asia. Rising out of poverty represents changes in consumption and spending habits, and in turn, can benefit a range of companies in areas like luxury consumer goods or healthcare. India alone is expected to see the percentage of households in poverty drop from 15% to 5% by 2030. A range of companies and industries may be able to capitalise off this transformation, changing what some investors might consider the "fair value" to actually be. An ETF like ETFS Reliance India Nifty 50 ETF (**NDIA**) provides exposure to blue-chip Indian companies which are well-positioned for the growth of the middle-class within India.

An enhanced core-satellite approach supports this view of efficient markets. Using smart beta ETFs at the core of a portfolio can assist in managing market and world activities and maintaining longer-term stability and growth by eliminating or including based on quality criteria. Satellite investments can be used to more selectively tilt towards growth or defensive assets based on themes in the market.

Cost-efficiencies for investors

Core-satellite portfolio construction also assists in cost management for investors. Passive investing is typically lower cost when compared to actively managed funds. Using ETFs may offer additional pricing efficiencies for investors, such as lower administration and management fees as well as lower entry point compared to managed funds and listed investment trusts. For example, in the top performing funds assessed under the Canstar Star Ratings, management fees for managed funds ranged from 0.19% up to 2.5%, with many including separate administration fees of up to 0.15% and performance fees up to 35%[3]. By contrast, management costs for ETFs generally range from less than 0.1% to 1% - with those at the higher end typically in more complex, or difficult to access asset classes or using greater tailoring in rules criteria[4].

ETFs also tend to be highly liquid (depending on the assets held in the benchmark index) allowing investors to free up funds as needed, for cash needs or to access other satellite opportunities in a relatively cost-effective way.

Aiming for the bulk of a portfolio to be flexible and lower cost may be a practical approach for many investors, when factoring both efficient market theory as well as the effect of fees on returns over the long-term. Investors can also consider selectively allocating higher fee budgets to satellite investments where they think there may be opportunities for outperformance.

ETFs also offer a point of difference for professional investors like financial advisers and planners to offer an all-inclusive service for 1% or less, with transparent investments. This type of service is becoming increasingly desirable, and even expected, by many retail investors in the wake of the events like the Global Financial Crisis and more recently, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Finding the right investments for the strategy

The continued growth of the ETF market means that it is becoming easier than ever to find ETFs to suit an enhanced core, or to match with opportunistic satellite needs or even to express moral and ethical views.

For more information on enhanced core-satellite portfolio construction or to find out more about using our range of ETFs in your portfolio, speak to ETF Securities.

Sales
Phone +61 2 8311 3488
infoAU@etfsecurities.com.au

Trading
Phone +61 2 8311 3483
primarymarkets@etfsecurities.com.au

[1] https://www.nasdaq.com/articles/case-using-coresatellite-portfolios-2016-06-30
[2] Malkiel, Burton G. The efficient market hypothesis and its critics, Journal of Economic Perspectives, Vol 17, No 1, Winter 2003, pages 59-82.
[3] https://www.canstar.com.au/managed-funds/managed-funds-how-do-fees-compare/
[4] https://www.canstar.com.au/investor-hub/etfs-highest-return/

Information current as at 4 February 2020.