Cover Story

The First Annual ETF Hall of Fame

The three winners are long-time fans who give ETFs large, impressive roles in their practices.

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By JANE WOLLMAN RUSOFF

Welcome to *Research* Magazine's first annual ETF Hall of Fame. The three advisors who have won our competition not only use ETFs but are long-time fans whose ETF assets under management have large and impressive roles in their practices.

Further, our honored FAs employ disciplined, proven strategies with these flexible investments — now totaling more than 500 — which shine at bringing diversification to portfolios.

The number of nominations we received was indeed impressive and the quality of advisors high, which doubtless made choosing the top three challenging to judge Ronald L. DeLegge , our monthly ETF Reporter correspondent and editor of www.etfguide.com .

Congratulations to our inaugural-year ETF honorees. Here's a little of what they're about:

Michael McClary

Principal, ValMark Securities, Director of Investment Advisor Services
Advisor Since: 2003
Home Base: Akron , Ohio
ETF AUM: 95% of $315 million firm-wide AUM in ETFs ; 100% of $15 million in McClary clients' AUM in ETFs
Civic Affiliation: Organized $480,000 donation to Akron 's Haven of Rest Rescue Mission

At age 20, 6'5" Michael McClary took over coaching a lackluster high school basketball team and, in tandem with his dad, turned it around to become a respected group of players that won more games.But Michael was just getting warmed up. The next year, as a rookie financial advisor, he took a big insurance broker-dealer's struggling ETF program in hand and soon turned it around to become a national RIA leader in ETF investments.

"I believe in ETFs . I hit the phones to tell the ETF story to all our advisors one by one and get them to believe in ETFs too. With active management and stock picking, it's a crap shoot. With ETFs , you can tell a story of a sound investment strategy that will work," says McClary , now 25.

In 2001, ValMark was about to chuck its five-month-old ETF program, which had only six accounts and $5 million in assets. Young McClary persuaded the firm to let him take a crack at making a success of the program by telling its 300-plus advisors facts about ETFs related to modern portfolio theory and the funds' advantages of low costs and tax efficiency.

Today the program manages assets of $315 million, and its six portfolios have outperformed their benchmarks for five years. "I tell advisors: If you're not already using ETFs , you'd better start because your clients are going to come after you about them. If you go into a sales situation where you're selling mutual funds and the other person is selling ETFs , you're going to get burned.

"The story is a hard one to beat," adds McClary , who joined ValMark while in grad school. He sparked to ETFs at the University of Akron , from which he graduated magna cum laude with a bachelor's in financial services. By 22, he'd earned his MBA there.

McClary's ETF strategy starts with developing an asset allocation using 14 or 15 different asset classes, then researching ETFs to find the appropriate indices and correct providers at the right costs. He pays attention to ETF liquidity, and "we keep a keen eye on tracking error — the performance of the ETFs [against] the indices we're trying to track," he notes. The FA favors "the more traditional" ETFs ; that is, those available for at least a decade.

He believes that ETFs are here to stay, though he's concerned about the mutual fund industry's marketing thrust that he says attacks index strategies and ETF efficiencies. It is like "a grassroots political smear campaign to stomp the momentum. Now that the ETF world has opened the door to criticism with [some expensive or misleading] new offerings, the mutual fund industry has gone on the offensive."

Actively managed ETFs worry him too. "You're taking something very pure and clouding it by adding active management. I think there'll be a lot of confusion about what's active and what's passive."

Born and bred in Akron , McClary grew up in a basketball family: Both his parents coached high school basketball, and his paternal grandfather is in the basketball coach Ohio Hall of Fame. Michael took his year-long coaching job just to get a taste.

"I didn't like that so many variables were involved coaching 17- and 18-year-olds: Stomach aches and girlfriends can make you lose more games!" he says.

Perhaps the most valuable part of McClary's basketball heritage is that it gave him a fine work ethic. "I had a lot of tough talks and good guidance," he says. "I took the inspiration from basketball and just moved it into what I do now."

Two years ago McClary , together with Alliance Benefit Group , became pioneers in putting ETFs in 401(k) plans by developing ETF Collective Investment Funds. "They unitize our entire ETF portfolio so that individual investors can participate," he says.

Apart from their investment benefits, ETFs are great for prospecting, McClary has found. "When people know you're an ETF advisor, you build credibility from Day One. They see a level of expertise. We've had doors open that weren't open before."

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Brian T. Fenelon

Senior Vice President-Wealth Management & Senior Portfolio Management Director for Citigroup Smith Barney
Advisor Since: 1984
Home Base: Jackson , Miss .
ETF AUM: $100 million AUM in ETFs out of $300 million total AUM
Diversions: Golf, Skiing, Hockey

Call it serendipity — or even fate — but when Brian Fenelon set out five years ago to design a better process to manage portfolio risk, he hit upon a way to both grow his practice and bolster client relationships.

To be sure, with exchange-traded funds, the advisor found the ideal tool to achieve all three happy scenarios. Now managing ETFs constitutes Fenelon's core business.

One of Smith Barney's Top 10 advisors in ETF management, he uses the strategy he created for his own team's clients in partnering with other SB advisors to look after their clients' ETF-based portfolios.

" ETFs help me make the investment process more understandable to clients. As they understand the process better, they value me as their advisor more — and our relationship becomes stronger," says Fenelon, 48, a St. Paul, Minn. , native.

Fenelon has been a member of the firm's Directors Council — Top 5 percent of producers — since 1991. His is a broad-based clientele, though mostly high-net-worth individuals. " ETFs are well suited even for the smaller investor too," he says. "They're fully scalable for a $50,000 account up to a $10 million one."

The FA's ETF strategy pivots on tactical asset allocation: He and his team analyze asset classes, sectors and broad markets around the world. Then they drill down to study the precise composition of each ETF under consideration.

Fenelon sticks with major providers and limits the number of ETFs to between 30 and 40, to reduce risk. Right now, he has 15 ETF holdings representing about 6,500 underlying stocks — "a gigantic diversification," he notes.

At press time, Fenelon was growth-oriented and in large-cap ETFs only. He was long on technology, consumer staples and aerospace, among other sectors. "But we've really trimmed back a lot," he says. "Our mantra is to participate in the upside and protect on the downside."

In the 2001-2002 market slide, a comment from a disappointed client with a separately managed account prompted Fenelon to find an improved way to allocate among managers to control market risk. He wound up discovering that using ETFs was an effective method to rebalance among asset classes.

"With ETFs , what you see is what you get — and that's the beauty of it," says the FA, who shifted a number of clients out of managed accounts and mutual funds, and into ETFs . "It was [usually] less expensive for the client [because of ETFs ' lower costs] and to me, just a better way. It isn't a conversation about a mutual fund or fund manager or individual stock. There's nothing in between the client and me."

ETFs allow Fenelon to construct portfolios that are adaptable to each client and market cycle chiefly because of their ease and efficiency in the asset allocation process. " ETFs let us identify those areas we want to be in according to sector or asset class or country or region," he notes.

He started his career in a bank's commercial loan department, then became a PaineWebber financial advisor, based for a while in New York City . In 1985, he and wife Kelley, a former advisor, settled in Jackson , Miss. — population: 300,000 — Kelley's hometown.

Fenelon ascribes much of his success to giving clients "an understandable investment process that helps them achieve goals while, hopefully, reducing risk. ETFs fit hand-in-glove — and it's where many referrals come from."

His best advice to advisors: "You have to know what you're buying. Not all ETFs are created equal. There are new ones that pop up all the time, and a lot are [hyped as] 'the hot thing going' [because] that's what the issuers can sell. But many [such] ETFs carry a specific strategy like a money manager has. To me, that's getting away from what I'm trying to accomplish with ETFs ."

He continues. " ETFs are the best tool I can use for my process. The end result is really client-focused, and that's what's cool about it. ETFs ' transparency is the secret. Clients 'get' it."

Now that he's been at it for five years — quite a while in the ETF new frontier — Fenelon says: " ETFs have grown organically with our practice. I feel like a grandpa doing this!"

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Daniel S. Schwartz

Senior Vice President-Financial Advisor & Senior Portfolio Manager, Schwartz/Epstein Group , Morgan Stanley
Advisor Since: 1989
Home Base: Ridgewood , N.J .
ETF AUM: 65% of $250 million AUM in ETFs and 65% of $400 million in transferring AUM in ETFs
Civic Affiliation: Co-Founder, Institute for Educational Achievement in New Milford , N.J. , for children with autism

Newark, N.J.-born Schwartz, 43, has been using ETFs exclusively to build stock and taxable bond portfolios for six years now — and they've been a big reason for the FA's success with his roster of high-net-worth clients.

" ETFs have led to tremendous consistency in what we do. The margin of error has really shrunk because we're not making mistakes in trying to pick individual managers who pick stocks. We don't have things blow up. There are no surprises. Clients don't have to worry that if the market is doing well, are they doing well? They know they're doing well. We're virtually guaranteeing the return," says Schwartz, who heads a group of five that includes three advisors.

He introduced ETFs into portfolios out of frustration with the performance of clients' managed accounts, which, he says, "weren't even delivering market returns. When ETFs came out, it was a huge change: They allowed us to execute our strategy in a very simple fashion. And we're using our expertise to highlight different areas at different points to add alpha to portfolios."

Schwartz has a disciplined, in-depth strategy for the lowest cost, highest after-tax returns that first looks at broad market sectors, analyzes the economy, considers interest rates, then determines attractive market segments. After that, he researches individual styles and uses sector analysis to highlight those sectors that are particularly appealing.

Schwartz primarily focuses on iShares and Vanguard ETFs . Right now, he likes large-cap growth and the technology, health and international sectors. " ETFs are hard to beat for that portion of the portfolio that needs to be in growth," he says. "If you invest in large-cap growth and it does well, you're guaranteed to do well."

Specialty ETFs , "designed to capture double the daily return of a particular index or sector, are very intriguing," says the FA. Indeed, "there are lots of tools and applications now available through ETFs that were not here five years ago." And for advisors who are too pressed for time to conduct much research, firms now offer "off-the-shelf solutions," he adds.

" ETFs are good for every client I have. It just depends on how you use them. The traditional low-cost ETF is very hard to beat for the average investor, and they're also super-attractive to institutional investors and very high-net-worth investors," he says.

ETFs ' ease of use is a major plus. "In this business, you try to keep things simple and elegant — ETFs really fit that. Sometimes advisors think that things need to be complicated in order to be good for a client. But the clients I work with are looking for something easy to understand and to be shown why it should work. I can't imagine anything easier than ETFs ," says Schwartz. "If you need to buy or sell anything, they're traded instantly. They have the liquidity of stock.

"Some people, though, think they can successfully trade ETFs day to day. I have yet to meet anybody who does."

Perhaps the advantage that excites Schwartz the most is what ETFs do for diversification. "You can get commodities exposure now. You can get currency exposure. ETFs offer you a way to get exposure to virtually anything you want. But you have to know what you're doing in how to allocate them."

And he warns: "Be very careful with the new actively managed fundamental-type indexes that create an index by coming up with their own models. As soon as you start moving into the actively managed world, you're taking away some ETFs benefits. Then, instead of being assured of a certain type of return, you're back to the word 'maybe' — maybe it works, maybe it doesn't."

Freelance writer Jane Wollman Rusoff is a Los Angeles-based contributing editor of Research *and is the founder of Family Star Productions.*

Photos for the Research 2007 ETF Advisor Hall of Fame by Gil Ford, Todd Biss and Daniel Byrne.