ETFs for the Alternative Space?

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On AdvisorIntelligence, we provide a list of low-fee index ETFs and index funds for all the asset classes where we believe there are robust/reliable index fund substitutes for the actively managed funds we own in the portfolios. It's pretty straightforward to make these substitutions into our current portfolio asset allocations. We also publish index model portfolios that predominantly use index ETFs.

There are some asset classes and strategies where we don't believe there are acceptable index ETF substitutes currently available. These include floating-rate loans, flexible income, arbitrage, and managed futures strategies. So we have selected actively managed funds for those allocations in our index models as well as our fully active portfolios.

We've looked at a few ETFs in the alternatives space, and there are a few problems:

1. The number that are investable in terms of AUM is very small. This takes into account both the liquidity of the ETF if you want to make a collectively large investment into it, or importantly, take significant money out of it, as well as the business risk that the firm decides to shut the ETF down because it just doesn't make sense economically. There are only five alt ETFs with AUM of at least $100 million when I looked recently.
2. A lot of these funds are very narrowly focused—"fad" would be overstating it, but I wouldn't consider using them as a core holding. They'd be something you might be interested in if you had a very specific tactical view. We'd be quite unlikely to have that strong a narrow tactical view to make it a significant weighting.
3. The performance of most of these ETFs is pretty bad. There are structural features in the ETFs that make them sub-optimal, like a much narrower universe of markets, the exclusion of some asset classes entirely, not being able to short certain markets—things that will permanently handicap performance regardless of environment. Also, the mutual fund managers have large teams and significant resources dedicated to making improvements to models, implementation, trading, etc. Managed futures is where you see the highest fees, and where we think you lose the most in going to an ETF. We're not married to these allocations however, and in an environment where more traditional assets are reasonably valued, alts could be a source of funds.

Obviously actively managed trend-following mutual funds have demonstrated poor performance recently as well, but that's a strategy-wide phenomenon since it's been a poor environment for the strategy for much of the last three years. We still think these funds will perform reasonably well over the long term, and particularly well in extended bear markets.

—Jason Steuerwalt, CFA