Generations ETFs episode 9: Tyler Mordy
Interview Transcript
Recorded December 9, 2015

Introduction
Welcome to Generation ETFs, brought to you by Horizons ETFs Management Canada Inc. This is a podcast series dedicated to the next generation of investing. I'm your host Donna Papacosta, and in this series, Generation ETFs will aim to educate and inspire investors to understand and be active in their portfolios by discussing market trends and investment strategies with the leading experts in the industry.

In this episode of Generation ETFs, you'll meet Tyler Mordy. Tyler is a CFA who is president and chief investment officer at Forstrong Global Asset Management. He is a recognized innovator in the design and application of "global macro" managed ETF portfolios, and is often quoted and interviewed by the financial media. Recently, ETF.com profiled Tyler as one of the "best and brightest" working in the ETF industry.

In this conversation, Tyler discusses ETF strategies and the next evolution of investment products.

Interview

Interviewer: Tyler, what does it mean for you to be an ETF Strategist?

Tyler Mordy: It's been a wonderful place to be. It's been a growing market. I think it's taken awhile for the definitions and the nomenclature to crystallize in the ETF industry. This definitely speaks to the ETF strategy industry. On a surface definition, ETF Strategist, the way that Morningstar or some of these other databases that track ETF strategists would define us, are asset managers that use 50% or more of ETFs in their portfolios. I like to come at it from a first principles perspective. Always looking at what are the important truths, if you will, that ETF strategists believe? I think if you look, certainly from our perspective, if you look at the wider wealth management industry as as whole, traditionally it's always been viewed that the only way to add alpha or to outperform has been through active stock selection. Stock pickers.

We completely disagree with that. We think there's one other really great way to add alpha and that's through the entire selection of asset classes. Our first principle, or our important truth if you will, is that it's actually easier to outperform by being in the right asset class rather than picking the right stock and I think that's fundamental difference. It's driving big organizational change in the industry as more and more people recognize this. You can view it almost as a ... Stock picking will still exist, but you can view us, ETF strategists, as having this philosophy that differentiates us somewhat.

Interviewer: You've been designing portfolios using ETFs for 15 years now. What is it about ETFs that make them so adaptable for your process?

Tyler Mordy: I think we need to go back to the early vision of the firm itself, four-strong global, and that is to look back to 2001 when the firm was started and to look at the founding philosophy. We all were global macro specialists. We all believed that a big picture perspective was the most important thing. We saw this little tool called the ETF that was coming out. It was very nascent at that point. Very little assets. Very little listings. We felt that the ETF would colonize the world's investment classes. You would be able to access all these different asset classes. If it was a great vehicle, why would you go track Chinese bonds? Or the gold market? Or whatever it is.

I think the marriage of a global macro process with the ETF tool as this enabler, if you want to call it that, enabler of access to all these world's asset classes, would be a really perfect marriage. Low and behold that's exactly what happened and today we're able to build, what we say, if you look back to the 1990s, we're able to build a better portfolio for $250,000. By better I mean more diversified. More robust. Better risk management. A better portfolio for $250,000 than we could for a multi-million dollar pension plan back in the 1990s. That's a very powerful statement.

Interviewer: We know Canadians are quite patriotic in their portfolios with heavy investment in Canadian stocks and bonds, but what's the danger of a home bias like that?

Tyler Mordy: I've traveled extensively and I've been in so many different countries over the last few years here and what's funny is that any country you go to in the world, the investors always have a strong home bias. I think what's different about Canada is that we have a very concentrated market so there's a heavy focus, as everybody knows, on resources in the financial services companies. If you look at it from a Canadian perspective we almost compare it to a vitamin deficiency. If you only have exposure to Canadian stocks and Canadian bonds, and even if you do have a little bit in international exposure, you probably have a fairly large global deficiency. You look at it from a diversification standpoint and a risk management standpoint. The interesting thing about finances that they say the only free lunch in investment management is being globally diversified. That's the best way, to be globally diversified.

The other angle that you can think about with going global and not having a strong home bias is that everybody always thinks about going global as accessing higher returns. So accessing riskier markets and hence having higher returns. I think what we look at ... We look at it completely differently. We look at it from a risk management perspective. By having this big picture view and looking at what's going on in the world economy and having a top down view, you're actually better able to manage risk. The best example of that right now is that, I think, you look at a lot of the Canadian stock pickers these days and they're picking good companies with solid balance sheets and good dividends and all that kind of thing. Stable everything else. They're frustrated that things aren't going up. The answer to that, why that's happening, is that macro influences are overwhelming the individual company dynamics.

Canada's in a bear market, oil's declining and money's flowing out of Canada. All those factors are much, much more important than anything going on at an individual company basis. Again, don't look at it as more of a return even though will ... You should get higher returns over the long term, but look at it from a risk management perspective.

Interviewer: Your investment process follows both shorter macro economic trends and larger trends, which you refer to as super themes. Can you explain the difference between the two and how super themes are positioned in your portfolio?

Tyler Mordy: Yeah. Just to preface some of my comments, I like to ... One of the criticisms that we do get is that global macro, there's so many variables out there and the world economy's complex and so fluid that how do you identify all the nature factors? Are there too many? I got a mathematics degree. I go back to my undergrad in math. There was something called the reduce form equation. That said that when you're faced with a complex problem or a complexity of variables, look to the reduced form equation. Look for a small number of explanatory variables that maybe explains 70-80% of what's going on and then at least you're not paralyzed by the complexity, but you can identify the right factors. That's exactly what we do in our portfolios for clients.

What we do is we have two tracks. We have what we call super trends. Those are the three to five year views in the world economy and global capital markets and those are the most important super trends out there that will impact portfolio returns. Today it could be the Asian demographic. A lot of older people in the west that have a ... Search for income. Or it could be the rise of China and it's internationalization of the renmindbi, their local currency. Those types of themes that will play out over a three to five year view. That's classic fundamental macroeconomic analysis.

Then there's something different we call tactical views and that the time horizon on that is less than 12 months and that really relies on more of behavioral analysis. Everybody loves to read the popular books like "Freakonomics" and anything related to behavioral finance. An interesting thing about this is there's a lot of work in academia suggesting that there's methods that you can use in behavioral finance to improve portfolio returns, but this stuff really hasn't made it's way into the practitioner world of money managers.

Behavioral finance we look at as anything that human beings create. Inefficiencies in financial markets. If human beings become overly optimistic at certain times, they become overly pessimistic at some times, you look back ... If you look at real time through the financial crisis, in the lead up to 2008, 2007 was a very big year for a lot of investors in terms of them risking up their portfolio. Which is interesting. They should have been doing the exact opposite. If you look back at the psychology, returns are good, it emboldens investors to take on more risk, complacency increases, and then ironically financial markets becomes less stable and that's what we saw in 2008 with the global financial crisis.

Then as we move through the financial crisis into 2009, we see investors becoming more and more demoralized, doing things with their portfolio like going to all cash, or going to all gold and doing the exact opposite things that they should do. Perhaps that a sad testament to human nature, but we rely on those behavioral finance clues and signals to manage risk for portfolios. So we were risking up in 2009, we're risking down in 2007. It tends to be a little bit contrary in nature, but I think if you look at it from our investment committee perspective, the way we view it and the way it happens in practical terms is that we look at consensus views out there. What are the big, enduring consensus views out there, and then we try to attack those views and say is the crowd missing something. You don't always find a contrary opportunity.

If you do find a compelling case that the crowd is thinking something that's totally not aligned with what we think of the future, then you have a big opportunity to outperform because if you're positioned differently from the crowd, that's where you get all our outperformance. It's incredibly need approach if you look at super trends, keeping your portfolio aligned with those big picture trends and then the tactical views which tend to be a little bit more shorter term in nature, but it's risk management from a human perspective.

Interviewer: You were speaking earlier about having a global perspective. It's one thing to buy stocks and bonds from other countries, but how should we approach global currencies that come into play?

Tyler Mordy: Currencies are by far my favorite asset class just because it's a largely ignored asset class. That speaks to the philosophy both in academia and in history at large for the last ... As far as anybody can remember. The view out there ... The common view, I should say, has been that because currencies are very volatile and they tend to wash out over long periods of time, you should ignore any sort of active currency decisions. You should take a purely passive approach on currencies. That might mean hedging all your foreign exchange risk or it may mean be fully unhedged in you foreign exchange risk, but just again, not making any active decisions.

I think that it's true that they wash out over long periods of time, but those periods of time tend to be 30 and 40 years, so I don't know any client who has that type of investment horizon. We look at it very differently. We look at currencies as any other investment class. They can become wildly overvalued, they can become wildly undervalued and speaking to the behavioral component they can become wildly over-loved and conversely under-loved as well. As the Canadian dollar was in the run up to it's peak in 2012.

It's a very interesting asset class. It's almost a stealth asset class that can really help us manage risk and ask alpha over the long term. If you look at the period through the financial crisis, one of the big reasons we outperformed our peers so significantly was because we saw a lot of undervalued, under-loved currencies out there and we were able to incorporate those via e-currency ETFs or bond ETFs into client portfolios. Again, it's an overlooked asset class and it's a component of a portfolio that we think you should incorporate into your view.

Interviewer: There are so many ETFs now, Tyler. About 400 in Toronto and thousands in New York. How do you and your firm choose which ones will represent the asset classes you need exposure to?

Tyler Mordy: It's been a wonderful evolution to watch all these ETFs proliferate and, as I say, colonize the world's asset classes. In some cases there's hundreds that come out every year, but we have such a selective approach that's almost become quite easy to screen these ETFs to determine which fit into our portfolios and which don't. What I would say is that as a macro investment manager there's two ways we look at ETFs. There's a quantitative way where we look at costs and liquidity and that type of thing. That tends to kick out a lot of ETFs. As a macro manger you're first picking the global decisions so whether you want to be long Chinese equities, as an example, or not. Then you're trying to find the ETF that best matches that macro view.

Here you have to be highly aware of the indexing methodology that is used in ETFs. We've had all these alternative weighting methodologies. We've had Smart Beta, we've had low volatility, we've had revenue weighted. The list goes on and on and on, but for example, if I wanted to ... If I like the U.S. multinational asset class as an example, then what we would do is we would tend to look for the sectors that most align with U.S. multinationals, which tends to be the consumer staples and telecoms. This is an example we used in portfolios. If you look at any deviations from the market cap index, you can go into dividend weighted indexes which tend to produce a sector bias that is aligned with those sector picks.

It's really knowing what kind of biases any deviation from pure beta market cap index produces and if those are aligned with your macro views. Or the other example would be China. There's so many different types of Chinese equities as a mainland Chinese A-Shares, those are A-Shares that trade in Hong Kong. Just being sure that the macro view that you're trying to pursue is really aligned with that ETF.

The real paradigm shift for ETFs is not necessarily the low cost or the tax efficiency or anything like that, even though those are great beneficial features of the wrapper itself. The real paradigm shift for the portfolio construction process is, again, having all these available tools that you can choose with that align with your global macro view.

Interviewer: It's certainly true that ETFs have come a long way in their 25 years. What do you see will be the next evolution of investment products?

Tyler Mordy: The biggest trends in financial markets, if you just took a huge big picture trend right now, the biggest trend has been globalization. By globalization I mean the globalization of finance. Whether you look at cross border flows; ie. money flowing between different borders or the liberalization of capital markets in some of these young emerging markets and so forth. The globalization of finance, as I call it, has been the biggest trend.

I think that relates a lot to the ETF revolution. We're not necessarily focused on new indexing methodologies or tweaking on the basic market cap index. What we've always been focused on is enabling access to different asset classes. I think when you look at the emerging markets, take China as an example. It's going through a huge market liberalization right now. What we see longer term as these capital markets mature is that you will have, just like in the west, you'll have all these emerging markets sliced and diced a little bit more. Right now we have a lot of broad based Chinese equity exposure. I see that going down into Chinese equity style, Chinese equity sector and so on and so forth. That's the real exciting part here.

The other part to think about too is I call this the Act Two of the ETF industry. Act One was all about acceptance of the ETF vehicle itself and embracing it as a viable tool for the portfolio construction process. That's more of a product type view. Do we accept the product? Is it something that the investing public is going to embrace? Is it good for the end client? I think the answer is, unequivocally, yes right now.

Act Two is moving from product to process. Process, again, this speaks to where the ETF evolution is going. Process is all about, so we have these wonderful tools. They prove themselves through all market climates. They're cheap, they're low cost, all those wonderful attributes. How best to use them in an active investment process. That's what leads you into global macro and typically any sort of global investment process. There's a lot of ETF strategists that are quantitative. We're definitely more of a qualitative manager. We definitely rely on more of these super trends and themes and that kind of thing to drive our portfolio strategies.

Interviewer: Thank you, Tyler.

detailed information about the Horizons Exchange Traded Products. Please read the prospectus before investing.
The views/opinions expressed herein may not necessarily be the views of AlphaPro Management Inc. or Horizons ETFs Management (Canada) Inc. All comments, opinions and views expressed are of a general nature and should not be considered as advice to purchase or to sell mentioned securities. Before making any investment decision, please consult your investment advisor or advisors.

Certain statements may constitute a forward-looking statement, including those identified by the expression “expect” and similar expressions (including grammatical variations thereof). The forward-looking statements are not historical facts but reflect the speaker’s current expectations regarding future results or events. These forward-looking statements are subject to a number of risks and uncertainties that could cause actual results or events to differ materially from current expectations. These and other factors should be considered carefully and listeners should not place undue reliance on such forward-looking statements. These forward-looking statements are made as of the date hereof and the speakers do not undertake to update any forward-looking statement that is contained herein, whether as a result of new information, future events or otherwise, unless required by applicable law.

end