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#### A Mutual Fund Of ETFs Makes The Scene

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First came mutual funds that hold other mutual funds. The first wave of mutual funds that hold ETFs was just a matter of time.

The CEO and founder of Smart Portfolios LLC, Bryce James, manages the Aston/Smart Allocation ETF Fund, which launched in January.

**IBD:** What leads you to believe that there's demand for a mutual fund made up of ETFs?

#### Bryce James



■ Aston/Smart Allocation ETF Fund

■ President

■ 48 years old

■ Education: B.S., accounting, finance and marketing,

Central Washington University

**James:** ETF proponents laud the merits of ETFs' tax efficiency, lower fees, liquidity, zero minimum investment levels, intraday pricing and diversification characteristics. These are all good things, but we were originally pushed into using ETFs by the growing wave of mutual funds restrictions, such as early-redemption penalties.

In the past two years, mutual fund companies have lobbied to enforce early redemption fees (under Rule 22c-2) on client accounts they deem to be active traders, tactical allocators, or market timers. It has become a bad thing to be considered one of these culprits.

A self-serving mutual fund industry has been deceiving the public and governing bodies by suggesting that active management is a bad thing. If we peel back the layers of Wall Street marketing, we find that the brokerage platforms are charging the mutual funds fees (averaging 30 basis points, or three tenths of 1%) to be hosted on their platforms. So an investor who sells early can actually create a loss for the fund

manager. I believe this is the main driver.

The only counterargument is that it does take some effort to manage the cash flow of a fund, and large buy and sell orders can create erratic cash flows for a mutual fund, especially those holding illiquid securities, such as real estate.

The mutual fund industry is enforcing Rule 22c-2 as a method to retain client assets and to offset the hidden platform fees charged to the mutual fund managers. This manipulation of investor rights is what will fuel the growth in ETFs.

**IBD:** You say you use a proprietary mathematical process to pick the holdings. Can you elaborate on what variables you look at and why?

**James:** Return should not be determined by using the historical average return to predict future results (Wall Street's caveat is "past performance is no guarantee of future results.")

Stocks movements are a product of fundamental projections (such as growth rates or dividend-income streams) and investor sentiment (fear and greed).

Using current security prices will reflect both of these functions. By examining the clustering of data using Generalized Auto-Regressive Conditional Heteroskedacity (GARCH), a method which awarded the two founders

the Nobel Prize in economics in 2002, you can better understand your current risk and return.

Furthermore, a financial engineer can track the movement of pricing (and risk and return) through running a series of simulations, typically 100,000 simulations, in a Monte Carlo simulation model.

The EVT model typically forecasts one month into the future using mutual funds or ETFs.

**IBD:** What are your rules or guidelines for buying and selling your holdings?

**James:** Similar to most allocation solutions, we set minimum-maximum constraints, such as no more than 8% in one ETF security (except cash, money market and one- to three-year Treasuries) and no more than 20% in any one industry.

When risk is high, we can go more conservative, such as we have been this year, or when expected risk is low and forecasted returns are high, we can turn up the volume, so to speak.

Current fund holdings:

- **Fixed Income:** 42% of net assets.

iShares Lehman 1-3 Year Treasury Bond ([SHY](#))

iShares iBoxx Liquid Investment Grade Index ([LQD](#))

iShares Lehman Aggregate Bond ([AGG](#))

- **Domestic Equity:** 30.5%

SPDRs Dow Jones Wilshire Small Cap Value ([DSV](#))

iShares S&P SmallCap 600 Value ([IJS](#))

iShares Russell 2000 Value ([IWN](#))

iShares Russell Midcap Value ([IWS](#))

iShares DJ U.S. Basic Materials ([IYM](#))

Vanguard Industrials ([VIS](#))

Materials Select Sector SPDR ([XLB](#))

Utilities Select Sector SPDR ([XLU](#))

- **Global Equity:** 11%

BLDRs Emerging Markets 50 ADR Index ([ADRD](#))

iShares MSCI South Korea ([EWY](#))

iShares MSCI EAFE ([EFA](#))

iShares S&P Latin America 40 ([ILE](#))

Vanguard Emerging Markets ([VWO](#))

- **Hard Assets:** 16.5%

Powershares DB Silver ([DBS](#))

iShares Cohen & Steers Realty Majors ([ICF](#))

iShares DJ U.S. Real Estate ([IYR](#))

DJ Wilshire REIT ([RWR](#))

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