streetwise The Gold Report®
Featuring investment coverage of precious metals, base metals and gems

Tyler Mordy: Gold-Backed ETFs on a Roll

Source: The Gold Report 03/03/2009

It was Warren Buffett who said that you learn who's been swimming naked when the tide goes out. But it is Tyler Mordy who's pointing out the few swimsuit-clad investment products standing on the shore now that the tide of economic growth has clearly ebbed—and some of them have a golden glow. A widely recognized innovator in the design and application of actively managed Exchange Traded Fund portfolios, Tyler is Research Director for HAHN Investment Stewards and publishes its ETFocus every other month. In this exclusive interview, he tells The Gold Report readers that global multi-asset ETF portfolios having investments in gold and gold stocks present excellent opportunities not only for preserving but building wealth. Case in point: inflows of 105 tons into gold-backed ETFs in January—approximately half the world's gold mine output for the month—pushed ETF bullion holdings to a record 1,317 tons.

The Gold Report: Can you explain how HAHN Investment arrived at a strategy that focuses on ETFs, and why investors should consider such vehicles as part of their portfolios?

Tyler Mordy: The advent of Exchange Traded Funds really created a paradigm shift in the wealth management industry by opening up asset classes that traditionally were either difficult to access or reserved for ultra high net worth investors or both. ETFs offer benefits to all, including instant diversification, tax efficiency, and very low maintenance and expense ratios.

Most importantly for HAHN as global tactical allocators, they're the perfect asset mix tool. So they really can track any published index. And we now have a selection of over 1,600 ETFs worldwide. The ETF industry has ballooned to about $650 billion in assets under management, up from about $70 billion in the year 2000 and a very long way from the first ETF that was launched in Canada in 1993.

So it's now possible to build better global multi-asset portfolios exclusively with ETFs, but it's only in the last five years that investors have really started to embrace them. Figures from 2008, for example, show that U.S. investor inflows into ETFs totaled $178 billion, while at the same time they pulled $320 billion out of traditional mutual funds. So investors are really running with the shift and embracing it. But, remember, they are just better tools to implement different types of strategies—active strategy formulation is still a critical component of the investment process.

TGR: You say it's possible to build ETF-exclusive portfolios like this. Are you actually doing it?

TM: Yes. Our firm runs actively managed core global balanced portfolios using only ETFs. While we have abdicated individual security selection for our clients, stock picking can certainly add value in certain investment classes, such as the less efficient smaller cap area, biotechnology and the junior mining stock sector. But for most investment classes, the high correlation among individual investments virtually ensures an incredibly difficult task to produce alpha within a particular index class.

Multiple studies confirm that most active stock-picking managers fail to beat their applicable indices regularly. For our firm that doesn't lead to a strict buy-and-hold passive indexing approach. In fact, we're not indexing purists at all, and we certainly don't embrace the efficient markets hypothesis. But rather for us it just shifts the investment decision-making process to asset mix and not picking stocks. So the key point is that active and passive are not mutually exclusive investment approaches. Our investment

committee is very engaged in active strategy bets and acknowledges that active management is necessary because business cycles require different investment posturing at different times. Regime shifts also occur which portfolios must adapt to.

And then, of course, there's the behavioral aspect to investing as we've seen in the last year. Those human elements ensure that financial markets remain cyclical. Asset values always overshoot on the upside and undershoot on the downside—that creates some incredible opportunities for active managers.

TGR: Why wouldn't you go directly into the indices? Why do you use ETFs?

TM: Good question. ETFs are just low-cost, transparent and tax-efficient vehicles for accessing exposure to the indices. They can track any published index and you can buy them as if you were buying Microsoft or any other single stock. It is just an efficient tool to build globally diversified portfolios.

TGR: You also mentioned that active stock picking has not generated above-average returns as measured against each applicable index. If the ETF is really a market basket of stocks, how do you generate better-than-average returns?

TM: Numerous studies, both from academia and from industry reports, show that it's incredibly difficult for managers to beat their bogeys or their applicable indices. So, as an example, U.S. equity fund managers by and large do not outperform the S&P 500 over long periods. So, at HAHN Investment, we do not devote time to individual stock selection but which index to be invested in. As an example, we will not spend time analyzing the differences between Canadian banks, such as Royal Bank or CIBC, the pertinent question for us is do we want to be invested in the Canadian financial services sector or not? So our team adds value through shifting asset mix, rather than stock picking within each index.

TGR: It sounds maybe more like sector picking than stock picking.

TM: You could say that. But we also make active strategy calls in countries, styles, and different sizes of capitalization. In the fixed income market, ETFs also allow us to make regional and country bets, along with credit and duration calls. We also have what we call an "opportunity investment class," which includes any indices outside the set of traditional developed market stocks and bonds. That includes gold bullion and gold stocks, emerging market equity and debt, property and so forth.

TGR: Suppose an investor just wants an ETF with exposure to international stocks, or maybe precious metals?

TM: We only run balanced portfolios. with a suite of nine portfolios ranging in risk from income all the way up to growth, and international content from domestic all the way up to full global portfolios. Last year, in response to low money market rates, we launched two "income focus" mandates. So, no, you wouldn't hire us to select an ETF for international stocks or precious metals—those would just be holdings in our balanced portfolios. If we're bullish on gold stocks, we would simply buy XGD, which is the Toronto-listed iShares global gold index.

TGR: Since you do global tactical allocation, what do you see happening in the world markets?

TM: Recent events in financial markets are following the classic boom-bust script from credit over-expansion to the inevitable painful aftermath. That's nothing new, really; all booms are marked by rapid credit growth and financial liberalization. Every cycle is the same in that lenders and investors vastly underestimate risk. Last year we had some of the lowest risk premiums on record. As risk is central to our investment process, we had positioned client portfolios relatively conservatively over the last few years. That investment posture served us well in the latest global equity market decline.

TGR: So the current climate is nothing new?

TM: Well, historical financial markets display similar patterns, but every cycle is unique. This cycle is much different than anybody's experience in the post-World War II period. One would have to go back to the Great Depression to find a period where there's been such massive wealth destruction during a period of declining asset prices and high debt levels. Of course, there are differences, but the salient point is that declining asset values are something new in the post-war period. We see the world trying to go back to business as usual, but most of the players lack experience in a situation like this. There's overconfidence in the capacity of Keynesian reflation to solve today's economic problems.

Policymakers are trying to do what they did in the past and even pursuing unorthodox investment policies, such as buying mortgage-related and asset-backed securities. Their balance sheets are absolutely exploding. But their actions so far have been relatively impotent. We know that because banks continue to hold liquidity and ration credit conservatively. But the focus on implementing the perfect rescue plan masks the fundamental problems of the U.S. economy. While a bailout may avert further financial crisis, we'll still be left with the structural problems and delay the necessary deleveraging and purging of what the Austrian economists always referred to as malinvestment (these are capital structures created during a bubble period but unsupported by real demand).

And, the U.S. government is just shifting the burden of failures from bondholders and stockholders to taxpayers. If you look at the real problems in the U.S. financial markets, the financial sector has grown too large in relation to the real economy. John Bogle always says that the financial economy has swamped the productive economy and that's absolutely true. At the height of the financialization boom in 2007, financial sector earnings accounted for over 40% of overall S&P 500 corporate profits. That was up from around 15% in the early 1980s. (Vanguard Group Founder and President of Vanguard's Bogle Financial Markets Research Center, Bogle is often called "the father of indexing.")

The second problem is that markets had become highly unregulated. Of course, the big danger there is that we go too far with regulation and stifle real economic growth. Policymakers are clearly moving too far in that direction. So given a more rigid set of constraints—more regulatory oversight, less leverage, stricter underwriting standards, not to mention the dead securitization model—the financial sector is going to be much less profitable.

But the central problem with the U.S. economy is that it's based upon unsustainable borrowing and chronic asset price bubbles. Look at the total credit market debt to GDP since World War II. It was stable at around 150% of GDP until 1980 and then skyrocketed to 350% as of the end of 2007. There is a long, long deleveraging process ahead, which will take many years, not months, to resolve. Neither Obama nor any policymaker has a silver bullet for the U.S. economy.

TGR: If the government's shifting the cost of failure from stockholders and bondholders to taxpayers plays out, how does the economic landscape look for people in the U.S. and Canada in the next two years?

TM: Well, because the world economy has become so globalized, we have to frame the Canadian and U.S. outlook within a global context. Clearly, the global economy had become highly lopsided. The U.S. had become increasingly dependent on a consumption bubble financed by foreign savings while the rest of the world, particularly export-dependent Asia and oil-exporting nations, had become reliant on U.S. consumer spending patterns and continued borrowing requirements. That was clearly a shaky foundation for a sustainable long-term economic relationship.

For the last few years, we've been saying that global consumption and investment patterns would have to become more balanced. It felt like beating a dead horse for a while (as I'm sure others in our camp felt), but we've now reached a global economic and financial inflection point and now taking steps to a necessary global rebalancing. So we're going into a very, very different environment.

And just to reiterate that the consumer deleveraging cycle in the Anglo-Saxon world is going to be with us for some time. Considering that U.S. consumer spending accounts for about 25% of GDP in the OECD (Organization for Economic Cooperation and Development) countries, it's going to be a longer term drag

on world economic growth. That 25% figure does not consider high consumption statistics in other OECD countries. Take the UK as an example. In many ways, they have many more problems than the U.S. and are the most consumer-leveraged industrialized country.

This deleveraging cycle is not going to be offset easily anywhere in the world, but this is where our view becomes rather positive—that's the view of a dual speed world. If you've read our HITCH reports (The Hahn Intellectual Tapdancing & Chicken Heroics Updates), written by our CIO Wilfred Hahn, he calls it the "bipolar" world. On the one side, you have the bubble bloc—the high financialization, high income, high debt, low growth world; basically, the developed world. On the other side is the hard bloc, which is now the surplus countries, the emerging markets that have been on a crazy capital spending boom in recent years.

There are critical differences between these two groups. Consumers in the hard bloc are not highly leveraged, which is vastly different from countries in the bubble bloc, of course. And those hard bloc countries have healthy public finance and balance of payment conditions, and are generally more structurally sound. That's a great departure from the recent past where we've had recurring economic crises—Latin America in the 1980s, the Mexican Tequila crisis, the Russian crisis—to name a few.

In the last decade, we have seen a complete turnaround in many developing economies. Emerging markets now hold 70% of the global foreign exchange reserves. 40% of all emerging market debt is now rated investment grade. That's up from only 2% a decade ago. Most important at this point in the credit cycle is that their banking systems are not going through the same crisis we see in the U.S., Europe and many parts of the industrialized world. So hard bloc banks and financial institutions will be able to finance their business cycle recovery much more successfully than their bubble bloc counterparts. We continue to see this in strong lending figures coming from China. Annual loan growth was up over 18% in December.

TGR: You said earlier that consumption patterns need to be balanced out. Why couldn't we look at the BRIC countries or your hard bloc countries to offset the decrease in consumption from bubble bloc countries in the next couple of years? Why wouldn't this balance out in a year or two?

TM: That's been a central debate in investment circles. I suppose it all ties in with last year's decoupling argument, but they really are not big enough at this point to offset a decline in global GDP. Chinese per capita income is less than 10% of U.S. levels. So while the economic power is moving towards the hard bloc countries, it's going to happen over a number of years. Currency realignments will play a major role in this transition. Currencies in the bubble bloc are clearly overvalued relative to hard bloc nations. That includes the U.S. dollar, the Euro, the pound. And if you look at the hard bloc world's currencies and, in particular, the Chinese Yuan those currencies are extremely undervalued.

So we expect strengthening currency levels and continuing wealth migration to hard bloc nations such as China and Brazil. Real incomes should rise relative to world standards, and consumption and investment patterns should become more balanced.

Of course, the hard bloc world's Achilles' heel is their heavy reliance on exports and the continuing fall in U.S. consumption will be a very difficult transition period for Chinese and other Asian manufacturers. So yes, we see absolutely horrific global trade figures coming in lately. But it will force export-dependent economies to revise their business models to focus more on their own domestic economies and trade amongst each other. For the global economy, these shifts are not yet large enough to offset the declines in the developed world. But they will be at some point in the next few decades.

TGR: If consumption in the hard bloc is not large enough to offset the declines in the bubble bloc countries, and recession in the bubble bloc will lead to further decreases in consumption, will that throw the entire world into a recession?

TM: There's no denying that 2009 is going to be an economically difficult year. But many emerging countries will still post positive GDP numbers.

TGR: So they will emerge first in terms of recovery.

TM: China, Brazil and other emerging countries will definitely lead the recovery, at least in terms of igniting marginal GDP growth within their domestic economies.

TGR: With the global context you've described as a backdrop, what sorts of investments appeal to you?

TM: Currently, we are focusing on a few areas. Number one, we like globally focused mega capitalization companies, because the critical issue is funding and we cannot know when the credit logjam will be broken in much of the world's banking system. Current credit conditions don't bode well for a lot of small-cap companies, but argues for maintaining an overweight to large-cap companies with fewer funding issues. That leads us to favor ultra mega-caps, the well-known corporations of the world—Microsoft, Exxon, Johnson & Johnson, etc.

One of the ETFs we like is the iShare Global 100 Index , which holds the top 100 globally focused companies. That could be a core holding for investors. Next, as we've discussed, Asia and other select emerging markets should be included in investor portfolios. These economies are more fiscally sound and credit access will be much easier from domestic banks than the western world.

TGR: What plays would you put on the Asian emerging markets?

TM: Our thesis has been that Western markets have been in a secular bear market since 2000. In the hard bloc world, it's the opposite. We are emphasizing Asia—India and China in particular. We have seen some indiscriminate liquidation in those markets due to what David Fuller (Fullermoney Global Strategy Service) calls the Wall Street leash effect—or Wall Street-led contagion. S&P figures for January show emerging Asia trading on 8.4 trailing 12-month P/Es, whereas the United States is trading on 17.5. The dividend yields in emerging Asia are about 5% on average and barely 3% in the United States. So, there is a margin of safety in Asia.

Another investment would be State Street's emerging Asia ETF, GMF listed on New York. Or, if China is the target, FXI, the iShares FTSE/Xinhua China 25 ETF, which tracks a basket of Chinese companies listed on Hong Kong. We also own the PowerShares India ETF.

On the Asian theme, one of our core holdings trades on Hong Kong; it's called the ABF Pan Asia Bond Index Fund. The Euro and commodity dollars have taken the brunt of adjustments vis-à-vis the U.S. dollar during this decade. But much of those adjustments are done. As the hard bloc countries continue to prosper, currency gains should shift to these surplus countries; namely, to the currencies of Asia and other select emerging markets. The ABF Pan Asia fund invests in local currency-denominated bonds issued by emerging Asian governments. It's a very good portfolio diversifier, with low correlation to both G7 bonds and their own equity markets. Other benefits include improving credit quality and liquidity and, of course, potential for large currency gains. The Holy Grail in running diversified portfolios is to find low or negatively correlated asset classes with attractive risk-return dynamics, and ABF is one that fits the bill. It really helped us outperform our composite benchmarks in 2008.

TGR: So we're looking at overweighting major caps. We're looking at international emerging markets, particularly India and China. What other sectors would you recommend that investors be holding or investing in?

TM: The other theme we're working on is global currency debasement. The Federal Reserve has indicated plans to buy long-term Treasury Bonds as they did in the Great Depression. Bernanke has even hinted at buying corporate bonds. All of these actions are ultimately inflationary. So we are entering an era of massive currency devaluation. This will drive investor flows to assets that can preserve wealth, mainly gold.

Recent purchases seem to be less speculative and more investors seeking a safe have to protect wealth. We

see that in record purchases of gold bars and coins, and more investors taking physical delivery once their futures contracts expire. January ETF figures show a record monthly inflow of 105 tonnes into gold-backed ETFs worldwide—that brought total ETF-owned holdings to an all-time high of 1,317 tons. About 1,000 tons, by the way, is in the U.S.-listed gold ETF, which is GLD. How do we currently invest in the gold sector? We're heavily overweight gold stocks—that's played through GDX or XGD. GDX is the Market Vector's Gold Miners ETF and XGD is the iShare Global Gold Index, which is listed in Toronto.

One reason gold mining stocks had been underperforming other commodity stocks in the last few years was the cost of production rising so dramatically. That situation has reversed and industrial commodities basically fell off a cliff last year while gold held steady. If you're a student of the Great Depression, you'd know that the gold stocks did incredibly well during that period, which was due to declining costs rather than an increase in the nominal price of gold. Profit margins for gold companies in the 1930s, such as Homestake Mining and Dome Mines, soared during that period as industrial demand declined and the cost of production fell.

Today's gold majors, such as Goldcorp (TSX:G) (NYSE:GG), Newmont Mining Corp. (NYSE:NEM), Kinross Gold Corporation (K.TO) (NYSE:KGC) and others—which are all held within XGD or GDX—are in a similar position that Homestake was in 1929. So, as ETF investors, we simply buy the basket of gold stocks and invest in the blue-chip gold stocks that way.

We've actually been debating this because a lot of folks are saying that gold stocks have risen too far too fast. That might be true in the short term; we could see a technical pullback. Gold stocks are up about 130% since their October lows, but they're still about 35% below their highs in 2008 and that's during a time when gold remained firm and industrial commodities declined drastically. So we continue to be positive on the gold mining sector and have held gold stocks in our portfolios as kind of a core opportunity position for some time now.

TGR: You mentioned in the '30s the healthy profit margins resulted from lower mining costs. But the whole rally toward gold now seems to be based on anticipation of the price of bullion going up. Do you expect these gold majors to produce better than the average returns even if the price of gold does not climb?

TM: Yes, exactly. Even if the price of gold stays where it is, we'll see some great earnings come out over the next few years. If you look at the ratio between industrial commodities and gold, gold is at a record high. Now, most industrial commodities are now approaching their average cost of production, so they're probably near a cyclical bottom. But we don't see a massive industrial commodity bull market just yet, because the global economy is so depressed. So as it stands now and likely for the next few years, we have an incredibly profitable environment for gold mining stocks.

TGR: So your approach is to look for the gold mining stocks rather than the gold bullion for more upside potential?

TM: Basically, we're not picking a Goldcorp or a Newmont or a Kinross, one over the other. We're just going to buy all of them as an index and limit the individual company risk. We hold XGD and GDX for all our client portfolios now. We have owned XGD for our clients since its inception in 2001.

TGR: You've had nice returns on that one.

TM: And we also had a few years during which it was not doing much!

TGR: Are you also putting GLD into your investor portfolios?

TM: We held GLD for a long time and sold it when gold was at $910 last fall. That decision was based on the fact that the ratio of gold to gold stocks clearly favored investing in the gold stocks, and we did feel the industrial commodities could have further declines. Now, we're looking at the gold stocks as a high beta

play on gold. It would be great if gold bullion rallied, too, but I think if gold bullion rallies, it's likely the industrial commodities will rally as well. Again, we are focusing on profit margins for gold mining stocks.

TGR: If gold retreats to the $700s, which is was not that long ago, would these still be profitable companies that won't need to go out for capital?

TM: Most definitely. I'm not speaking to specific companies, but a lot of the costs of production are for the majors are now much lower than the $700 area.

TGR: Obviously, all the stocks went down in October when all the markets crashed. Why haven't these rebounded faster, given what you're saying, if they're basically going to outperform even if the price of gold goes down?

TM: The gold stocks have rallied hard but lower costs will translate into better earnings, even in the next few quarters. If you look at the earnings of Homestake Mining and Dome Mines in the '30s, they increased astronomically and that was only into 1931 and 1932. Are you saying that because industrial commodities have fallen so fast and gold has not, you would think the gold stocks would rally more?

TGR: Not so much that as the fact that so much money is sitting on the sidelines. If the gold majors represent a higher-than-average return in this environment, why hasn't the money gone into those at this point in time since there's so little else to invest in?

TM: It's a good question, but I think when the earnings come through that you will see a lot more money moving in there. If you look at GLD, the bullion-backed ETF listed on New York, it's absolutely crazy how much money has flowed into that ETF. I think people are moving into it and, again, as more of a *wealth* preservation measure rather than a speculation on getting a double.

Gold stocks are already up 130% from their October lows, so they're doing incredibly well. That's why a lot of people are saying it's too much too quick and so gold stocks are due for a fall. We do not emphasize the short term and attempt to trade in and out of asset classes. We take a longer-term view. I don't care what gold stocks do in the next month or two. Longer term, those profit margins will be there and we come again to the theme of protection against global currency debasement. It will be a race for economies to debase their currencies. Every country wants to stay competitive in global trade game and that's the key issue.

TGR: You've identified a number of core themes for the overall portfolio. One is overweighting for the major caps, another is international, and a third is gold. Are you looking at any other major themes?

TM: All of our portfolios take a globally diversified, balanced approach and emphasize risk management as a central focus. A lot of folks are taking less risk now after the markets have tanked; you can see that in retail investors pouring money into money-market funds and institutional investors with extremely low equity weightings and high bond weightings. Merrill Lynch's latest global fund manager survey represented a very, very bearish reading. In other words, professional portfolio managers are positioned very, very conservatively and are holding record amounts of cash and a record underweight to emerging markets and so forth. Investors always tend to react after it's happened.

At this stage, our firm is progressively taking on more risk. In fact, we have as much risk in our portfolios now as we've had since 2003. We had been underweight equities and emphasizing quality over the last three to four years. Now we are gradually shifting back into risky assets. There are good values and yields are very decent in some markets.

TGR: Everyone's been saying this is the time to buy. If you've got the cash and the aptitude, there are lots of good bargains out there right now.

TM: Most definitely.

TGR: Percentage-wise, how are you weighting the major caps, the international, and the gold stocks? Is it even across all three? Or how would you divide it up for the next year?

TM: We run nine different globally balanced portfolios, so the weightings differ in all the different mandates. Certain mandates have higher international content and certain mandates are a riskier in their nature. But, as an example, the fully global portfolios have approximately 7.5% in emerging Asian equity, up to 10% in the gold sector and the remainder is diversified in other global stock, bond and special situation ETFs.

TGR: Any other predictions or sectors you'd like to talk about?

TM: The global economy is going through significant changes, and ones that will have an impact on how investors should position portfolios. Many of the things that worked in the last two decades are not going to work now. The U.S. will no longer lead the economic world; nor will Europe. These circumstances call for putting on a different pair of glasses to look at the world. We're going to see a shift of focus and that creates some very exciting investment opportunities.

Tyler Mordy, a key player on the Hahn Investment Stewards team (http://www.hahninvest.com/), joined the company in February 2003 after starting his career in the international investment arena with Deutsche Asset Management in London. Now Director of Research and Portfolio Manager as well as serving on HAHN's Investment Committee, Tyler is credited with making significant contributions in the development of the firm's proprietary portfolio engines. He is engaged in bottom-up research of ETFs, top-down strategy development, investment policy and securities selection. Widely regarded for his expertise in the burgeoning ETF arena, Tyler is a University of British Columbia alumnus (mathematics and English literature) and holds the Chartered Financial Analyst designation.

Want to read more exclusive Gold Report interviews like this? Sign up for our free e-newsletter, and you'll learn when new articles have been published. To see a list of recent interviews with industry analysts and commentators, visit our Expert Insights page.

Site Index Usage Agreement
© 2008 Streetwise Inc.