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Our experts, clockwise from top left: David Cleary, Lazard Asset Management; Will McGough, Stadion Money Management; John Forlines III, JAForlines Global; and Fritz Folts, 3EDGE Asset Management.

**SPECIAL REPORT:**
**ETF ROUNDTABLE**

## These four experts tell us how to use ETFs to play global investing trends.

# AROUND THE WORLD

**By Chris Dieterich** It's only spring, but 2016 is already shaping up to be the most vexing market since the financial crisis.

A sharp, early-year global stock swoon briefly inflamed fears about a coming economic recession, but the bulls have reasserted control. After falling more than 10% in the first six weeks of the year, the Standard & Poor's 500 index now sits just below an all-time high. Despite the turmoil, nearly $35 billion has rolled into the market's nearly 1,700 exchange-traded funds this year, according to research firm XTF. The proliferation of ETFs allows do-it-yourself investors to cobble together, at low cost, complex global portfolios of stocks, bonds, and commodities. The flip side, of course, is that overly active investors can easily find themselves wrong-footed chasing hot money.

Amid 2016's market churn, where are the ETF-picking pros looking for value and yield? How can do-it-yourself investors use exchange-traded funds to create a well-rounded, global portfolio – built for the long-term, but not ignoring the short? Barron's convened a panel of global experts to find out what they're buying and why.

David Cleary is managing director and portfolio manager at Lazard Asset Management in New York. Since 2004, Cleary has run portfolios that make up Lazard's ETF-focused global asset allocation strategies. He spent most of the previous decade as a senior bond portfolio manager at Lazard and still has a leadership position in the firm's fixed-income business.

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DOW JONES

**"It's been the U.S.…but we can't do it forever," says John Forlines III, referring to the global economy's main accelerator.**

Fritz Folts is chief investment strategist at 3EDGE Asset Management. The Boston-based investment firm is the newest endeavor for Folts, who served for more than 11 years on the investment committee at Windhaven Investment Management, a well-regarded pioneer in ETF-focused money management. Folts left Windhaven in January 2015, more than four years after it was purchased by Charles Schwab.

John Forlines III is chair and chief investment officer at JAForlines Global, a New York-based investment firm that oversees $484 million, most of which is invested via ETFs. He is also an executive-in-residence professor of economics at Duke University, specializing in behavioral finance.

Will McGough is a portfolio manager and macro-investment specialist at Stadion Money Management, a $3.7 billion asset manager based in Watkinsville, Ga., one of the largest ETF-focused firms tracked by Morningstar.

***Barron's:* It's been a wild 2016. Most of last year's forecasts have been turned on their heads. For starters, the Federal Reserve's first interest-rate increase in nearly 10 years was supposed to boost the U.S. dollar and hurt bonds and gold — none of which has played out. What happened?**

**Fritz Folts:** The Fed blinked. They raised interest rates in December and laid out four more increases for 2016, but then, in early January, the Chinese devalued their currency, and people started talking about a global recession again.

**The first 10 trading days of 2016 were the worst start to any year on record for the S&P 500. Did that contribute to the Fed dialing back its plans?**

**Will McGough:** The Fed is driving everything. Anticipation of higher rates strengthened the dollar last year. The Chinese were unhappy with that, presumably, because China has a direct peg to the dollar.

**A strengthening dollar leads to a strengthening yuan, which hurts Chinese exporters.**

**McGough:** Right. The Chinese started getting concerned and sent a warning [by devaluing the yuan]. The stock market got volatile. Then, all of a sudden, in late January, the Fed signaled that it wants to keep rates lower, so markets can go higher. There was this transition by the Fed from its dependency on economic data [in determining when to raise rates] to containing uncertainty.

**David Cleary:** Another factor was the stabilization of commodity prices.

**U.S. oil prices bottomed near $26 in February.**

**Cleary:** Some raw commodities, like aluminum, bottomed months before more speculative commodities, like oil. Producers were reducing their excess capacity, limiting how far prices could fall, which allowed materials and energy companies to focus on business decisions, rather than plummeting prices.

**Was the dollar a factor? A weaker dollar tends to help oil prices because it becomes cheaper for overseas buyers.**

**Cleary:** You could argue that, but supply-and-demand dynamics were also changing.

**What happened to this notion that a 0.25% short-term interest-rate increase wasn't going to be a big deal? Everything went haywire as soon as it happened.**

**Cleary:** Keep in mind another thing that was happening — the processing of negative interest rates at the European Central Bank and Bank of Japan.

## The Pros' Picks

Our experts share how they're investing in today's confounding market.

| ETF/Ticker | Recent Price | Market Val (bil) | Comment |
|---|---|---|---|
| **JOHN FORLINES' PICKS** | | | |
| **iShares International High Yield Bond** / HYXU | $48.27 | $0.2 | Owns primarily junk bonds issued by European companies, but also has some Canadian and U.K.-based bonds |
| **iShares U.S. Preferred Stock ETF** / PFF | 38.88 | 15.2 | Preferred shares are largely issued by financial companies; the ETF yields 5.6% |
| **iShares MSCI EAFE Minimum Volatility** / EFAV | 66.73 | 6.7 | An international stock index that weeds out the market's most volatile stocks |
| **iShares MSCI USA Minimum Volatility** / USMV | 44.08 | 12.5 | Same as above in strategy. This ETF has been one of the most popular this year in terms of attracting new money |
| **iShares MSCI Canada** / EWC | 24.15 | 2.7 | A single-country ETF comprised mainly of financial and energy companies; should rise if oil prices rally further |
| **iShares MSCI Australia** / EWA | 19.51 | 1.6 | Australia is a commodity producer that exports heavily to China; this ETF is a way to avoid the risks of owning Chinese stocks directly |

Source: ETF.com; prices as of May 5

**The ECB introduced negative interest rates in 2014, requiring commercial banks to pay to deposit money. The Bank of Japan did it in January.**

**Cleary:** This is uncharted territory, and is clearly not a reflection of strength in the European or Japanese economies.

**Folts:** And Japan got exactly the opposite of what they wanted. Instead of falling, the yen has risen more than 12% versus the U.S. dollar this year.

**So we have a sluggish U.S. economy that won't permit the Fed to raise interest rates, and stimulus efforts from overseas central banks producing confusion.**

**John Forlines:** It is so difficult to see where the economic acceleration will be globally, and who is going to drive it. It's been the U.S. for a long time, but we can't do it forever. We're seeing the cracks in that now. Inflation, for one thing, has been subdued despite the stabilization in the oil market, and there is tremendous weakness in world employment, particularly growth in wages.

**Folts:** You have to wonder whether this is the beginning of the end of people's belief that monetary policy can be effective. The central banks have tried so hard to bolster animal spirits that it might have robbed future returns from the market.

**McGough:** The fiscal side of the equation isn't there.

**Forlines:** Most of the developed world is waiting for fiscal policy.

**Folts:** If we fail to generate the kind of growth or inflation that the Fed wants, the next debate will be about government spending. If, by some miracle in this political environment, the government starts to spend, it will have to issue more debt, which could debase currencies and support gold.

**Is that a rationale for gold today?**

**Folts:** We don't always own gold, but we recently added iShares Gold Trust [ticker: IAU] and gold miners, the VanEck Vectors Gold Miners [GDX].

**Why those ETFs, specifically?**

**Folts:** The iShares Gold Trust has a lower expense ratio, 0.25%, than the SPDR Gold Shares [GLD], which is 0.4%. We like that particular miners ETF because it's the largest and best-known.

**Forlines:** The only real reason to own gold is as an alternative currency. Historically, gold tends to do best when the majority of the world is debasing currencies, which we're seeing in this lower-interest-rate-for-longer world. Countries are hoping to spur growth by allowing currencies to decline. We took our first allocation to GLD back in December, the first time since 2011.

**Cleary:** We haven't added physical gold. Instead, we have rotated toward materials companies, which is part of a related theme.

**What theme is that?**

**Cleary:** Look at the price movement of gold, relative to gold miners, as a good example of why we are gravitating toward financial assets, including stocks, as opposed to the hard assets themselves.

**Gold-mining stocks are up about 80% this year, versus 20% for gold.**

**Cleary:** These were so deeply distressed relative to the underlying commodities that we've been looking not only at materials, like iShares Global Materials [MXI], but also energy and some emerging markets.

**McGough:** Our more-aggressive growth and international strategies have also picked up on these themes, particularly through emerging markets, adding iShares Core MSCI Emerging Markets [IEMG] and SPDR MSCI Emerging Markets Quality Mix [QEMM] late last year.

**Why that mix?**

**McGough:** We keep about half in funds that track our benchmark MSCI index, and the other half in an ETF that screens stocks for attractive traits – value, minimum volatility, and quality – which, we hope, can do a bit better than the benchmark.

**What's to like about emerging markets if global growth is weak?**

**McGough:** A lot of people have had the idea beaten into them that emerging markets look good in the long term because of big trends like population growth. But with the more recently dovish Fed and oil recovering a bit, we have some short-term head winds – the dollar and commodity prices – that have turned into tail winds and created momentum.

**Folts:** We are always looking for undervalued asset classes. When the dollar reversed earlier this year, we took a position in the largest, most frequently traded Brazil ETF, the iShares MSCI Brazil Capped [EWZ]. Just about every possible bad thing that could happen has happened in Brazil – falling commodity prices, weak economy, budget deficits, political scandal, and now Zika. But if the commodity cycle starts to improve and they somehow get this government into shape, there is still value there.

**Anywhere else?**

**Folts:** We like India in general as a long-term option. The central bank is in a position to lower interest rates, and infrastructure companies in particular haven't participated in the broad market's gains, so they now look undervalued. There are just so many young people that there will be no choice but to step up spending on infrastructure. We own EGShares India Infrastructure [INXX].

**Cleary:** We're starting to see governance improvements in Latin America broadly, not just in Brazil. We like the iShares Latin America 40 [ILF]. About half its assets are in Brazil and a good portion in Mexico.

**Forlines:** When China busts, places like Brazil get really sick. Conversely, if there's stabilization in China, Brazil isn't a bad place to look around. So far, though, we've only tiptoed into emerging markets. We went into emerging-market bonds with the iShares J.P. Morgan USD Emerging Markets Bond [EMB], mostly because we saw some value. It also owns dollar-based bonds, so you don't have to take currency risk.

**Not so much in stocks, though?**

**Forlines:** We haven't bought into the sustainability of emerging markets yet. We've been targeting emerging-market proxies – countries that have exposure to emerging markets, such as Canada and Australia. We own iShares MSCI Canada [EWC] and iShares MSCI Australia [EWA].

**Because Canada and Australia are big commodity producers, which sell materials to places like China?**

**Forlines:** We've done it for a couple of reasons: Those currencies, the Canadian dollar and the Australian dollar, were looking like they may have hit bottom earlier this year.

**So as those currencies rebound, you'll see bigger returns in their markets?**

**Forlines:** Right. So the currency is one reason, and there was value in the emerging-markets exposure. Plus yield: The Australia ETF, for instance, yields 5.2%.

**Cleary:** And these markets are correlated to emerging markets, but without government risk.

**McGough:** Obviously, China is a wild card in this entire scenario. They have the very easy potential to send shocks through the system, which we've seen twice in the past year.

**Forlines:** Too many people have firm opinions about data that is uncertain. China is a good example. There's been so much volatility from China coming from very little transparent information. That's why we don't play China directly; we prefer to play it in other ways, like our Australia position.

**Let's talk about U.S. stocks.**

**McGough:** In the early part of this year's rebound, it was dividend stocks, utilities, and consumer staples that really led the way. More recently, commodities and some of the more cyclically oriented sectors have kicked in. Those are mixed signals. It's like the market doesn't know whether to play offense or defense.

**What does that mean for your portfolios?**

**McGough:** When we don't have a clear view, we like the iShares Core High Dividend ETF [HDV].

**Forlines:** We had a great run in '14 and '15 with health care and technology, but we've moved away from both sectors because they got expensive. We shifted our U.S. position last year to the iShares MSCI USA Minimum Volatility [USMV]. This ETF can make you a bit nervous when the S&P 500 rallies, because you'll miss some of the upside – like in the early part of the post-crisis rally, which was broad-based. Now there's more uncertainty, and that's when these low-vol strategies do best.

**Cleary:** We still like consumer services and technology, though not as much as we did in 2014 and 2015. Consumers benefit from lower oil prices. On tech, we see productivity enhancements across the U.S. economy that are less tied to variables like energy. We like the low-cost iShares North American Tech [IGM] and iShares U.S. Consumer Services [IYC].

**Folts:** We're also neutral when it comes to the direction of the U.S. stock market. When that's the case, we'll use a barbell approach, mixing growth via a big ETF such as the PowerShares QQQ [QQQ], which owns the biggest Nasdaq-listed stocks, such as Apple [AAPL] and Alphabet [GOOGL], with small-cap value, via the Vanguard Small Cap Value [VBR]. Blending the two doesn't tilt the portfolio too much in one direction or the other, because the combination blends small and large, growth and value.

**Let's switch gears to bonds. What looks appealing?**

**Cleary:** Back in January and February, when credit spreads widened significantly, I thought that was completely overdone. They were flashing recession in some cases.

**One example of that is the SPDR Barclays High Yield Bond ETF [JNK], which traded in February at its lowest price since early 2009, when the U.S. was in a recession.**

**Cleary:** There was this huge gap in overall default expectations and the expectations for energy and materials companies to default, but credit spreads widened across the high-yield universe. We added to the PowerShares Fundamental High Yield Corporate Bond Portfolio [PHB].

**Why that one?**

**Cleary:** For a long time we were trying to avoid energy-related credits. You can't completely avoid them because of the basket nature of ETFs, but we preferred the one with lower allocation to energy.

**It had fewer of the riskiest energy credits than bigger ETFS, such as the iShares iBoxx $ High Yield Corporate Bond [HYG].**

**Cleary:** More recently, we've targeted what are known as crossover credits, or fallen angels. These have moved from investment-grade to non-investment grade.

**Wouldn't that include a lot of energy-company debt, with more to come?**

**Cleary:** These are viable companies, and although they've moved from investment-grade to high-yield, they're likely survivors. The ETF for this is the VanEck Vectors Fallen Angel High Yield Bond [ANGL].

**Folts:** We've used Treasury inflation-protected securities [TIPS] instead of cash. Since inflation expectations are so low, TIPS are cheap.

**Forlines:** We like preferreds, via the iShares U.S. Preferred Stock [PFF], because they are mostly issued by financials, which are going to continue to be the grease behind the global markets, despite regulatory restraints. You get a solid yield that you can no longer get from bank stocks. We have a big position. We also like the iShares International High Yield Bond ETF [HYXU].

**Why?**

**Forlines:** The iShares preferred ETF is one of the oldest and has good liquidity. Same with high yield; if you look under the hood, it's mostly European, with some Canada and a U.K. kicker.

**How about developed countries outside the U.S.? It seemed like many investors were hot on places like Europe and Japan in recent years.**

**Cleary:** We're in the process of rotating from a developed-market recovery theme to an emerging-market recovery theme. Our positioning in Europe and Japan is diminished. What we still have in Europe is mostly in small-caps, such as the iShares MSCI Europe Small-Cap [IEUS], which have less exposure to financial stocks, which we think are least likely to see their earnings hurt by negative interest rates and are less exposed to currency shifts, since they do most business domestically.

**Folts:** We currently don't have any exposure to Europe. It isn't that we are so negative, just that there are more attractive options elsewhere.

**McGough:** Europe has been in the process of kicking the proverbial can down the road when it comes to dealing with issues like Greece's debt, which will eventually come back into the headlines. European banks are one of the worst-performing assets in recent months.

**How about currency-hedged ETFs, which benefit from declining currencies, such as the yen and euro? ETFs such as WisdomTree Europe Hedged Equity [HEDJ] and the Deutsche X-trackers MSCI EAFE Hedged Equity ETF [DBEF], which owns European and Japanese stocks, were some of the most popular in terms of inflows in 2015.**

**Forlines:** We were big players in hedged ETFs back in '13, '14 and '15, and it was mainly a dollar call. We were at one point fully hedged in Japan and Europe, but late last year felt that the dollar was going to take a bit of a pause. Right now, we're totally unhedged in our currency exposure with ETFs such as iShares MSCI EAFE Minimum Volatility [EFAV], which owns

Europe, Japan, and a little bit of Australia.
**Cleary:** We can transact in the currencies themselves, so we don't need to use the exchange-traded funds if we want to hedge. We actually were long in the yen outright earlier this year, because it tends to rise in times of market turmoil.

**McGough:** The currency-hedged theme looks overdone now, and we won't see it for a while because the big moves – like the falling yen and euro in recent years – seem to have been made. You're going to see a much more measured environment.

**There are now 90 currency-hedged foreign stock ETFs. Some fund companies argue that currency-hedged exchange-traded funds make sense to own all the time, for the long term. What do you think?**

**McGough:** It's true that, by hedging the currency, you're taking out a source of volatility. But it can be tricky when you take behavioral biases into account. How many investors are true long-term investors? In practice, it's rare for somebody to be a purely strategic, buy-and-hold investor. That's the challenge: Currency hedging is either a tactical play on the direction of a currency, or you need to hold it forever. Our strategies will track a specific benchmark, and we'll tactically use hedged or unhedged when either one has some momentum behind it.

**These ETFs are best used by professionals?**

**Folts:** I wouldn't recommend them for individual investors because it's a bit of a dangerous game. When we owned the WisdomTree Japan Hedged Equity fund [DXJ] we bought into the story that the yen was going to come down, so it really only made sense to play it that way. But it's not always obvious. The yen is up sharply this year versus the dollar, even though Japan has offered more easy-money policies.

**Cleary:** There is definitely a subset of exchange-traded vehicles that are better utilized by professional investors.

**Folts:** Strategies like this work until they don't. There is too much at the buffet in the ETF world right now. It can be too tempting to think you are going to be able to execute these strategies.

**What should investors watch out for?**

**Cleary:** Some of the single-country funds are heavily biased towards one company that might not be representative of a local economy, or disproportionately heavy in sectors.

**Folts:** It can be scary for individual investors when there are so many products. In general, we want the most pure, transparent, liquid ETF we can find. But there's usually a compromise. For instance, we think food producers will benefit from population growth, particularly if these extreme weather issues end up creating a shortage of supply. So we own a small position in iShares MSCI Global Agriculture Producers [VEGI]. But this ETF has 12% in Monsanto [MON], which we probably already own elsewhere. If we had our druthers, we like to only own the ex-U.S. food producers.

**McGough:** It's important to pick a single index provider because there is some disparity with how different index providers construct the world. For instance, iShares MSCI EAFE [EFA] doesn't include Canada, but Vanguard FTSE All-World ex-US [VEU] has 6% in Canada.

**Forlines:** People say, oh gee, there are 1,700 ETFs, but there are something like 8,000 mutual funds out there, many of which have been treading water for years. We're still in an early stage, and the business of constructing ETF portfolios is still emerging. I'm confident that we'll get better equipment.

**Speaking of better equipment: Back in August, prices for many big, popular ETFs briefly fell more than 20% one morning before snapping back in line with the value of their stockholdings. Is this a concern?**

**Cleary:** ETFs got a lot of bad press, but the problem was really a lack of coordination between exchanges, a problem with the underlying stock-market structure.

**McGough:** ETFs weren't really the problem, and it isn't something that worries me. If you look at that day, Aug. 24, fixed-income ETFs and international stock ETFs traded just fine. It was U.S. stock ETFs that were affected because it was a U.S. stock market problem. ETFs actually trade more cleanly in many cases than underlying assets.

**Forlines:** The genius behind the ETF phenomenon is that it's a cleaner, derivative play.

**Barron's: Thanks, gentlemen.** ■

**AI JAForlines Risk-Managed Allocation Fund**

*Sub-advised by J.A. Forlines, LLC*

**A Class: AARMX**
**C Class: ACRMX**
**I Class: RMAIX**

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At the time the discussion occurred, accounts managed by JAForlines Global and John Forlines III owned some or all of the ETFs mentioned in the article. JAForlines Global and John Forlines III serve as the sub-adviser to the AI JAForlines Risk-Managed Allocation Fund (the "Fund").

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