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2021 ETF Guide

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ETFs: Useful for a disciplined approach

This approach is based on diversification and strict risk management.

By: Alizée Calza | Source: Finance et Investissement | October 13, 2021 | 00:07

Courtesy photo

Alizée Calza

Laurent Wermenlinger has been an investment advisor with Desjardins Securities since 2006 and has 40 years of experience in the financial sector. He is also a portfolio manager and financial planner, and was one of the first investment advisors to use exchange-traded funds (ETFs) in Quebec in 1998.

At the time, Laurent Wermenlinger worked at PWL Capital, a firm he co-founded in 1996. His investment approach was based on minimal risk management and portfolio construction from a range of asset classes, "rather than based on forecasts by investment prophets."

Before diving in, he did his research. This included attending talks in the United States to learn all the details about the products in question. "I built up a basic knowledge of the products available. There weren’t many at the time," he recalled.

When Barclays Global Investors, then the world leader in ETFs, established itself in Canada, he forged ties with the firm so that his clients could benefit from its strategies.

Low costs, transparency and tax efficiency were the key benefits of ETFs at the time. "If you have those three elements, you have a winning combination for most people,” he said.

"If the average return on a portfolio is 4% and you pay between 1.50% and 2% in management fees, it will be tough. That's even truer today. The intrinsic cost of an investment has to maximize the client's chances of earning an acceptable return that meets their investment objective."

Today, the ETF sector is much more diversified and offers advisors a host of strategies. Laurent Wermenlinger is still creating portfolios composed mainly of ETFs offered by iShares, Vanguard and State Street Global Advisors. They also contain very low-cost quant mutual funds from Dimensional Fund Advisors, a firm that aims to generate additional returns through strategies based on university research. His portfolios are also unique in that they're made up of only a few individual securities.

Laurent Wermenlinger manages the assets of 170 families, which total $275 million. He works primarily with high-net-worth clients who want to preserve their capital. As he handles the discretionary management of his clients' portfolios, ETFs are his investment vehicles of choice.

Another advantage of many ETFs is that they allow for risk to be managed through diversification. "Diversification is one of the free benefits on the market," he likes to say to his clients. In addition to relying on diversification by security and geographic region, Laurent Wermenlinger has also worked on diversifying his clients' investment strategies.

In the late 1990s, while in the United States, he met academics Eugene Fama and Kenneth French, pioneers of the three-factor model. Laurent Wermenlinger still uses that approach today.

"We met with them regularly and they shared the basics of their research with us," he said. At the time, they were focused on three key factors:

- The "market" factor, or the expected higher return when investing in a diversified portfolio of equity positions
- The "value" factor of shares in companies with a high price-to-book ratio versus growth stocks

- The decision to favour small-cap rather than large-cap securities

Of course, since then, other styles have been incorporated into the two Americans' theories and into Laurent Wermenlinger's portfolios.

And while some factors seem to be taking their time generating excess returns, such as value stocks, which have underperformed growth stocks over the last 12 years, Laurent Wermenlinger is patient.

"My goal isn't to guess the style [that will be illustrated], but rather to structure a portfolio with a value factor that's present all the time," he explained.

He believes that an investment should be considered a long-term commitment. His methodology doesn’t extend over one or two years, but rather over the "investor's useful life," or as long as the investor is prepared to take a certain risk.

Even back then, portfolio management was a process for Laurent Wermenlinger, with the goal of taking into account a client's risk tolerance and financial planning, and then determining the returns they could expect.

"As a portfolio manager, you need to give your clients as many opportunities as possible to achieve their goals," he said.

Far from speculation

By focusing on investments to be kept for years, which improves the tax efficiency of his portfolios, Laurent Wermenlinger avoids speculation with ETFs and cryptocurrency ETFs. He likes to keep his investments for several decades and doesn't believe that cryptocurrency ETFs are the best-suited products for his philosophy.

"I favour strategic investment over tactical investment. There may be one or two opportunities for it, but it isn't the approach I use most of the time," he said.

Similarly, the pandemic has had little influence on the composition of his portfolios. He sold a few US currency holdings as there were significant foreign exchange gains to be made, but he then found equivalents in Canada. He also slightly increased the liquidity in his portfolios in order to take advantage of opportunities. However, these were only minor moves.

"You can't predict the future in a systematic and reliable way, but you can structure a portfolio so as to be present in an organized, structured and well thought-out manner. I invest in a range of markets and according to different methodologies, and I also now take into account environmental, social and governance (ESG) factors."

Favourable to ESG factors

Laurent Wermenlinger was quick to begin incorporating ESG factors. He noted that these considerations were very important to his clients' children, whom he also serves. "They had a deep conviction, and we need to listen to our clients. Three years ago, I spoke with all the manufacturers I do business with to tell them that this was the direction I was heading in. They really paid attention," he said.

Laurent Wermenlinger's team moved the portion of the portfolio with a quantitative approach to ESG investments. The team is now doing the same in its regional approaches. However, adopting an ESG policy isn't as simple as that.

"You have to thoroughly look at the funds and analyze them. Research is ongoing in this area. You can't change everything in one fell swoop. The finance sector is evolving," he said.

However, he's confident about the future and hopes to have an ESG bias for all of his asset classes. Laurent Wermenlinger expects things to change quickly in this regard, and for fund analyses to be more precise, which will make it easier to manage ESG risks.

A unique international approach

In his portfolio construction, Laurent Wermenlinger's geographic allocation differs from that of most portfolio managers, who often have a favourable bias toward domestic financial securities. Compared to the standard Canadian and international portfolios held by Canadian portfolio managers, he and his team underweight Canadian and US equities.

Of course, Canada is still represented in his portfolios, particularly in the financial sector. "It's far from 50%," he said. Our portfolios are truly international. We focus on regions, sectors (global sectors) and currencies."

Laurent Wermenlinger also invests in Europe and Asia, but says that he pays particular attention to the factor component in his portfolios.

"Factors are less and less important in my portfolios, but they still play a role. The key element is the proportion of money I invest in the markets: equity positions versus debt securities. That's still the number-one decision."

As for the future, Laurent Wermenlinger doesn't intend to give up on ETFs. Instead, he hopes that they'll continue to evolve.

"It's a great structure, but it has its limits. In terms of equity positions, North America is very well covered, but Asia and Europe are only partially covered," said the manager, who hopes that over time, these other regions will have a better ETF offering.