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THE MAGAZINE FOR ETF ADVISORS AUGUST 2013

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SEEKING
Safety In Storms

By Cinthia Murphy

CHICAGO'S GOOD HARBOR FINANCIAL designs tactical strategies that work in market sell-offs as well as in rallies.

Neil Peplinski founded Good Harbor Financial on the belief that one should manage the downside rather than trying to avoid it

NEIL PEPLINSKI IS A UNIVERSITY OF CHICAGO GRADUATE WHO FIRST PUT his MBA to work at Motorola until 2003, when the investing world came calling. Struggling to find an investment strategy for his own money, Peplinski began developing a model that fit with his views on market fluctuations. He believed risk premiums—rather than company fundamentals—were the key factor driving equity prices, and that in the longer term, managing the downside was more important than striving to avoid it.

Advisor Quick View

FIRM	Good Harbor Financial
FOUNDED	2003
LOCATION	Chicago
AUM	$6 Billion
ALL ETFs?	No

Others seemed to agree, and Good Harbor Financial was born.

The open floor plan overlooking Chicago's busy Wacker Drive in the heart of the city's financial district, and the long desks his team shares, seem like the perfect breeding ground for good ideas. But what sets Good Harbor apart is its unfailingly disciplined approach to tactical asset allocation, a trait advisors came to depend on in the height of the 2008 credit crisis. The firm's tactical strategy proved its worth during those tumultuous times, and opened the door for a strong following. Now, 10 years since its inception, Good Harbor is managing some $6 billion in assets, and continues to attract new investors every month.

How did Good Harbor get started?

Good Harbor Financial, as an investment advisory firm, was launched in 2003 by me, and it was born out of my own needs for a methodology to manage my own portfolio. As the methodology started to play out, there was a lot of interest around it. This was during the tech sell-off from 2000 to 2002. It was run very much as a sideline business for the first few years, while we finished proving out the concept and accumulated a little more track record. We really got serious about raising assets in late 2008/early 2009.

What set your approach apart at the height of the U.S. credit crisis, when you first saw assets really start to come in?

Our story is a tactical one – our flagship product is our Tactical Core U.S. portfolio. Markets were very fickle during that time. But, ultimately, our view was that what damages a portfolio is not missing a few days of gains, but when you experience the drawdown that tends to coincide with a market crisis. To the extent that we could try to minimize that drawdown, we thought we could put portfolios into a better position. That's been our story since day one. But nobody was really interested in hearing that story until post-2008. It wasn't just that there was a steep sell-off in the markets, but it was the second one in a decade. People finally had their eyes opened to the notion that these sell-offs are really what kill a portfolio.

These sell-offs happen more often than people think—the fact that we saw two in a 10-year period is not necessarily that unusual, if you look at it from a pure statistical standpoint. In fact, you should expect to see a 20 percent sell-off in the markets about every seven years or so. But people were so used to the 1990s. That's why we became popular.

Has using ETFs helped at all with your popularity?

We manage a portfolio of ETFs, which was desirable at that period, as was separately managed account delivery. That's because you had a lot of people seeking out transparency as opposed to the more opaque view of limited partnerships and hedge funds, so we were well positioned to capitalize on that market demand.

As far as your approach to investing, from the beginning, you have been a very risk-focused shop. Is risk the main metric you look at?

Absolutely. It's our fundamental belief to look at risk—and we have a suite of products that are built around this. Again, our flagship is the Tactical Core U.S., but we now have other versions of it, too. But the underlying premise of that Tactical Core suite of products is the belief that what really drives equity prices in the short term has very little to do with company fundamentals, and has more to do with appetite for risk by the investor base.

If investors are fearful, people's risk premiums rise as they become nervous about the markets. And sometimes you'll hear it referred to as expected return or required return. But the idea is that it's a reflection of how people are feeling about risk. If they're fearful, these risk premiums rise, which through a very straightforward discounted cash flow framework, you can link to price fluctuations. That's to say that if people's views on risk are changing, then prices will change.

Brent Kopp, Vice President, Sales

There's great research coming out of places like the University of Chicago that basically shows that views on risk matter. In its simplest form, I would say it's a quantification of the fear and greed notion. I think the reason our story tends to resonate with people is that no one had really connected the dots between fear and greed as drivers of performance. The way we've approached it, it's one way to connect the dots that people are comfortable with.

What would you say is most unique about Good Harbor's Tactical Core strategies?

What makes us unique is that neither Paul [Ingersoll, managing partner] nor I come from traditional backgrounds, so we find ourselves deviating from the traditional thinking. When we first started talking about how changing views on risk are a key driver, we expected to find other people doing the same thing, and that maybe our model was a slightly different implementation of that idea. But what we found was that nobody was really capitalizing on this.

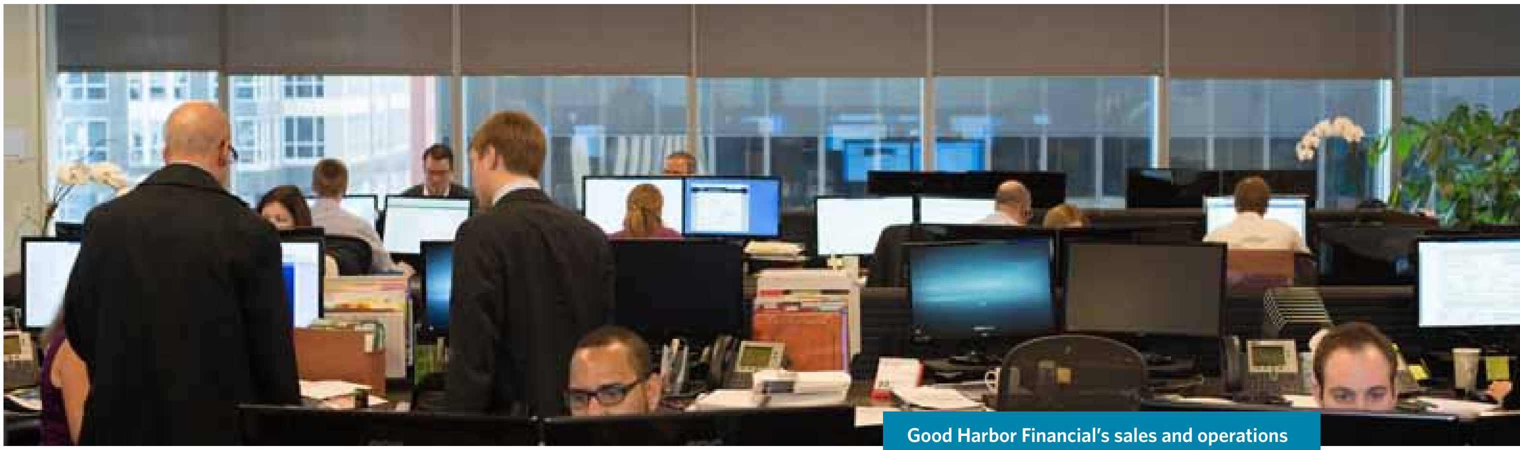
NO ONE HAD REALLY CONNECTED THE DOTS BETWEEN FEAR AND GREED AS DRIVERS OF PERFORMANCE

One big reason for that is it's more widely believed that the risk premiums are constant. If you look at a lot of the classical finance theory, when you talk about this risk premium quantity, it's often assumed to just be a number that reflects the reward you should get for holding equity risk in your portfolio. There was never a lot of flexibility to allow that metric to change based on the economic environment or the equity environment itself.

What are some of the challenges with this approach, and what can go wrong with this model?

There are some hurdles when you try to take this idea of time-varying risk premium and put it into practice. The biggest hurdle is that this risk premium idea is not something that we can directly observe. We can look at historical data, but there's no convenient way to pull the data up and see where this risk premium is going to go. So, we built a process to try to capitalize on that idea, overcoming the hurdle of being unable to directly observe it.

When you think about successful investment strategies, we as a firm believe—and our philosophy is—that there are a couple of main components that are necessary.



Good Harbor Financial's sales and operations teams at work in the company offices

The first is that you have an underlying premise, which for us is the time-varying risk premium.

To the extent that your premise could be flawed, ultimately, your platform could be flawed, but I would argue that when you look at price variation through the lens of time-varying risk premium, you can trace that back to human nature.

We're talking about fear and greed. We're talking about people who do not want to buy risky assets when they're plummeting. To me, that human nature validates our premise, and that's something we have going for us.

Secondly, problems can come from the implementation of that premise, so we do things with our portfolio to minimize that, like rebalancing monthly, and using broad-based ETF products.

How is your product designed?

We have a set of input data that are designed not to tell us what the risk premium is per se, but to help us identify whether we think we're in an environment where risk premiums are likely to rise or fall. If we think we're in an environment where they're likely to rise, our Tactical Core suite of products will take less equity exposure. And if we think we're in an environment where risk premiums are likely to fall, or people are going to become more comfortable with risk, then we'll take on more equity exposure.

You have some very practical limitations on things that can go wrong. For example, we could be in equities—we start our equity allocation in the middle of the month. And equities could sell off for whatever reason because our input data didn't quite pick up on the environment. But we're very disciplined, and the discipline to stick with it often ends up being the hardest part. That means we're going to have months where we're in equities and we wish we weren't.

From there, the next logical potential pitfall with our approach would be deciding, if you're not going to hold equity risk in what is otherwise characterized as an equity portfolio, where you are going to invest. Cash is a pretty effective choice.

We also looked at whether we should short the market or go long in inverse ETFs, and what we found is that, while it can improve the absolute return, it adds too much volatility. Instead, we go into short-dated U.S. Treasurys. When we don't want equity risk, we position it in the Treasury market, expecting to capitalize on that safe-haven nature.

In general, why is model-based investing a better approach?

This is obviously a philosophical discussion. I'm a big believer in model-based approaches because I think the notion that you can have a subjective overlay to any kind of process that adds value is foolish. Ultimately, while that might work in more normal times, that subjective element tends to fail in the more stressful periods. One of the biggest advantages of a model-based approach is that it gives you a framework for making decisions, particularly during times when decision-making is really hard—times like Q4 of 2008 and Q1 of 2009.

One of the most valuable aspects of a model-based approach is that it helps you have the discipline to stick with the plan. When I look at our approach, we've had a very successful track record over the last 10 years—though not without years of underperformance, for sure. But I don't believe you need the *best* idea. I think what you need is a *good* idea, and the discipline to follow it.

Photos by Stephanie SeRine

What kind of advisors are using your service? And do they use you to build their entire portfolio? Or do they piecemeal?

It's a mix. First and foremost, we position our flagship Tactical Core U.S. portfolio as an equity product, so when we're talking with advisors, our first piece of advice is to use it for any clients that don't yet have equity exposure. But beyond that, if they've got equity exposure, we say, "Hey, this is a product that's worth looking at."

Very early on, we spent a lot of time talking about why you might want to consider tactical approaches over the more traditional buy-and-hold strategic allocation. Now, we have advisors that come to us and say, "Look, I get tactical; we don't need to spend any time on the value of tactical. I went in search of a tactical equity approach, and your name came up."

The amount of tactical exposure that advisors are giving their clients can vary across the board, but even in cases when advisors come to us and say they are putting their clients 100 percent in tactical solutions, we're often just one piece of the equity, which is great. We would never expect to be all the equity.

Is there a particular platform you're on?

Our biggest distribution channel right now is the intermediary channel. We don't have a direct business, per se, outside of institutional. We're interfacing with the end client through advisors such as Wells Fargo and others. But what's interesting is that when we first started going out and really trying to build assets in Good Harbor, it was our position that any advisor that was going to look at us and allocate to us was already going to be taking a chance on a new idea.

So we decided we were not going to make advisors take a chance on a new idea and then have them move their clients' assets to some platform that we chose. Wherever the advisor is at, that's where we'll go—the idea being that we'll just get on several platforms, and we'll make it easy for the advisor.

That actually introduced some operational issues, and we've internally built some great infrastructure that allows us to ensure that if we have a client who is a Wells Fargo client, they have the same experience as, say, an RBC client, or a Credit Suisse client. They get the same fill across the board. We're on 40-plus platforms.

Emilio Ramos, Operations Associate

Do you plan to grow now that you just had a recent private equity investment?

We did do a private equity transaction that was a minority investment, and one that's positioned us to take the firm to the next level. We've got our product in the tactical-equity space, and we are now focusing on tactical-equity international. We're also rolling out a tactical-equity-income product. But ultimately, we want Good Harbor to be known for high-quality, tactical solutions across the board. We want to build a sizable product suite that addresses a lot of areas that people might be looking for, and that should help us diversify our business risk.

This private equity transaction also sets us up well to do some acquisitions. There's no denying that, in the investment world, there are lot of bad ideas out there, but if we can find the good ones and acquire them, that will help us build our product suite.

Do you have any advice you can offer an advisor on how to go about choosing an ETF strategist?

First, make sure that you understand the value the ETF itself is offering you. Or get confidence that the manager you chose understands the value that the ETF is offering. The great thing about ETFs is that they are a very convenient way to get exposure in areas that would have otherwise been difficult. If you're looking at managed ETF portfolios, you need to do your due diligence, and ultimately, you want to be comfortable with the manager and their process.

What's most important is that investors and advisors not get blinded by a track record, but really look past the track record and see if there is a reason those results are likely to be consistent going forward. To do that, you have to look at management style. You have to look at process. It's very easy to just drive your decision by performance, and oftentimes, that can lead to less-than-satisfactory results.