

Transcript

Beverly Chandler

Hi there, my name is Beverly Chandler and I welcome you to this outing of Off the Record. The podcast about all Things ETF brought to you by ETF Express in partnership with Harbor Capital Advisors. All views expressed in this podcast are the speakers own and, we hope, suitably controversial. This episode is on the joy of small focusing on Harbor Capital Advisors, Harbor Alpha Edge, small cap earners ETF EBIT, E-B-I-T. And Kristof Gleich, president and CIO of Harbor Capital Advisors to discuss the firm's approach. Kristof, I want you to tell me a little bit about yourself and also about Harbor Capital Advisors.

Kristof Gleich

Hello, Beverly. I'll try and be as controversial as possible, that was a nice intro. So a little bit about myself. I'm from the UK, I live in the US. I'm here recording this from the beautiful city of Chicago. I am the President and the Chief Investment Officer of Harbor Capital Advisors. For your listeners, Harbor Capital Advisors are a slightly newer, entrant into ETFs. We've been in the ETF business now for a little over three years, we just celebrated our three-year anniversary, but we've been a mutual fund shop since the 1980s. So we've been investing for over 40 years now. And what we tend to focus on creating solutions that we believe can deliver strong risk adjusted returns for our clients historically in mutual funds, but really today and going forward in ETFs.

Beverly Chandler

And how long have you been with the firm?

Kristof Gleich

I've been here for six years. Before joining Harbor, I was with JP Morgan. I joined JP Morgan in 2010, worked for them in London for a number of years and they asked me to move for a big global job in New York, and so I moved with my wife and then three-year old son about 10 years ago to New York and then about six years ago, I decided that small is beautiful and I wanted to join a more boutique oriented asset manager which is Harbor Capital. So I've been in the great city of Chicago and at Harbor and enjoying it ever since.

Beverly Chandler

And growing your own large boutique.

Kristof Gleich

I guess there's a different unit of measure between the UK and the US. The US is such a big, colossal market. Look, we run \$63 billion today and \$63 billion is a huge amount of money. We're very privileged and we take very seriously the business of running that money as well as we possibly can on behalf of all of our clients that are ultimately saving for retirement of one form or another. But the US is a ginormous market, and we live in an era of the likes of Vanguard and Black Rock running, you know, trillions and trillions and trillions of dollars. So in that sense, context is everything. We would still very much consider ourselves a specialized boutique. Even though I fully acknowledge \$63 billion is a huge amount of money.

Beverly Chandler

Tell me about the Harbor Alpha Edge small cap earners ETF EBIT.

Kristof Gleich

So EBIT stands for earnings before interest and tax. We launched EBIT, the Harbor Alpha Edge, Small CAP ETF a few months ago. It's been an idea that we've been working on, we had it in the lab for a while. So we like small caps. Not many people do. Part of the reason we like small caps is because they've been out of favor for so long. So if you look back, historically, this is probably small caps, worst ever relative

performance to large caps. We think that in this cycle investors have very much been hiding out in the perceived safety of larger caps. And there's also, large caps have done very well, you know with Magnificent 7, we can talk about those all day long, these huge cash flow generating machines, but we really think that small cap plays a valuable role in a diversified portfolio and that because of recency bias, people have given up on the asset class and so as investors, we're always looking forward and unfortunately you can't benefit from the returns that we've had in the last 10 years. You have to look forward and think about what does the next 10 years look like. And we think the setup for small caps is attractive. Now specifically for small caps. There's some interesting things going on if you sort of double click into the asset class or look underneath the hood and not all small cap stocks are born or created equally. And if you take the industry standard benchmark for small cap, which is the Russell 2000, it has a large number of unprofitable small cap companies in it, and it actually has a record high number of unprofitable small caps in it. And this phenomenon has been growing really since the financial crisis. And if you look at the number of unprofitable small caps, it's about 40%, Four zero of the Russell 2000 are unprofitable, and if you look at it by market cap is about 25%. And we believe that on average, those unprofitable small caps drag down the returns of the overall asset class. And so that when you look at the overall asset class, the returns are pretty insipid in a large part because they've been dragged down by this unprofitable cohort. So that was the thinking and the hypothesis that led us to create an ETF that seeks to strip out the unprofitable part of the asset class.

Beverly Chandler

And how do you define small in this small cap scenario?

Kristof Gleich

So we've licensed with Russell in that we wanted to keep this very straightforward. I'm a big believer in Occam's razor. You find the most simple and elegant solution or tool for the job that you're trying to do, or the job in hand that you have. So we didn't want to overthink the definition of small cap too much and generally, the industry, when they view small cap, they start with the Russell 2000 and so our starting investment universe are all the constituents of the Russell 2000.

Beverly Chandler

Am I right that it's just US, presumably because of the index?

Kristof Gleich

It is, yeah. And so in the US marketplace and clients and advisors tend to look at their portfolios, domestic, domestic large cap, domestic mid cap, domestic small cap, and then they look internationally. And allocators in the US tend to bifurcate and favor those domestically focused side of their portfolio, and then those international specialist side of their portfolio. And the US small CAP universe is quite large and so we decided to just concentrate this on the US side of things rather than being global.

Beverly Chandler

So to create the index on which this is based, you have had to go in and look for the companies

Kristof Gleich

Yeah, that's right. So we decided to create an index. And so think of an index as nothing more or nothing less than a consistent transparent rules-based approach to investing. And what I don't want your listeners to think of is an index means it's passive. It's a big pet peeve of mine in the industry, is when people say that index investing and passive investing is synonymous with one another. So our definition of passive investing would be very low cost market cap slices of different segments of the market. Take the S&P 500, take the SP Y you know large ETF out there. If there is such a thing as passive investing and that's another whole two hour conversation that we could have, let's just say there is something called passive investing. If there is the SPY, something like that is going to be the definition of passive investing. Anything else that isn't doing that, in our camp, is active. There are different ways that you can provide active management

to the marketplace. You can have a discretionary manager that's doing fundamental research, looking to underwrite specific companies and do very, very detailed kind of due diligence. You can have more quantitative approaches or more systematic approaches. So this is a systematic approach that's delivered in an index and what the index seeks to do is start with the Russell 2000. And then every six months, so at the end of every July and at the end of every January, it looks back, it looks at the Russell 2000 and it systematically excludes the companies that fail our profitability threshold and our profitability threshold is something that we spent quite a lot of time on and I'm happy to jump into that if you'd like me to.

Beverly Chandler

Yeah, I think so. Actually. How do you establish a profitability threshold?

Kristof Gleich

So we look at the operating profits of a business and we want to make sure that we are including companies that are profitable from an accounting perspective, but also if you like that they're in the spirit of being profitable. And let me explain by what I mean by that. There are different accounting tricks that you can pull to create profitability and say, hey, we want to make sure that we're not a loss-making company and you end up with like \$1.00 of profits. So in theory you're profitable. But in our mind, that's not really the spirit of sustainable profitability. So what we do is rather than looking at any sort of short term period in time, we actually have a three-year look back and we want to make sure that the. Businesses that we invest in on a three-year look back have a profit margin of at least 1% over that three-year period and we want to make sure that the median quarter is also above 1%. So we look to exclude companies that one could argue are potentially trying to gain the system and it means that we're looking for sustainable profitability above a minimum threshold as a way of capturing what we would argue is the profitability risk premia that exists in small cap.

Beverly Chandler

Interesting. Tell me, what do you think an exposure to small cap companies would bring to a portfolio?

Kristof Gleich

The US is a huge market. It's a very creative and innovative entrepreneurial startup mentality. The culture of the US is about innovation, creating businesses, ideas, having belief in those ideas and by investing only in large caps, you're only investing in a tiny piece of the economy, that is the US economy. And so by investing in small caps, it gives you diversification to parts of the economy that you otherwise wouldn't get if you just concentrated on large caps. And we believe that over the long term there is a small cap premium. When I began investing 20 plus years ago, there was a small cap premium and it was kind of accepted as almost religion like you got your small cap premium, you invest in small caps, you have a higher return because you're accepting more risk and you're being paid in higher returns for that risk. Well, something really interesting has happened is that that small cap premium has seemingly kind of disappeared. And we think the reason that small cap premium has disappeared is because the quality in that index has gone down over time as more unprofitable companies have come into that. So we like to think a way of kind of getting back that small cap premium, strip out those serial unprofitable companies focus on the profitable sector and then if you do that, we think once again you can allocate to small caps with the belief that going forward they can both diversify but also enhance returns for your overall portfolio.

Beverly Chandler

Because you mentioned risk there and I was wondering about that, how do you manage risk within this portfolio because you are getting a premium because it's more volatile, presumably the small cap?

Kristof Gleich

So the risk is really managed in the design of the index that we think we are managing risk by eliminating the riskiest part of the investment universe. As I said at the beginning like 40% of the names are

unprofitable. And unprofitable names, you know generally rely on outside financing to keep funding their operations and they tend to lead themselves to more volatile sectors such as biotechnology. Now I have nothing against bio tech. But if you want to invest in that, you take the deep domain expertise. And so our risk is by excluding in our view the riskiest segment of the market. So if you actually look at the index that underpins EBIT, it generally keeps up with small caps when they're outperforming.

When small caps are underperforming, we actually think it reduces volatility versus something like the Russell 2000.

Beverly Chandler

So just to finish up here, can you tell me what you think this investment in this ETF would bring to a client's portfolio?

Kristof Gleich

I would urge listeners to look at your asset allocation, make sure that you're not positioned today as a result of kind of recency bias and everything that's just worked in last 10 years, which by the way, is really difficult to do. It's difficult to not chase what's done well, just emotionally, behaviorally, from a career perspective, from all of the above. And look at those areas of the market that have been overlooked like international or in this case small cap. And by having an allocation to small cap, acknowledging that the environment going forward is going to look different, I think from the last 10 years and that we think by allocating to the most attractive area, the profitable segment of small cap in a tax efficient transparent daily liquid ETF such as EBIT, we think clients that do that. Will be satisfied with their investments if they have a sufficiently long time horizon, and when we talk about time horizons at Harbor, we're talking about building longer term durable investment portfolios to help people save for retirement. So we're not looking at the next three months, the next six months, we're not even looking at the next 12 months. It's really three years, five years, seven years, 10 years and beyond.

Beverly Chandler

Thank you so much. Well, I want to say thank you to my guest today and thank you to you for listening. Remember to subscribe and leave a review and feel free to contact us at podcast@chandlerpublishing.com. This has been an off the record podcast from ETF Express brought to you in partnership with Harbor Capital Advisors.

Outro

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The Harbor AlphaEdge Small Cap Earners Index evaluates the performance of a specific subset within the small cap US Equity market. This subset comprises companies listed in the Russell 2000 Index that have met profitability criteria over the past twelve quarters. The index employs a modified profitability weighting methodology.

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