REPRINTED FROM MAY 8, 2017

THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Managing Risk Through Factor-Based ETFs

LAWRENCE WHISTLER, CFA, is President and Chief Investment Officer at Nottingham Advisors. He has over 20 years of experience, including 10 years as a bond trader for Merrill Lynch Capital Markets in Los Angeles, California, and New York, New York, prior to relocating to Buffalo in 2004. He is currently the President for the CFA Society of Buffalo. He is an adjunct professor at the Canisius College Wehle School of Business. He has a bachelor's degree in finance from The College of William & Mary and an MBA from Emory University.

SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the firm?

Mr. Whistler: We're a registered investment advisory firm, headquartered here in Buffalo, New York, with a satellite office down in North Palm Beach, Florida. We run separately managed accounts for high net worth individuals and institutions, a little over $1.1 billion in assets under management and advisement currently.

TWST: Do you have a unique investment philosophy?

Mr. Whistler: We do. We run globally oriented asset allocation models. We look to express our views on equities via index funds. We run what we consider to be dynamic indexing models. So we'll express, again, all of our views on equities via an exchange-traded fund, and we often pair that with a customized fixed income solution for our clients. We have a core satellite exposure, if you will, or strategic/tactical, where we have a core that may be a little bit unique and that we employ factor-based or strategic beta ETFs as a way to help manage risk. And we pair with that more tactically oriented positions, too, that are the result of our research process internally.

TWST: Did you want to highlight a company or fund that you find interesting?

Mr. Whistler: So we don't, again, trade individual stocks or track individual companies, but I can talk about a couple of exchange-traded funds, or ETFs, that we have in our models currently, one being USMV. That's part of our core. Again, it's a factor-based or strategic beta ETF. It's the iShares Edge MSCI Minimum Volatility USA ETF. So it's large-cap, but it basically tracks the investment results of an index that is geared toward low volatility or a minimum variance portfolio. So we like that because it gives you a return profile of perhaps 90% of the upside and maybe 70% of the downside over time, and we like that characteristic for controlling risk in our portfolios.

TWST: And is risk a concern of your clients?

Mr. Whistler: Yes, it is, all the time. I mean, we're as much risk managers as we are return seekers. So depending on the client, depending on the objective — as we said earlier, we run all separately managed accounts. So for some clients, risk control and risk management is paramount or of greater priority than return seeking, but for others, it's just part and parcel of running the portfolios. We tend to really monitor our Sharpe ratios. So we look to maximize Sharpe ratios in that context, which is your return per unit of risk versus a benchmark. That's where we like some of these factor-based or strategic beta ETFs to help us maximize Sharpe ratios.

TWST: Did you want to talk about another fund?

Mr. Whistler: Another one that we use in our domestic space — and we actually carry this kind of factor tilt, if you will, across our international holdings as well, and I can share a little bit of that with you too — but the ticker is JPUS. It's the JPMorgan Diversified Return U.S. Equity ETF, which looks to track the performance of the Russell 1000 Diversified Factor Index. And so what this is, is an exchange-traded fund that's, again, factor-based. It basically looks to target the factors of value, quality and momentum. And it optimizes a portfolio based around those three factors. And so we combine that with a single factor of USMV, as well as a position in a market-cap-weighted security like in IVV, the S&P 500, and that would form basically the core of our domestic large-cap holdings.

And as I said, that methodology carries over to our international exposures where we may have EFAV, which is the iShares minimum volatility ETF for the international space, and also JPIN, which is the JPMorgan Diversified Return International Equity ETF — sort of the

equivalent of JPUS, but in a little different way. It targets different factors. In this case for JPIN, it's value, size, momentum and low volatility. So we have a combination of a market-cap-weighted position with a single-factor ETF and a multifactor ETF.

Now, the factors don't work all the time; they work over cycles. And so by diversifying your factors, you can make up, oftentimes, for the periods of time when that one factor may be out of favor or not quite working. That's why we tend to like that, but as opposed to strictly market-cap-weighted portfolios, we tend to prefer monitoring factors and including them in our exposures.

TWST: Do a lot of your investors want to have some exposure to the international and global sectors?

Mr. Whistler: We've been around since 1981, and we've run globally diversified portfolios since around 2001. So it's been 16 years with international exposure, and returns tend to be cyclical in a sense where we've had the sustained period of underperformance of international relative to domestic really since the Great Recession of 2008 and 2009. But we're just starting to see — actually this year, in Q1, you did see outperformance of the international space versus the U.S. space, and certainly from a valuation standpoint, which we're very sensitive to, you could say that U.S. markets are currently priced to perfection, with U.S. large caps trading around 21 times earnings. And there are definitely more favorable valuation metrics when you look internationally, whether it's Europe, certain countries in Europe, or whether we look into emerging markets, which are trading at a more favorable valuation profile.

Highlights

Lawrence Whistler discusses Nottingham Advisors. The firm handles separately managed accounts for high net worth individuals and institutions. Mr. Whistler's investment philosophy is unique in that it runs globally oriented asset allocation models that he considers to be dynamic indexing models. He expresses his views on equities via exchange-traded funds. In addition to investing in ETFs, he often includes a fixed income solution that is customized for the specific client. To manage risk, Mr. Whistler uses factor-based ETFs. According to him, factors work over cycles, so by diversifying factors, he is able to make up for periods of time when one factor may be out of favor.

Companies discussed: Community Bank System (NYSE:CBU).

TWST: I understand you offer customized fixed income solutions for both individuals and institutions. Did you want to maybe describe how those might be different, depending on whether it's for an individual or institution, and what the goals of those are?

Mr. Whistler: Sure. So for instance, let's take a pension fund, where we're doing more asset liability matching, where you have — maybe the pension fund has long-dated liabilities and we have to match assets accordingly, so we may construct a longer-dated portfolio of investment-grade corporate bonds to match with those liabilities versus a high net worth individual who's retired and living off some of their investment income, where there is a certain tax-sensitivity there, in which case we may employ high-quality municipal bonds and structure a portfolio that's designed to provide them with a specific level of income that may be shorter-duration or intermediate-duration, but that's going to be tailored exactly to that client. And we also have clients in the corporate space that have excess cash, and they're looking for a safe return on their money but something in excess of what they can earn at the bank or in T-bills, and in which case, we're going to build for them customized, short-duration fixed income portfolios that can — again, kind of an inflation-plus-type mandate, where you're just looking to not go too far out on the curve but earn them a better rate of return than they can get having that cash sitting in a bank.

TWST: Have you been paying really close attention to interest rates, and is this a concern of many of your investors?

Mr. Whistler: Yes, we monitor them in real time. I mean, it's been a concern for savers for quite some time, since the advent of quantitative easing and the Fed suppressing short-term interest rates. It's been a very difficult environment for savers — those used to not having to take a lot of risk in order to realize a reasonable rate of return, whether that may be 4% or 5%, which pre-recession they were able to do by buying bank CDs, and now, they have to buy high yield bonds. So it's a really different environment for them.

Their risk profile is far different than it may have been 10 years ago, but they also can't live on the 50 basis points that's available at your local bank or in a checking account. And short-term Treasuries really aren't providing enough yield for most investors. We're just not getting enough growth in the economy right now. We're not seeing inflation accelerate, which is what the Fed is hoping for. So our guess is, maybe we won't see two more interest rate hikes this year, but we sure would like to see that for the benefit of our clients — that our retirees looking to go back to their older model of investing conservatively and clipping coupons.

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TWST: For a lot of those retirees, especially the Baby Boomers and those who are going to retire, ideally, would they like to be able to do a lot with fixed-income-type things as opposed to either ETFs or equities or mutual funds?

Mr. Whistler: Yes, they would. I think the goal for most investors is to achieve your target rate of return with as little risk as possible. OK, so don't take excessive risk if you don't have to. I think

that if you can achieve your goal of a 5% pretax return owning bonds, you can do that with a lot less volatility than owning equities, but in this environment, again since 2008/2009, investors haven't had that luxury. They've had to stray into areas of the market where they may not have strayed before, and whether that is emerging market debt, or whether that's bank loans or high yield bonds or high-dividend-paying equities, like utilities and things, or a blend of all those, that's what they've had to do in order to generate that rate of return that they need in retirement.

The market is slowly starting to normalize, and our expectation is that it will normalize over time over the next couple of years. We'll see interest rates back up, and investors can return to their more traditional manner of investing, but for now, it's what they have to do to realize the rate of return that they need.

TWST: For many of the Baby Boomers, are they also thinking in terms of saving money for their heirs, descendants, after they're gone and that's part of their investment strategy?

Mr. Whistler: It sure is. And it's getting that much harder to do, and that's part of the concern, is that they're really spending down more of their principal because interest rates are so low. If they haven't migrated to a greater equity concentration, their total returns over the last few years have been below their burn rate, call it, if you will, and so they're starting to, in various instances, burn down a little of that principal, and it's less that they'll have to leave to their children, so that is certainly a concern.

TWST: For those who have children who are in the Millennial generation, many of those haven't really begun to get that involved in investing themselves because of a variety of economic concerns. So do you see them getting more involved as the economy starts to pick up, and maybe looking for ETFs and other vehicles?

Mr. Whistler: We'd certainly hope so. I mean, you think about the Millennials, they're part of the generation that grew up within a decade of severe drawdowns in the equity market. So they're probably a little bit concerned and gun-shy with respect to equities, but we're also seeing broader research that indicates that perhaps their savings aren't going into the equity market, that they're taking a more conservative stance and conservative posture with respect to some of their savings. And so you would hope that they would adopt a long-term focus and migrate out into equities and embrace that, because if you look at history, it's really been your best bet in terms of staying ahead of inflation and preserving your purchasing power just to have a diversified portfolio, but really with a solid core of equities.

TWST: For some of them, until they inherit wealth, is that going to be where they're really going to start to get serious about their own investments, or do you think that if the economy starts to pick up, they might get more involved on their own?

Mr. Whistler: That's a good question. I really don't know the answer to that. You would hope. You read about some of the issues with student loan debt, right? There's over $1 trillion of student loan debt hanging out there. I think you've got an entire generation that's struggling with that right now, and that impacts decisions on if and when you buy a house, if and when you start a family, so that's a real concern. I think this student loan problem that's out there, it's impacting the current generation of 20-somethings and 30-somethings, and that's probably part of the reason why they're undersaved, if you will, or not willing to really take a lot of risk or tie up funds in a longer-term investment plan.

You've seen rents rise as well. Since the recession, the rent-to-own ratio has skewed back the other way, where it was overwhelmingly in favor of renting back at the housing bubble, and now, it's gone back the other way, but home prices just reached a new high. Over the last six months, the Case-Shiller CoreLogic Home Price Index just set a new high. So yes, I mean, that's all a result of the Fed's low interest rate policy, which is another reason we hope that things normalize a little bit.

TWST: As you talk with investors, what are some of the concerns that they've been voicing to you in 2017 as they look to the future?

Mr. Whistler: A lot of it centers around Washington. OK, so you saw after the election that bonds sold off, interest rates surged. We saw the equity market rally, especially financials. XLF, which is the Financial Select Sector SPDR, it's an ETF. It was up almost 30% postelection. It's pulled back maybe 5% to 10%. We still actually like that security by the way. We do think financials are in the early innings of a broad sustained recovery, but yes, I think there's some uncertainty around Washington.

Everybody thought that some of President Trump's promises around tax reform, infrastructure spending and deregulation would happen within the first 90 days, and unfortunately, these things take time, and they're unlikely to happen even this calendar year, but our guess is things will get done in early 2018. There will be some form of tax reform or a corporate tax cut, hopefully, repatriation of foreign profits and certainly some fiscal stimulus, infrastructure spending occurring, and we're starting to see a little bit of the easing of the regulatory burden, certainly as it pertains to banks, signing legislation and seemingly daily rolling back some of the rules and regulations that the Obama administration had put in place.

So all that is positive for equities in time, but we just think the market got a little bit ahead of itself, and to us, today, valuation is the biggest concern. Valuations are not excessive, but corporate earnings haven't grown in three years. So you've seen the market rise simply because of multiple expansion, and at some point, we need to see earnings rise.

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TWST: Do you think investors appreciate what is available in the financial sector, or are they sort of sometimes shying away from it because they associate it with the whole series of events that happened in the 2008 period?

Mr. Whistler: Yes, they certainly can be forgiven for not wanting to tread into that space. I think banks were sort of persona non grata following the crash, and their reputations were sullied a little bit, but they certainly did get cheap enough, trading below book value. A lot of the rules that were part of Dodd-Frank actually were reasonable and well-thought-out, and they have improved the capitalization of banks. The banks are far safer today than they were in 2006 and 2007, so it worked. It probably was a little excessive in terms of some of the regulations, and if those get rolled back, it will help improve bank profitability.

I probably should say we are owned by a bank, a publicly traded bank known as **Community Bank System, Inc.** (NYSE:CBU), so I'll give you that full disclosure as I talk about banks. But yes, I think it's one sector that certainly underperformed for a long time, but we're just starting to see it come back. I think if you have a longer time horizon — three, four, five years — and you're willing to commit to a sector, I think that's probably one that merits some consideration relative to other sectors. What sector might experience outsized growth? I certainly think maybe financials over the coming years.

TWST: That would be true of both the large financial companies that are known throughout the world and also regional banks that might do mortgages and commercial loans and those kinds of things?

Mr. Whistler: Yes, I think broadly speaking. Again, it depends on the extent of the deregulation. It depends to a degree on the extent of tax reform. What is the corporate tax rate going to be? And lastly, a lot depends on interest rates, right? So if the Fed pulls back or holds off, and we continue in this low interest rate environment, that won't be helpful, but if rates do migrate higher, banks and financially oriented companies, financial service companies should benefit from higher interest rates.

TWST: As you talk with investors, are there one or two things that they'd really like to see the Trump administration do or Congress do — no matter who's in power — that they think that would benefit their financial picture?

Mr. Whistler: It's a good question. There doesn't seem to be one singular theme. I think those people that voted for Donald Trump voted for him for a reason, and that was the promises he made around tax reform, infrastructure spending and deregulation, so they want to see him follow through on his promises. I think those that maybe didn't vote for him aren't so eager to see him change too much because I think they might have been happy with the status quo. So I guess it depends on the eye of the beholder.

TWST: Thank you. (ES)

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