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Tom Dorsey: 'ETF Alchemy' Is The Future

By Olly Ludwig | May 17, 2013

Tom Dorsey, president and founder of Dorsey Wright & Associates, has been around ETFs since before they were even called ETFs. In other words, you won't find a bigger ETF enthusiast. In fact, his business of point and figure technical analysis is now focused on ETFs, and their role in all he does will only increase.

Dorsey is always quick to say he considers the ETF the most important financial innovation in his nearly 40-year career in the money management industry, and sees ETF development so far amounting to the first foot of a 26-mile marathon.

To put a finer point on that, he told IndexUniverse.com Managing Editor Olly Ludwig that while development of individual ETFs is likely to slow down, what he calls "ETF alchemy"—an active overlay involving the combination of different ETFs to enhance returns—is already taking off in the world of money management.

IU.com:In the first four months of 2013, asset gathering for U.S. ETFs was in the neighborhood of $64 billion, and on pace to beat 2012's record of $188 billion. Are you surprised? Is the sky the limit? How far is this ETF juggernaut going to go?

Dorsey: Well, I don't think the sky is going to be the limit. I don't know that there are any more ETFs that anyone can bring out that will be the new fandango. The key word here is a phrase I coined: "ETF alchemy."

IU.com: ETF alchemy?

Dorsey: Think about this for a second: If I take H_2 and I add O, what do I get?

IU.com: Water.

Dorsey: Yes, water. Each one of those two elements is separate. But when I combine the two, I come up with a substance—water—that you can't live without. Each one separately is not as good as the two combined. And the concept here is, What's out there in terms of ETFs I can combine together to make a better product?

Take for instance the Standard & Poor's Low Volatility Index—and if you add that to PDP, which is our Technical Leaders Index, and combine the two, it's like taking two glasses of water and pouring them into one bigger glass of water, 50-50. I end up with a better product than either one of them separately.

You'll find this as we go along: the ability to combine different ETFs to create a better unit where the whole is better than the sum of its parts.

IU.com: You're combining the PowerShares DWA Technical Leaders Portfolio (NYSEArca: PDP) and the PowerShares S&P 500 Low Volatility Portfolio (NYSEArca: SPLV) in that example? Can you be a little more granular about how this combination is established or how it works in practice?

Dorsey: The way it works is the Standard & Poor's Low Volatility is exactly what it suggests. So, a low-volatility version of the S&P 500 would be more of a beta type of thing, and I want to add alpha to that, which would be PDP. Our PDP outperforms all of its bogeys: the S&P 500, the Equal Weight S&P 500, whatever you want to compare it to, but PDP outperforms it.

Dorsey (cont'd.): But in times of market consolidation, you want something in that combination that has some brakes, and that is the Standard & Poor's Low Volatility Index. I can do the same thing with our PowerShares DWA Emerging Markets Technical Leaders (NYSEArca: PIE), our emerging market ETF. It outperforms, hands down (NYSEArca: VWO) and (NYSEArca: EEM) which is another story unto itself. But why stop there? Take the PIE, let's say, and add it to (NYSEArca: EELV), which is emerging market low volatility. Combining those two I have a better product.

I only mentioned our products because that's mostly what we have worked with in putting these into our backtester. And by taking these together, you're creating something that, working in combination, is better than any one of them by themselves. And you can create models in this way, and I think that's ETF alchemy. The "alchemy of ETFs" is combining things together to make better products, and that is really where this is going to end up being the biggest play for portfolios.

IU.com: You're saying that the ETF world is quite possibly saturated already. But this ETF alchemy frontier is going to afford a whole new impetus to allocate to the exchange-traded approach. So, what does this mean for mutual funds?

Dorsey: Well, for mutual funds, as long as there is a commission trailer, and as long as it's beneficial to the advisor selling the mutual fund, I think you'll see flows continuing to go into mutual funds. If they were able to, say, make mutual funds equal to ETFs, where you just had one fee and there was no trailer, nothing combined to it, I think at that point you would find that mutual funds would begin to lose a lot of money, and that it naturally would be put it into ETFs. Until that happens, and you still have the trailers, and it's beneficial for the broker to own mutual funds, you're going to see still a lot of money in mutual funds.

IU.com: At the risk of sounding a little snarky, you're saying that as long as the gravy train of brokerage fees in the form of a trailers, for example, remains, that will be what preserves the mutual fund—even though that's probably not in the interest of investors in terms of taking some of their returns out of their pockets and into the pockets of brokers?

Dorsey: Yes, this is not telling stories out of school or anything like that. It's the trailers. If you're an advisor and you're getting that trailer, and it means more money to you to be recommending that, then firms are going to want you to do that.

The key for the ETFs for the advisor is being in a program in which the advisor is the portfolio manager, like where the broker charges a fee for what he does. Then the ETF is going to make more sense to him at that point in time.

IU.com: ETFs are now 20 years old—the SPDR S&P 500 ETF (NYSEArca: SPY) was launched in January 1993. And this ETF alchemy, as you're describing it, is the new frontier. In terms of time, when do you see this ETF alchemy manifesting and becoming a bigger part of how ETFs are used and integrated into investment portfolios?

Dorsey: Well, it's already happening. At Dorsey Wright, we're probably the first ones to have begun modeling ETFs out there. We've had models actually running for iShares since 2002, and we were modeling long before that. People have picked up on that, and as more people create models, they're fundamental, they're technical, they're built in many, many different ways. Ours are 100 percent relative strength, where we compare and contrast different things like our PDP. Our technical leaders are the 100 strongest relative-strength stocks out of 1,500. And that's updated every quarter.

IU.com: Are you pretty much of an unequivocal fan of ETFs, or do you see some downsides?

Dorsey: Unequivocal.

IU.com: Please explain.

Dorsey: The reason I'm an unequivocal fan is, No.1, I'm probably the first person to ever be involved with an ETF with the Philadelphia Stock Exchange when they created the index participation unit which was the first ETF that ever traded in the 1980s. It was a Standard & Poor's 500 security.

The problem with that first one is we used derivatives as the underlying, and ultimately we were sued by the futures exchange as being a futures product instead of a fund, and the futures exchange won and took the product.

IU.com: Right, I've heard about those.

Dorsey: So when that didn't work, the Toronto Exchange came to the Philadelphia exchange and said, "Hey, could we use your template?" The Philadelphia exchange gave them a template and they came out with the TIPs, Toronto index participation units. But the difference here is the underlying was real stocks. So it was the first one that took and traded and has been trading every since.

IU.com: So that's really the first ETF.

Dorsey: Yes, and I can't tell you how many seminars I have taught to professionals on ETFs and the eyes that widen and the lives that change once they understand it and understand how to use it; it tells me we're on the right path and this is the exact right product.

Like I've said to you before, it's probably the most important product ever created in my 39 years in this business. And I believe back then when I talked to you that we're in the first foot of a 26-mile marathon.

IU.com: And regarding this educational effort that needs to take shape over the coming years, when does a typical investor with sizable investable assets turn to his or her broker and say, "Listen, we need to segue my holdings into an ETF wrapper"? Will that happen in five years, or 10 years? What do you think?

Dorsey: I'd say we'll be a long way down the road in five years. So, any stockbroker out there, any advisor, had better embrace ETFs, had better embrace ETF alchemy and understand how to put these portfolios together, and companies like DWA need to help brokers. Because as fees and commissions continue to get more compressed, they have to find new ways to go out and talk to the public and get new accounts.