Private equity firms target ETF portfolio managers

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By Jessica Toonkel

NEW YORK (Reuters) - Private equity investors have found another way to get into the growing U.S. exchange traded fund (ETF) market: investing in firms that manage ETF portfolios.

Seven years ago, venture capitalists clamored to invest in start-up ETFs - investment funds that are traded much like stocks. But with over 1,460 ETFs now available in the U.S., the landscape is crowded. That has led to a growing interest in ETF model portfolio firms - the companies that manage a portfolio made up solely of ETFs.

The model portfolio invests in a selection of ETFs, rather than individual securities. On the other end, a retail investor gets exposure to a basket of index ETFs. The portfolio manager actively manages that basket and can switch in and out of ETFs.

FTV Capital, Aquiline Capital Partners LLC, Century Capital and Grail Partners are among the private equity firms actively looking to acquire or make investments in such firms.

Model ETF portfolios have become more popular as people turn away from traditional mutual funds in search of less expensive and more transparent options, said Andrew Gogerty, an ETF managed portfolio strategist at Morningstar.

Unlike mutual funds, which often pay brokerage firms to sell their portfolios at-cost to investors, ETF portfolios only charge investors management fees, which means they are cheaper and there are fewer potential conflicts of interest, Gogerty said.

Equity mutual funds saw $2.5 billion in outflows in the first quarter of this year while equity ETFs saw $22.6 billion in new money, according to Lipper.

BlackRock's iShares ETF business keeps one of the most comprehensive lists of model ETF portfolios available today. Called the iShares Connect Program, it includes the majority of providers in the U.S., with more than 200 strategies run by 104 managers with a total of $46 billion in assets.

The firm projects the ETF model portfolio market to hit $120 billion by the end of 2015. Venture capitalists say they expect model ETF portfolios to become mainstream in the next few years.

"The big-hit sensation of the mid-2000s was anything ETF," said Liz Nesvold, managing partner of Silver Lane Advisors, a New York-based investment banking firm that is representing a number of model ETF portfolio providers in discussions with potential investors. "Now the focus is on how to use the ETFs."

GROWTH FACTORS

Charles Schwab Corp. (SCHW.N: Quote, Profile, Research, Stock Buzz) put ETF model portfolios on the map for private equity and retail investors in 2010 when it acquired Windward Investment Management, a $3.8 billion ETF model portfolio provider. Then, in June 2011, TA Associates bought a 54 percent stake in ETF model portfolio provider Stadion Money Management LLC. Terms were not disclosed.

Not long after, Morningstar began ranking these portfolios, leading more private equity investors to take notice. Those investors say there a number of trends that will contribute to the growth of the ETF portfolio market.

Several years of volatile markets have created a new appreciation among investors for tactical allocations - where managers can jump from one asset class to another to generate returns - experts said. ETF model managers can do this while mutual funds managers usually cannot.

Later this year new regulations require investors and employers to be shown the fees they pay for their 401(k) investments. That could pave the way for cheaper ETF models to gain traction in retirement plans.

"We think ETF model portfolios will stack up very well versus target-date mutual funds, which we think have not been good for most investors," said Chris Lalonde, a principal at Century Capital Management, a Boston-based private equity firm that hopes to invest in a model portfolio provider this year.

Most target-date funds only include portfolios managed by the fund's parent company, Lalonde said. ETF model providers are not bound to use specific ETFs and are therefore likely to perform better, he said.

Grail Partners LLC, chief executive Don Putnam said the firm is looking at ETF model portfolio providers even though in April 2011, it sold its own actively-managed ETF business after it failed to gain enough assets. Putnam said he believes there is more growth potential in the ETF model portfolio business today.

CHALLENGES

One challenge for venture capital firms is determining whether model ETF portfolio providers have enough resources in place to sell their products.

Some providers have a sales force. Others have partnered with a firm that sells the portfolios for them. But many have neither or maintain only a small sales force, making it hard to gain assets, experts said.

"You can have a great product but if you don't understand distribution you will have $100 million in assets and low profitability," said Ben Cukier, a partner at private equity firm FTV Capital, which invests in a number of ETF providers.

Discerning a model ETF firm's performance can also be tricky. Many providers are new and others haven't been in business long enough to discuss anything more than hypothetical historical performance.

Most firms said they will not consider investing in a provider that does not have at least three or five years of actual performance. That has limited the options and led some private equity firms to stay on the sideline - for now.

"The firms are so small that we would not invest in these at such an early stage," said Jeffrey Lovell, a managing director at Lovell Minnick Partners. "But it will stay on our radar."

(Reporting by Jessica Toonkel, editing by Jennifer Merritt, desking by Andrew Hay)