Kevin O'Leary has taken his well-known exacting standards and applied them to a family of ETFs.

Mr. Wonderful has an ETF

by Daniel P. Collins

Kevin O'Leary had a long successful career in finance well before he became famous and ironically dubbed "Mr. Wonderful" as perhaps the hardest shark to convince on the wildly successful show Shark Tank.

The Canadian-born entrepreneur, along with a few partners, launched SoftKey Software Products in 1986 from his basement using proceeds from an earlier Canadian television venture. As sales took off, O'Leary moved headquarters to the Boston area and began acquiring competitors. He rebranded his company "The Learning Company" after purchasing that firm and would eventually sell TLC to Mattel for more than $3 billion.

His newest venture, O'Shares Investments, is indirectly connected to The Learning Company because O'Leary set up a family trust after earning a windfall from the firm. It was structured to be 50% in fixed income and 50% equities with specific concentration rules. There could be no more than a 5% allocation in any one stock or 20% in any one sector. The rules set for the family trust are the rules O'Leary maintained in building the O'Shares exchange traded funds (ETFs). "It was designed to be multi-generational and work for hundreds of years," O'Leary says. "The key was the trust had to pay out 5% a year without using leverage, without using derivatives, long only, totally invested in all times."

This was not a problem in the late 1990s, as the 5% nut could be satisfied with a ladder of government bonds. In the more challenging interest rate environment of the last decade it has become more difficult. "I have used every asset class," O'Leary says. "Hired hedge funds, private equity, founded my own mutual fund company, [but] what I found was every seven to 10 years my managers would go flat or blow-up. You can see examples today of fantastic hedge fund managers that are down 30% to 40% for whatever reason."

More recently, O'Leary noticed more ETFs finding their way into mutual funds. "Three years ago I asked my researchers, 'Is there a way to use ETFs to populate the entire equity portion of those trusts?'" he says. At the time there were 49 dividend paying — an absolute must for O'Leary — ETFs. "I need dividends because I have to pay 5% — I thought we could use five-to-seven of them [because they're] typically very tax efficient, very low cost and less expensive than mutual funds."

What he discovered was that nearly all the ETFs were market cap rated. "The trouble with the market cap weighted is you can own an index where many names are more than 5%, I can't own any of that," O'Leary says.

So that is how O'Shares were conceived. "I called up FTSE Russell and said, 'Guys I can't believe I can't find an ETF that doesn't have some sort of covenant regarding concentration. If you could design something that fits my rules, I'd pay you for it,'" he says.

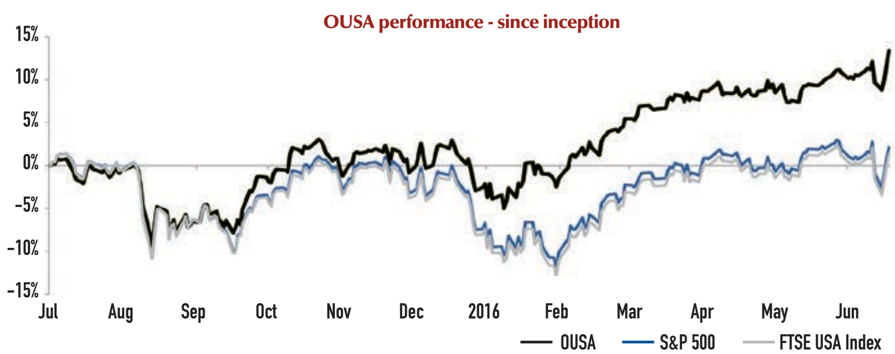
O'Leary met the FTSE Russell team along with his mutual fund CEO Connor O'Brien. Basically, O'Leary gave them a list of his requirements and asked them to find stocks that met those requirements (see "Punch list," right).

PUNCH LIST

Each stock in the O'Shares family of ETFs must meet these requirements.

- No stocks can be more than 5% of the allocation
- No sector can represent more than 20% of the ETF
- Every sector has to be represented
- Stocks must pay dividends
- Companies in the index cannot use accrual in sales
- Stocks that use leverage to maintain or increase its dividends cannot be in the index
- Stocks in the index must be 20% less volatile than the broad market (based on a five-year backtest)
- If returns on assets (ROA) in a stock are falling it can't be in

BEATING THE BENCHMARK



Total return		
OUSA	S&P 500	FTSE USA Index
13.4%	2.1%	1.4%

Source: O'Shares Investments

Building an ETF

While the approach is completely systematic, some of the requirements are complex and require an efficient team of researchers, which Russell provided. "Now, instead of having my portfolio team of analysts, I have 150 of them," O'Leary says. "I told them to build me that product; they went away and worked with Conner, and O'Shares FTSE Quality Dividend ETF (OUSA) was born July 14, 2015."

In its first 12 months, the OUSA ETF outperformed the S&P 500 by 10.6% (see "Beating the benchmark," above). "It tells you that the quality of the balance sheet matters," O'Leary says. "This kind of innovation is just starting in the ETF space; it's as if I found the very best managers in the world and crystallized their talents in perpetuity."

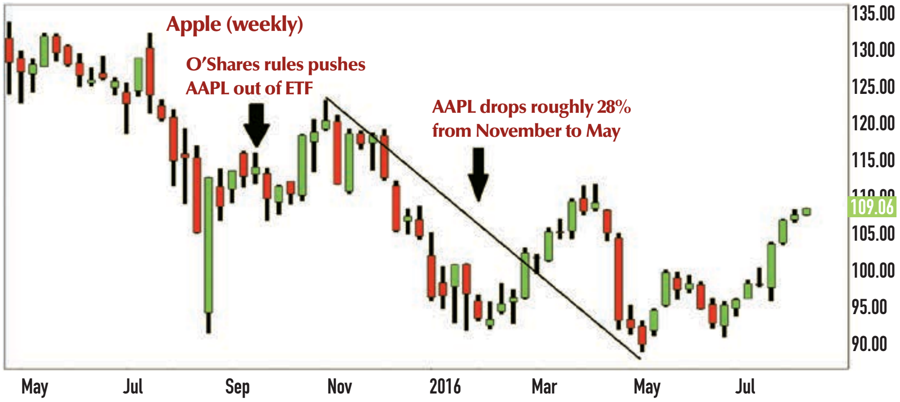
When you include the FTSE Russell Index along with the S&P 500, there were 650 stocks examined for the ETF and 142 made the cut. The initial performance was so strong that they expanded. "When I saw that performance starting to emerge I asked FTSE Russell to do it for me in Europe and Asia and create hedged and non-hedged products," says O'Leary. Now there are five ETFs: OUSA, OEUR (Europe), OEUH (Europe hedged), OASI (Asia Pacific, OAPH (Asia Pacific hedged).

Rules are rules

One of the great things about rules-based strategies—as every systematic trend follower should know — is that you can take the emotion out of trad-

GOOD TIMING (I WILL CREATE)

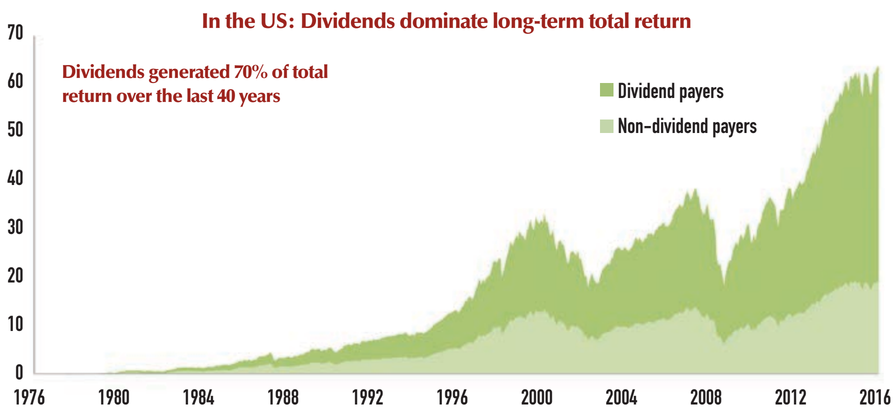
O'Leary's rules-based approach tossed Apple out of the ETF shortly before a larger downward correction.



Source: eSignal

SOURCE OF EQUITY RETURNS

Dividends accounted for a great deal of equity return over the last 40 years, and that percentage could increase in our current low-growth environment.



Source: O'Shares Investments

ing and investing.

Last Sept. 21 FTSE called up O'Leary and said they were taking Apple (AAPL) out of the index. "What? That is the biggest company in the world," O'Leary exclaimed. "They said, 'Yes, but they are issuing billions in debt overseas. When they want to do a dividend they've got to borrow money overseas and bring it over to avoid repatriation taxes.'"

It was the rate-of-return test that pushed Apple out of the index. The stock plunged at the beginning of November (see "Good timing," above). "That is an example of why you want these multiple tests. We don't own Disney because of the volatility and you see what's happened there. This is a very conservative mandate. This is for people who want to invest long term," O'Leary says. "That is the great thing about ETFing, there is no emotion. I didn't have a choice about Apple. It didn't make the cut. It will be reexamined again on Sept. 21 when the whole index is reconstituted. There is no style drift; there is no individual in a room making a decision based on their gut emotion. It is hard core rule-based investing."

Dividends pay

Dividends have always been a key factor in investing in stocks for O'Leary, but he says that it is even more important in the current environment. "What is going to really matter over the next 10 years is, can you find companies that are able to sustain cash flows and return capital to you as a shareholder?" O'Leary asks. "If the whole universe is only growing 1.5% GDP, you obviously want to make more than 2%. You've got to mine for companies that are able to sustain or grow cash flows and pay a significant portion of what they earn to you."

He says he will be able to get two-thirds of his target 5% through cash dividends, but adds, "It is not so much about dividends. We are mining for really good balance sheets. The yield for the S&P 500 is about 2.1%, our yield is 40% higher. What is important about that is not the dividend itself, it is that I believe over the next 10 years more than half of your returns will come from dividends."

He points out that during the last 40 years, 71% returns in the S&P 500 came from dividends, not capital appreciation (see "Source of equity returns," left). "Many people don't realize that," he says. "In a very slow growth GDP environment, you have to think a lot about where are the returns going to come from. Are they going to come from dividends or capital appreciation? The answer is both but now because of low GDP growth the majority of them will come from return on capital."

Long-term investing

The key for O'Leary in building O'Shares was to have something liquid that would stand the test of time.

O'Shares are completely liquid. "The average market cap inside OUSA is $128 billion. You can put $100 million into O'Shares in one trade and not move it 1¢," says O'Leary.

And while O'Shares are only a year old, the FTSE team has back-tested the ETFs 20 years. "What is great about this strategy is that since inception it captures 95% of the upside and between 43% and 60% of the downside," O'Leary says. "So, the question I have to ask myself is 'Am I willing to give up the last 5% of a market to protect myself against 40% of the downside?' The answer is, 'Absolutely.'"

And the backtest was not based on the current ETF portfolios; FTSE Russell applied the strategy metrics to the markets for the last 20 years. "The reason they get paid is that they maintain the data for every public company. That is extremely valuable," O'Leary says.

Diversification is the most important factor in investing for O'Leary, and he says that the ETF space is providing that with innovative vehicles. "I find that ETFs today are extraordinary efficient vehicles. You get diversification, you do not get style drift, extremely low cost, tax efficient—those are the hallmarks of a good investment strategy," he says, "And that is why you are seeing of all the asset classes out there, including alternatives; the ones that are growing the fastest are the new multi-factor ETFs."

His approach to building the O'Shares family of ETFS couldn't be any further from his work on Shark Tank. While it is clear that O'Leary is a hard sell, venture investing takes a bit of faith.

"What I care most about is the balance sheet because I am going to own the company for decades. Its ability to generate cash, maintain its dividend stream and retain return on capital is paramount," O'Leary says. "Shark Tank and venture investing is a completely different thing than O'Shares. Venture investing is highly risky; we don't do any of that in O'Shares. We are extremely conservative in the trust. Remember the family trust is designed to take care of multiple generations. The trust is really boring, Shark Tank is very exciting; but sometimes boring is what you need. ∆

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Swimming with the sharks

If there is something more odd than the sometimes edgy O'Leary being dubbed "Mr. Wonderful," it is the popularity of the show itself and the breadth of the demographics.

O'Leary tells a story of how an 11-year-girl ran up to him in San Francisco and said: Mr. Wonderful, you should have done a convertible debenture with up to a 20% stake, last night.

"She saw me use the term on the show [and] went online and learned about it," O'Leary exclaims. "How cool is it that an 11 year old girl is interested in this kind of thing. I am really proud of what the platform has become. The fact that our fastest growing demographic is nine to 18 year old girls, nobody thought that at ABC or Disney."

He has also seen over eight years of working on Shark Tank that young entrepreneurs are more globally focused.

"Millennials in their mid-20s are starting to think globally in a way we never thought before in America, he says. "They see innovation in what they create and wonder why they can't sell in Europe, Asia or South America. These are small companies; to be thinking internationally is extraordinary. That is the big difference with millennials. They are not bound by geography in a way we were. I would have never thought in the early days of starting my educational software company that I would be selling internationally. Eventually it did, but it was after we had grown a lot in the domestic market."

As for the "Mr. Wonderful" moniker, he thinks it grew of a conversation with fellow Shark Barbara Corcoran. "I said that I am always the shark that tells the truth and that is important in business and she said 'isn't that just wonderful," and I said yeah I am Mr. Wonderful, I am the only shark that tells the truth, never thinking it would stick.