



## Newsflash

A new month and the thirty seventh issue of Viewpoint from FP.

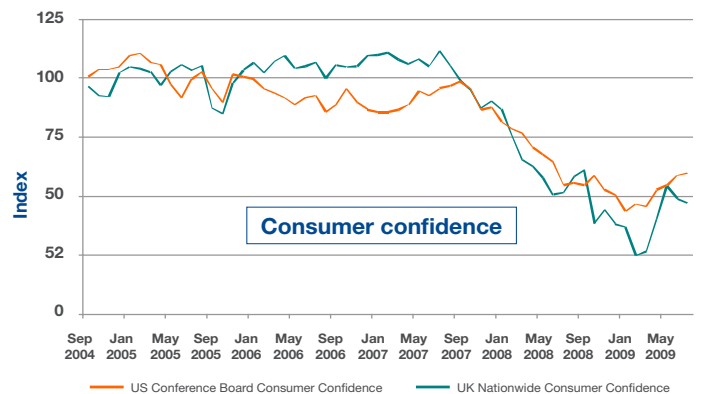
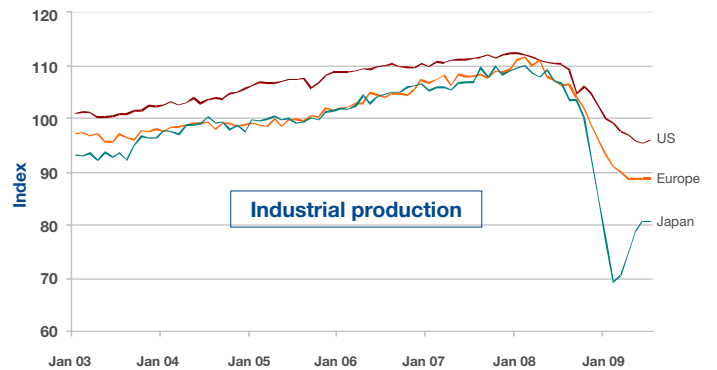
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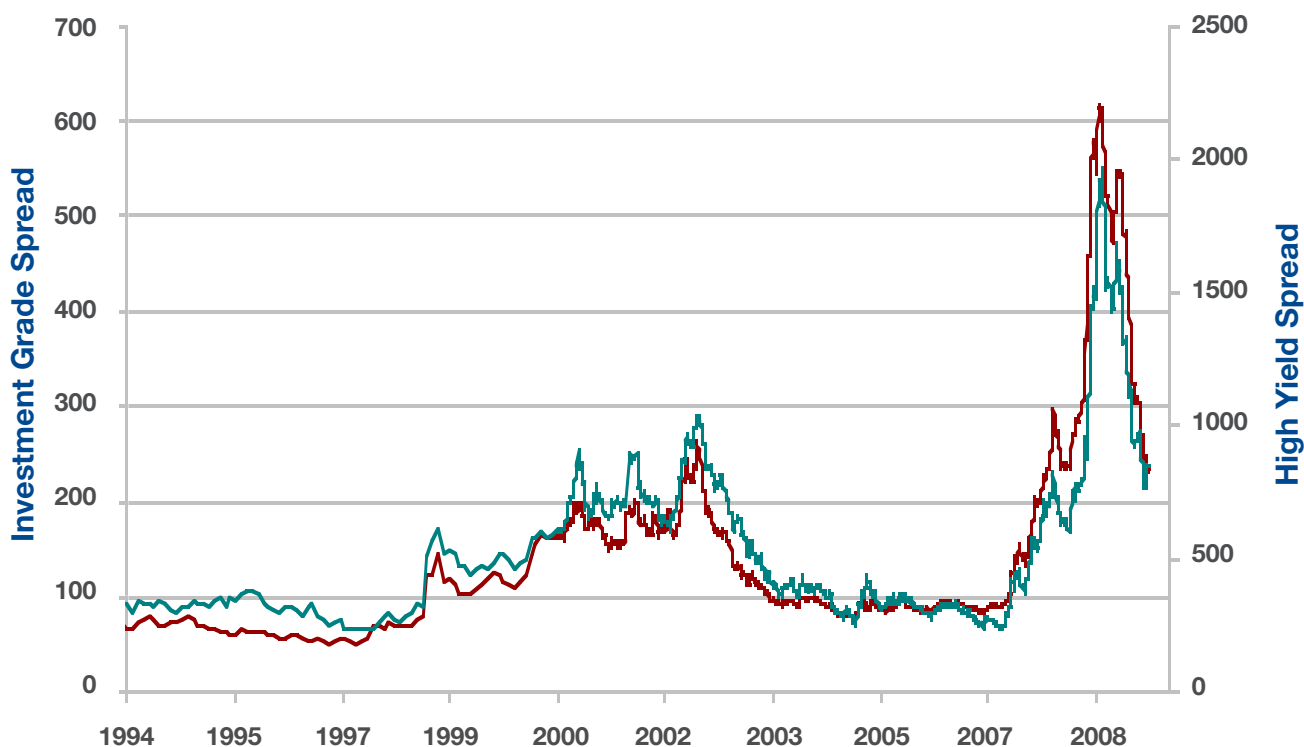
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Continued strength in both equity and bond markets was the main theme in August 2009. Ever improving economic data supported the current rally in a broad range of risky assets, much to the surprise of many market commentators who expected, if not a pullback, at least some moderation in the upwards movement of equity and related markets.





It is nearly a year since Lehman Brothers filed for bankruptcy; an event which (amongst others) led to a near meltdown in most of the developed world's banking institutions and eventually to global government bailout plans, the likes of which have never been seen before. In the meantime short-term interest rates in all major currencies reduced to, or near to, historical lows, and will probably remain there for some time. Inventories were cut significantly, and as a result global production has decreased dramatically. With inventory only needing to be cut once, and the extent of global fiscal stimulus programs, it is little wonder that consumer confidence along with global production is making a turn for the better (albeit from a very low base – see graphs above).

The fall in house prices in the important UK and US markets seems to have tailed off (at least for the time being) with a turnaround in values in the second quarter of 2009. This is of course good news for banks with extensive mortgage books, as a continuous decline in house prices would probably lead to

more write downs for bad debt and a subsequent weakening of balance sheets – something that a number of large banks can ill afford after the major re-capitalisation drive earlier this year.

Global developed equity markets (up 4.1%) were relatively stronger in August as emerging market equities (down -0.4%) took a bit of a breather having returned more than 50% for the year to date. Viewpoint remains bullish towards emerging market equities over the longer term given their relative structural strength versus the US, Europe and the UK.

However given the extent of the rally over the last six months it was not a surprise to see a bit of weakness, driven by the sudden decline in China on 31 August.

Bond markets rallied across the board with all of the major bond asset classes that Viewpoint monitors in positive territory. High yield and convertible bonds continued to produce solid returns as equity markets continued to rally.

Global government bonds were up a solid 2.0% for the month, whilst UK gilts and corporate bonds produced stellar returns, ending the month up 3.8% and 4.6% respectively. Real yields (nominal yield less inflation) on government bonds in the US are still quite high, which may over the short term support the bond market somewhat more than the current nominal rate suggests. The contraction of the yield spread of corporate and high yield bonds over treasuries has slowed down, especially in the non-financial sector. These spreads are now around the same levels that they were in 2000 – 2002, and Viewpoint does not expect them to quite reach the lows of

2003 – 2007 again. We could therefore see some further value in these asset classes, but perhaps not to the extent seen in the first quarter of this year.

On the back of continued strength in risky assets the US Dollar lost ground against most major currencies during the month, and for the year to date has only gained a meagre 2.3%, against the Japanese Yen. Viewpoint's preference remains exposure to a variety of emerging market currencies, where economies face mostly cyclical headwinds but not the same structural headwinds as seen in most of the Western markets.

## Asset Class Performances

Asset Class/Region	Index	Currency	Aug 2009	YTD 2009
<b>Equities</b>				
United States	S&P 500 NR	USD	3.5	14.4
United Kingdom	FTSE All Share TR	GBP	7.7	17.8
Continental Europe	MSCI Europe ex UK NR	EUR	5.4	19.8
Japan	Topix TR	JPY	1.7	13.7
Global	MSCI World NR	USD	4.1	20.1
Global Emerging Markets	MSCI World Emerging Markets TR	USD	-0.4	50.8
<b>Bonds</b>				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	1.0	-3.3
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	0.8	6.3
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	1.5	14.7
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	1.8	41.3
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	3.8	0.9
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	4.6	9.0
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.5	3.7
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	1.1	12.0
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	3.9	56.5
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.6	0.1
Global Government Bonds	JP Morgan Global GBI	USD	2.0	1.6
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	1.7	4.8
Global Convertible Bonds	UBS Global Convertible Bond	USD	3.7	30.8
Global Emerging Market bonds		USD	1.9	18.1
<b>Property</b>				
US Property securities	MSCI US REIT TR	USD	13.9	9.0
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	19.4	11.2
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	15.2	31.6
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	-0.7	34.6
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	7.2	20.9

Source: Lipper Hindsight, August 2009

Asset Class/Region	Index	Currency	Aug 2009	YTD 2009
<b>Currencies</b>				
Euro		USD	1.2	3.2
Sterling		USD	-1.7	13.4
Yen		USD	2.6	-2.3
Australian Dollar		USD	1.4	20.9
Rand		USD	0.6	18.7
<b>Commodities</b>				
Commodities	RICI TR	USD	-1.4	13.1
Agricultural Commodities	RICI Agriculture TR	USD	-2.4	-4.8
Oil	Brent Crude Index (ICE) CR	USD	4.2	80.7
Gold	Gold index	USD	1.1	10.3
<b>Interest rates</b>				
	<b>Last meeting</b>		<b>Current rate</b>	<b>Last change</b>
United States	12 August 2009	USD	0.25%	0.00%
United Kingdom	10 September 2009	GBP	0.50%	0.00%
Eurozone	3 September 2009	EUR	1.00%	0.00%
Japan	17 September 2009	JPY	0.10%	0.00%
Australia	1 September 2009	AUD	3.00%	0.00%
South Africa	14 August 2009	ZAR	7.00%	-0.50%

Source: Lipper Hindsight, September 2009

## FOCUS

**In the second of a two part series we take a look at exchange traded funds (ETFs), and their application in portfolio construction. Last month we looked at the basic working of an ETF, and this month we focus on the advantages and disadvantages of ETFs, as well as innovation in this new investment field.**

### The advantages of ETFs

For market participants, ETFs can have a number of advantages. The basic long only, passive and ungeared ETFs have the ability to offer cheap and liquid exposure to an asset class of the investor's choosing. As the universe of ETFs expanded, so have the available indices being tracked. This provides investors with the benefit of flexibility and choice from the perspective of asset class allocation. ETFs for this purpose should be chosen for a low tracking error versus their target portfolio. ETFs should generally also be a low cost vehicle. The management fees charged for passive strategies should be low. The fees applicable for management of these strategies generally range from 0.05% p.a. to 1.60% p.a. Furthermore, the fact that the tracking portfolios should be low-turnover in nature, combined with no need for the ETF manager to rebalance for flows (these are made in specie) will tend to keep TERs and tracking errors low. The equity-like nature of ETFs means that purchasers and sellers may employ equity trading techniques such as limit orders, buying on margin, stop loss orders and possibly even short selling where security lending is available. Furthermore, like equities, some ETFs may have options written against them. The traditional ETFs are also notable for their transparency. The index tracking funds have a very clear investment aim and the fact that the NAV and composition is published frequently to allow creation and redemption units provides regular holdings updates for investors that other tracking strategies may not provide. The foremost reasons why ETFs are used by investors are :

**Transparency** Investors know the composition of an ETF at any given time.

**Liquidity** ETFs offer liquidity through both their secondary market trading volumes and also via the creation and redemption process.

**Diversification** ETFs provide immediate exposure to a basket of securities for diversification within that strategy and there is a broad range of lowly correlated asset class ETFs available.

**Flexibility** By being listed on an exchange ETFs can trade throughout the day while the exchange is open Pricing is continuous throughout the day.

**Cost Effectiveness** ETFs offer a direct route to diversified market exposure and the average TER for equity ETFs in Europe is 37bps versus 87bps p.a. for the average equity index tracker and 175bps for the average equity fund.

### The disadvantages of ETFs

Despite the fact that ungeared long-only ETFs are an efficient way to track an index they still have some shortcomings. There are a number of investment-related risks to the ETF portfolio and the underlying holdings. These will be covered in some depth in each ETF's prospectus and therefore will not be considered in this report. One disadvantage is that ETFs are traded through the market and there is no guarantee that the ETF, at time of purchase, will be broadly fair value when compared to the underlying holdings' NAV. As a result, prospective buyers or sellers of ETFs must ensure that the market price available is not unrepresentative of the underlying NAV. Furthermore as these vehicles are traded on exchanges, they will be subject to a bid and offer spread. This spread will likely differ depending on the prevailing trading conditions at that time and the liquidity of the particular issue. Furthermore, as ETFs will need to be traded through a brokerage there will likely be some broker fees payable.

Mutual funds are generally cheaper in this regard as they can be traded directly with the management company. Another issue is that ultimately the functioning of the ETFs in the secondary market is reliant upon the efficacy of the institutional investors to exploit arbitrage opportunities in order to keep the price on the exchange within a reasonable margin with the underlying NAV. The possibility of price deviation of ETFs in the market was investigated in 2008 by Dow Jones Newswires. The investigation made 300 trades in lightly traded ETFs, where they found prices 5% off NAV occurred once in approximately every 14 trades, and the average price that investors received was more than 1% off.

## Innovative ETFs

The most recent innovations in the ETF universe are ETFs which are not designed to slavishly track an index, but rather to intentionally deviate from that index either as a result of an 'index plus' type of strategy, which brings a degree of trading emphasis into the portfolio, or on the basis of fundamental or technical factors. Other types of ETFs are effectively geared plays on the underlying indices. For example a 2X ETF will be designed to return double the daily movement of the index, and these leveraged strategies can also be inverse strategies, looking to return an inverse multiple of the return of an index over a stated investment period. Strategies such as these represent a shift of ETFs out from their traditional stronghold into a higher margin and more complex universe.

Creating actively managed ETFs is a move which ETF managers hope will allow them to compete with conventional mutual funds that employ stock picking managers. Thus far the active ETFs have been greeted with a lukewarm response from investors. According to the Wall Street Journal, the most successful active funds appear to be the WisdomTree range which raised USD120 million collectively in twelve funds within a week of their launch in May 2008<sup>1</sup>. One reason for the apparent apathy towards active ETFs might be the advent of these new ETFs just prior to and within the worst equity market conditions for several decades and the attendant risk aversion which it brought. A second possibility is that potential investors into the active ETF market will give the strategies time to prove their worth before making an investment. With 'traditional' index tracking ETFs, investors could buy from reputable investment houses and

have a reasonable understanding of what to expect in terms of future performance. Performance for active ETFs is something of an unknown quantity and it is possible that investors will be reluctant to commit to this latest iteration until they have proved their worth. Furthermore other reasons for the slow start might be that this approach somewhat serves to undermine the most attractive characteristics of ETFs such as their cheapness, low tracking error and transparency.

Geared ETFs have also failed to live up to investors' expectations and this might be a consequence both of the strategies, but also the expectations themselves. The reason for this is that many geared ETFs are designed to offer a certain investment experience over a very specific time frame. As a result of this, investors who have invested in these assets with the intention to hold for a different period (perhaps due to a lack of understanding of the structure) than the ETF is designed for may find their total returns at the end to be awry compared to the benchmark. Leveraged ETFs will often use derivatives to gear their exposure to a particular market which bring with them greater cost to the fund and the additional investment and investment related risks which are associated with derivatives. As a result of these factors, investors who are considering buying leveraged ETFs must be sure that their intended holding period is appropriate for that strategy and also that the risks outlined in the prospectus are heeded.

To illustrate some of the dangers of inappropriate holding periods, the graphs below and overleaf and data have been compiled. 'First is a hypothetical example using a market that moves by  $\pm 10\%$  per day and some geared examples of that daily move. This hypothetical ETF is therefore designed to return a multiple of each daily move rather than a multiple of a longer period holding return. The results are below<sup>2</sup>:

Day	Cumulative Multiple			
	X	Index	Change	of X
1		100.000		
2	+10%	110.000	10.00%	1.000
3	-10%	99.000	-1.00%	1.000
4	+10%	108.900	8.90%	1.000
5	-10%	98.010	-1.99%	1.000
6	+10%	107.811	7.81%	1.000

<sup>1</sup> Source: Wall Street Journal. <http://online.wsj.com/article/SB121141796203112751.html>

<sup>2</sup> Source: I-Net and Momentum Investment Consulting, July 2009

Day	Cumulative Multiple			
	1.5X	Index	Change	of X
1		100.000		
2	+15%	115.000	15.00%	1.500
3	-15%	97.750	-2.25%	2.250
4	+15%	112.413	12.41%	1.395
5	-15%	95.551	-4.45%	2.236
6	+15%	109.883	9.88%	1.265

Day	Cumulative Multiple			
	2X	Index	Change	of X
1		100.000		
2	+20%	120.000	20.00%	2.000
3	-20%	96.000	-4.00%	4.000
4	+20%	115.200	15.20%	1.708
5	-20%	92.160	-7.84%	3.940
6	+20%	110.592	10.59%	1.356

Day	Cumulative Multiple			
	3X	Index	Change	of X
1		100.000		
2	+30%	130.000	30.00%	3.000
3	-30%	91.000	-9.00%	9.000
4	+30%	118.300	18.30%	2.056
5	-30%	82.810	-17.19%	8.638
6	+30%	107.653	7.65%	0.980

From the short example period it is clear that the accumulation of geared daily changes can result in a holding period return that is significantly different from that which a '2X' moniker, for example, may suggest. The greatest differentials are apparent with the highest gearing levels with the cumulative gains in the 3X index return moving from 9X to 0.9X of the ungeared market holding period return. From this short investigation it is apparent that if investors hold an investment for a different period than that in which the gearing is designed to operate, the returns experience can be significantly different from expectations.

The reciprocating changes of  $\pm 10\%$  per day are somewhat artificial and as a result the same test was performed with a random string of actual equity market data<sup>3</sup>:

Day	Cumulative Multiple			
	X	Index	Change	of X
1		100.000		
2	2.31%	102.307	2.31%	1.000
3	1.14%	103.474	3.47%	1.000
4	0.35%	103.837	3.84%	1.000
5	-1.91%	101.851	1.85%	1.000
6	1.32%	103.191	3.19%	1.000

Day	Cumulative Multiple			
	1.5X	Index	Change	of X
1		100.000		
2	3.46%	103.460	3.46%	1.500
3	1.71%	105.231	5.23%	1.506
4	0.53%	105.784	5.78%	1.508
5	-2.87%	102.750	2.75%	1.485
6	1.97%	104.778	4.78%	1.497

Day	Cumulative Multiple			
	2X	Index	Change	of X
1		100.000		
2	4.61%	104.613	4.61%	2.000
3	2.28%	107.001	7.00%	2.015
4	0.70%	107.751	7.75%	2.020
5	-3.82%	103.631	3.63%	1.961
6	2.63%	106.357	6.36%	1.992

Day	Cumulative Multiple			
	3X	Index	Change	of X
1		100.000		
2	6.92%	106.920	6.92%	3.000
3	3.42%	110.581	10.58%	3.045
4	1.05%	111.743	11.74%	3.061
5	-5.74%	105.334	5.33%	2.881
6	3.95%	109.491	9.49%	2.974

Again, it is clear that the cumulative change will differ from the professed daily change, although the difference is less severe in a gentler trading market. It should also be remembered that the above data is experimental in nature and therefore does not make any account for the TER of an ETF which would detract from performance.

<sup>3</sup> Source: I-Net and Momentum Investment Consulting, July 2009

The difficulty with using the above market data is, however, the extremely short holding period in question. Below are actual equity market data tested on different rolling holding periods and different notional gearing of daily returns. The below table summarises these findings in terms of the ratio of the cumulative holding period returns for the geared indices versus the ungeared. The number provided equates to the actual ratio between the long-term holding period returns. The table below suggests that over the very long holding period, the mean ratios between the geared and ungeared index returns are similar to the expressed gearing ratio, albeit somewhat below in all three instances. The issue for investors is the degree of inconsistency in this ratio as demonstrated by the range between the maximum and minimum result as well as the standard deviations. The results are presented below<sup>4</sup>:

	1.5X			
	Total HPR	HPR 12m	HPR 6m	HPR 1m
Max Ratio	1.713	12.909	27.014	33.766
Min Ratio	-15.149	-4.661	-5.878	-14.059
Mean Ratio	1.442	1.488	1.500	1.516
Median Ratio	1.546	1.518	1.458	1.499
St Dev	0.600	0.695	1.288	1.339

	2X			
	Total HPR	HPR 12m	HPR 6m	HPR 1m
Max Ratio	2.566	31.786	68.732	87.787
Min Ratio	-42.310	-14.120	-17.616	-39.641
Mean Ratio	1.828	1.947	1.983	2.041
Median Ratio	2.100	2.026	1.872	1.997
St Dev	1.597	1.816	3.369	3.566

	3X			
	Total HPR	HPR 12m	HPR 6m	HPR 1m
Max Ratio	4.611	86.718	191.870	257.880
Min Ratio	-129.180	-42.450	-55.002	-122.730
Mean Ratio	2.428	2.722	2.853	3.104
Median Ratio	3.176	2.911	2.536	2.986
St Dev	4.699	5.120	9.545	10.636

From the previous table, it is clear that the holding period has a significant impact on the risks associated with this investment. A portfolio that is designed to provide double the daily returns of an index, for example, may only provide returns to match that expectation in the very short term. Ultimately, the average return over a longer period, for a geared daily index return could be similar to simply multiplying the long-term index return by the express gearing ratio. The significant risk to investors is where a holding period is unfortunate enough to fall on periods where the remarkable performance differentials occur. Couple this possibility of a poor investment return to the additional costs of leverage and the need to be regularly rebalancing the portfolio, and the geared ETF story may be less compelling than on an only cursory assessment.

### Uses for ETFs

As a result of ETF's low TERs and generally high liquidity, investors will often use them to get quick and cheap access to an asset class. It is this flexibility that enables the ETF to be used as a device through which to express tactical asset allocation in portfolios. According to a recent State Street Global Advisers (SSgA) and Knowledge@Wharton survey of 840 investment professionals, 76% of financial advisers classified themselves as light to moderate users of the structures, with less than 50% of their portfolios in ETFs. This suggests that the ETF is at present viewed as a tool for asset allocation rather than the best destination for the majority of portfolio assets. Despite the low overall proportion in most investment portfolios, it is noteworthy that the same study suggested that only 4% of financial advisers did not use ETFs at all.

Broadly speaking differently focused ETFs could have different applications. Style and sector ETFs can be used to allow diversified tactical positions. ETFs can be a cheap and flexible way for individual investors to access international investments or investments in regions which, due to their specialised nature, are generally too difficult from an investment minima point of view.

Ultimately ETFs can be used for strategic asset allocation positions where active management has failed to outperform in the past and for tactical asset allocation positions where

<sup>4</sup> Source: I-Net and Momentum Investment Consulting, July 2009. The data runs from 19/09/2005 to 16/07/09 inclusive

investors seek quick, cheap and representative access to a more esoteric asset class.

## Conclusion

In this document, the characteristics and uses for ETFs have been briefly introduced. Despite the plethora of ETF products available, the industry is still in its infancy. Innovations such as actively managed ETFs and geared ETFs have yet to experience the rapid acceptance that their 'traditional' ETF counterparts have experienced and many of the reasons

why have been covered above. The youthfulness of this asset class, however, means that there are likely to be many more adaptations and new enhancements yet. Thus far the success of the ETF market has been the result of virtues such as transparency, liquidity, cheapness and low tracking errors. Innovations that take ETFs from their traditional strengths may take some time to find acceptance with investors.

**Note:** *If you want a copy of the complete report on ETFs please e-mail us and we'll be happy to send it to you.*

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