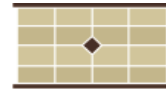


EXCLUSIVE OUTLOOK



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INVESTING IN ETFs IS NOT A SILVER BULLET

“At a certain point investors have to start asking themselves if these fees are warranted given the fact that these ETFs are passively managed”

ETFs WILL NOT REPLACE ACTIVE INVESTMENT MANAGERS

Interest in Exchange Traded Funds (ETFs) has exploded over the past few years. Investors have flocked to these funds for a number of reasons, not least of which is that they can provide exposure to specific market niches in a way that other investment vehicles often cannot. Consequently, some active money managers may be looking in the mirror and wondering if this trend will materially impact their business going forward. However, it is our position that no one should look at the popularity of ETFs and conclude that they are anything near a suitable replacement for long-term oriented portfolio managers.

For those unfamiliar with ETFs, they are funds that track an index but can be traded like stocks. Unlike mutual funds, most ETFs are passively managed and thus offer a lower fee structure in conjunction with greater ease of trading. Data provided by equity market liquidity research firm Trim Tabs¹ (presented below) indicates that investors have poured into equity ETFs over the last few years, ostensibly at the expense of mutual funds.

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Unfortunately, there are a number of issues with ETFs that both retail and institutional investors should be aware of. As such, the following analysis highlights some pitfalls of relying on ETFs as opposed to finding a professional manager with a defined investment strategy and a long track record of success.

2. Levered ETFs are not appropriate for most retail investors: Do you think the S&P 500 is poised for a large plunge? Do you want to bolster returns by adding some leverage? Without opening up a margin account you can make a levered short bet on the companies in the S&P 500 or many other indexes. Sounds great,

Year	All Equities (\$US billions)			US Equities (\$US billions)		
	Mutual Fund Flow	ETF Flow	Combined	Mutual Fund Flow	ETF Flow	Combined
2005	135.6	49.6	185.2	30.8	26.4	57.2
2006	159.5	54.3	213.8	11.0	29.8	40.8
2007	94.5	125.5	220.0	(43.3)	81.6	38.3
2008	(245.1)	140.1	(105.0)	(162.4)	120.8	(41.6)
2009	5.2	9.3	14.5	(36.2)	(24.5)	(60.7)
YTD 2010	35.6	(4.7)	30.9	10.7	(7.6)	3.1
Last 12 Months	55.0	51.9	106.9	(13.1)	17.6	4.5

1. Enhanced liquidity may be detrimental to returns:

The common refrain is that the more liquid an asset, the less risk premium is required. Being able to buy or sell an asset in an active, transparent market allows investors to alter their portfolios dynamically as market conditions fluctuate. So, how could liquidity actually hurt the returns of retail investors? Well, Trim Tabs examined data regarding ETF returns and came up with the following troubling conclusions:

"We found an extremely strong negative correlation between flows into equity ETFs and future market returns. Our results were strong across all the periodicities and holding periods we tested. We built several simulations showing that investors can obtain excellent returns by using equity ETF flows as a contrary leading indicator."

Equity ETF flows are a much better contrary indicator than equity mutual fund flows. While many mutual fund investors take a "buy-and-hold" approach, the greater liquidity of ETFs allows retail investors to make bad investment decisions throughout the day."

In essence, it appears that the improved liquidity inherent in widely traded ETFs (relative to mutual funds) has caused retail investors to use them as trading vehicles. Consequently, in an attempt to time the market, many investors are buying high and selling low and their returns are suffering as a consequence. What about on the short side? Are investors better at timing purchases of short ETFs? Trim Tabs has the unfortunate answer:

"Short equity ETF flows are positively correlated with future stock returns, and these correlation coefficients are also significant. Simply put, ETF investors are exceptionally poor market timers in both directions."

Finally, on the flip side, some very exotic ETFs that focus on small market niches may have very limited liquidity, a small number of assets under management and very wide bid-ask spreads. This lack of liquidity can reduce returns by increasing trading cost and can even cause the fund to trade at a large premium or discount to its net asset value. Therefore, investors who are not aware of these risks can be in for a nasty surprise when they open up their monthly statements.

right? Well, the problem is that the arithmetic of these levered ETFs just doesn't work. The following discussion from SmartMoney2 summarizes the issue in simple terms:

"Let's say you pay \$100 for a LETF [Levered ETF] that tracks an index and that the index is (conveniently) at 100. If the index goes up 20% the first day, it will be at 120. Your LETF promises you twice the 20% return -- that's 40% -- so your \$100 grows to \$140. So far, very good."

Now suppose the next day the index falls back to 100. That's a drop of 16.7%, so the LETF has to give you twice that -- a loss of 33.3%. Does that bring your LETF back to \$100 where you bought it? You'd think it would; since the index is back to square one, why shouldn't your LETF be back there, too? Simple. Your LETF was worth \$140, and 33.3% of that is \$46.70. So your LETF is now worth \$93.33, not \$100."

You see what happened? Over each of the two single days, the LETF did exactly what was promised -- exactly twice the daily return of the index. But over both days put together, it didn't do that at all. Over two days, the index had a zero return -- so you'd think the LETF should give you twice zero, which is still zero. But, no, it gives you a net loss of 6.7%."

This is just an example of the divergence that can occur over a two day time frame. Over longer periods of time, the discrepancy between the returns of the index and the ETF can expand dramatically. As Donald Luskin highlights in the SmartMoney piece, if a person had bought the ProShares Ultra S&P 500 ETF the day it began trading in June 2006, it would have been down an amazing 42.5% (at the time the article was written) compared to a mere 5% decline in the index.

Therefore, it is our view that these levered ETFs should be considered solely as trading vehicles for individuals whose job it is to try to time the market and that retail investors should find safer ways to express their analysis of the markets. For example, retail investors who get involved in dangerous inverse securities with the intention of hedging their long equity exposure are risking losing money on the "hedge" and on their stocks. As such, we believe that

investors who are looking for ways to hedge their portfolios should invest with investment managers who have a successful track record of protecting capital during market declines.

Additionally, investors who are extremely bullish on the long prospects of niches such as emerging markets now have many different investment vehicles at their disposal. For example, they can buy the Direxion Emerging Markets Bull 3X tripled levered ETF. But, due to the issues inherent to levered ETFs, these investors may end up being correct about the direction of those markets but still lose money on their investment. Thus, we believe that those who feel that certain sectors or countries have uniquely compelling risk-reward profiles should seek out managers who have an expertise in those domains and the ability to select individual stocks that will benefit if the investment thesis is proven correct. Bottom's up analysis that unearths specific undervalued companies is likely to

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produce higher returns than any ETF or mutual fund since, by definition, the diversification in those vehicles diminishes their changes of outperforming.

3. ETFs charge how much in fees for passive management?

Vanguard has been a pioneer over the last few decades when it comes to lowering fees for retail investors. The company's foray into ETFs has been no different. Specifically, the Vanguard ETFs consistently have some of the lowest expense ratios in the ETF space. However, what if retail investors are not aware of the fee discrepancies across sponsors? Could their returns suffer as a result?

For a quick answer to that question, let's look at the expense ratio for a couple of different emerging market ETFs. The Vanguard Emerging Market ETF³ has an expense ratio of .27%. The iShares MSCI Emerging Market Index⁴ has a ratio of .72%. The SPDR S&P Emerging Markets⁵ fund has a ratio of .59%. If you want to add leverage to your emerging markets bet then ProShares will charge you .95% for its Ultra MSCI Emerging Markets⁶ fund.

While these fees are often lower than those of mutual funds, the wide variation in the amount charged can lead retail investors to pay extra fees that reduce their returns.

At a certain point investors have to start asking themselves if

these fees are warranted given the fact that these ETFs are passively managed. For not much higher fees people can invest with active managers who have the ability to navigate turbulent financial markets and take measures to protect capital when they deem it necessary. Clearly, investing with professionals diminishes control, but as the Trim Tabs data referenced above suggests, maybe investors should be willing to pay higher fees just to prevent themselves from investing at precisely the wrong times.

In conclusion, we believe that for investors who want nothing more than to track an index, buying cheap ETFs like those managed by Vanguard is a very prudent solution. However, for those who are interested in generating some alpha (excess return over that of a benchmark), actively investing in individual ETFs without the guidance of a professional is subject to the pitfalls listed above and can destroy wealth. Security analysis and portfolio management should be taken very seriously and those who are not willing or able to invest the time to learn the required skills should be very cautious when it comes to investing in individual stocks or niche ETFs. Generally speaking, prudent investors should rely on professional managers who have the expertise to deploy capital when opportunities present themselves and protect assets when markets begin to falter.

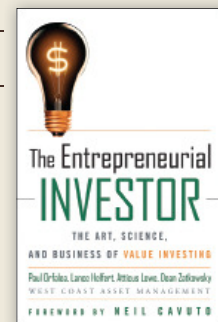
SOURCES:

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