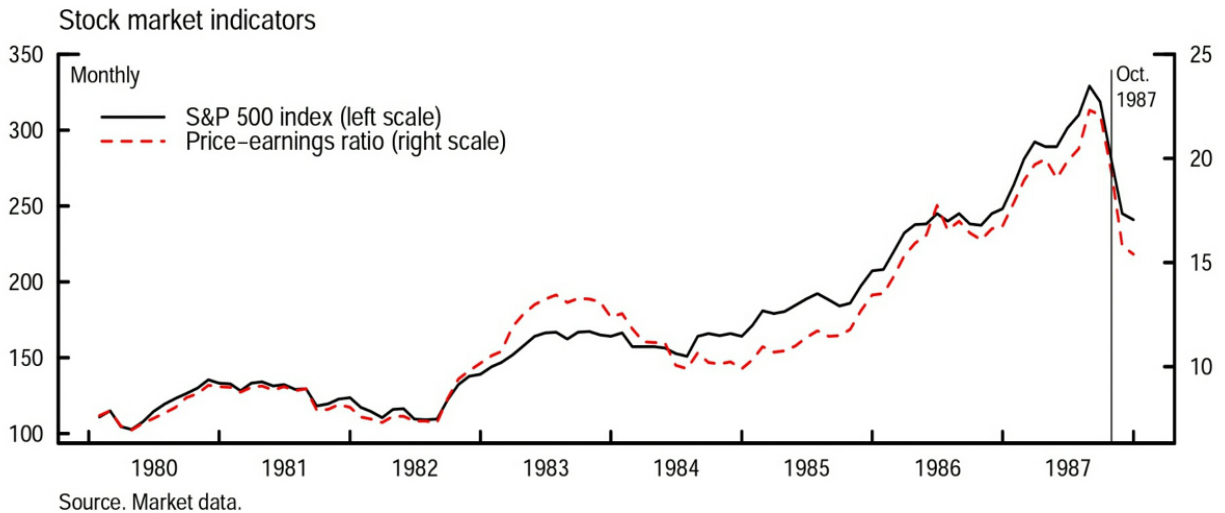




The Story of the Exchange Traded Fund: Part 1

Over 1600 different Exchange Traded Funds (ETFs) trade in the United States, offering to track almost any index or index subset in a variety of ways. No other financial product has attracted as much money in such a short period as the ETF. ETFs have amassed over \$2 trillion in assets to-date, while actively managed vehicles continue to lose out to them on a daily basis. Recently ETFs have attracted a considerable amount of regulatory scrutiny under the pretense that they bring undue volatility to capital markets. The irony over this concern is that ETFs were initially developed in order to quell market volatility. In this three-part series on ETFs, we will explore ETF roots, the mechanism through which they are created and traded and finally, the challenges these investments generate.

ETFs were created as a result of the market crash of October 19, 1987, also known as Black Monday. On that day, stock and futures markets categorically collapsed; the S&P 500 Index fell by over 20% in one day (see chart below). Not long after Black Monday, the SEC distributed an 840-page report, attributing the crash to two program trading strategies. The first, 'portfolio insurance', a strategy designed to limit losses in declining markets. The computer models behind the strategy sold stock market indices on the futures exchange in an effort to limit losses. The combination of low margin requirements and the strategy's high speed was incompatible with a second strategy called 'index arbitrage", designed to profit by exploiting discrepancies between the value of stocks in an index against the value of its index futures contract. The arbitrageur would buy the cheaper of the two while simultaneously selling the other. The overarching issue was the absence of one stock that represented the whole market in the same way a futures contract could represent the market. At that time, in 1987, there did not exist a basket of securities able to be purchased through one stock, forcing the arbitrageur to buy each stock within the index individually. The mismatch generated wild swings and at the same time volatility became exacerbated by the portfolio insurance strategy, all of which triggered a mass sell order. The aforementioned SEC report specifically suggested that perhaps there could be a security that represented a basket of stocks in an index that could be managed by an exchange specialist instructed to make markets in such a security. The theory was that the basket index could be sold without causing a market collapse.



The recommendation was picked-up by the American Stock Exchange VP of New Product Development, Nathan Most and his colleague Steven Bloom. Amex had been losing business to the NYSE and Nasdaq and needed new products. The Amex team started developing the idea and approached Jack Bogle, head of Vanguard, in the hope of establishing a partnership. Jack, true to his conservative nature and afraid of frequent trading, rejected the idea, although he did make suggestions to improve the product. Another irony, today Vanguard runs one of the largest ETF platforms in the business.

The challenge the Amex team faced was how to structure the basket index, while making it fast and tax efficient. Nathan Most had been a commodities trader and was comfortable trading warehouse receipts (a document providing proof of the commodity's ownership, quantity and location), as commodities are often traded. He wanted to apply the same concept to ETFs and needed a virtual custodian/warehouse to store the stocks. The Amex team approached State Street Bank and selected the S&P 500 Index as its market index. The team then developed the methodology for creating, trading, and redeeming (more on this in part II) the units. The next obstacle was the SEC approval process, which became a four-year task. In 1993 the first ETF, Standard & Poor's Depository Receipts, ticker SPY, was launched. For years it struggled to gain assets and was considered a niche product that would attract limited interest as brokers were not keen to recommend a product from which they made no money. Many investors were unaware of ETFs or their existence even after 10 years on the exchanges.



Today, there are four primary ETF structures, each with unique characteristics and different risk attributes.

- 1) Open-End Fund: The majority of ETFs are structured as open-end funds under the Investment Company Act of 1940. Open-end structures allow immediate reinvestment of dividends, which reduces cash drag. Typically, this structure is unsuitable for commodities or for markets with onerous restrictions. Example: XLU
- 2) Unit Investment Trust (UIT): A small number of ETFs are created as UITs. UITs are inflexible, and are used to track a broad index. UITs do not reinvest dividends and make investor distributions periodically. In a rising market this creates a cash drag and the potential for a tracking error. Example: SPY
- 3) Grantor Trust: Typically used by commodity investors, Grantor Trust ETFs are required to hold a fixed portfolio. Investors are considered direct shareholders of the underlying investments and are taxed as if they officially own the asset. Example: GLD
- 4) Exchange Traded Note (ETN): Generally, issued by a bank, an ETN promises to pay/track an index, while not actually owning the underlying securities. Investors are unsecured creditors of the bank. ETNs are used by issuers to track niche or illiquid markets. Example: AMJ

Please stay tuned for next month's installment, within which we will discuss the ETF itself; how ETF units are created, traded and redeemed.