

# ETF Watch

[canadianetfwatch.com](http://canadianetfwatch.com)



*The*  
**Evolution  
of ETF  
Construction**

- Exchange Traded Forum 2011  
Toronto Review
- Canada's ETF Providers  
Announce Creation of the  
Canadian ETF Association
- What's in Your 40?  
Tactical Allocations with  
Fixed Income ETFs
- Tasting Alpha
- Temporary Dip, or  
Rebel Without A Pause
- Weakness May Present  
Buying Opportunities
- Can ETFs Blow Up? No



Investors ploughed over \$13 billion into ETFs last month in a broad move into most asset classes. Gold funds in particular shined amid a slowing economy and a rancorous debate in Washington, D.C. over the U.S. debt ceiling. Assets rose just under 1 percent to \$1.108 trillion, as inflows offset sliding stock prices.

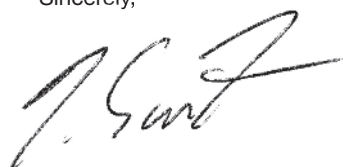
Money flowed into equities, fixed income and commodities, in both the U.S. and Canada as well as internationally, with only leverage, inverse and alternative ETF categories recording outflows, according to data compiled by IndexUniverse.

IndexUniverse July 2011 ETF Fund Flow data highlights include:

- ETF inflows topped \$13 billion in July, with gold funds, in particular, shining brightly amid all the market turmoil last month
- The net inflows were enough to offset declines in stock prices, with total assets in U.S-listed ETFs rising a bit less than 1 percent to \$1.108 trillion
- Including the \$58 million in inflows in the first half of 2011, year-to-date ETF inflows topped \$73 billion
- Together the world's two biggest physical gold ETFs hauled in a total of \$3.48 billion
- Of those gold bullion ETFs, the SPDR Gold Shares (NYSEArca: GLD) raked in \$2.85 billion and the iShares Gold Trust (NYSEArca: IAU) pulled in \$631.6 million
- The single most popular fund was the SPDR S&P 500 ETF (NYSEArca: SPY), which collected \$3.27 billion in new assets
- Junk bond ETFs also came back into favor in July, after spooked investors began dumping them in June
- The iShares iBoxx \$ High Yield Corporate Bond Fund (NYSEArca: HYG) gathered \$506.3 million, while the SPDR Barclays Capital High Yield Bond ETF (NYSEArca: JNK) added \$407.6 million in new assets
- Fueled by new money pouring into SPY and GLD, State Street Global Advisors led all other ETF issuers in asset gathering with \$5.80 billion

Again, we would like to thank our readers and authors for their continued support. We hope you enjoy **Canadian ETF Watch Volume 2, Issue 4**.

Sincerely,



**Tony Sanfelice**, President  
Radius Financial Education



## **14 The Evolution of ETF Construction**

Most ETFs are linked to traditional capitalization weighted benchmarks that gauge the performance of equity fixed income, commodity and other markets.

## **05 Types of ETFs**

## **06 Exchange Traded Forum 2011 Toronto Review**

## **10 Canada's ETF Providers Announce Creation of the Canadian ETF Association**

## **16 What's in Your 40? Tactical Allocations with Fixed Income ETFs**

With the recent sovereign debt troubles surrounding the United States and Europe, fixed income investments have received more attention lately.

## **18 Tasting Alpha**

Best Practices for ETF Best Execution: Not Just For Dummies.

## **22 Temporary Dip, or Rebel Without A Pause**

## **26 Weakness May Present Buying Opportunities**

"Sell in May and go away," so goes the old adage in the investment world. Does the saying however have any validity or does it exist simply because it rhymes?

## **28 Can ETFs Blow Up? No**

While ETF settlement delays may sound scary, there is no cause for alarm.

## **30 Announcements**

## **34 ETF Spotlight**

## **36 ETF July Fund Performance**

# Tasting Alpha



## Best Practices for ETF Best Execution: Not Just For Dummies.



Jay Berkman  
Principal,  
JLC Group

*You're a fund manager; you sell a product (some call it a service) that provides a return on capital. Regardless of nomenclature, what you provide is intended to keep your customers coming back every day of the week, every week of the year, for as many years as you're operating your business. Let's call this product "Alpha."*

Many other people are selling Alpha too, albeit under their own brand name, which makes Alpha a commoditized product, and everyone's Alpha is measured according to a numerical "taste" factor.

Note: anybody that's selling Alpha is considered to be a *fiduciary*, which means you have certain ethical obligations to your customers, including but not limited to making sure that your vendors are devoid of any conflicts of interest. You must also abide by an ever-growing list of regulatory requirements imposed by state and federal government agencies.



## Premise #1

The raw ingredients that you and your competitors use to make Alpha are the same (the UPC codes are identical); the difference in taste between your finished products is a function of (3) primary elements\*:

- (i) The cost of acquiring (and disposing of) your raw ingredients (“COAD”).
- (ii) Your particular recipe, e.g. plain-tasting stocks, a bouillabaisse of ETFs, or option-centric formulas.
- (iii) Cook time.

*\*Not to be discounted in the course of calculating net Alpha, many chefs also include the cost of operating their “kitchen”, which includes overhead, ingredient storage and a variety of administration fees.*

So, here you are, competing every quarter (if not every month) against other “chefs” to deliver the best tasting Alpha, while at the same time, those other chefs are holding out a warm basket of great smelling croissants to lure your customers to their place of business.

## Premise #2

Any chef that’s worth his big white hat will agree that after recipe and cook time, the cost of acquiring and disposing of ingredients can be the deciding factor for a great tasting Alpha. That said, let’s focus on the where, how, and cost(s) associated with “COAD”. Some people call this process ‘best execution.’

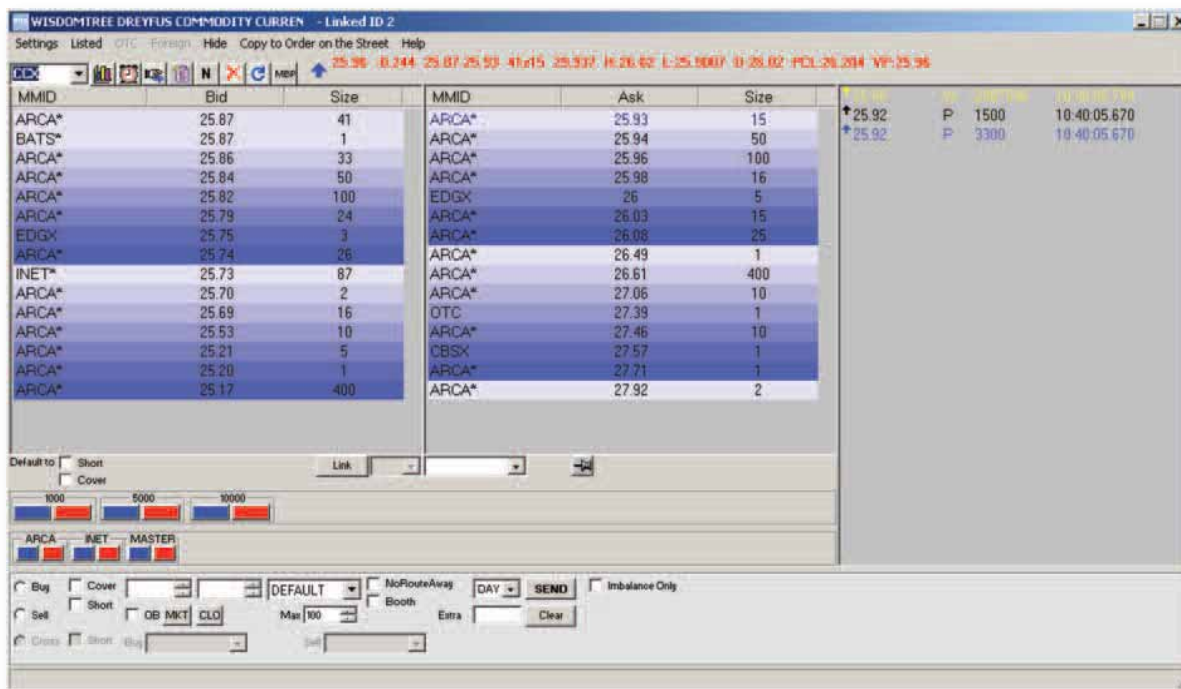
1 However generic the ingredients to Alpha might be, and, as much we’d like to think that 21st century e-commerce technology ensures razor-sharp pricing within “transparent” ingredient e-marketplaces, we all know the price for a case of Coca-Cola at Walmart.com is not the same as the price at Costco.com, no more than the price of a Delta business-class fare between New York and Chicago might be at two competing travel sites that are accessed at the same moment in time. Suffice it to say, other than new-fangled bells and whistles, the ingredients marketplace of today is less-than-transparent, and highly-fragmented; not much different than an old-fashioned spice bazaar.

2 Unless you’re one of the few multi-tasking chefs that have the time and resources to “shop” end suppliers, or the kind of chef that’s determined to deal directly with one or two end suppliers because they provide you with “free recipe ideas”, or throw in a basket of “value-added extras”(without skirting those pesky fiduciary obligations), you’re like the vast majority of chefs: you concoct your own recipes, and you outsource ingredient acquisition to professional shoppers (“PROS”) to discretely buy the ingredients for you at the most cost efficient price, and necessarily, to help dispose of those ingredients when you’ve finished using them.

## Premise #3

There are three (3) primary components to COAD:

- i. Transaction fees/commissions. These costs are typically transparent and reasonably competitive. Depending on where you shop, and regardless of whether you transact 50,000 units every month, 500,000 every quarter, or 50 million units every year, your *per unit* transaction cost might be less than a penny, or as much as 3 or 4 cents, if not more. The variance in per unit cost could be a function of the outer box packing material, or those “value-add” products that you get for “free” (e.g. new recipe ideas) from your ingredient supplier.
- ii. “Opportunity Cost.” This is *typically higher* than above-noted “per unit transaction cost;” it’s the factor by which your end supplier might have been able to sell you ingredients (or buy from you) at a price that’s better than advertised in their real-time catalog, or the factor by which your PROS might have been able to negotiate a better price while scouring the marketplace. According to industry expert Andrew McOrmond, Managing Director and co-head the ETF desk at WallachBeth Capital, “...any failure to canvass suppliers properly, coupled with any mistaken nuance when sourcing or negotiating the purchase or sale [of ingredients] could cost you an *additional* three cents, five cents, or maybe even twenty cents per unit. It all depends on the particular ingredient in question, the prevailing bid/offer market, and the skill of your PROS to properly negotiate the price.”



Above screen shot illustrates a PROS acquisition of 2,987,000 ‘units’ of a seemingly illiquid ‘ingredient’, an ETF product that tracks the price of currencies. The ‘electronic market’ indicated less than 20,000 shares had traded prior to the large block, and less than 15,000 units were offered for sale within ten cents of the ‘best price.’ The PROS, using a combination of networking tools, sourced and acquired close to 3 million ingredient units from suppliers within the context of the prevailing bid/offer screen-based market, and without disrupting the prevailing market pricing.

Continued on page 20

iii. "Market Impact Cost." This cost is directly related to above (ii); it's the difference between the execution price of the ingredient transaction and the price that would have existed in the absence of a trade. *Market impact costs become particularly noticeable when your recipe calls for anything other than the most popular, actively-shopped ingredients.*

1 If you're bound by some type of agreement to deal with direct end suppliers (who in turn, are in the business of acquiring, disposing or hedging ingredients in the 'wholesale' market in the course of satisfying your "PO's"), they know you're captive to them. This implies they control pricing, not you. This also implies there could be a conflict between what your best interest is (best price) vs. the best interest of your supplier.

2 If you're using a PROS, you'd obviously hope that agent to be discrete, so as not to create a pricing frenzy every time he walks into the bizarre (see above 'market impact' discussion). You'd also like to presume that he's shopping the entire bizarre, including the hidden shops under the tent, as opposed to simply going to the store down the street that provides incentives to PROSs; a practice that's not uncommon in any industry.


Consequently, PROS play a critical role for those working to create the best tasting Alpha. If your PROS sources (or disposes) ingredients at the wrong price, your Alpha will taste less than it could have. And, when your Alpha starts to lose its flavor, that's when your guests will leave your restaurant to source out another chef.

Some chefs are captive to suppliers that offer bulk-rate transaction pricing based on the number of pallets of ingredients that chefs buy or sell, or based on their overall ingredient budget, aka "AUM".

Typically, these suppliers will give "free access" to their super-duper, expert shopper system that allows you to enter orders via their online hub that ostensibly connects you to "great deals." By the way, many of these suppliers aren't really suppliers; they're quasi-PROS who either connect to end suppliers, or to yet other PROS that source ingredients. It's not only the math that's fuzzy in this bizarre market.

For those familiar with Amazon.com, you might know that the "suppliers" pay Amazon a commission every time they do a transaction with an Amazon customer. This means the price on Amazon incorporates a mark-up, as opposed to the price you could have received using a PROS that deals with an end supplier on a direct basis. If you shop frequently on Amazon, it often misses the mark when it comes to the real best prices, which require interrogating multiple, competing sites that are trafficking in those same items. This process is also known as 'price discovery'.

More than a few discerning chefs have figured out the best way to operate the most efficient restaurant; they've weighed the pros, avoided the "cons" and now outsource the ingredient sourcing process to PROS such as WallachBeth Capital and/or other agency-only firms; trading experts that navigate markets with the stealth of top-gun aviators, and otherwise live and breathe to capture the right price, the right way, whenever their chef-clients are entering or exiting any trading position; big or small, simple or complex.

Those on the sell-side of the securities industry are required to follow the "know your customer" rule. Until such time as registered investment advisors, PM's and other fiduciaries are bound by a "know your broker" rule, WallachBeth's Andy McOrmond likens his firm's philosophy to that of retail clothier Sy Syms: "An educated consumer is our best customer." 

Jay Berkman, Principal, JLC Group [jay@jlcgroup.net](mailto:jay@jlcgroup.net)

# Stay on top of industry news

## IE INVESTMENT EXECUTIVE

**INVESTMENT EXECUTIVE** is Canada's national newspaper for stockbrokers, mutual fund sales people, financial planners, insurance advisors and personal bankers. To subscribe, go to [www.investmentexecutive.com](http://www.investmentexecutive.com)

**IE MOBILE**  
News you need in the palm of your hand. *Investment Executive* is now available as a free download from your BlackBerry or iPhone mobile browser. Click on [m.investmentexecutive.com](http://m.investmentexecutive.com)



**E-NEWSLETTER**  
*investmentexecutive.com* offers up-to-the-minute industry news. In conjunction with this site, we have a daily e-newsletter service.

**SMART EDITION**  
*Investment Executive* is also available as a virtual paper. This version of *IE* is uploaded at the same time as the newspaper hits the streets. You can bookmark it so that you are notified when the next issue is available as well as when topics of interest to you are covered. Visit our website and click on *IE SmartEdition*

Visit [www.investmentexecutive.com](http://www.investmentexecutive.com) for more information or to subscribe to any of our services.