

ETFs: 2010 And The Outlook For 2011

By Cory Banks and Olivier Ludwig

As this issue of *ETFR* goes to press, the U.S. ETF industry just cleared a major milestone: Total industry assets under management have reached the magic \$1 trillion barrier. Pop the champagne corks!

There's nothing inherently special about round numbers, but they *do* provide the perfect opportunity to take stock of what's come before. Exchange-traded funds as an industry began 18 years ago with the launch of the SPDR S&P 500 ETF (NYSE Arca: SPY). All this time later, the industry offers well over 1,000 products. That's a tremendous amount of growth.

And from here, the numbers look good. Through November 2010, investors poured \$103 billion in net new assets into ETFs. That's up from \$90 billion through the same time period in 2009.

The nature of the flows has shifted as well. This past year, as questions loomed over the U.S. economy, investors poured more than \$37 billion into international

equity funds. Fixed-income ETFs gained almost \$30 billion, though less than 1 percent of that was in international bonds.

This focus on investments abroad led to big wins for emerging markets funds. Assets almost doubled in the Vanguard MSCI Emerging Markets ETF (NYSE Arca: VWO) to more than \$41 billion, making it the fastest-growing fund of 2010; the fund pulled in \$18.3 billion in new money through November. iShares' MSCI Emerging Markets ETF (NYSE Arca: EEM) finished the year with over \$46 billion in AUM, although it attracted just \$3.7 billion in net new money. Both funds gave investors highly desired exposure to emerging market securities, but VWO won out on flows due to its lower costs (an expense ratio of 0.27 percent vs. 0.72 percent for EEM) and better tracking.

While most expect the emerging market giants to continue to grow, there is room for more granular parsing of those markets, says Tyler Mordy, a financial advisor 5▶

UPDATES

Kauffman Report Roils Waters

A 60-plus-page report released in early November by the Kauffman Foundation said that exchange-traded funds are the "main" cause for the slowdown in the U.S. IPO market, restricting the access that smaller companies have to capital.

The study also argued that ETFs may have been one of the main factors behind the "flash crash" on May 6, contradicting the conclusion regulators drew last month when they said the swift

market sell-off was caused by the sale of a large position of E-mini futures by a single mutual fund company. The paper additionally argued that short-selling ETFs could pose systemic risk, and that without significant market reforms, another flash crash and general market instability are almost inevitable.

The paper was quickly denounced as error-filled and mis-argued by ETF experts. The authors were forced to make

a number of corrections, noting that the original version of the paper misrepresented how the ETF creation/redemption process works, among other problems.

Still, despite the flaws, the paper received extensive press and elicited much concern among advisors and investors alike.

Among the more interesting areas discussed was a proposal that the Federal Reserve require weekly reports from custodial banks of "fails-to-receive" 3▶

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and macro analyst at Toronto-based Hahn Investment Stewards. According to Mordy, the assets that make up VWO and EEM are often skewed toward exporting to the developed world, making them behave more like emerging market multinationals.

ETF companies have been dicing the emerging markets into finer and finer segments, and many expect these products to move into the spotlight going forward. These include single-country ETFs that now provide exposure to more than 17 individual emerging market countries, ranging from Brazil to Vietnam, as well as an increasing number of sector-focused emerging market funds, such as the Global X China Consumer ETF (NYSE Arca: YAO). There is also a move afoot to create emerging markets ETFs tied to alternative weighting strategies, as a way of avoiding or limiting the multinational problem: This includes the recently launched Rydex MSCI Emerging Markets Equal Weight ETF (NYSE Arca: EWEM), which equal-weights components to avoid being dominated by large multinational firms like Petrobras and Taiwan Semiconductor.

Bonds Go Big ... And International

As impressive as the emerging markets numbers were, the \$30 billion flowing into fixed-income ETFs is more surprising. Bonds have been riding a bull market for years, and investors, spooked by more than a decade of flat equity markets, have rewarded them with an increasing share of assets.

Vanguard's Total Bond Market fund (NYSE Arca: BND), the iShares Preferred Stock fund (NYSE Arca: PFF) and the iShares Barclays 1-3 Year Credit Bond fund (NYSE Arca: CSJ) were the strongest in net flows through November for bond funds, at \$2.7 billion, \$2.7 billion and \$2.4 billion, respectively.

Next up were the two competing high-yield funds: HYG from iShares and JNK from State Street Global Advisors, which pulled in \$2.3 billion and \$2.1 billion, respectively.

International bond funds could become the next big play. The sudden success of ETFs like the WisdomTree Emerging Market Local Debt Fund (NYSE Arca: ELD) and the Market Vectors Emerging Mar-

Figure 1

Largest ETFs Launched In 2010

NAME	TICKER	NET FLOW (\$M)	AUM (\$M)	INCEPTION
ETFS Physical Palladium	PALL	457.48	645.87	1/8/2010
ETFS Physical Platinum	PPLT	583.80	601.91	1/8/2010
WisdomTree Emrg Mrkts Local Debt	ELD	442.60	436.71	8/9/2010
Alerian MLP ETF	AMLPL	397.13	405.25	8/25/2010
Global X Silver Miners	SIL	205.31	269.89	4/20/2010
Schwab Emerging Markets Equity	SCHE	245.44	258.98	1/14/10
iShares MSCI Indonesia	EIDO	247.58	240.56	5/7/2010
E-TRACS Alerian MLP Infrastr ETN	MLPI	180.51	195.11	3/31/10
First Trust BICK	BICK	179.69	176.84	4/13/2010
PowerShares CEF Income Composite	PCEF	172.49	172.73	2/19/2010

Source: IndexUniverse.com, as of 12/16/2010

kets Local Currency Bond ETF (NYSE Arca: EMLC)—both of which launched last summer—proves how hungry investors are for granular slices of emerging markets. ELD gathered \$166 million in its first two weeks and, as of Dec. 14, has grown to \$515 million, making it one of the fastest-growing new funds in 2010 (see Figure 1).

James Ross, head of ETFs at SSgA, says that while big funds such as his firm's SPY—the world's biggest ETF, with more than \$83 billion in assets—will still dominate asset gathering, new ideas focusing outside the U.S., and on fixed income in particular, are highly prospective.

"You can fundamentally make the case that if you're not investing internationally with your fixed-income portfolio, you're missing out on 60 to 70 percent of the world's fixed-income securities," Ross said.

The Money In Metals

The SPDR Gold Trust (NYSE Arca: GLD) rose to \$57 million in assets as gold frenzy gripped the commodities markets. GLD was everywhere, from specialized investor reports to top-of-the-hour newscasts on CNBC. While the industry can't seem to agree on the soundness of adding gold to your portfolio, investors were all over gold's glitter in 2010, as gold bullion ETFs added \$7.9 billion of the nearly \$10 billion in inflows to commodity products through November 2010.

Much of the rest of the flows fell into other bullion products, such as the iShares Silver ETF (NYSE Arca: SLV), which pulled in more than \$1 billion in

new assets. Platinum and palladium—previously untapped resources for ETF-focused investors—are now available through funds from ETF Securities. Both the ETFS Physical Palladium Shares (NYSE Arca: PALL) and the ETFS Physical Platinum Shares (NYSE Arca: PPLT) finished strong in their inaugural year, with \$646 million and \$602 million in assets, respectively. They are the largest ETFs to launch in 2010 (see Figure 1).

Other metal equities funds launched this year to wide acclaim. Van Eck rolled out the Market Vectors Rare Earth/Strategic Metals ETF (NYSE Arca: REMX) in late October. Even with the late start, REMX closed out the year with \$126 million in AUM. And Global X launched a silver fund built around mining operations in April; its Silver Miners fund (NYSE Arca: SIL) has already accrued \$270 million in assets.

Metals were hot in 2010, and next year looks to be just as impressive.

Other Growth Areas

Another space that saw its share of new entrants in 2010 was master limited partnerships, with seven new products. Most were ETNs issued by UBS as part of its E-TRACS family, but the majority of the nearly \$800 million in assets currently invested in the new MLP products are held by the only ETF in the group, the Alerian MLP ETF (NYSE Arca: AMLP), which has \$405 million in AUM. There are also ETNs that capture the infrastructure and natural gas sectors of the MLP space, and others that provide leveraged and inverse exposure.

Figure 2

10 Interesting ETFs In Registration		
FUND COMPANY	FUND NAME	TICKER
AdvisorShares	Active Bear ETF	HDGE
Barclays	iPath Dow Jones-UBS Copper	JJCC
Direxion	Direxion Daily Russia Bull 2X	N/A
Emerging Global	Emerging Global Shares INDXX Brazil Mid Cap Index Fund	N/A
Global X	Global X Pakistan	N/A
PowerShares	PowerShares FSE RAFI China	N/A
Russell	Russell One World Small Cap	OWS
State Street Global Advisors	SPDR Barclays Capital Corporate Financial Bond	N/A
Van Eck	Market Vectors All China Healthcare	N/A
WisdomTree	WisdomTree Asia Emerging Markets Total Dividend	N/A

Source: IndexUniverse.com's ETF Watch

Figure 3

Selected Firms With 40-APP Filings	
FILER	TYPE OF ETF
Alliance Bernstein	Active fixed income/equity
Dreyfus	Active/passive fixed income/equity
Eaton Vance	Active fixed income
Goldman Sachs	Passive fixed income/equity
Janus	Active fixed income/equity
John Hancock Advisers	Active/passive fixed income/equity
J.P. Morgan	Active/passive fixed income/equity/other asset classes
Legg Mason	Active fixed income/equity
Russell	Active/passive fixed income/equity
T. Rowe Price	Active fixed income/equity

Source: IndexUniverse.com's ETF Watch

Unsurprisingly, at a time when investors are acutely aware of stock market volatility, a slew of ETNs tied to volatility indexes also made their debuts in 2010—10 products, to be exact. The

largest of those, the iPath Inverse S&P 500 VIX Short-Term Futures ETN (NYSE Arca: XXV), has accumulated only about \$40 million in assets. However, given that the iPath S&P 500 VIX Mid-Term

Futures ETN (NYSE Arca: VXZ) and iPath S&P 500 VIX Short-Term Futures ETN (NYSE Arca: VXX)—launched in early 2009—each have more than \$1 billion in AUM, there does appear to be room for XXV and the other volatility products to gain some traction.

Funds To Come

Two hundred and two new exchange-traded products launched in 2010, adding \$7.6 billion in assets. Can 2011 top that? With 763 filings lined up at the SEC (see Figure 2), the future holds plenty of potential.

Emerging markets will remain in demand, both as all-encompassing funds and products built for specific approaches. "Both WisdomTree and Van Eck have applied for ETFs tracking local currency Asian bonds in emerging nations," Hahn's Mordy says. "This is great. It's a niche that's largely ignored. They're slicing and dicing emerging Asia and emerging Latin America; we're really interested in emerging Asia."

Fixed-income products should also remain a big focus—more investors and advisors will look to bonds on U.S. and foreign soil for diversification.

The coming year could also bring the rise of active management in passive investing. Every week it seems some new big-name fund company—J.P. Morgan, Alliance Bernstein, Legg Mason, etc.—files so-called 40-APP papers with the SEC for the right to enter the ETF space, often with active funds (see Figure 3). Some are even putting their money where their mouth is: Eaton Vance recently acquired Gary Gastineau's Managed ETFs LLC, a move that may signal they're ready to start funds with active strategies.

Whether investors will embrace active funds is an entirely separate matter. There are virtually no assets in the active equity ETFs currently on the market. The only actively managed ETF with enough assets to matter is the Pimco Enhanced Short Maturity Strategy Fund, better known by its ultra-cute ticker: MINT. It holds \$844 million in assets—hardly the beginning of a revolution.

Whether or not active takes off, 2011 promises to be an even bigger year than 2010 for ETFs. ♦