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# CANADIAN ETF Watch

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## PowerShares Canada Touts the Benefits of Low Volatility Investing

SPECIAL CONFERENCE EDITION
EXCHANGE TRADED FORUM 2013
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TORONTO

- Investors Seeking Higher Returns From Intelligent ETFs
- Dividend Stocks: Why Now?
- Canada's Mutual Fund Regulations Provide a Strong Framework for ETFs
- Maximizing the Benefits of Preferred Shares
- Are Managed Futures the Superhero of the Capital Markets?


# No end in sight to market volatility?

PowerShares Canada is the first Canadian ETF provider to offer investors a suite of low-volatility index ETFs for Canadian and U.S. equities: PowerShares S&P/TSX Composite Low Volatility Index ETF (TLV) and PowerShares S&P 500 Low Volatility (CAD Hedged) Index ETF (ULV). These ETFs are designed to reduce the risk of wild market swings while maintaining equity exposure.

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## Inflows For the ETF Industry Continue to Grow

One look at the annual net inflows for the ETF industry and you will see that the growth story is back on. There was $177 billion in net inflows in 2008, but the recession caused that number to slide to $116 billion in 2009. A slight gain was recorded in 2010 with net inflows reaching $118B in 2010 and they stay at that level in 2011. Last year, the industry posted and industry record with $185 billion of net inflows.

2012 inflows are worth a closer look. The industry saw $53B in first quarter 2012, followed by $25B in the second quarter and then $52B and $55B in quarters three and four respectively. So as the market improved, the industry saw a willingness on the part of investors to shift their assets from cash.

Interestingly, the industry saw a net inflow for fixed-income products of $356B with $52B of that coming in the form of ETFS. They noted that equities saw a net outflow of $20B as equity mutual funds saw $153B in redemptions but there was $133B in net inflows for equity ETFs.

Record inflows coincided with major stock indexes hitting a series of record highs last month. The Dow rose 11% in the first quarter, its best start to a year since 1998, while the S&P 500 jumped 10% and the TSX was up 3%.

In a recent Globe and Mail article they ran a screen looking for the biggest money-makers among Canadian-listed exchange traded funds during the first quarter of 2013 and found that it's getting brighter in the land of the rising sun.

While the U.S. equity market climbed nearly 11 per cent (in U.S. dollars) in the first three months of this year versus 3 per cent for its Canadian peer, Japanese stocks enjoyed an even better party.

Japan's Nikkei 225 Index, the main index tracking stocks in the world's third-largest economy, rose 20 per cent in yen terms. The benchmark has been gaining momentum since the December election of new Prime Minister Shinzo Abe. His economic policy supports aggressive monetary easing by Japan's central bank.

## Spring is Finally Here

Spring has arrived. Here in Canada we've probably been awaiting spring more passionately than our colleagues in warmer parts of the world. The snow is finally gone, the days are getting a little longer, the air is warmer and we sure know to appreciate it after the long winter. I hope the remainder of the year brings great happiness and great success to you and the ones that matter most. All the best.

J Street

**Judy Street**, Vice President
Radius Financial Education

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# CONTENTS

# Types of ETFs

*There are a variety of **Exchange Traded Funds (ETFs)** that provide investors an opportunity to develop a diversified investment portfolio. ETF sponsors are constantly adding to the types of ETFs available, providing investors with more choice. Many ETFs track the performance of an underlying index or benchmark. The underlying index or benchmark may be broad, or sector-specific, or be linked to commodities or currencies. ETFs have evolved, however, to include those that do not passively track an underlying index or benchmark.*

ETFs can be grouped into different categories, which may include:

## Index ETFs

ETFs that use an index tracking approach generally follow a pre-selected index, called a benchmark, and the return on the ETF will closely correlate with that of the underlying index. Index ETFs follow a variety of indices, including the broad market (both Canadian and international), sectors such as infrastructure or health care, and commodities (including natural gas, oil and gold), as well as indices that offer exposure to dividends or fixed income. The weightings used in the underlying index could be based on market capitalization of the constituents or on fundamental factors such as financial criteria. Index ETFs may also follow indices that adhere to a certain investment style, such as value or growth.

## Inverse and Leveraged ETFs

Inverse ETFs are designed to seek daily investment results that correspond to the inverse daily performance of their underlying index or benchmark. To meet their investment objectives, inverse ETFs use a variety of derivatives such as futures contracts and index swaps to reproduce a daily result that is the opposite of the underlying index or benchmark; so, when the index or benchmark goes down in value on a given day, the inverse ETF will correspondingly go up in value for that given day. Conversely, when the index or benchmark goes up in value, the inverse ETF will correspondingly go down in value. Investing in these ETFs is similar to holding short positions, or using a combination of advanced investment strategies to profit from declining prices.

Leveraged ETFs are designed to seek daily investment results to provide a multiple of the daily performance return of an underlying index or benchmark (for example, 200% the return). They are not intended to provide that same multiple of the return over the mid or long term. Investors should be aware that, while leveraged ETFs typically achieve their stated objective of a multiple of the daily performance of an underlying index on a daily basis, their returns can vary considerably from that stated objective if held for a period longer than one day. Note that some leveraged ETFs are also inverse, in that they track the opposite of the return of an underlying benchmark.

To meet their investment objectives, leveraged ETFs use a variety of derivatives such as futures contracts and index swaps to provide a multiple of the market exposure of the stocks in the fund. Leveraging increases the risk of the investment in such an ETF, in that losses will be magnified by that same multiple.

Inverse and leveraged ETFs are generally intended for use in daily or short-term trading strategies, and are not intended for investors who are looking to hold positions in a security beyond the short-term. Over time, a leveraged fund can drift from its benchmark due to the effects of compounding, especially during periods of market volatility. Therefore, the return on these ETFs for periods longer than a single day will not correlate with the return of the underlying benchmark. Accordingly, significantly more risk is involved in these types of ETFs than in index ETFs.

It is important that investors clearly understand the nature and risks of any ETF prior to investing.

## Commodity ETFs

Commodity ETFs provide exposure to commodities such as energy (e.g., natural gas or oil), precious metals (e.g., gold, silver or platinum), or livestock and grains, either by (i) holding the physical commodity directly, (ii) tracking the performance of the spot market price through physical forward contracts, or (iii) investing in or tracking the performance of commodity futures contracts. ETFs that hold the physical commodity provide exposure to the spot price of the commodity without the trouble of storing the commodity. ETFs that hold futures provide exposure to futures without the trouble of rolling them over. Most commodity indices are futures price indices, reflecting a change in the price of commodity futures, not in the commodity price.

## Currency ETFs

Currency ETFs provide exposure to currencies and can also hold either the actual currency or futures contracts. Some are designed to be long or short on one currency against others; some are designed to hold a mix of long and short futures positions among several currencies.

## Actively Managed ETFs

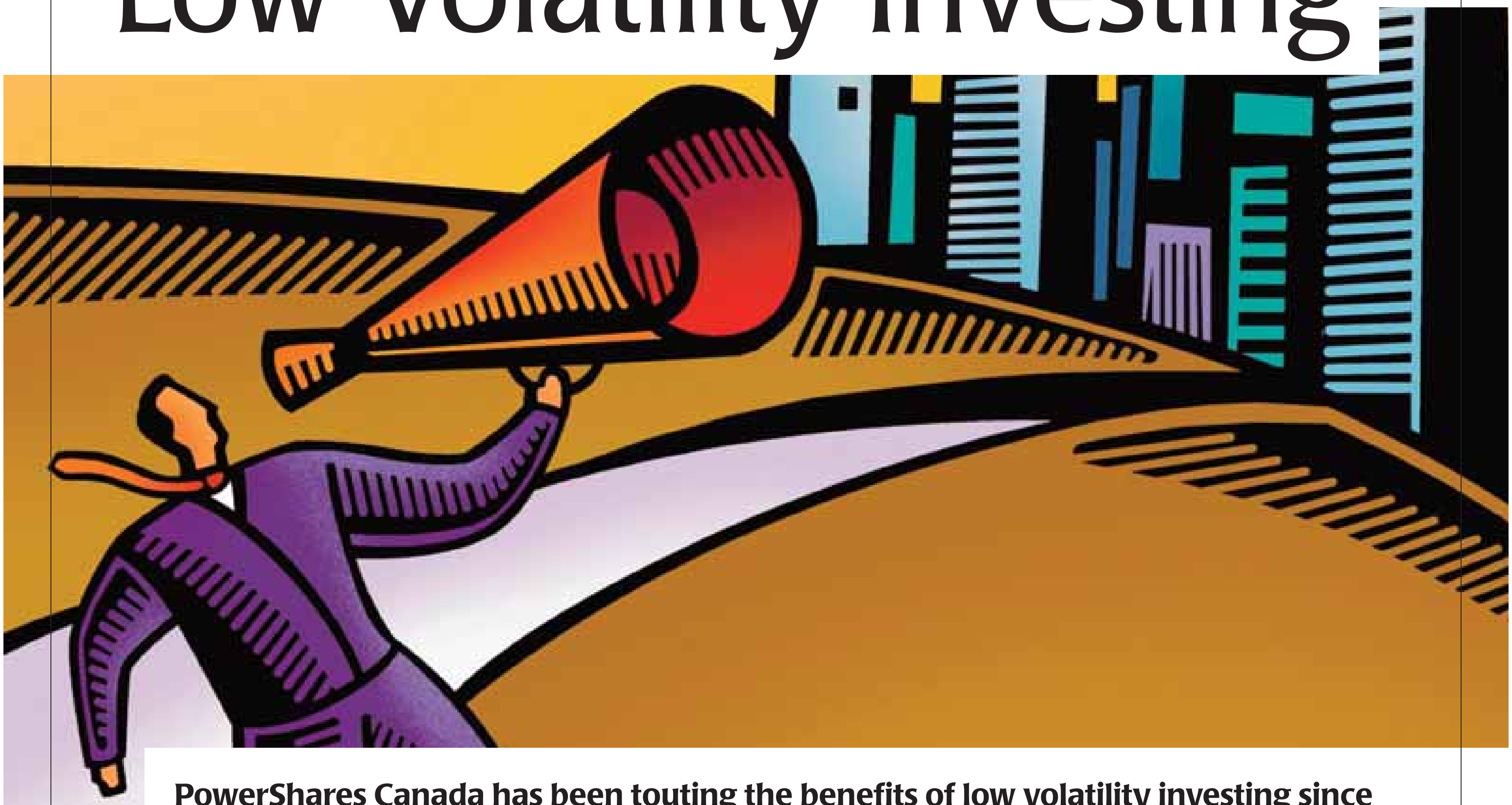
Index ETFs are generally designed around a passive strategy and therefore typically have lower management fees. Some ETF providers offer actively managed ETFs that operate more closely to the concept of a mutual fund. These ETFs have an active manager making investment decisions, often with the objective of outperforming rather than tracking a particular benchmark index, but usually with lower management fees than a traditional mutual fund.

## Exchange Traded Notes (ETNs)

Exchange traded notes are debt obligations of the issuer and trade like ETFs. They do not guarantee any return of principal at maturity and do not pay any interest during their term. While they exhibit no tracking error in that their return at maturity is linked to the return of the underlying index (minus expenses), they do exhibit credit risk linked to the issuer. ETNs offer long and short or inverse exposure to commodities and currencies as well as leveraged exposure.

Source: tmxmoney.com

# PowerShares Canada Touts the Benefits of Low Volatility Investing



**PowerShares Canada has been touting the benefits of low volatility investing since the launch of PowerShares S&P 500 Low Volatility (CAD Hedged) Index ETF (ULV) in January 2012.**

***In the past year, we've experienced many different market environments and our low volatility strategies have continued to perform throughout. In the 12-month period ending March 31, 2013, ULV returned 19.32%, outperforming the S&P 500® Hedged to Canadian Dollars Index by 4.99%.***

Additionally, recent equity market downturns illustrate how a low-volatility strategy can help protect investors by reducing losses. As seen on April 15, 2013, the worst-performing market day this year, ULV delivered:

The key driver of this outperformance has been the persistence of the "low volatility anomaly." We'd like to revisit an earlier piece describing the anomaly in detail. We will reiterate the factors we believe will continue to drive this unique strategy and the reasons to include it as a core part of any portfolio.

Michael Cooke
*Head of Distribution*
*PowerShares*
*Canada*

| Ticker/Index | 1-day return (%) |
|---|---|
| ULV | -1.68% |
| S&P 500® Hedged to Canadian Dollars Index | -2.29% |
| Low-volatility advantage | 0.61% |

Source: Invesco and Bloomberg L.P. as at April 15, 2013

## Low-Volatility Strategies - The Surprising Truth

Growing demand for investment products designed to minimize volatility seems to continue with each passing year. This trend began in earnest with the dot-com crash and accelerated with the financial crisis of 2008.

As the oldest baby boomers were heading into retirement, the sudden drop in the value of their retirement funds left many rattled.

### The Low-Volatility Anomaly

The concept of low-volatility investing is not new to investors, but it has become more relevant in the last five years. The financial crisis of 2008 and lingering economic uncertainty have made investors more averse to volatility and risk.

Volatile financial markets combined with record low interest rates have made investment and retirement planning a much more daunting process for Canadians.

Many investors have chosen to reduce the risk in their portfolios, but conventional wisdom tells us that lower-risk portfolios should lead to lower returns. Fortunately, there is an investment strategy that offers the potential for higher returns and reduced risk, the low-volatility portfolio.

Reconstructed performance data (see table below) shows low-volatility investing can reduce volatility by 25% to 35% over the long term, versus capitalization-weighted indices such as the S&P/TSX Composite Index or the S&P 500® Index.

Research has shown that over the period December 31, 1985 to January 31, 2006 investing in a selection of the least volatile stocks would have outperformed a broad cap-weighted index during down-markets and underperformed during broad up-markets. However, over the long term, the benefits of down-market protection would have made up for the strategy's bull market underperformance, leading to significantly higher risk-adjusted returns than the benchmark[1].

In 2011, the Financial Analysts Journal[2] reported that the "long-term outperformance of low-risk portfolios is perhaps the greatest anomaly in finance. Large in magnitude, it challenges the basic notion of a risk-return trade-off."

Whether an investor is seeking risk reduction or not, a portfolio of low volatility equities offers a potentially better way to invest over the long term.

### Can the low volatility anomaly persist?

Can the anomaly continue to reward investors with high risk-adjusted returns than the benchmark? In our opinion, the answer lies in an analysis of what has created the anomaly in the first place – investor and institutional biases.

Behavioral biases have historically led to investor demand for higher-volatility stocks – demand that is not warranted by fundamental valuations.

Such behaviour is based on the inability of many investors' to evaluate small differences in probabilities – especially when large outcomes are possible. This can create an apparent preference for riskier assets. As the security's price is driven higher, future underperformance becomes more likely.

Another key contributor to the low-volatility anomaly is the requirement imposed on many institutional investors to track index benchmarks. This may limit their opportunity to arbitrage between overpriced stocks and undervalued stocks.

Because many of these massive investment pools are required to track a benchmark index, they can generate the inefficiencies that contribute to the low-volatility anomaly. Until these biases are broken, a low-volatility strategy may continue to outperform over the long term.

*Michael Cooke, Head of Distribution*
*PowerShares Canada*
***michael.cooke@invesco.com***

1 Blitz, David and Pim van Vliet, "The Volatility Effect: Lower Risk without Lower Return," Erasmus Research Institute of Management, July 2007. For this research, Blitz and van Vliet considered the FTSE World Developed Index as the market portfolio.
2 January/ February issue, volume 67, no.1, www.cfapubs.org

| **Ticker/Index** | **YTD** | **1 Yr** | **Since Inception** month end (Jan 2012) |
|---|---|---|---|
| ULV | 13.11% | 19.32% | 21.10% |
| S&P 500® Hedged to Canadian Dollars Index | 10.83% | 14.33% | 19.46% |

Sources: Invesco and Bloomberg L.P. as at March 31, 2013 ULV returned 19.40% since its inception date of January 24, 2012.

* In December 2012, the S&P 500® Low Volatility Index was recognized as having the most significant impact on the indexing industry over the previous 12 months and was named the William F. Sharpe Indexing Product of the Year.

Commissions, management fees and expenses may all be associated with investments in exchange-traded funds (ETFs). Unless otherwise indicated, rates of return for periods greater than one year are historical annual compound total returns including changes in unit value and reinvestment of all distributions, and do not take into account any brokerage commissions or income taxes payable by any unitholder that would have reduced returns. ETFs are not guaranteed, their values change frequently and past performance may not be repeated. Please read the prospectus before investing. Copies are available from Invesco Canada Ltd. at www.powershares.ca.

There are risks involved with investing in ETFs. Please read the prospectus for a complete description of risks relevant to the ETF. Ordinary brokerage commissions apply to purchases and sales of ETF units.

Most PowerShares ETFs seek to replicate, before fees and expenses, the performance of the applicable Index and are not actively managed. This means that the Sub-advisor will not attempt to take defensive positions in declining markets and the ETF will continue to provide exposure to each of the securities in the Index regardless of whether the financial condition of one or more issuers of securities in the Index deteriorates. In contrast, if a PowerShares ETF is actively managed, then the Sub-advisor has discretion to adjust that PowerShares ETF's holdings in accordance with the ETF's investment objectives and strategies.

ETFs are not diversified investments.



Continued on page 8

Continued from : PowerShares Canada... page 7

## PowerShares Canada Low-Volatility ETFs

Based on investor demand, PowerShares Canada offers two low-volatility ETFs: PowerShares S&P 500 Low Volatility (CAD Hedged) Index ETF (ULV) and PowerShares S&P/TSX Composite Low Volatility Index ETF (TLV).

TLV seeks to replicate, before fees and expenses, the performance of the S&P/TSX Composite Low Volatility Index, which is designed to measure the performance of the 50 stocks from the S&P/TSX Composite Index with the lowest realized volatility over the past 252 trading days, as of the most recent quarterly rebalancing.

ULV seeks to replicate, before fees and expenses, the performance of the S&P 500® Low Volatility Index (CAD Hedged). The ETF is designed to track the currency-hedged version of the award-winning* strategy to provide exposure to the 100 stocks from the S&P 500® Index with the lowest realized volatility over the past 252 trading days, as of the most recent quarterly rebalancing.

| | Annualized Return* | Standard Deviation* |
|---|---|---|
| S&P/TSX Composite Index[1] | 7.29% | 16.19% |
| S&P/TSX Composite Low Volatility Index[1] | 11.76% | 10.78% |
| S&P 500® Index[2] | 9.60% | 14.83% |
| S&P 500® Low Volatility Index[2] | 10.95% | 11.17% |

Source: StyleADVISOR

[1]for the period April 1, 1997 to March 31, 2013, in CAD [2]for the period December 1, 1990 to March 31, 2013, in USD

* The S&P 500® Low Volatility Index was created January 22, 2012 and the S&P/TSX Composite Low Volatility Index was created April 10, 2012. Index data shown before these creation dates have been reconstructed and are calculated on a basis consistent with their current basis of calculation. The reconstructed performance is hypothetical and for illustrative purposes only. You cannot invest directly in an index. Index performance does not reflect fees and expenses that would be applicable to a fund. The hypothetical performance data for the Indices should not be taken as indicating that if the Indices had, in fact, existed during the shown time periods before their creation that these Indices would have achieved the hypothetical results shown as actual results might have differed.

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# TMX – an ETP leader

TMX | Toronto Stock Exchange


## Exchange Traded Products ETPs | TMX

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Dividend
Value
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S&P/TSX Composite
Low Volatility
High Beta
S&P/TSX Small Cap
Covered Calls
S&P/TSX Venture Select
MSCI Canada
FTSE RAFI Canada
Morningstar Canada
Dow Jones Canada

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VIX Mid-Term Futures
Managed Futures
Hedge Fund

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Barbells
Senior Loan

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# Investors Seeking Higher Returns From Intelligent ETFs

**Exchange traded funds (ETFs) that use intelligent indexing - otherwise called intelligent ETFs – are becoming increasingly popular among investors; and for good reason.**

Barry Gordon
*President & Chief Executive Officer*
*First Asset*

***They are designed to provide potentially higher returns, and/or lower risk, than traditional capitalization weighted indices, making them attractive to investors.***

Unlike traditional ETFs that mimic the performance of static market capitalization weighted indices, such as the S&P/TSX 60 or S&P 500, intelligent ETFs are constructed using either objective rules-based, fundamental and/or technical analysis to select stocks from a benchmark or a customized index.

For example, investors can acquire an intelligent momentum or value ETF, with the knowledge that they are getting exposure to an underlying portfolio with characteristics they desire, as opposed to one that invests in all the stocks on a broad market index.

So what does an intelligent ETF using fundamental analysis do? Fundamental analysis is often associated with value investing. In the case of intelligent ETFs, stock selection is determined through the use of analytical screens, using factors such as earnings per share, price-to-earnings, price-to-book, price-to-cash flow, and other criteria as measurements.

FirstAsset
Exchange Traded Funds

Basically, these key financial ratios are evaluated to determine the current health of a company, its prospects for growth, and how its stock is valued on the market. For example, an analysis of earnings indicates how much money the company is currently making and how much it might make in the future. A similar criterion is a company's price-to-earnings ratio, which gives an idea of what the market is willing to pay for its earnings. Generally, the higher the price-to-earnings ratio, the more investors would pay for the stock.

Unlike value investing, momentum investing is more closely associated with technical analysis. Intelligent ETFs that use momentum investing strategies aim to invest in the best performing stocks at all times. They employ technical price screens that look for stocks trading at or near their 12 month highs, as these price trends often continue for a period of time. The ultimate goal is to determine the optimal entry and exit point into the market in order to maximize performance.

Among the more popular intelligent ETFs are those based on customized indices such as the Morningstar Canada Value Index and the Morningstar Canada Momentum Index. According to Morningstar, each of these indices employs transparent, rules-based methodologies that are back-tested and supported by original proprietary research. They are vetted for appropriateness and investment value and reveal the most meaningful differences in stock style, capitalization, sectors, and other traits. These indices can be used for precise asset allocation and benchmarking and as efficient tools for portfolio construction and market analysis.

The Morningstar Canada Value Index and the Morningstar Canada Momentum Index conduct quantitative equity research and portfolio analysis on more than 700 Canadian stocks. Essentially, intelligent indexing selects stocks - based on their research and pre-defined criteria - that will potentially outperform the broad index. The selection process is not constrained, as with traditional index ETFs, where stocks with the largest market value have the heaviest weight in a portfolio.

Given that intelligent ETFs are typically rebalanced on a quarterly basis, investors also benefit from active rather than passive management that is typical of a traditional ETF, further increasing the potential of receiving a higher return.

Two intelligent ETFs that use Morningstar indices under license are the First Asset Morningstar Canada Value Index ETF (TSX: FXM) and the First Asset Morningstar Canada Momentum Index ETF (TSX: WXM). Both have shown positive performance to date. As of March 31, 2013, FXM has posted an impressive 18.9% return since inception[1], while WXM has returned 17.4% since inception[2].

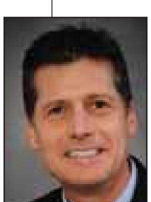
Intelligent ETFs are gaining traction with investors who want more than passive, cap-weighted index returns, with all the benefits provided by ETFs.

*Barry Gordon, President and Chief Executive Officer, First Asset*
***bgordon@firstasset.com***

1. Inception date of FXM is February 15, 2012. 1 yr return as at Mar 31, 2013 was 15.6%.
2. Inception date of WXM is February 15, 2012. 1 yr return as at Mar 31, 2013 was 16.7%.

# Dividend Stocks: Why Now?

## A Revolution in the Making.



**Howard J. Atkinson**
*President, Horizons ETFs Management (Canada) Inc.*

***In 2012 ETFs in Canada grew at a pace over three times faster than that of conventional mutual funds. With their attractive features including intraday liquidity, independent price discovery, lower fees and ease of administration, ETFs are here to stay – and mutual funds have taken notice.***

Most existing ETFs are passive investment vehicles, in that they hold a mix of securities designed to replicate the returns or otherwise match the characteristics of a particular published securities index. But now the actively managed mutual funds are getting into the act. Some of the largest mutual fund companies in the United States have applied to the Securities and Exchange Commission (SEC) for exemptive relief to enable their actively managed funds to be offered in an ETF format. And the SEC is slowly but surely relaxing restrictions, to enable actively managed funds to be created and launched. Many industry watchers expect actively managed ETFs to grow faster in coming years than their passive counterparts, including McKinsey & Co. which recently predicted that assets in actively managed ETFs will explode to $500 billion by 2020, up from $10 billion today. Others are of the view that this estimate is too low.

We've now seen more actively managed ETFs created, notably PIMCO's actively managed bond ETF launched in March 2012 which has now reached $4 billion in assets under administration. However, most of the actively managed ETFs recently launched are in the fixed income category. What's holding back mutual funds from launching actively managed *equity* ETFs? The main reason is daily portfolio disclosure. In the United States, regulations require all ETFs to disclose their portfolio holdings daily.

Applications have been made to the SEC to relax this requirement. But in Canada the situation is different, and actively managed ETFs are not required by law or regulation to publish or otherwise disclose their holdings daily.

Unlike mutual funds, most transactions in ETF shares are conducted in the secondary market (i.e. on the exchange) and do not involve the movement of assets in or out of the fund. The secondary market price of ETF shares is determined by supply and demand and is affected by the current value of the portfolio of investments held by an ETF. The creation and redemption of ETF shares are typically done between market makers and the ETF, with the ETF exchanging ETF shares for a block of the ETF's underlying holdings having a value equal to the ETF shares. In order to provide efficient intraday trading in ETF shares, market makers must be able to engage in hedging and arbitrage activities to manage risk, and daily knowledge of the detailed portfolio composition is needed to carry out these activities. Typically, market makers will hedge the sale or purchase of ETF shares to or from investors by taking an opposite position in the securities contained in the ETF's portfolio. Or they might make trading profits by arbitraging differences between an ETF's share price on the exchange and the current value of the ETF's holdings. If the composition of the actively managed funds were not known to the market makers, trading of such funds intraday could be extremely difficult since accurate pricing vehicles (such as arbitrage and hedging) would not be present.

However, daily portfolio disclosure would expose the actively managed mutual fund to the risks of free riding and front running: free riding by duplicating the fund portfolio manager's added value and intellectual property without compensation, and front running by identifying stock positions under accumulation by the fund portfolio manager and buying ahead of the full accumulation. These problems are particularly acute in the case of equity funds, because free riding and front running with other asset classes such as fixed income are more difficult and/or less profitable activities to carry out than with equity funds.

In the US, mutual funds await a decision of the SEC to relax the daily transparency requirement. But in Canada the problem is a practical one: how to enable market makers to efficiently make markets in actively managed ETFs by carrying out hedging and arbitrage activities without daily knowledge of detailed portfolio composition.

Robson has developed a pragmatic solution to the practical problem. Its proprietary system (patent pending), provides a mechanism for market makers to engage in hedging and arbitrage activities and thereby effectively price the shares of an actively managed ETF without knowing the actual underlying holdings of the actively managed fund. Mutual funds and other active managers will not have to make any greater or more frequent portfolio disclosure than they do currently. The system will deter free riding and front running by maintaining the confidentiality of underlying portfolios, thus preserving the benefits of the proprietary management strategies and the advantages to investors of the ETF format. Mutual funds have shown interest in the system, and Robson is working with industry participants to further develop a workable platform based on its system.

If and when mutual funds (and other actively managed investment funds) can create ETF versions of their actively managed equity funds, the investment floodgates will open. ETFs will then be clearly viewed as a fund distribution format, and a delivery mechanism superior to the conventional mutual fund format, rather than a separate asset class. Actively managed equity ETFs will transform the way mutual funds are sold – and the revolution might happen first in Canada.

*Howard J. Atkinson, CFA, CIMA®, ICD.D*
*President, Horizons ETFs Management (Canada) Inc.*
***info@horizonsetfs.com***

# Canada's Mutual Fund Regulations Provide a Strong Framework for ETFs

**Canada has in recent years earned much praise for its strong regulatory environment and prudent investment culture.**


**Ronald C. Landry**
*Executive Director, ETFs & Alternative Investments*


*Mutual funds have been available to retail and institutional investors in Canada since the 1930s: Canadians and foreign investors into this country have come to know and trust that these funds are operating within an effective and respected governance structure. This very same regulatory framework in fact applies to exchange-traded funds (ETFs) in Canada, which are governed under a set of key regulatory instruments that also govern mutual funds. ETFs and mutual funds stem from the same regulatory structure, but there are key differences in how they interface with investors – and they offer a different set of choices to investors.*

### ETFs and mutual funds: a shared regulatory framework

Both ETFs and mutual funds are subject to National Instrument 81-102 - Mutual Funds ("NI 81-102") which includes restrictions on concentration, control, investment types and illiquid assets. NI 81-102 was put into place in 2000, and has been amended several times – most recently in 2012. Among other things, this instrument governs the participation of mutual funds in securities lending, sales communication and prohibited representation. This instrument also sets out a requirement for the use of an independent custodian for portfolio assets, which helps provide investors with third-party assurance that stated assets are in fact held by the fund.

CIBC MELLON

ETFs in Canada can be classified as either regular mutual funds or commodity pools: the former are governed by NI 81-102, while the latter are governed by another regulatory instrument – National Instrument 81-104 (NI 81-104). NI 81-104 eases certain restrictions around derivatives contained in NI 81-102, but in turn requires individuals selling a commodity pool or trading derivatives for commodity pool, to have a higher level of registration – for example, additional certification around derivatives.

Mutual funds and ETFs are likewise both subject to National Instrument 81-106 - Investment Fund Continue Disclosure, which sets out rules for:

- Financial statements and disclosure
- Management Reports of Fund Performance (MRFP)
- Quarterly portfolio disclosure
- Calculation of net asset value (NAV)
- Calculation of management expense ratio (MER)

In other words, when ETFs are being structured, they have to abide by the same regulations as mutual funds: this means that the structural risks associated with Canadian ETFs mirror those associated with Canadian mutual funds. Of course, this doesn't mean that individual ETFs or mutual funds don't apply for and obtain relief from various aspects of these regulations. For example, passive-index ETFs may apply for an exemption to a prohibition against concentration limits: an index tracking a small batch of technology stocks might see a holding in a company with a very large capitalization like Apple or Google exceed the regulatory concentration threshold and reasonably seek an exception. Canada's regulatory structure compels participants to disclose these exceptions to investors within their offering documents. Within the individual instruments, there are some segments that do not apply to certain fund structures. For example, within NI 81-102, Part 9 – "Sale of Securities of a Mutual Fund" does not apply to ETFs.

## A strong regulatory regime across the board

One of the keys to Canada's success from a regulatory perspective is a collaborative approach based on combining open dialogue with participants and having clear and effective rules. Regulators not only provide policies and guidelines to structure the market, but also engage directly with participants to encourage best practices that help position the market as a whole to maintain stability. Canada has several highly-effective industry associations that contribute to constructive dialogue between market participants, regulators and legislators. Canada's strong performance through recent years reinforces that our market participants and stakeholders are on the right path.

## Leveraged and inverted perceptions

Despite a consistent regulatory baseline across ETFs and mutual funds, less-traditional ETFs structures such as leveraged, inverse and synthetic ETFs continue to be perceived by some investors as harbouring disproportionate risk. Currently these structures are more often used by ETFs, but the first leveraged products were in fact mutual funds, and a retail mutual fund today can just as easily utilize synthetic swaps in order to gain exposure to a desired underlying index. Certainly inverse/leveraged structures entail different risks, but this has less to do with regulatory structures than it does with investor choice: a leveraged or inverse fund offers a different investment risk profile, and the intent of these structures is that they are precisely proportional. All in all, an investor's decision to invest into a fund – ETF or mutual – that engages in those activities is a matter of investment strategy rather than a question of regulatory structures.

## The key difference: investor choice

The central difference between ETFs and mutual funds is the intra-day liquidity associated with ETFs. Investors are able to buy and sell ETFs on a stock exchange, which opens investors to both the opportunities and risks associated with intraday trading activities. For example, an investor with a negative outlook on the market could seek to gain exposure to an inverse return by shorting a TSX index etf, or by purchasing an inverse ETF instrument - each option presents different risks, rewards and investment costs. Like any investment decision, an investor must weigh the risk profile of the prospective investment, their risk appetite and the relative likelihood that the prospective investment will meet their goals.

## Making the choice that's right for your needs

Canadian ETFs and mutual funds are based on the same strong regulatory framework for which Canada is known. The various mutual and exchange-traded fund sponsors start from the same regulatory instruments, and any exceptions must be disclosed to investors. ETFs and mutual funds each offer varying advantages, profiles, risks and opportunities: neither structure is inherently more or less risky. Ultimately, it is up to individual investors to make appropriate decisions about what is right for their investment needs, and to weigh individual investment opportunities to find the right fit, rather than contrasting entire classes or painting them with a broad brush.

### Additional resources

Ontario Securities commission – regulations and amendments related to NI 81-102 **www.osc.gov.on.ca/en/13046.htm**

*Ronald C. Landry, Executive Director, ETFs & Alternative Investments,*
***ron_landry@cibcmellon.com***

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**Pat Boland**

**Pat Bolland**, Moderator
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# Maximizing the Benefits of Preferred Shares

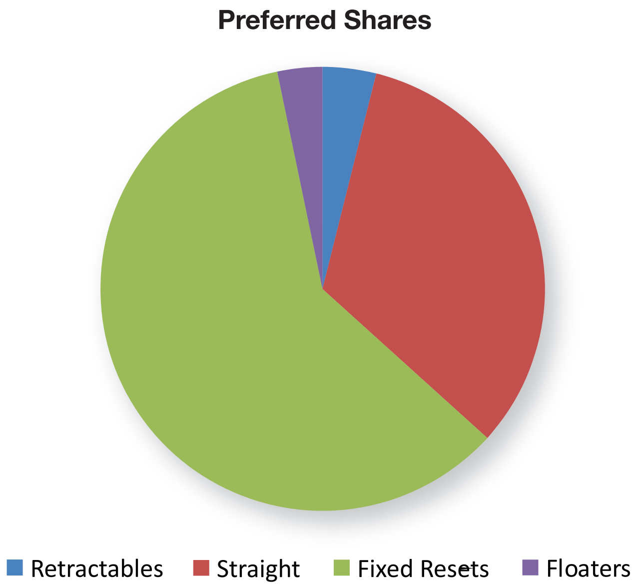
**Although the S&P/TSX Composite has gained 78.47% on a total return basis from its March 2009 lows, the last five years have been particularly challenging for investors. Low interest rates and macro-economic uncertainty have made equity markets prone to sudden shocks in volatility.**

**Alfred Lee**
*Vice President, BMO ETFs Portfolio Manager & Investment Strategist*

***Asset allocation models have thus been refined to adapt to today's more dynamic market conditions and consequently, a growing number of investors have moved away from "traditional 60/40 portfolios" (60% equities and 40% bonds) and have sought out the addition of asset classes that exhibit both higher yield and greater stability.***

Preferred shares have gained significant traction with investors, as it is an asset class that exhibits characteristics of yield and stability. Although not a substitute for either fixed income or equities, the low correlation of preferred shares to both equities and bonds, makes them complementary to 60/40 asset mixes. In normalized market conditions, preferred shares provide near bond-like volatility with their par value but since their distributions are considered dividends, they provide a more tax efficient yield than fixed income.

Despite their many favourable attributes, preferred shares are extremely sensitive to rising interest rates since they are perpetual in nature (with no maturity date), making them similar to long duration bonds (with call features). One concern this year, at least to preferred share investors, will be whether economic fundamentals continue to




improve, which would likely result in the Bank of Canada (BoC) finally tightening its monetary policy vis-à-vis higher interest rates. Economists forecast rates to rise in the latter half of 2013. In fact, interest rate futures are beginning to price in a chance (albeit, still a small one) that the overnight lending rate will rise 0.25% by the December BoC meeting.

Even if rates rise, they aren't expected to rise significantly. However, with five-year Government of Canada bonds currently yielding 1.19%, there is more room for rates to rise than to decline. Despite the risk of rising interest rates, preferred shares can still benefit a portfolio as long as this risk is managed.

One growing segment of the preferred share market has been the "rate resets" preferred shares, which pay a fixed dividend for a specified number of years. Although still perpetual in nature, rate reset preferred shares are more attractive than straight perpetual preferred shares in a rising interest rate environment as their dividends rates are typically reset every five years to reflect the then current interest rate environment. If the rate reset preferred share is not called back by its issuer, its dividend rate will be equivalent to the Government of Canada bond yield (with a similar term) at that time plus some reset spread, akin to a corporate spread of a bond. Given the ability to adjust dividends in a rising rate environment, rate resets provide investors with a greater level of protection against rising rates.

The BMO S&P/TSX Laddered Preferred Share Index ETF (ZPR) is a portfolio of rate reset preferred shares, but also provides added protection against rising interest rates by using a unique methodology. Similar to a bond ladder, this ETF structures the preferred shares in the portfolio so that every year an equal portion of the portfolio will reset to the current interest rate environment. Upon its reset date, if the preferred share is not called by the issuer, it will move to the back ladder where it will be scheduled to reset in another five years. With the five-year ladder, every year 20% of the portfolio will reset to the current interest rate environment, helping to evenly distribute interest rate risk across different terms.

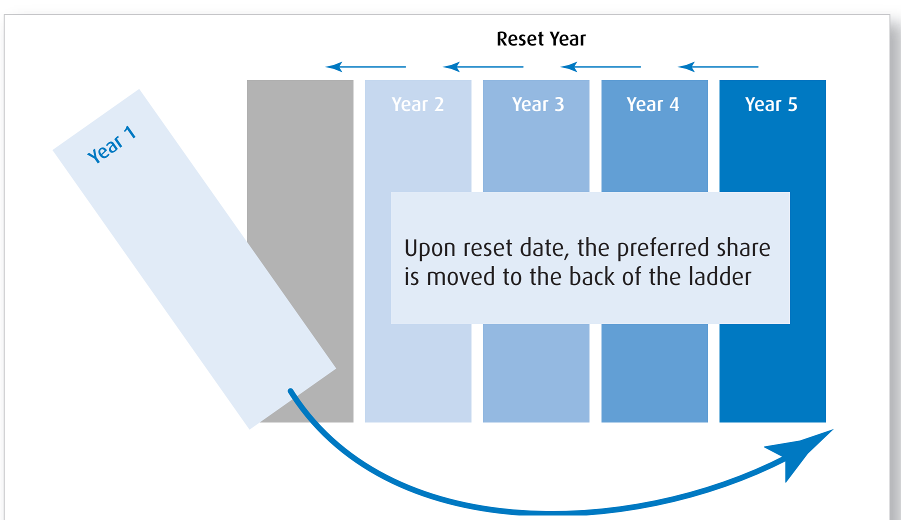
This ETF is a diversified portfolio of approximately 120 different issues and 45 different issuers, minimizing both company specific risk and evenly spreading out both redemption and reset risk. For even institutional investors, this level of diversification would be difficult to achieve, but through ZPR, investors can access this diversification even with smaller accounts, as each unit is made up of the underlying basket of securities. Furthermore, with a quarterly rebalancing and reconstitution, this ETF can add newer issues to the mix, potentially becoming more diversified with time.

With a growing trend away from 60/40 portfolios, constructing multi-asset portfolios will become increasingly important in minimizing volatility and increasing yield in today's market. The key will be complementing traditional assets such as bonds and equities with non-correlated assets such as preferred shares, which offer attractive properties to multi-asset portfolios. Managing the risk of rising interest rates will be the key to maximizing the benefits of this asset class.



*Alfred Lee, Vice President, BMO ETFs, Lead Portfolio Manager of the BMO S&P/TSX Laddered Preferred Share Index ETF (ZPR).*

**Ladder Portfolio**



# Are Managed Futures the Superhero of the Capital Markets?

**Low correlation to equities, positive expected return, a powerful diversifier and an asset class that delivers when markets are down - "It's a bird! It's a plane! It's managed futures!"**

Ioulia Tretiakova
*Vice President, Director of Quantitative Strategies*

***Institutional investors have long taken advantage of the diversification power of managed futures. While the traditionally steep minimum investment has made the asset class inaccessible to a retail investor, the introduction of managed futures ETFs could be a game changer. We will look at how this asset class can benefit a core portfolio and review the ETF options that are available to retail investors.***

Managed futures, also referred to as Commodity Trading Advisor (CTA) programs, have been in existence for over thirty years. This alternative asset class consists of a broad umbrella of strategies that invest in highly liquid futures contracts and often use a trending approach to generate buy and sell signals. Risk management is key with the risk budget spread over multiple long and short positions in commodity, equity, interest rate and currency futures.

Many researchers, notably professor John Lintner of Harvard University, have explored the risk-return profiles of the managed futures strategies and a remarkable observation emerged. On average, managed futures are "long" volatility; in other words, when volatility is high, managed futures tend to deliver strong performance. This is in sharp contrast with equities that have a negative relationship to volatility and generate poor returns in turbulent markets.

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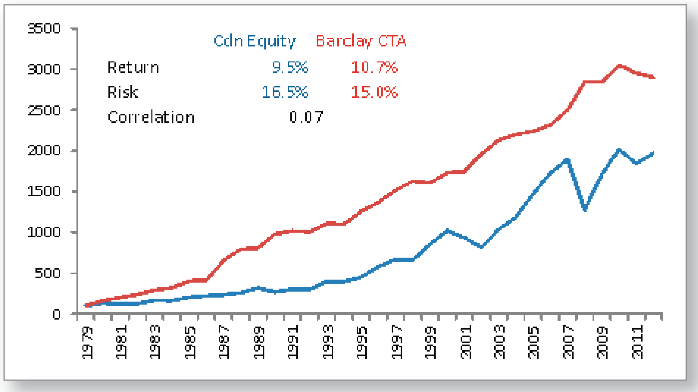
## This Looks Like A Job For Superman

Another way to get a beneficial diversifying exposure to long volatility is to buy VIX futures or an ETF that can do it for you. The VIX index tracks implied volatility of U.S. equities and, if added to a core portfolio of equities and bonds, significantly decreases the risk of the overall portfolio. The problem is, being such a powerful diversifier, the addition of VIX futures comes with a high price tag of negative expected return due to the negative roll yield of VIX futures. While managed futures also provide a long exposure to volatility they do not suffer from a negative expected return. The chart below shows the historical risk-return characteristics of managed futures represented by Barclay CTA index since inception in 1980 compared to Canadian equities. The Barclay CTA index is the oldest industry benchmark that tracks the actual performance of CTA programs. Of particular note is the index does not suffer from survivorship bias when poorly performing funds are closed and not accounted for in the index. Canadian equities are represented by the S&P/TSX Capped Composite index.



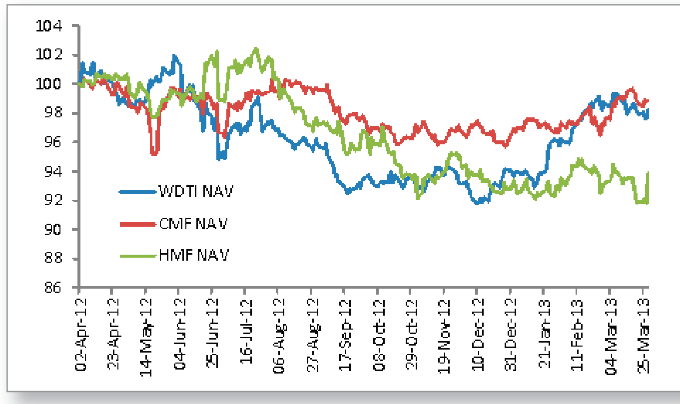

Historically, allocating 80% to Canadian equities and 20% to managed futures would have resulted in a portfolio with higher expected return of 10.1% and lower risk of 13.7% compared to investing in Canadian equities alone. How did the strategy perform during adverse markets? This 80:20 portfolio's return in 2008 during the credit crisis would have been -23.6% compared with Canadian equities -33.0% because the managed futures portion would have returned a healthy 14.1%. During the "tech-wreck" of 2001-2002, Canadian equities were down -19.8% in 2001-2002 while managed futures were up 13.3% for the same period. Performing well in volatile markets, this asset class has demonstrated the ability to help mitigate tail risk of core asset classes.

Managed futures have traditionally been accessible only to institutional investors and ultra-high net worth individuals due to significant minimum investment requirements. With the introduction of managed futures ETFs in the U.S. and Canada, the diversification benefits of the strategy are now available to retail investors.

The indices that provide the building blocks in the managed futures ETF space are S&P Diversified Trends, Guggenheim Managed Futures and Auspice Managed Futures Excess Return. These indices implement quantitative methodologies designed to mimic a representative managed futures strategy through trend-following. How well do these single-strategy indices capture the diversified managed futures exposure as measured by the Barclay CTA index? The S&P Diversified Trends shows a correlation of 49% since inception in 2004; the Guggenheim Managed Futures index is approximated by the performance of a U.S. mutual fund that has followed this strategy since 2007 and demonstrates a correlation of 42% to Barclays CTA index over that period; the Auspice Managed Futures Excess Return Index shows 80% correlation to Barclay CTA index since the inception in 2000.

## One Hero or Many

The performance dispersion of the three ETFs is quite surprising because they follow seemingly related strategies.




The dispersion in the return experience of individual managed futures ETFs is not surprising. The Barclay CTA index contains over 500 diverse managed futures strategies, not all of which are highly correlated with each other. This additional diversification benefit within the index creates a potentially superior risk-return profile compared to investing in a single managed futures strategy. But time will tell.

## Conclusion

Performance histories for these ETFs are fairly short and it remains to be seen if single managed futures strategies can deliver the same heroic benefits as a diversified-strategy managed futures index. However if investors believe that they can, a 20% weight in a balanced portfolio would provide good insurance. The introduction of managed futures ETFs attempts to deliver managed future exposure without the traditional "2-20" fee structure of 2% annual fee and 20% performance fee. The management fee of the ETFs in this group is 0.95% across the board. So while cautious investors and advisors may want to wait for these new vehicles to develop a track record, the advantage of lower fees makes a positive contribution to the product shelf. It remains to be seen whether the ETF versions of managed futures strategies can deliver on the strategy's substantial promise. The significantly more affordable ETF format with tangible risk management benefits keeps the cost of the cape low in the meantime.

*Ioulia Tretiakova, Vice President, Director of Quantitative Strategies, PŮR Investing Inc.* ***itretiakova@purinvesting.com***

### Managed Futures ETFs

| ETF | | MgmtFee | Inception | Index |
|---|---|---|---|---|
| WDTI (US) | WisdomTree Managed Futures Strategy Fund | 0.95% | 05-Jan-11 | S&P Diversified Trends Indicator |
| CMF | iShares Managed Futures Index Fund | 0.95% | 10-Feb-11 | Guggenheim Managed Futures |
| HMF | Horizons Auspice Managed Futures Index ETF | 0.95% | 02-Apr-12 | Auspice Managed Futures Excess Return |

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### Thursday, May 2 & Friday, May 3 ~ Toronto
### Wednesday, June 19 ~ Vancouver / October ~ Montreal

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## Niagara Institutional Dialogue

### Monday, June 10 to Wednesday, June 12 ~ Niagara-on-the-Lake

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### Monday, June 17 ~ Calgary
### Monday, Sept. 9 to Wednesday, Sept. 11 ~ Niagara Falls

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