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Foreign Withholding Taxes on ETFs for Canadian Investors

- Beyond Beta: Overcoming the Pitfalls of Traditional Weighted Strategies
- Fundamentally Better – The Evolution of Index Investing
- Slugging it Out in the Equity Arena
- ETF News

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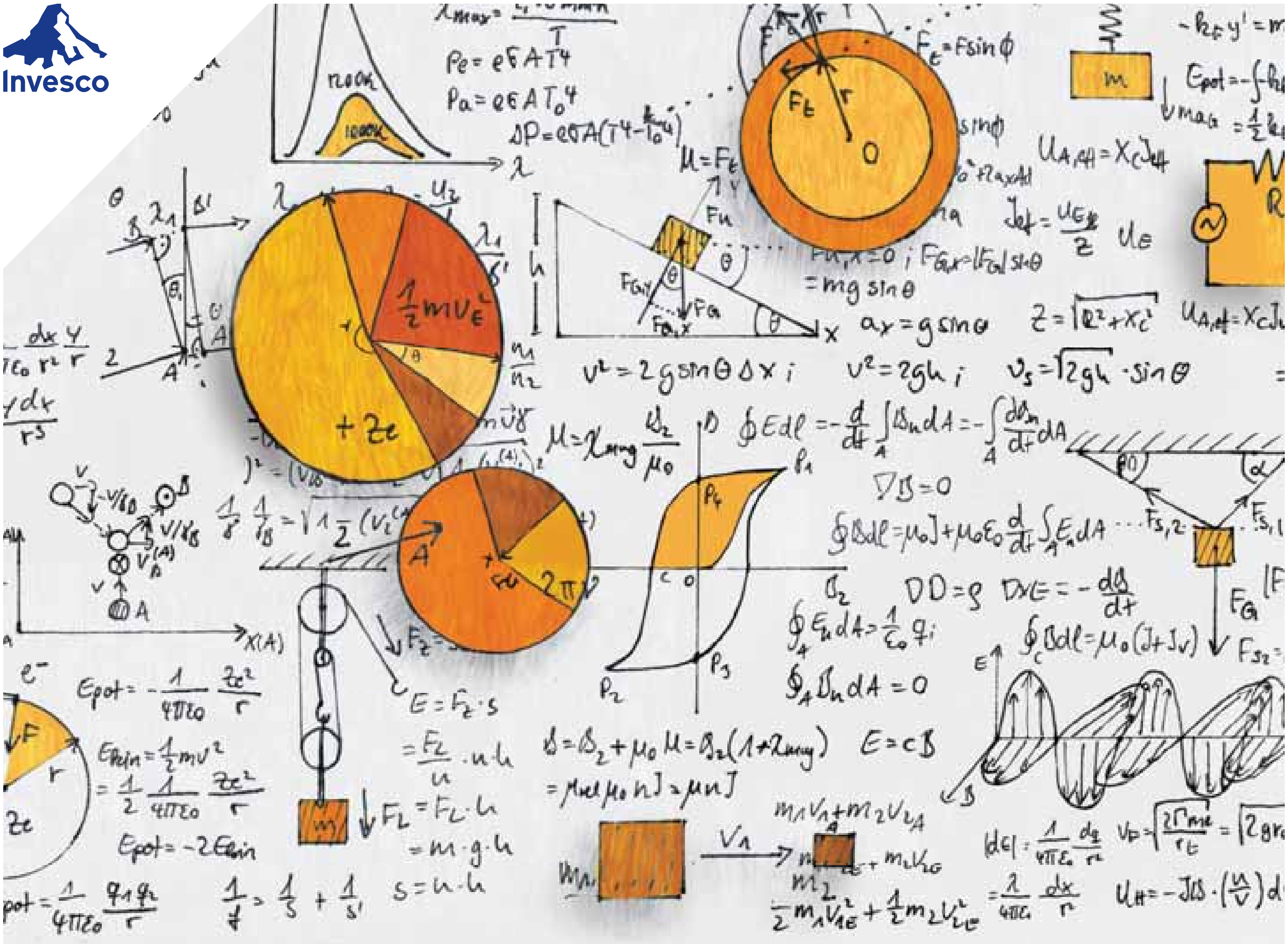

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ACCORDING TO ETFGI:
ETFS AND ETPS LISTED GLOBALLY REACHED US$2.64 TRILLION IN ASSETS, A NEW RECORD HIGH, AT THE END OF Q2 2014

LONDON – July 7th, 2014 – ETFs and ETPs listed globally gathered US$34.8 Bn in net new assets in June and US$126.6 Bn YTD, which outpaces the previous high of US$106.4 Bn at this point set in 2012. Net flows combined with positive market performance during H1 2014 pushed assets in the global ETF/ETP industry to a new record high of US$2.64 Tn invested in 5,359 ETFs/ETPs, with 10,401 listings, from 219 providers listed on 59 exchanges, according to preliminary data from ETFGI's end H1 2014 Global ETF and ETP industry insights report.

The ETF/ETP industry in most countries and regions reached new record highs in assets at the end of Q2 2014, including: in the United States US$1.86 Tn; in Europe US$470 Bn; in Asia Pacific ex Japan US$ 96.7 Bn; in Japan US$90.1 Bn; in Canada US$65.7 Bn and in the Middle East and Africa US$43.5 Bn.

"In June investors invested almost all net new money into equity exposures with the US and emerging markets being the preferred allocations. The S&P 500 index ended up 7% at the end of Q2 2014, closing at an all-time high (1963) on June 20th. Internationally, developed markets gained 2% and emerging markets are up 4%. The positive equity market performance has helped to improve investor confidence during the first half of 2014." according to Deborah Fuhr, Managing Partner at ETFGI.

At the end of Q2 ETFs/ETPs had gathered a record level of US$126.6 Bn in net inflows. Equity ETFs/ETPs gathered US$84.2 Bn, followed by fixed income with US$36.5 Bn, while commodity ETFs/ETPs had net outflows of US$3.0 Bn.

Assets in iShares ETFs/ETPs surpassed US$1 Tn at the end of Q2 2014. In the past two years assets invested in iShares ETFs/ETPs have increased by US$351 Bn, while iShares' market share has declined by nearly 1%, falling from 38.7% to 37.9%. YTD iShares gathered the largest in net inflows, US$38.0 Bn, followed by Vanguard with US$34.7 Bn, First Trust with US$6.51 Bn, Nomura AM with US$4.66 Bn and Guggenheim with US$4.39 Bn in net inflows.

Source: ETFGI.com

Please contact **deborah.fuhr@etfgi.com** if you would like to subscribe to ETFGI's monthly **Global ETF** and **ETP industry insights reports**, containing over 300 pages of charts and analysis, **ETFGI's Institutional Users of ETFs** and **ETPs report** or custom analysis. Professional investors can register on ETFGI's website to receive updates, press releases and ETFGI's free monthly newsletter.

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CONTENTS

Foreign Withholding Taxes on ETFs for Canadian Investors

When investing in foreign securities, the most tax-efficient ETFs available to Canadian investors are Canadian-listed ETFs that invest directly in a portfolio of international stocks. Knowing more about how your ETFs are structured may mean more investor savings.

Barry Gordon
CEO & President, First Asset Exchange Traded Funds

While it is true that you can't avoid paying taxes, when it comes to exchange traded funds, there are some strategies available to help minimize the withholding tax that you are subject to. By fully understanding how ETFs are taxed, you can ensure you are choosing the most tax-efficient investment solution available to you. ***First Asset Exchange Traded Funds*** *offer a variety of tax-efficient ETF solutions to include in your portfolio.*

ETF structures and withholding taxes

When investing in an Exchange Traded Fund (ETF), you should be familiar with how the ETF obtains exposure to international markets. An ETF's structure and the type of account used to hold it could significantly affect how much withholding tax an investor is subject to. Once you understand the impact of foreign withholding taxes on ETFs, you will be better equipped to make investment choices that will maximize your after-tax returns.

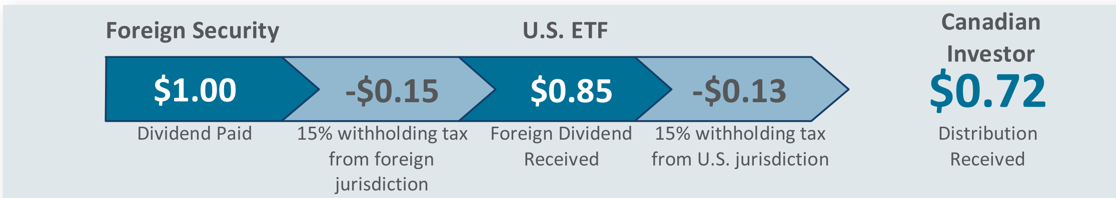
There are three common ETF structures available to Canadian investors that provide access to international markets. First Asset's international ETFs employ the most tax-efficient structure by investing directly in portfolios of international stocks (see Structure 3).

FIRSTASSET™
Exchange Traded Funds

Structure 1

U.S.-listed ETF that invests directly in international stocks - investor has direct exposure to international markets

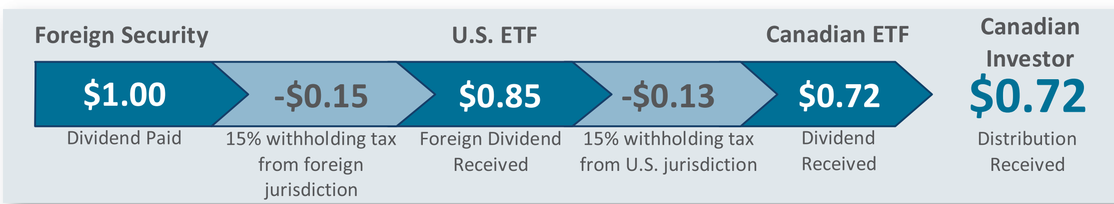
With this first structure, there are two levels of withholding tax a Canadian investor may be exposed to. First, an investor is subject to the taxes levied by the country in which each foreign stock is based. Second, the U.S. government may levy an additional withholding tax, up to 15%, on certain distributions made by the U.S. ETF to a Canadian investor's account. The amount of taxation depends on local jurisdictional tax legislation, as well as any respective income tax treaties.



Structure 2

Canadian-listed ETF holding a U.S.-listed ETF that invests in a portfolio of international stocks - investor has indirect exposure to international markets

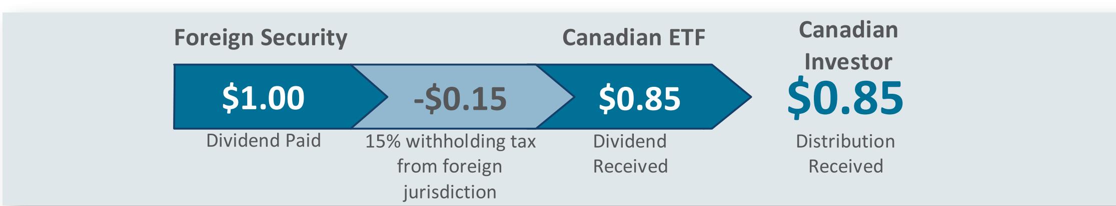
Also known in Canada as a "wrapped" ETF, within this structure a dividend paid by a foreign company may be subject to withholding taxes since the payments are sent to the U.S. ETF. Distributions by the U.S. ETF may then be subject to an additional U.S. withholding tax as they are distributed to the Canadian ETF.



Structure 3

Canadian-listed ETF that invests directly in a portfolio of international stocks - investor has direct exposure to international markets

This is the most tax-efficient ETF available to Canadian investors. Withholding tax only applies to the Canadian investor according to the country where the foreign stock is domiciled. A dividend paid by a foreign company may be subject to one level of withholding tax as the payments are made to the Canadian ETF.



Continued on page 6

Continued from : Foreign Witholding Taxes... page 5

First Asset's International ETF solutions

First Asset ETFs are Canadian-listed and invest directly in U.S. and international securities. Our ETF solutions are structured to ensure that Canadian investors are only subject to one level of withholding tax, making our ETFs more tax-efficient than investing in fund-of-fund structures.

US Equity	ETF Ticker[1]
First Asset Morningstar US Value Index ETF (CAD Hedged)	XXM
First Asset Morningstar US Momentum Index ETF (CAD Hedged)	YXM
First Asset Morningstar US Dividend Target 50 Index ETF (CAD Hedged)	UXM
First Asset MSCI USA Low Risk Weighted ETF (CAD Hedged)	RWU
European Equity	
First Asset Hamilton Capital European Bank ETF (Actively Managed) ***NEW***	FHB
First Asset MSCI Europe Low Risk Weighted ETF (CAD Hedged)	RWE
Global Equity	
First Asset MSCI World Low Risk Weighted ETF (CAD Hedged)	RWW

1. Common class units. Advisor class units are also available.

From a tax perspective, Canadian investors are best served when investing in international equities directly through Canadian-listed ETFs. To learn more about **First Asset's** tax-efficient ETF products, please contact us today at **1.877.642.1289** or **www.firstasset.com.**

Barry H. Gordon, CEO & President, First Asset Exchange Traded Funds

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Beyond Beta: Overcoming the Pitfalls of Traditional Weighted Strategies

Examining Various Weighting Strategies.

Trevor Cummings
Head of Business Development, Exchange Traded Funds, RBC Global Asset Management

With few exceptions, market-cap-weighted indices have been accepted as the appropriate measure of market beta. Initially, ETFs were introduced as an efficient, cost-effective solution designed to deliver beta-like returns. However, as the ETF market has developed, many of today's ETFs aim to provide either "better" beta (such as market-like returns with lower volatility) or alpha generation. A simple first step towards the goal of delivering alpha or enhanced beta often involves implementing a weighting system that differs from the traditional market-cap strategy.

In this article, we examine various weighting strategies, including:
• The challenges and risks of traditional market-cap weighting strategies.
• Popular weighting strategies used by many of today's dividend-focused ETFs.
• A new weighting methodology brought to market by RBC Quant Dividend Leaders ETFs.

Market-cap weighting biases

Market-cap weighting has long been accepted as the standard measure of market beta. This isn't likely to change anytime soon and will likely always be the benchmark against which other strategies are measured. However, the biases that lie within a market-cap strategy can result in both poor diversification and questionable market timing.

Large-cap bias

The large-cap bias in a market-cap strategy often drives unreasonably high single-name exposure, which results in poor diversification. For example, today, Apple represents about 17.5% of the S&P 500's Information Technology sector and over 11% of the NASDAQ 100. Furthermore, many Canadian investors will recall the period when Nortel represented about 30% of the entire Canadian equity market.

For a broad all-cap strategy like the Russell 3000, market-cap weighting also virtually nullifies small-cap performance. For example, over the past 10 years, U.S. small caps outperformed large caps by about 1.3% annually. However, returns for the all-cap Russell 3000 Index, which includes large caps and small caps, were only 0.1% ahead of the Russell 1000 Index, which includes only large caps. (see table below).

Despite Small-Cap Outperformance, They Add Little Value to a Market Weighted All-Cap Strategy

Asset Class	Market-Cap-Weighted Benchmark	10-Year Returns As of 31-Dec-13
U.S. large caps	Russell 1000 Index US$	7.78%
U.S. small caps	Russell 2000 Index US$	9.07%
U.S. all caps	Russell 3000 Index US$*	7.88%

*Russell 3000 Index combines all Russell 1000 and Russell 2000 companies

Momentum bias

Market-cap strategies also introduce a momentum bias that tends towards maximizing positions in stocks at their highs and minimizing positions at their lows – often selling a company altogether when it is cut from an index at an all-time low.

"One way of illustrating momentum risk in market-cap indices is to consider that such passive strategies usually reach maximum investment or weight in a company close to its high and a minimum weight close to its low. The economics of this risk are not attractive; and, in fact, it's economics that explain the result as large, successful companies face competitive pressure from new and more agile competition, diminishing their world-beater status."

Bill Tilford, Head of Quantitative Investments,
RBC Global Asset Management

Capped indices do little to solve the problem

Capped strategies place a cap, often around 10%, on single-name exposure as a way to mitigate some of the momentum and large-cap biases of a market-cap strategy. In a small portfolio of 30 or fewer names, a 10% single-name exposure cap may be reasonable. However, for strategies that aim to invest across the full breadth of the market, capping single names generally does little to eliminate large-cap and momentum biases or provide meaningful exposure to small or mid caps.

Equal weight performs well, but new problems arise

Equal-weight strategies are a simple way to reduce the large-cap and momentum biases of market-cap weighting and they generally back-test well from a performance standpoint. However, equal weighting simply introduces a small-cap bias – picture the smallest company on the Russell 3000, which is Covisint, being equally weighted with Apple in a portfolio; or, in Canada, a $600 million company such as Wajax being equally weighted with a $100 billion company like RBC.

Small-cap biases such as these can introduce problematic liquidity risks and trading costs, especially once an ETF gains significant assets. There are three main reasons for this:

1. Small-cap liquidity can be poor, which drives up trading costs and liquidity premiums.
2. The high turnover rate from constantly rebalancing to bring weightings back to equal can be cost prohibitive.
3. Equal-weight positions can also result in a larger ETF becoming a material shareholder in a small-cap name, bringing with it potential governance and disclosure issues.

"When evaluating any weighting or rules-based strategy, it's important to consider the potential capacity of the strategy in relation to the size of the pool of assets to be managed. It's one thing to maybe run $5 million with some of these ideas. It's a whole other topic to get $5 billion into these strategies."

Bill Tilford, Head of Quantitative Investments,
RBC Global Asset Management

High-yield dividend strategies

Record low interest rates and income-seeking baby boomers are increasingly supporting the need for dividend-paying investments. The result in the ETF industry has been a large number of ETFs investing solely in high-dividend-paying or dividend-growing stocks.

While many of these strategies can be effective in providing the higher income investors desire, traditional weighting strategies used by many of these solutions are fraught with the same large-cap and momentum biases that we have discussed previously.

Some dividend-focused ETFs utilize a yield-weighted strategy, placing a higher weighting on higher-yielding companies and vice versa. Simply put, most investors are well aware that high yields are often red flags pointing to a potential dividend cut or other financial trouble for a company. Yet these strategies allocate their highest weights to these companies.

Continued on page 10

Continued from : Beyond Beta page 9

If dividends are eventually cut, the stock price often drops long before many ETF strategies can respond by rebalancing and eliminating or reducing the position. The subsequent capital loss can be many multiples of the dividend received – and take years to recover.

A new innovative approach to weighting

With market-cap and equal-weight strategies, investors are forced to make a mutually exclusive decision to either accept large-cap and momentum biases or introduce small-cap biases and liquidity risk. Neither of these scenarios is desirable on a long-term basis.

Developing a new approach

To solve for this problem, the RBC Quantitative Investment Management team devised an approach that minimizes weighting biases and liquidity risks while providing long-term outperformance. Factors that they address include:

1. The economic reality that most large- and mega-caps are unlikely to outperform the market in a meaningful way over the long term. Why? Firms have trouble holding on to economic or technological advantages over the long term. New entrants can move more quickly, employees leave and join competitors, patents expire, etc.
2. Large- and mega-cap stocks nonetheless have an important diversification role to play in a portfolio.
3. The economic reality that small and mid caps are likely to outperform the broad market over the long term.
4. How to introduce a meaningful position in small and mid caps without introducing problematic liquidity risk.
5. Ensuring the weighting strategy could be implemented in a larger mandate.

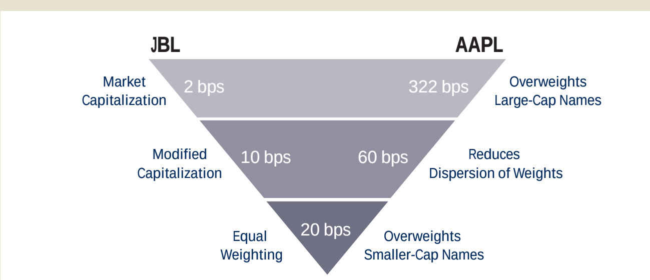
Modified-cap weighting

The team's research led to the development of a proprietary modified-cap weighting system. The strategy uses a formulaic weighting system designed to optimally smooth the weight differentials of large caps relative to small caps.

Striking the right balance

As shown in the table below, the modified-cap strategy bridges the gap between its market-cap and equal-weight counterparts. When compared to the cap-weighted S&P 500 Index, modified-cap weighting significantly reduces single-name exposure to large-cap stocks, such as Apple (AAPL), and increases exposure to the smaller companies on the index, such as Jabil Circuits (JBL).

S&P 500: Alternative Weighting Schemes

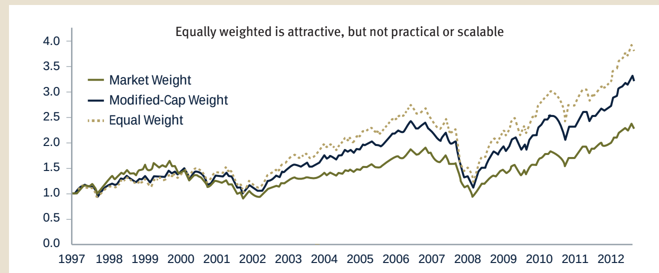


Performance and feasibility

After extensive back-testing and scenario analysis across all major equity indices, the team determined that over the long term:

1. Liquidity risk would be low in a modified-cap-weighted mandate, even one with large AUM.
2. The strategy should contribute to alpha over the long term relative to a cap-weighted strategy (see chart below).
3. A broad market approach would be most desirable – one that includes small-, mid- and large-cap stocks.

S&P 500: Alternative Weighting Schemes



Source: RBC Global Asset Management. Jan. 1997–Aug. 2013.

RBC Quant Dividend Leaders ETFs bring the strategy to life

With traditional weighting systems, investors are either forced to choose between large-cap risks and biases, small-cap risks and biases, or high-dividend risk. To address these challenges and provide the potential to generate alpha, modified-cap weighting has been implemented across RBC Quant Dividend Leaders ETFs. In addition to enhanced risk-return potential, modified-cap weighting benefits these ETFs by providing:

- Access to the full breadth of the market with minimized liquidity risk.
- Exposure to the growth potential of small- and mid-cap stocks.
- Exposure to the diversification benefits of large-cap stocks.

In combining this innovative weighting strategy with a high-quality dividend portfolio, RBC Quant Dividend Leaders ETFs stand apart as a versatile and cost-effective tool that can serve as either a core or satellite component of a portfolio.

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Trevor Cummings, Head of Business Development, Exchange Traded Funds, RBC Global Asset Management ***etfs.investments@rbc.com***

Fundamentally Better – The Evolution of Index Investing

"How's the market doing?"

Karl Cheong, CFA
Senior Vice President,
Head of Product Development,
First Trust Portfolios Canada

Early Days of Indexing

The most common question on the minds of investors is *"How's the market doing?"*. But rarely do we stop to ask, *"What exactly is the "market" and how is it defined?"*. Even novice investors recognize the common definitions of the various stock markets (i.e. well publicized market indexes such as the S&P/TSX Composite Index which represents the performance of the Canadian stock market). Today, equity indexes have evolved from a few relatively simple structures to many complex variations, some which have become extremely sophisticated in their construction, but that was not always the case.

Originally, indexes were designed to measure the average performance of a group of stocks that were considered representative of the broad market. Indexes were also developed to serve as benchmarks that investors could use to gauge the performance of professional investment advisors. Because indexes were intended to mirror the market, the vast majority weighted stocks according to market capitalization which gave a greater weight to the movements of large company stock prices compared to those of small company stock prices. Later, mutual funds and ETFs were introduced which were designed to track the performance of these traditional market capitalization weighted indexes.

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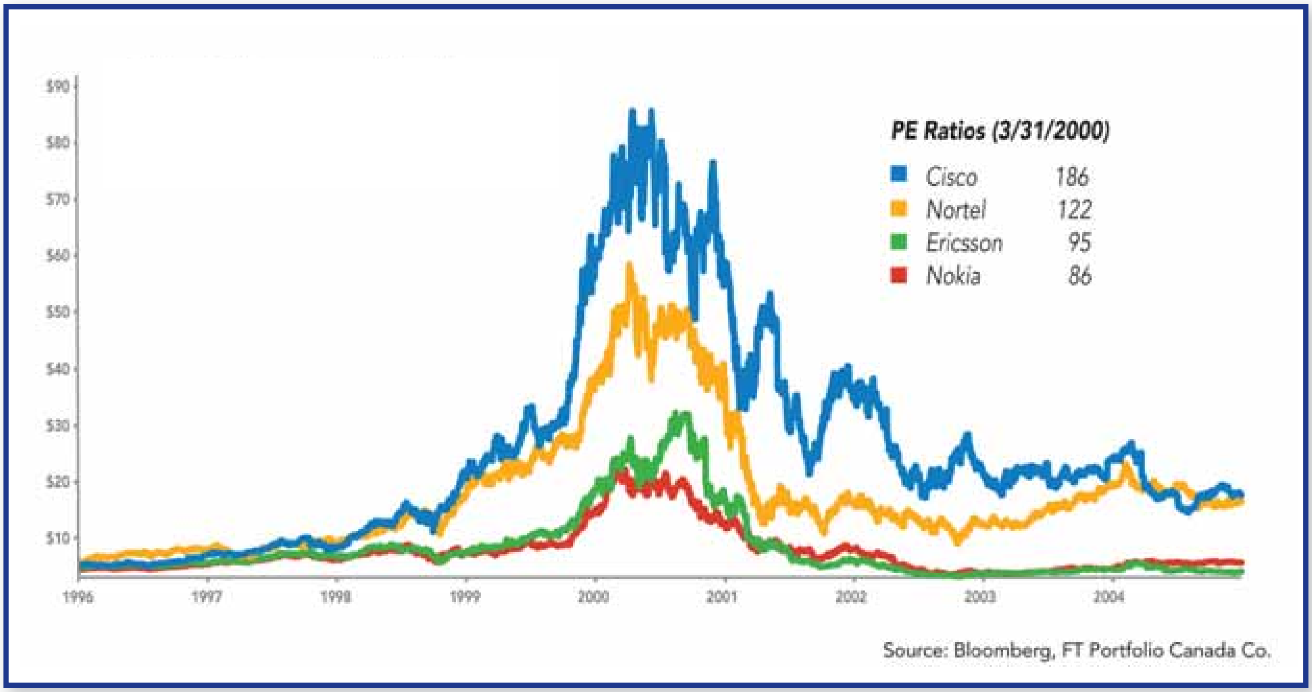
Problem with Market Capitalization Weighting

The market is generally extremely efficient at reflecting the prices investors are currently willing to pay for a company based on available information. However, the market is not immune to periods of speculation and changes in investor sentiment which can cause a company's share price to deviate significantly from its fundamental value. This scenario is best demonstrated by the internet and technology-driven bull market in the late 1990's (see chart below). This period of market speculation exposed a potential flaw inherent in capitalization weighted indexes. Capitalization weighted indexes, by their very nature, were forced to overweight larger overvalued companies and underweight smaller, potentially undervalued companies causing a drag on an index's returns.

The Rise and Fall of Technology stocks



The chart above is meant to illustrate the technology bubble crash which is widely accepted to have occurred on March 10, 2000.

Fundamentals Matter

Many investors have started to embrace fundamental indexing due to the tendency for stock prices to deviate from a company's true value. Unlike traditional market capitalization weighted indexes which rely solely on the price that the market places on a company to determine its weight in the index, fundamentally weighted indexes evaluate a company based on fundamental measures such as price to book value and price to cash flow to determine a company's weight within an index. As a result, fundamental weighting attempts to limit exposure to over-priced stocks and increase exposure to those which are trading at more attractive valuations. While different methods of indexing are plagued by different inherent limitations, fundamental indexes have historically generated higher returns[1] and often times lowered volatility when compared to market cap weighted indexes. While the majority of ETFs and assets under management in Canada currently follow market capitalization weighted indexes, I believe investors will seek to diversify their portfolios into fundamental strategies as part of a natural evolution and trend toward diversification among investment strategies.

[1] Tzee-man Chow, Jason Hsu, Vitali Kalesnik, and Bryce Little. 2011. "A Survey of Alternative Equity Index Strategies" Journal of Finance, vol. 67, no. 5 (September/October):37-56

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KEY POINTS

1. Smart beta strategies are countercyclical, periodically rebalancing out of winning stocks and into losers. They may underperform for extended periods but they ultimately tend to prevail.

2. Investors' procyclical behavior, selling recent losers and buying recent winners, pays for the estimated 2% per year in long-term value added by smart beta strategies.

3. Smart beta investing can be reasonably expected to have an edge as long as investors persist in following trends and chasing performance.

Slugging It Out in the Equity Arena

"No más." One of the most memorable boxing matches in history ended when those two words were uttered by Roberto Durán in the eighth round of his title rematch with Sugar Ray Leonard in 1980. Nearly 34 years later, Durán's reasons for walking out of the ring remain a matter of speculation and controversy. Was it stomach cramps? An injury? Or simply frustration at being outclassed by an opponent he had beaten soundly a scant five months earlier? Regardless, his quitting sent shockwaves through his native Panama and the entire boxing world. For Durán was the quintessential tough guy. He grew up on the hard streets of Panama City and became a professional fighter at the age of 16; his brawling style spawned the nickname "Manos de Piedra" (hands of stone). If there were "a least likely to quit mid-fight" award, Durán would win it hands down. But, whatever the reason, he just couldn't take it any longer.

Like prizefighters, investors can take quite a beating. Sometimes the blows are absolute, catastrophic losses. But more often the jabs and uppercuts come in the form of relative shortfalls. Fortified with long investment horizons, diversified rosters of managers, limited short-term liquidity needs, and ample risk tolerances, most investors should be tough enough to absorb the punishment. But all too often they, too, are sorely tempted to give up the good fight and abandon their convictions in the middle rounds. Hope fades, and they sell the stocks that have lost value. Desperation sets in, and they buy stocks that have already appreciated, on the chance they might continue to rise. In short, they quit.

Selling recent losers and buying recent winners is the antithesis of the systematic rebalancing discipline through which smart beta strategies earn long-term excess returns. Indeed, we contend that this procyclical behavior is what pays, over time, for the value added by fundamentally weighted index investing and other smart beta strategies.

Smart Betas Trading

To us, the smart beta moniker refers to rules-based investment strategies that use non-price-related weighting methods to construct and maintain a portfolio of stocks.[1] The research literature shows that smart beta strategies earn long-term returns around 2% higher than market capitalization-weighted indices. Moreover, smart beta strategies do not require any insight into the weighting mechanism. One can build a smart beta strategy with any stock ranking methodology that is not related to prices, from a strategy as naïve and transaction-intensive as equal weighting to a more efficient approach such as weighting on the basis of fundamental economic scale. For example, a low volatility portfolio and its inverse, a high volatility portfolio, both outperform the market by roughly

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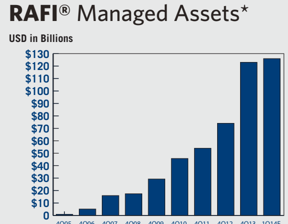

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2%—as long as they are systematically rebalanced.[2] It is not the weighting method but the rebalancing operation that creates most of smart beta's excess return. Acting in a countercyclical or contrarian fashion, smart beta strategies buy stocks that have fallen in price and sell stocks that have risen.

Because all smart beta strategies are inherently doing the same thing—contra-trading against price movements by means of the rebalancing process—they are generally buying and selling the same stocks.[3] It seems reasonable to assume they have pretty much the same trading partners.

To illustrate this commonality, we analyzed the 2013 reconstitution of a fundamentals-weighted index in the light of the constituents' recent performance. **Table 1** lists the top 20 portfolio holdings by weight prior to rebalancing. We evaluated how the stock performed relative to the market over the previous 12 months and noted whether the rebalancing trade was a purchase or a sale. In 90% of the observations, the fundamentally weighted index is buying when the stock underperforms and selling when the stock outperforms.[4] To see whether another smart beta strategy would have traded the same stocks in the same direction, we also looked at the transactions that would have been executed by a hypothetical equal-weighted index whose holdings were contained in the Russell 1000® Index. The fundamentals- and equal-weighted strategies bought and sold 80% of the same stocks. These results indicate that smart beta strategies with meaningfully different weighting methodologies tend to engage in similar countercyclical stock trading.

"Like prizefighters, investors can take quite a beating."

Who Trades Opposite Smart Beta?

The stock market is an equilibrium market. For every trade, there must be a buyer and a seller, and for one investor to profit another must lose. This simple arithmetic means that investors

Table 1. Going the Same Direction (March 2013)

Top 20 Holdings	Weight (% of Total): Pre-Reconstitution	Weight (% of Total): Post-Reconstitution	Relative Performance* (%)	Reconstitution Trades: Fundamentals-Weighted	Reconstitution Trades: Equal-Weighted
Bank of America	3.16	2.22	14.31	Sell	Sell
Exxon Mobil	2.74	2.98	−12.65	Buy	Buy
General Electric	2.26	1.94	1.54	Sell	Sell
Citigroup	2.15	1.65	9.25	Sell	Sell
AT&T	2.11	2.08	2.69	Sell	Sell
JPMorgan Chase	1.96	1.78	−4.18	Sell	Sell
Chevron	1.77	1.97	−6.64	Buy	Buy
Pfizer	1.64	1.40	14.17	Sell	Sell
Wal-Mart	1.58	1.03	4.09	Sell	Sell
Verizon	1.54	1.43	8.22	Sell	Sell
Berkshire Hathaway	1.47	1.12	7.70	Sell	Sell
Wells Fargo	1.31	1.44	−3.52	Buy	Sell
Johnson & Johnson	1.15	1.13	7.17	Sell	Sell
Procter & Gamble	1.06	1.11	−1.08	Buy	Sell
ConocoPhillips	0.90	1.33	−14.32	Buy	Buy
IBM	0.81	0.92	−11.88	Buy	Buy
Goldman Sachs	0.80	0.59	8.11	Sell	Sell
Microsoft	0.78	0.99	−28.27	Buy	Buy
Merck	0.75	0.78	2.84	Buy	Sell
Home Depot	0.64	0.48	25.98	Sell	Sell

*Relative performance is the stock's total return minus the total return of the Russell 1000® Index from March 19, 2012 to March 15, 2013.
Source: Research Affiliates, based on data from FactSet.

in aggregate will earn the market return and no more. Indeed, less, because Jack Bogle's "Cost Matters Hypothesis" is right: *"Gross returns in the financial markets minus the costs of financial intermediation equal the net returns actually delivered to investors."*[5] And if we take away the low-cost index funds, what's left are the active managers, whose investment management fees are much higher. In Bogle's phrase, it's humble arithmetic—index investors will win. Nonetheless, smart beta strategies claim to beat the market by 2%. What gives?

Clearly, there is no way to determine precisely who trades with fundamentals-weighted and other smart beta strategies. Conceptually, however, investors taking the other side of smart beta trades would be those who buy stocks after they rise in price and sell after they fall. They are trend-following, performance-chasing investors; we consider them "procyclical" investors. Smart beta strategies are countercyclical, periodically rebalancing out of what has been working and into less favored stocks. We believe actively managed portfolios, cap-weighted index funds, and many ETFs trade procyclically, but in a larger sense smart beta strategies' most important trading partners are the end investors—the clients who channel cash to investment vehicles.

Procyclical Investors

Many investors are procyclical. Russ Kinnel of Morningstar published "Mind the Gap 2014," updating his seminal 2005 article that compared reported mutual fund performance with the returns actually earned by the average investor. The gap—the difference between the fund's

> *"For one investor to profit, another must lose."*

total time-weighted return and the average investor's money-weighted return—reflects the value added (or subtracted) by investors' decisions to move cash into and out of funds. In other words, the gap is the return impact of investors' market timing decisions (**Table 2**).[6]

The conclusion is not unexpected, but it's still stunning. Over the past 10 years, the average investor earned a return that was 2.5% worse than the return of the average fund they invested in! The drag ranged from −1.7% for U.S. equities to −3.1% for sector funds. Kinnel's findings are consistent over different long-term time periods and across all asset classes. Of course, these are retail investors; one might expect to find that they are prone to run as a herd. But several studies reported in peer-reviewed journals suggest that institutional investors are no less susceptible to the same procyclical behavior, resulting in a return drag between 1% and 2%.[7]

Investors chase returns. Cash streams into outperforming strategies and equity styles. In particular, more capital is channeled to the managers who recently achieved superior results, and so the managers themselves become *de facto* trend chasers, adding to their positions in the same stocks or the same type of stock already in their portfolios. The stocks they buy have lately had strong returns—they are, after all, the very stocks driving the managers' outperformance—and they are probably expensive.

Clearly, there is a common thread when the returns of all kinds of investors (retail and institutional) in all asset classes (stocks, bonds, commodities, and alternatives) fall behind the long-term returns of the funds they invest in. Why do investors persist in costly procyclical behavior? The short answer, as Chris Brightman wrote in this space last month, is that they prefer to do what is comfortable. Buying winners and avoiding losers is a chronic pattern of financial behavior.

Table 2. The Gap Between Fund and Investor Returns

	10-Year Returns through December 31, 2013		
	Total Return (%)	Investor Return (%)	Returns Gap (%)
All Funds	7.30	4.81	−2.49
US Equity	8.18	6.52	−1.66
Sector Equity	9.46	6.32	−3.14
Balanced	6.93	4.81	−2.12
International Equity	8.77	5.76	−3.01
Taxable Bond	5.39	3.15	−2.24
Municipal	3.53	1.65	−1.88
Alternative	0.96	−1.15	−2.11

Source: Research Affiliates based on Kinnel (2014).

Client Behavior: A Case Study

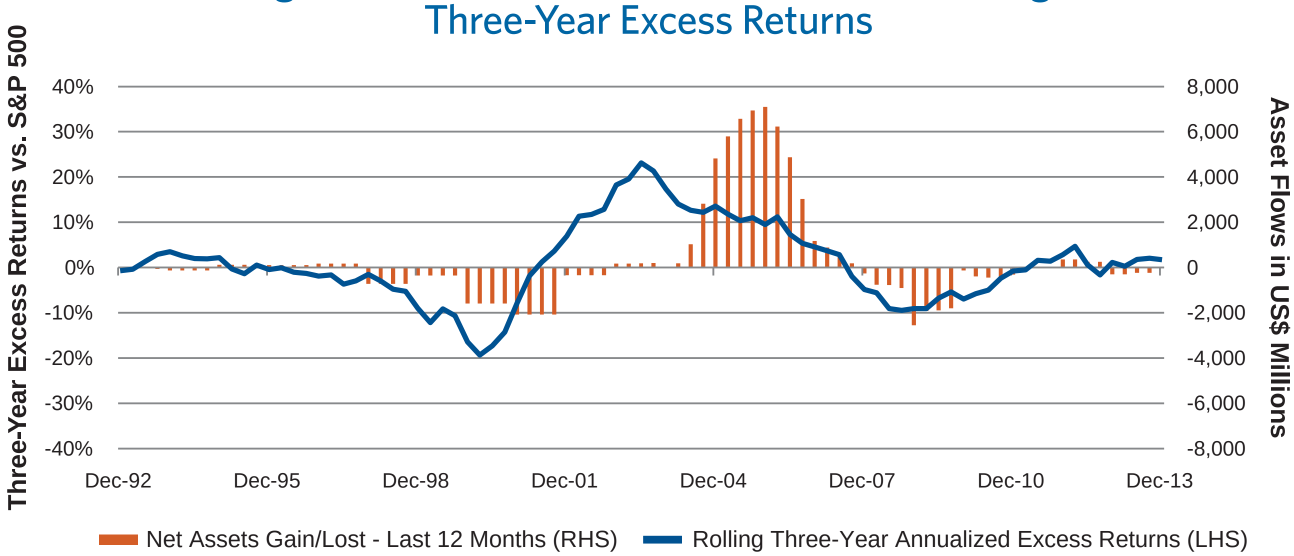
For a more focused investigation of clients' market timing decisions, we looked at a highly reputable asset management boutique with a long track record in value investing. A fund launched by the firm more than 20 years ago has an annualized inception-to-date return that is 1.4% higher than the S&P 500 Index return for the same period. But this exceedingly favorable long-term result came with quite a bit of short-term variability, as one would expect of a value strategy.[8]

The solid line in **Figure 1** shows the cyclicality of the fund's annualized three-year excess returns, which range between 20% below and 23% above the corresponding S&P 500 return. It comes as no surprise that the fund's investors responded to these peaks and troughs in relative performance in a most procyclical manner. The strategy's net asset flows, represented by the columns, track its trailing excess returns quite closely. Higher excess returns are followed by net asset inflows; lower excess returns induce outflows. Moreover, inflows tend to continue rising after performance has peaked (investors buy high), and outflows tend to be greatest after performance has hit bottom (investors sell low).

Smart beta strategies are not taking their 2% excess returns directly from this or any other financial intermediary. As we noted, the long-term excess return of the fund used in this example is positive. Instead, smart beta strategies are earning their value-added returns from end investors whose procyclical behavior forces the manager to sell stocks in bad times (usually when they are at the bottom of a cycle and cheap) and buy stocks in good times (when these stocks have outperformed and are expensive). Smart beta managers and other countercyclical or contrarian investors are the counterparties to those trades.

We took one more step and looked at the largest positions held by the value fund in question at the end of 2008 (**Table 3**). These are stocks they might have been compelled to sell during a period of significant outflows. We further observed that, in the course of rebalancing early in 2009, a fundamentally weighted U.S. large company strategy purchased two-thirds of the value fund's top holdings (the shaded companies in Table 3). And we found much the same phenomenon with other managers who similarly experienced procyclical client behavior. Smart beta strategies were buying the stocks these managers were forced to sell. This is the 2% excess return payment in action.

Figure 1. Value Fund Net Asset Flows vs. Trailing Three-Year Excess Returns



Source: Research Affiliates based on data from eVestment Alliance.

Table 3. Top Holdings of a Value Fund as of December 31, 2008

Company*	Weight (% of Total)
CA	5.76
Philip Morris	5.02
Microsoft	4.60
Bank of America	4.29
Merck & Co.	4.27
Exelon Corp.	4.13
Eli Lilly and Co.	3.79
JPMorgan Chase & Co.	3.58
Home Depot	3.33
Tyco International	3.03
Wells Fargo	2.80
Tyco Electronics	2.67
Safeway	2.67
FPL Group	2.60
Bristol-Myers Squibb	2.40
PACCAR	2.27
Citigroup	2.25
Pfizer	2.10
Lorillard	2.05
eBay	1.78

*Shaded stocks were purchased in the first quarter 2009 rebalancing of a fundamentally weighted U.S. large company index.

Source: Research Affiliates based on data from FactSet.

Procyclical Investing: Can It Last?

In the United States, the sport of boxing has lost much of the popularity it still enjoyed when Sugar Ray Leonard squared off against Roberto Durán. Certainly there are fewer local boxing gyms to supply new generations of trained fighters, perhaps because nowadays many parents encourage their children to take up less dangerous sports. Procyclical investing, however, is as prevalent as ever. To be sure, procyclical investors can prevail over many rounds, and when they win their behavior is reinforced. But researchers in the field of behavioral finance have also identified a series of cognitive biases and psychological inclinations underlying investors' penchant for going along with the emotional crowd. They include overconfidence, a compelling need for social validation, and a confirmation bias that leads people to discount or disregard contrary evidence. Because it is hard for people to change their habitual ways of thinking, we do not anticipate a mass movement toward countercyclical investing anytime soon. And as long as investors persist in following trends and chasing returns, someone will throw in the towel and take the other side of smart beta trades.

> *"We do not anticipate a mass movement toward countercyclical investing."*

Endnotes

1. Research Affiliates did not coin the popular term smart beta. We are using it as a convenient way to refer to non-price-weighted, rules-based investment strategies in which periodic rebalancing is the central mechanism for capturing premium returns.
2. The risk-adjusted returns may differ. For example, over the 1964–2012 period, a portfolio whose stock weights were based on the standard deviation σ of monthly returns over five years (thus, a high-volatility portfolio) had a Sharpe ratio of 0.36. The inverse portfolio whose stocks were weighted by $1/\sigma$ (therefore, a low-volatility portfolio) had a Sharpe ratio of 0.47. See Arnott, Hsu, Kalesnik, and Tindall (2013).
3. This does not mean the trades are precisely the same. Different weighting methods will naturally result in somewhat different rebalancing transactions. Portfolios are also likely to operate on different rebalancing schedules.
4. We also looked at full portfolios for a fundamentally weighted and an equal-weighted index and found they executed countercyclical trades (buying underperforming stocks and selling outperforming stocks) in 75% of their stock positions at the latest reconstitution.
5. Bogle (2005), p. 22. Bogle's emphasis.
6. Because investment managers generally don't control the timing and magnitude of external cash flows (that is, investors' contributions and withdrawals), they quite properly report returns on a time-weighted basis. The investors' experience, however, is reflected by their individual money-weighted returns, which do take external cash flows into account. Kinnel uses industry aggregate cash flow information to estimate the average investor's actual return. For more information about time-weighted and money-weighted rates of return, see Bailey, Richards, and Tierney (2007), pp. 724–729.
7. See Stewart, Neumann, Knittel, and Heisler (2009) and Goyal and Wahal (2008).
8. We also analyzed the results against an appropriate value style index and found nearly identical results. We chose to show the S&P 500 here because we wanted to display the cyclicality of excess returns against the broad market.

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Performance Update

FTSE RAFI® Equity Index Series*

TOTAL RETURN AS OF 3/31/14	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	5 YEAR	10 YEAR	10 YEAR STANDARD DEV.
FTSE RAFI® All World 3000[1]	TFRAW3	1.97%	21.39%	9.11%	21.33%	9.70%	18.60%
MSCI All Country World[2]	GDUEACWF	1.21%	17.17%	9.14%	18.43%	7.53%	16.63%
FTSE RAFI® Developed ex US 1000[3]	FRX1XTR	1.73%	24.05%	6.38%	18.18%	8.15%	20.31%
MSCI World ex US[4]	MLCUWXUG	0.86%	17.00%	6.80%	16.44%	7.21%	18.27%
FTSE RAFI® Developed ex US Mid Small[5]	TFRDXUSU	2.74%	18.45%	7.26%	21.86%	10.31%	18.77%
MSCI World ex US Small Cap[6]	GCUDWXUS	3.55%	21.56%	7.95%	21.94%	8.80%	20.17%
FTSE RAFI® Emerging Markets[7]	TFREMU	-1.63%	-5.11%	-5.51%	13.33%	12.69%	24.40%
MSCI Emerging Markets[8]	GDUEEGF	-0.37%	-1.07%	-2.54%	14.83%	10.45%	23.96%
FTSE RAFI® 1000[9]	FR10XTR	2.49%	23.25%	15.38%	26.41%	9.33%	17.18%
Russell 1000[10]	RU10INTR	2.05%	22.41%	14.75%	21.73%	7.80%	15.01%
S&P 500[11]	SPTR	1.81%	21.86%	14.66%	21.16%	7.42%	14.71%
FTSE RAFI® US 1500[12]	FR15USTR	1.61%	28.91%	14.41%	30.86%	11.33%	21.78%
Russell 2000[13]	RU20INTR	1.12%	24.90%	13.18%	24.31%	8.53%	19.74%
FTSE RAFI® Europe[14]	TFREUE	3.97%	35.36%	7.94%	19.54%	8.85%	22.87%
MSCI Europe[15]	GDDLE15	2.21%	25.20%	9.05%	18.22%	8.03%	20.00%
FTSE RAFI® Australia[16]	FRAUSTR	5.90%	1.03%	7.17%	21.52%	12.28%	23.98%
S&P/ASX 200[17]	ASA51	5.76%	0.87%	4.65%	20.12%	11.51%	24.34%
FTSE RAFI® Canada[18]	FRCANTR	1.55%	7.76%	1.61%	19.75%	11.45%	21.16%
S&P/TSX 60[19]	TX60AR	1.57%	6.53%	-0.74%	15.34%	10.21%	21.41%
FTSE RAFI® Japan[20]	FRJPNTR	-5.44%	9.81%	4.95%	11.17%	3.29%	16.24%
MSCI Japan[21]	GDDLJN	-5.47%	7.77%	5.57%	10.53%	2.32%	15.87%
FTSE RAFI® UK[22]	FRGBRTR	-0.50%	19.85%	10.55%	20.47%	7.49%	19.60%
MSCI UK[23]	GDDLUK	-0.82%	16.81%	9.04%	18.64%	6.84%	17.82%

*To see the complete series, please go to: http://www.ftse.com/Indices/FTSE_RAFI_Index_Series/index.jsp.

Russell Fundamental Index Series*

TOTAL RETURN AS OF 3/31/14	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	5 YEAR	10 YEAR	10 YEAR STANDARD DEV.
Russell Fundamental Global Index Large Company[24]	RUFGLTU	1.92%	21.92%	10.38%	20.71%	9.86%	16.93%
MSCI All Country World Large Cap[25]	MLCUAWOG	0.94%	16.88%	9.15%	17.88%	7.17%	16.33%
Russell Fundamental Developed ex US Index Large Company[26]	RUFDXLTU	2.57%	26.40%	7.69%	17.57%	8.75%	18.41%
MSCI World ex US Large Cap[27]	MLCUWXUG	0.52%	16.69%	6.81%	16.06%	6.93%	18.16%
Russell Fundamental Developed ex US Index Small Company[28]	RUFDXSTU	2.32%	20.48%	9.83%	22.00%	10.28%	18.09%
MSCI World ex US Small Cap[6]	GCUDWXUS	3.55%	21.56%	7.95%	21.94%	8.80%	20.17%
Russell Fundamental Emerging Markets[29]	RUFGETRU	-1.84%	-0.09%	-2.05%	16.49%	13.83%	23.94%
MSCI Emerging Markets[8]	GDUEEGF	-0.37%	-1.07%	-2.54%	14.83%	10.45%	23.96%
Russell Fundamental US Index Large Company[30]	RUFUSLTU	2.15%	22.04%	15.55%	24.20%	9.69%	15.57%
Russell 1000[10]	RU10INTR	2.05%	22.41%	14.75%	21.73%	7.80%	15.01%
S&P 500[11]	SPTR	1.81%	21.86%	14.66%	21.16%	7.42%	14.71%
Russell Fundamental US Index Small Company[31]	RUFUSSTU	2.62%	26.95%	14.62%	30.22%	12.33%	20.78%
Russell 2000[13]	RU20INTR	1.12%	24.90%	13.18%	24.31%	8.53%	19.74%
Russell Fundamental Europe[32]	RUFEUTE	3.68%	32.73%	8.20%	19.70%	10.03%	21.29%
MSCI Europe[15]	GDDLE15	2.21%	25.20%	9.05%	18.22%	8.03%	20.00%

*To see the complete series, please go to: http://www.russell.com/indexes/data/Fundamental/About_Russell_Fundamental_indexes.asp.

Performance Update

Fixed Income/Alternatives

TOTAL RETURN AS OF 3/31/14	BLOOMBERG TICKER	YTD	12 MONTH	ANNUALIZED 3 YEAR	5 YEAR	10 YEAR	10 YEAR STANDARD DEV.
RAFI® Bonds US Investment Grade Master[33]	—	2.97%	0.93%	5.96%	9.34%	5.57%	5.82%
ML Corporate Master[34]	C0A0	2.97%	1.42%	6.04%	9.89%	5.28%	5.95%
RAFI® Bonds US High Yield Master[35]	—	2.61%	5.42%	8.60%	17.82%	9.15%	9.45%
ML Corporate Master II High Yield BB-B[36]	H0A4	2.98%	6.92%	8.51%	15.80%	7.86%	9.15%
RAFI® US Equity Long/Short[37]	—	1.19%	7.83%	3.29%	11.80%	4.93%	11.26%
1-Month T-Bill[38]	GB1M	0.01%	0.03%	0.04%	0.07%	1.48%	0.53%
FTSE RAFI® Global ex US Real Estate[39]	FRXR	-2.61%	2.04%	4.61%	21.67%	—	—
FTSE EPRA/NAREIT Global ex US[40]	EGXU	-0.32%	-2.58%	5.45%	18.49%	—	—
FTSE RAFI® US 100 Real Estate[41]	FRUR	8.15%	2.27%	10.08%	33.19%	—	—
FTSE EPRA/NAREIT United States[42]	UNUS	10.15%	4.58%	10.52%	28.69%	—	—
Citi RAFI Sovereign Developed Markets Bond Index Master[43]	CRFDMU	2.49%	2.98%	3.82%	5.41%	5.31%	7.32%
Merrill Lynch Global Governments Bond Index II[44]	W0G1	2.68%	1.04%	2.00%	3.92%	4.28%	6.70%
Citi RAFI Sovereign Emerging Markets Local Currency Bond Index Master[45]	CRFELMU	1.62%	-9.69%	—	—	—	—
JPMorgan GBI-EM Global Diversified[46]	JGENVUUG	1.90%	-7.14%	—	—	—	—

Sources and Method: All index returns are calculated using total return data from Bloomberg and FactSet. Returns for all single country strategies and Europe regional strategies are in local currency. All other returns are in USD. Annualized returns are geometrically linked returns, calculated using monthly data. Annualized standard deviation is calculated using sample standard deviation and monthly return data.

Definition of Indices

(1) The FTSE RAFI® All World 3000 Index is a measure of the largest 3,000 companies, selected and weighted using fundamental factors; (sales, cash flow, dividends, book value), across both developed and emerging markets.

(2) The MSCI All Country World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets.

(3) The FTSE RAFI® Developed ex US 1000 Index is a measure of the largest 1000 non U.S. listed, developed market companies, selected and weighted using fundamental factors; (sales, cash flow, dividends, book value).

(4) The MSCI World ex US Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets, excluding the United States.

(5) The FTSE RAFI® Developed ex US Mid Small Index tracks the performance of small and mid-cap companies domiciled in developed international markets (excluding the United States), selected and weighted based on the following four fundamental measures of firm size: sales, cash flow, dividends and book value.

(6) The MSCI World ex US Small Cap Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of small cap developed markets, excluding the United States.

(7) The FTSE RAFI® Emerging Markets Index comprises the largest 350 Emerging Market companies selected and weighted using fundamental factors (sales, cash flow, dividends, book value).

(8) The MSCI Emerging Markets Index is an unmanaged, free-float-adjusted cap-weighted index designed to measure equity market performance of emerging markets.

(9) The FTSE RAFI® 1000 Index is a measure of the largest 1,000 U.S. listed companies, selected and weighted using fundamental factors; (sales, cash flow, dividends, book value).

(10) The Russell 1000 Index is a market-capitalization-weighted benchmark index made up of the 1,000 highest-ranking U.S. stocks in the Russell 3000.

(11) The S&P 500 Index is an unmanaged market index that focuses on the large-cap segment of the U.S. equities market.

(12) The FTSE RAFI® US 1500 Index is a measure of the 1,001st to 2,500th largest U.S. listed companies, selected and weighted using fundamental factors; (sales, cash flow, dividends, book value).

(13) The Russell 2000 is a market-capitalization weighted benchmark index made up of the 2,000 smallest U.S. companies in the Russell 3000.

(14) The FTSE RAFI® Europe Index is comprised of all European companies listed in the FTSE RAFI® Developed ex U.S. 1000 Index, which in turn is comprised of the largest 1,000 non U.S. listed developed market companies, selected and weighted using fundamental factors; (sales, cash flow, dividends, book value).

(15) The MSCI Europe Index is a free-float adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe.

(16) The FTSE RAFI® Australia Index is comprised of all Australian companies listed in the FTSE RAFI® Developed ex U.S. 1000 Index, which in turn is comprised of the largest 1,000 non U.S. listed developed market companies, selected and weighted using fundamental factors; (sales, cash flow, dividends, book value).

(17) The S&P/ASX 200 Index, representing approximately 78% of the Australian equity market, is a free-float-adjusted, cap-weighted index.

(18) The FTSE RAFI® Canada Index is comprised of all Canadian companies listed in the FTSE RAFI® Developed ex U.S. 1000 Index, which in turn is comprised of the largest 1,000 non U.S. listed developed market companies, selected andweighted using fundamental factors; (sales, cash flow, dividends, book value).

(19) The S&P/Toronto Stock Exchange (TSX) 60 is a cap-weighted index consisting of 60 of the largest and most liquid (heavily traded) stocks listed on the TSX, usually domestic or multinational industry leaders.

(20) The FTSE RAFI® Japan Index is comprised of all Japanese companies listed in the FTSE RAFI® Developed ex U.S. 1000 Index, which in turn is comprised of the largest 1,000 non U.S. listed developed market companies, selected and weighted using fundamental factors; (sales, cash flow, dividends, book value).

(21) The MSCI Japan Index is an unmanaged, free-float-adjusted cap-weighted index that aims to capture 85% of the publicly available total market capitalization of the Japanese equity market.

(22) The FTSE RAFI® UK Index is comprised of all UK companies listed in the FTSE RAFI® Developed ex U.S. 1000 Index, which in turn is comprised of the largest 1,000 non-U.S. listed developed market companies, selected and weighted using fundamental factors; (sales, cash flow, dividends, book value).

(23) The MSCI UK Index is an unmanaged, free-float-adjusted cap-weighted index that aims to capture 85% of the publicly available total market capitalization of the British equity market.

(24) The Russell Fundamental Global Index Large Company is a measure of the largest companies, selected and weighted using fundamental factors; (adjusted sales, retained cash flow, dividends + buybacks), across both developed and emerging markets.

(25) The MSCI All Country World Large Cap Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets.

(26) The Russell Fundamental Developed ex US Large Company is a subset of the Russell Fundamental Developed ex US Index, and is a measure of the largest non-U.S. listed developed country companies, selected and weighted using fundamental factors; (adjusted sales, retained cash flow, dividends + buybacks).

(27) The MSCI World ex US Large Cap Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of large cap-developed markets, excluding the United States.

(28) The Russell Fundamental Developed ex US Index Small Company is a subset of the Russell Fundamental Developed ex US Index, and is a measure of small non-U.S. listed developed country companies, selected and weighted using fundamental factors; (adjusted sales, retained cash flow, dividends + buybacks).

(29) The Russell Fundamental Emerging Markets Index is a measure of Emerging Market companies, selected and weighted using fundamental factors; (adjusted sales, retained cash flow, dividends + buybacks).

(30) The Russell Fundamental U.S. Index Large Company is a subset of the Russell Fundamental US Index, and is a measure of the largest U.S. listed companies, selected and weighted using fundamental measures; (adjusted sales, retained cash flow, dividends + buybacks).

(31) The Russell Fundamental US Index Small Company is a subset of the Russell Fundamental US Index, and is a measure of U.S. listed small companies, selected and weighted using fundamental measures; (adjusted sales, retained cash flow, dividends + buybacks).

(32) The Russell Fundamental Europe Index is a measure of European companies, selected and weighted using fundamental factors; (adjusted sales, retained cash flow, dividends + buybacks).

(33) The RAFI® Bonds US Investment Grade Master Index is a U.S. investment-grade corporate bond index comprised of non-zero fixed coupon debt with maturities ranging from 1 to 30 years issued by publicly traded companies. The issuers held in the index are weighted by a combination of four measures of their fundamental size—sales, cash flow, dividends, and book value of assets.

(34) The Merrill Lynch U.S. Corporate Master Index is representative of the entire U.S. corporate bond market. The index includes dollar-denominated investment-grade corporate public debt issued in the U.S. bond market.

(35) The RAFI® Bonds US High Yield Master is a U.S. high-yield corporate bond index comprised of non-zero fixed coupon debt with maturities ranging from 1 to 30 years issued by publicly traded companies. The issuers held in the index are weighted by a combination of four measures of their fundamental size—sales, cash flow, dividends, and book value of assets.

(36) The Merrill Lynch Corporate Master II High Yield BB-B Index is representative of the U.S. high yield bond market. The index includes domestic high-yield bonds, including deferred interest bonds and payment-in-kind securities. Issues included in the index have maturities of one year or more and have a credit rating lower than BBB-/Baa3, but are not in default.

(37) The RAFI® US Equity Long/Short Index utilizes the Research Affiliates Fundamental Index® (RAFI®) methodology to identify opportunities that are implemented through long and short securities positions for a selection of U.S. domiciled publicly traded companies listed on major exchanges. Returns for the index are collateralized and represent the return of the strategy plus the return of a cash collateral yield.

(38) The 1-Month T-bill return is calculated using the Bloomberg Generic 1-month T-bill. The index is interpolated based off of the currently active U.S. 1 Month T-bill and the cash management bill closest to maturing 30 days from today.

(39) The FTSE RAFI® Global ex US Real Estate Index comprises 150 companies with the largest RAFI fundamental values selected from the constituents of the FTSE Global All Cap ex U.S. Index that are classified by the Industry Classification Benchmark (ICB) as Real Estate.

(40) The FTSE EPRA/NAREIT Global ex US Index is a free float-adjusted index, and is designed to represent general trends in eligible listed real estate stocks worldwide, excluding the United State. Relevant real estate activities are defined as the ownership, trading and development of income-producing real estate.

(41) The FTSE RAFI® US 100 Real Estate Index comprises of the 100 U.S. companies with the largest RAFI fundamental values selected from the constituents of the FTSE USA All Cap Index that are classified by the Industry Classification Benchmark (ICB) as Real Estate.

(42) The FTSE EPRA/NAREIT United States Index is a free float-adjusted index, is a subset of the EPRA/NARIET Global Index and the EPRA/NAREIT North America Index and contains publicly quoted real estate companies that meet the EPRA Ground Rules. EPRA/NARIET Index series is seen as the representative benchmark for the real estate sector.

(43) The Citi RAFI Sovereign Developed Markets Bond Index Series seeks to reflect exposure to the government securities of a universe of 22 developed markets. By weighting components by their fundamentals, the indices aim to represent each country's economic footprint and proxies for its ability to service debt. Performance may be positive or negative. Past performance is not an indication of future results. Historical data used from index inception date of 09/30/2001 (index = 100) until 12/31/2011. Live data used since 01/01/2012.

(44) The Merrill Lynch Global Government Bond Index II tracks the performance of investment grade sovereign debt publicly issued and denominated in the issuer's own domestic market
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(46) The JPMorgan GBI-EM Diversified Index seeks exposure to the local currency sovereign debt of over 15 countries in the emerging markets.

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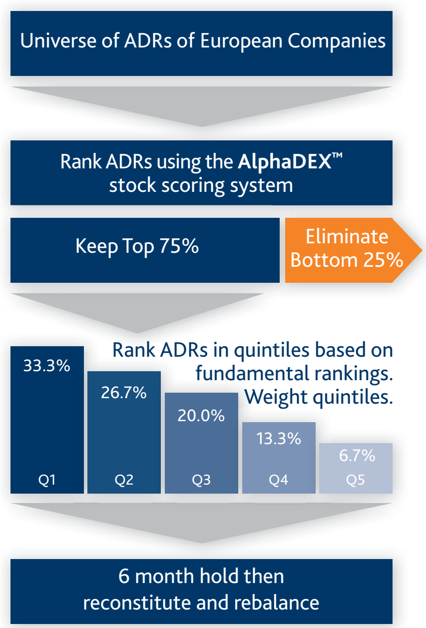

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Unique arrangement makes this the first time MFDA-licensed reps are able to offer clients ETFs

Investment Executive - Clare O'Hara - Mutual fund representatives with Burlington, Ont.-based Mandeville Wealth Services Inc., the fund dealer subsidiary of Michael Lee-Chin's Mandeville Holdings Inc., are now able to sell exchange-traded funds (ETFs).

The announcement in May from Mandeville has, in effect, stolen the thunder from an industry working group led by the Canadian ETF Association (CETFA) that has been working on a similar initiative over the past year and had anticipated launching an ETF offering for mutual fund advisors in early 2015.

"Of course, it would have been nice to be the first one out of the gate," says Pat Dunwoody, the CETFA's executive director. "But everyone on the CETFA board sees this as great news because it proves our point. It shows what we have been trying to accomplish over the past year is now possible."

Frank Laferriere, senior vice president and chief operating officer at Mandeville, says the firm spent about three months developing its system: "Our [reps] are already proficient in mutual funds, and we don't believe it is that much of a stretch to be able to give them this extra tool to service their clients. Intrinsically, ETFs are mutual funds, so why shouldn't a mutual fund advisor be able to offer these products?"

The lack of access to ETFs for mutual fund advisors is not primarily the result of legal or registration issues, but because of technological limitations and lack of creativity, says Laferriere. Currently, advisors licensed by the Mutual Fund Dealers Association of Canada (MFDA) are registered to sell ETFs but do not have access to a securities exchange to purchase the ETFs.

"Making ETFs available to mutual fund dealers is really an industry interface challenge akin to the round hole/square peg clichÃ©," says Scott Mackenzie, senior vice president, business development, with Toronto-based Fidelity Clearing Canada ULC (FCC). "The traditional MFDA platforms don't have the ability to connect with or understand the securities market infrastructure, such as the exchanges and clearing houses, so they are not able to access or easily support ETFs."

Mandeville was able to set up its ETF offering quickly by utilizing its existing back-office relationships with Toronto-based Broadridge Financial Solutions Inc. and FCC. Mandeville mutual fund reps place ETF trade orders directly on Broadridge's Dataphile platform. Those trades then are executed through Mandeville's relationship with its carrying broker, FCC, which executes and settles the trades and provides custody services for the ETFs on behalf of Mandeville via Dataphile.

The overall process involved discussions with Mandeville's back-office partners but also with internal compliance people and industry regulators.

"It was simply about putting the pieces together," says Laferriere, "understanding the obstacles and then coming up with a solution."

Broadridge was able to configure a system on the MFDA platform that would only allow approved Mandeville advisors to order trades with specific ETFs.

"We had to make sure the system was configured so that only specific [Mandeville]-authorized ETFs were allowed to be processed," says Paul Strijckers, Broadridge's vice president of business solutions, "as well as ensure [the system] satisfied [Mandeville]'s defined regulatory requirements."

There are more than 300 ETFs available in Canada, but Mandeville mutual fund reps will have access to a pre-approved list of approximately 60.

"We went through a filtering approach," says Laferriere, "to identify those ETFs that were largely mutual fund-based, as opposed to a commodity pool."

A major obstacle for dealers to consider is that although MFDA advisors are licenced to sell ETFs, current MFDA courses do not contain any information on ETFs.

The Ontario Securities Commission (OSC) says that mutual fund dealers will need to address this proficiency gap before trading ETFs. An email from the OSC confirms that the regulator has not met directly with Mandeville.

Laferriere agrees that advisor education is key to investor protection. Thus, Mandeville will be assessing the proficiencies of its MFDA advisors before they are approved to sell ETFs. For now, only those MFDA advisors who have completed the Canadian securities course (CSC) are permitted to handle ETF orders. But Laferriere is quick to say he is in discussions with several service providers to provide ETF-specific training.

The CETFA also has advisor education at the top of its list and its working group, which includes TMX Group Ltd. and Clearing and Depository Services Inc., will continue to develop a set of best practices that would be based on proficiency requirements already in place for selling mutual funds. The group is continuing with its plans to launch a pilot project in Ontario by the end of 2014.

The group's plan proposes using a member of a securities exchange to conduct the trade of an ETF on behalf of MFDA-licensed advisors. Windsor, Ont.-based Sterling Mutuals Inc. and Vaughn, Ont.-based FundEx Investments Inc. also will participate in the pilot project.

"Hats off to Mandeville for finding a solution that will provide its advisors with access to the ETF market," says Nelson Cheng, CEO of Sterling Mutuals. "However, the [CETFA] working group is developing a solution that will work with all dealers and their various back-office systems, including proficiency requirements for advisors and registration requirements for dealers."

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