CANADIAN ETF Watch

VOL 1 ISSUE 1 OCTOBER 2010

The Art of Core and Satellite Investing with ETFs

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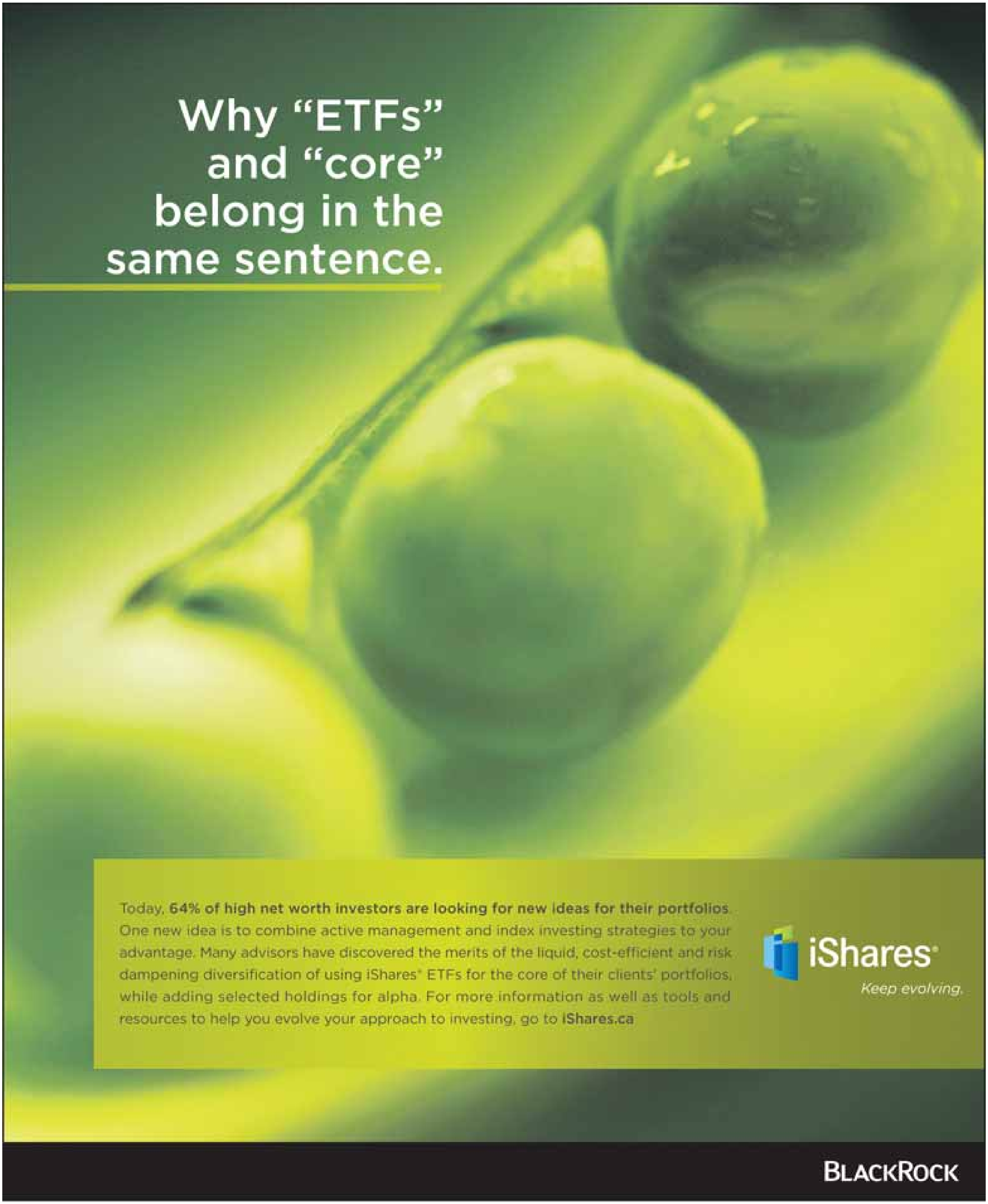
INAUGURAL ISSUE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Radius Financial Education announces the inaugural issue of *Canadian ETF Watch.*

Radius Financial Education (RFE) is proud to announce the inaugural issue of our quarterly publication **Canadian ETF Watch**. At the same time we will launch our new website **www.CanadianETFWatch.com**, a web portal devoted to the world of Exchange Traded Funds while specializing in Canada.

In the summer of 2010 RFE set out to create an online publication and web site that would address education, updates and timely issues in the Canadian ETF space. We are proud to say that Volume 1, Issue 1 accomplishes this goal. The authors of this issue have contributed important and timely articles on a range of topics including ***The Fast Growing World of ETFs***, ***Emerging Markets, Bond ETFs*** and ***Utilizing ETFs to Increase Portfolio Efficiency*** to name a few. We encourage you to engage in discussion with our authors and other readers by commenting on the articles using the author's email address provided.

Publications like **Canadian ETF Watch** only materialize through the hard work of many individuals, and we had a host of people to thank for their time and generosity during the creation of this issue. We hope our efforts and this compilation of articles makes them proud to be a part of our first issue.

At **Radius Financial Education**, our goal is to provide our visitors with informative content that is developed and written for your specific ETF needs. In addition, we will continually strive to add more information to update you with the latest happenings and news in the ETF sector. Check out the site and let us know what you think.

We would lastly like to thank our readers for their continued support. We hope you enjoy **Canadian ETF Watch Volume 1, Issue 1.**

Tony Sanfelice, President
Radius Financial Education

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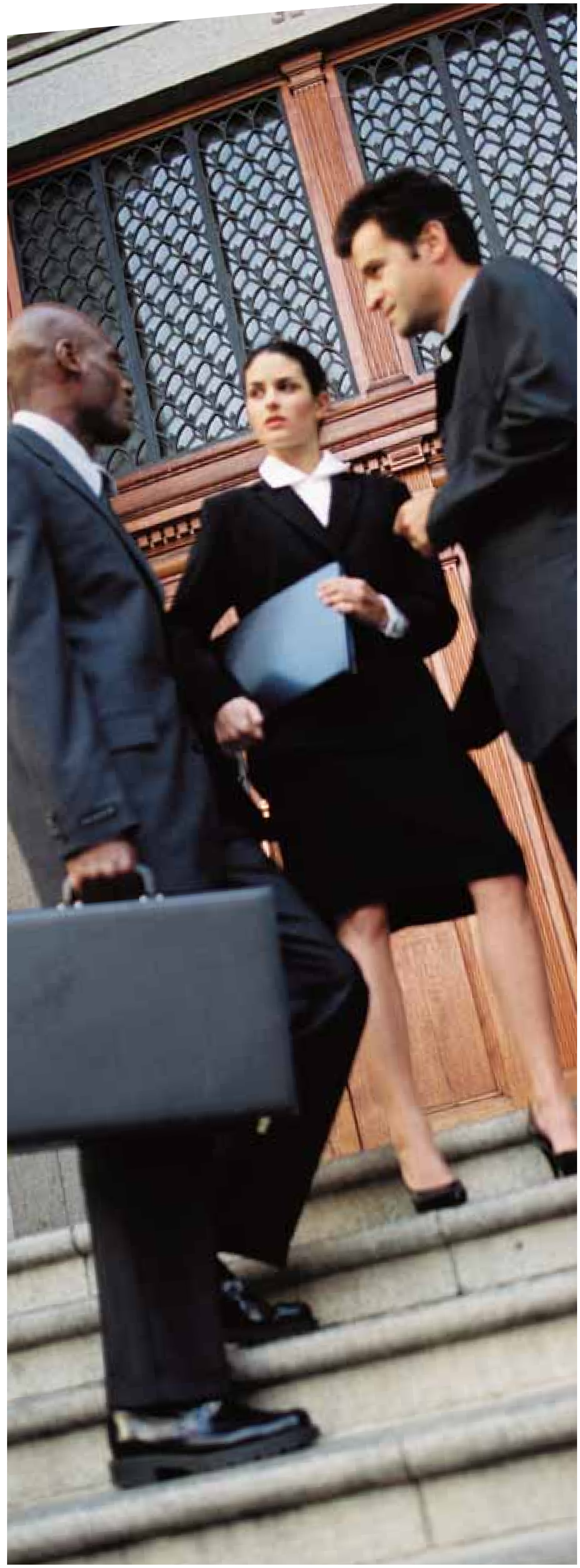

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Types of ETFs

*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

The Art of Core and Satellite Investing with ETFs

Since the financial crisis shook markets in late 2008, the long-standing merits of exchange-traded funds (ETFs) have gathered increasing attention.

Mary Anne Wiley
Managing Director, Head of iShares Distribution, BlackRock Asset Management Canada Limited

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Low fees, transparency, liquidity and easy access to diversification are only a few of the benefits that have attracted the focus of advisors and investors alike. At the same time, mutual funds have faced increased scrutiny particularly with respect to the high rate of management fees and less than stellar performance.

But is simply replacing mutual funds with ETFs the answer to a well formulated financial portfolio? No. Even at BlackRock Asset Management Canada Limited we believe a more sophisticated and balanced viewpoint is required. Our experience is that a wisely composed portfolio will make room for multiple instruments, tailored to an individual's specific investment objectives. In broad terms, we have always believed that optimal market performance is achieved by employing a core/satellite strategy that explicitly combines index and active investments.

Core/satellite investing can take a variety of forms, but the essential characteristic is a reliance of "core," investments with the addition of separate, unrelated strategies or asset classes – also known as "satellites" – that can offer diversification and the potential for returns over and above the core. In fact, recent trends have seen traditional core/satellite strategies employed across asset classes – an approach that provides both a diversified asset allocation and potential for risk-controlled, enhanced performance. A simple example of this is combining a satellite investment in Chinese equities with core holdings in Canadian stocks and bonds. With investment vehicles such as ETFs, and portfolio management tools such as active risk budgeting, retail investors now have the ability to fine-tune and adopt core/satellite strategies that were previously available only to institutional investors.

Incorporating both ETFs and mutual funds in a core/satellite strategy offers a host of other benefits. First, the overall portfolio fees should fall, because ETFs are highly cost-effective to other instruments. As well, investors can implement tactical calls efficiently using ETFs, particularly in asset classes where manager or security selection is difficult. The greatest advantage, however, is that the approach simultaneously facilitates freedom, flexibility, and precision in portfolio building. Investors can combine mutual funds and ETFS to get the exact desired mix of equity and bonds, and adjust their portfolio risk by blending active and index management. For example, one investor might choose to index their Canadian large cap and fixed income but use a trusted manager for small cap stocks. Another may use active funds for Canadian exposure, but overlay international and emerging markets using ETFs. In this way, the complexion and composition of one's investment strategies can be far more finely tuned.

How to Develop a Core/Satellite Strategy?

The primary factor to consider is how much risk – active risk in particular – one is willing to assume. While many investors rely on the expertise of active managers to help reduce risk, active investment strategies can sometimes provoke the opposite outcome. Why? Because in order to try to beat the benchmark index, active managers must make bets relative to the wider market. By definition, not all of these bets will pay off positively, and no strategy is perfectly consistent.

Even more basically, active management is not always successful and the returns may not justify the risks involved. That is why it is important to incorporate cost effective, passive investments such as ETFs into the mix; ETFs present a cost effective solution to manage active risk and preserve the integrity of the asset allocation model desired.

After determining a risk profile, it will be necessary to establish a strong core based on an asset allocation strategy. Asset allocation is one of the most critical steps in investment planning. It serves as the foundation upon which the rest of the investment process is based. An effective core includes a range of diversified holdings – from traditional asset classes such as domestic equities and fixed income, to alternative asset classes such as real estate or hedge funds. The objective is to build a base that includes a breadth of unique risk/return exposures that will, over time, provide the best returns given one's risk tolerance. Fundamentally, you're looking for your core to provide predictable, reliable returns that can sustain a smaller category of more aggressive investments.

Having established one's core, the next step is to select those more aggressive positions as your "satellites." These can take the form of either index or active investments, and should be chosen with an eye to generating "alpha" returns – within your risk profile. Investments such as individual securities, separately managed accounts, mutual funds and ETFs are all suitable satellites. To construct a truly well-diversified portfolio, customize the mix between index and active, asset class by asset class. This provides an additional layer of flexibility when it comes time to rebalance.

For example, if an active manager is underperforming, traditional rebalancing strategies suggest investing more with that manager with the expectation that they will come back in favour. Unfortunately, that does not always happen and underperformance can sometimes persist for long periods of time.

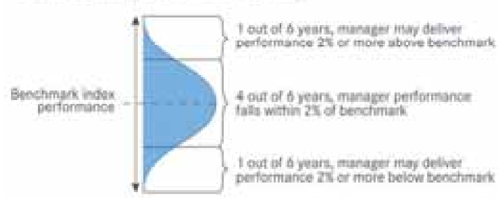
Instead, investors who employ today's core/satellite strategies rebalance using an index investment that tracks the corresponding asset class benchmark, keeping their portfolio allocated as intended, while not rewarding underperformance with more dollars.

By the same token, investments with an outperforming manager can create an overweight in that asset class relative to the asset allocation model. To solve this problem, few investors will want to trim back their recently successful positions. Instead, investors who adopt the current core/satellite model start with a combination of index and active investments within that asset class. When it is time to rebalance, they sell some of their index position. This allows the investor to keep the portfolio appropriately invested in an asset class, while retaining a good manager.

In terms of determining the right balance between index and active, there are a number of options investors can employ. One option is to create an active risk budget for each asset class or the whole portfolio for an institutionally precise risk strategy. Active risk budgeting limits the amount of variation that the portfolio or manager will experience relative to the asset allocation or asset class. Once the budget is set, appropriate investments can be determined. The higher the active risk of a manager, the more widely dispersed the returns will be for the asset class benchmark. The following graph highlights the impact of a 2% active risk budget to the investor and the overall investment strategy.

TOTAL AVERAGE RETURNS	100% Index (S&P®/TSX® Capped Composite Index)	100% ACTIVE	2% ACTIVE RISK BUDGET
5-year	5.70%	5.85%	5.80%
10-year	11.01%	10.53%	10.85%
Annualized Active Risk (10 years)		5.08%	2.00%

For illustration only: not indicative of any fund, manager or investment.
Source: BlackRock Asset Management Canada Limited



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The benefit of this model is the ability to precisely define the amount of risk taken in any asset class and in the overall portfolio. Not only are investors able to clearly see the expected range of possible under- and outperformance, but they can see how risk is managed relative to the overall asset allocation and investment plan target.

The range of options and strategies becomes quite broadly appealing. For example, another approach is to employ the percentage blend. This strategy allows investors to adopt a set mix of index and active investments. Investors can use this style of investing to mitigate periods of manager underperformance. The following graph highlights the performance of a manager relative to the benchmark, with and without blending. While it is less precise than active risk budgeting, it provides an easy-to-understand risk management solution and allows for a "smoother ride." In this sense it can be quite appealing to many investors unwilling to commit the energy and expertise required by active risk budgeting.

Of course, no matter what model or design you adopt, there is as much art as science to investment management. However, strategies to increase science and diminish the art are well worth the search. The financial crisis has turned "tried and true" investing strategies on their head and as a result, new approaches are being given greater consideration. Unlike past models, modern core and satellite strategies do not require you to choose between ETFs or mutual funds and adopt one over the other. These contemporary approaches allow you to strike a better balance between the two and create a truly diversified portfolio that is agnostic in nature. This gives you additional control, provides opportunities for higher returns based on your risk profile and, ideally, enables greater flexibility and satisfaction in your investment experience.

Mary Anne Wiley, Managing Director, Head of iShares Distribution, BlackRock Asset Management Canada Limited
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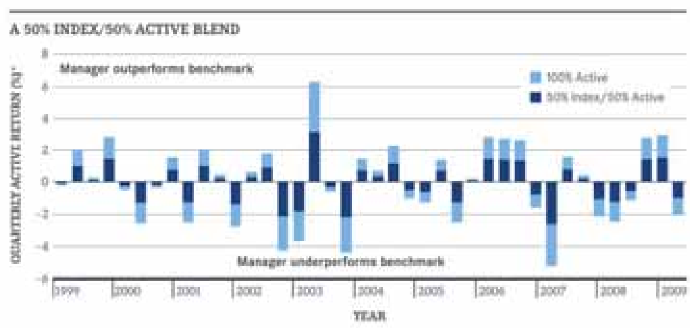
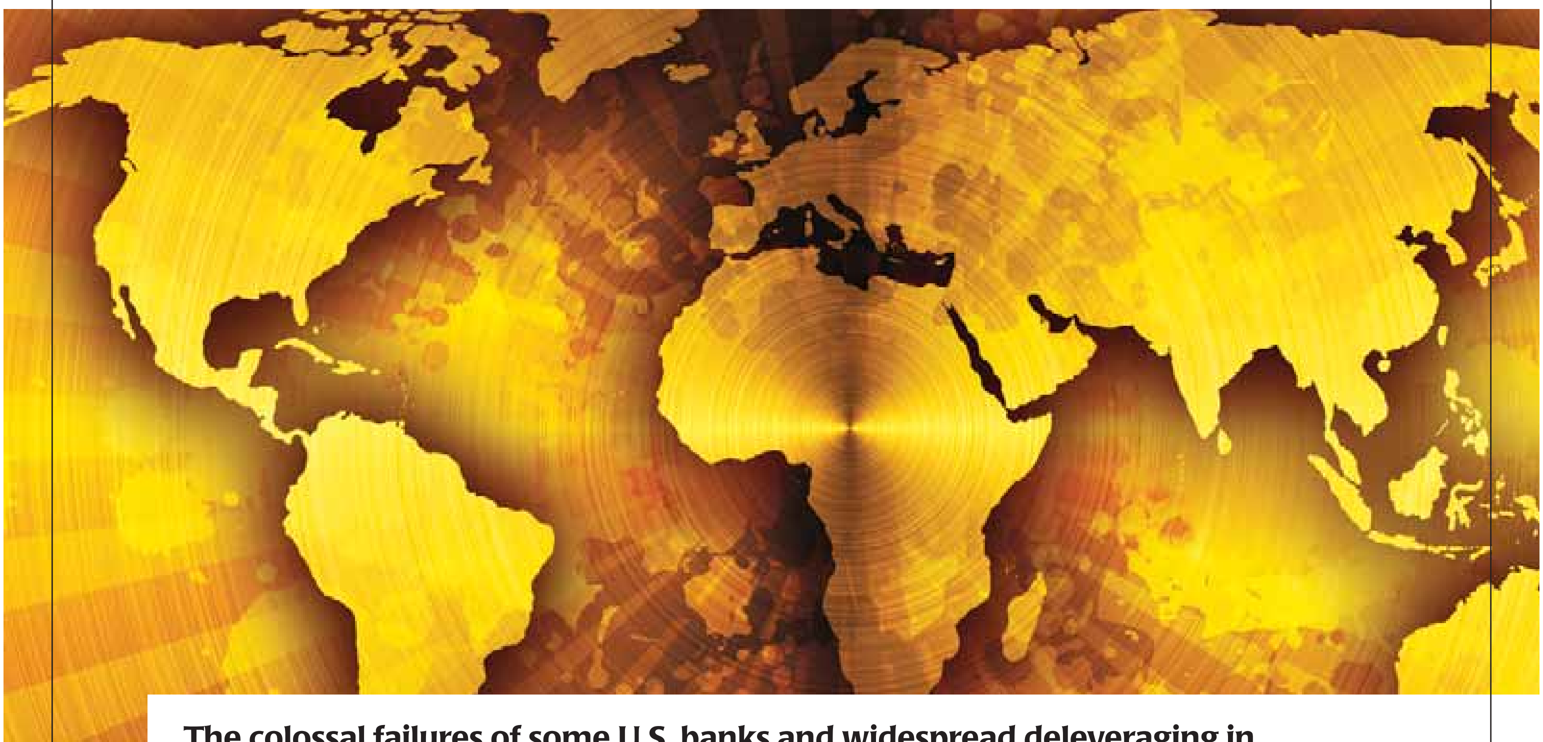


TOTAL AVERAGE RETURNS	100% Index (S&P®/TSX® Capped Composite Index)	100% ACTIVE	50% INDEX/ 50% ACTIVE BLEND
5-year	5.70%	5.85%	5.82%
10-year	11.01%	10.53%	10.80%
Annualized Active Risk (10 years)†		5.08%	2.54%

* Active return measures the performance of the manager relative to the return of the benchmark index.
† Active risk is measured as the standard deviation, or variability, of a manager's active returns.
For illustration only: not indicative of any fund, manager or investment.
Source: BlackRock Asset Management Canada Limited

Emerging Markets, the Drivers of Global Growth



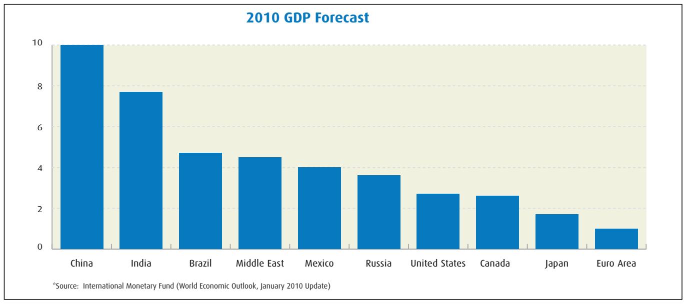
The colossal failures of some U.S. banks and widespread deleveraging in global markets has had many questioning the capitalist system.

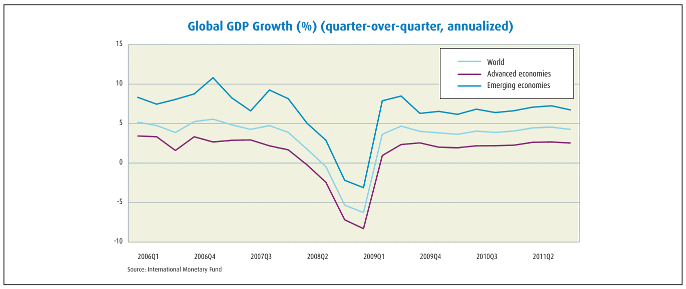
Alfred Lee
Investment Strategist, BMO ETFs & Global Structured Investments

What a difference a year makes. Co-ordinated monetary and fiscal policy between the world's central banks were a fundamental component in helping the global economy avert what was dubbed "the Great Depression 2.0" in 2009.

However, another key to last year's V-shaped recovery was the emerging market economies. In normal economic cycles, emerging markets have exhibited a strong tendency to lag those of developed nations or "rich economies." However, this time around emerging markets have proved to be the engine of the global economy rather than the caboose. Lessons learned from the Asian and Brazilian crises during the late 1990's may have helped, but many of these emerging nations had stimulus plans that were far more effective than their developed counterparts. Net exporting nations, particularly in the Far East, were able to build up foreign exchange surpluses which were used to help fund these counter-cyclical programs, whereas developed nations such as the U.S. had to go further into deficit to do the same.

BMO Financial Group
Exchange Traded Funds





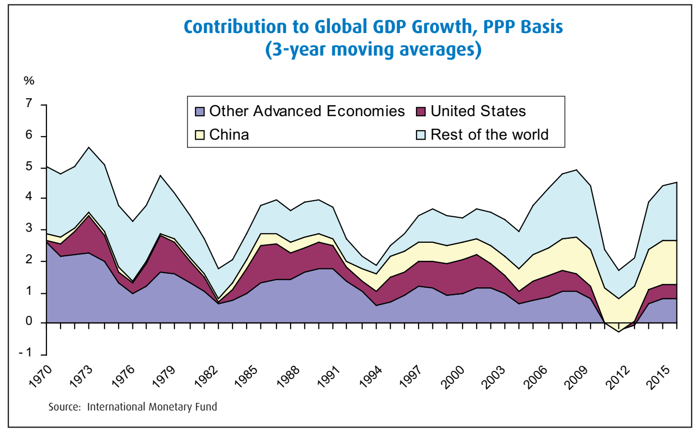
Although the peak-to-trough fall in the equity markets of emerging nations were profound during the crisis, it can be argued that much of this was exaggerated. Panic and forced liquidation may have been a factor as investors awaited the impact of struggling Western nations on the emerging markets. Though not unscathed, when economic data suggested that the economies of certain emerging markets, most notably China and India, were in far better shape than expected, those markets rallied. New data is now suggesting that these two economies are back to expanding at near pre-crisis rates. Similar to how Great Britain lost its global pre-eminence to the U.S. early last century, we may be witnessing a similar seismic shift in global power. Potential future economic powerhouses such as China and India boast rapidly growing economies, and as such may warrant a spot in an investor's portfolio.

China Cooling the Jets for Long-Term Sustainability

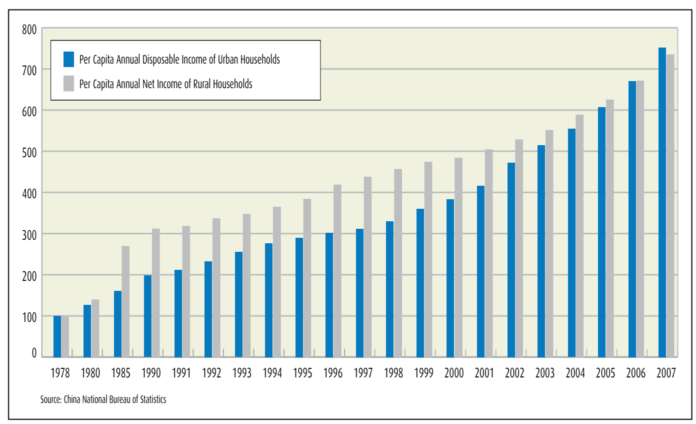
The Economist Intelligence Unit predicts two major milestones for the Chinese economy this year:

1. it will overtake Japan as the second largest economy in the world, and
2. its exports will reach 10% of world trade.

Looks like it is well on track to hit these targets. In late January, China's National Bureau of Statistics (NBR) reported that the country's full year 2009 GDP came in at 8.7%, easily exceeding its target of 8.0%. This led China to order its banks to raise its reserve ratios and signalled the market to anticipate rate hikes in the first half of 2010. Although this caused some softness in global equity markets, it was likely needed to ensure its economy does not become overheated. The tightening of monetary policy may make this an attractive buying opportunity for long-term investors. It's also a testament to the government's intention to sustain its long-term growth. China has significantly increased its contribution to global GDP, suggesting it's already a major economic player. Despite its amazing year over year growth since 2000, keep in mind that its per capita GDP is still one tenth of that of Japan, suggesting that there is still ample room for growth.



China still remains dependent on exports however, as according to Geneva-based Global Trade Information Services Inc., it recently surpassed Germany as the largest exporting nation in the world. Since the U.S. is still China's main export market, any talks of Decoupling or even "Decoupling 2.0," is likely far fetched at this point. Currently the U.S.'s trade deficit with China makes up approximately half of America's total deficit. Regardless, as salary levels and hence disposable income in China have gone up and its younger population become more westernized they will have a tendency to consume more, making its economy more self sustainable. Signs of China's increased domestic consumption have already become more evident. According to the Economist magazine, China has now overtaken the U.S. as the main destination for smaller Asian and even Japanese exporters. The trade will work both ways as rising income in nearby Asian countries will also help China with its own export market, moving it away from being overly reliant on the U.S. market over the long-term.



Despite the Shanghai Stock Exchange Composite Index surging 80% in 2009, it still trades at a price-to-earnings (P/E) ratio of 34.9x, a discount to its pre-crisis high of 52.1x. Investors looking for a cost-effective way to get exposure to Chinese equities may want to consider the BMO China Equity Hedged to CAD ETF (ZCH), which provides exposure to Chinese companies through a diversified portfolio of American Depository Receipts (ADRs) and Global Depository Receipts (GDRs). A benefit of using ADRs and GDRs ensures that companies report according to U.S. GAAP. Foreign companies that hold ADRs and GDRs tend to be higher quality than emerging market companies that do not. The BMO China Index ETF (ZCH) is also hedged to the Canadian dollar, which helps to neutralize much of the currency movements between the U.S. and Canadian dollars.

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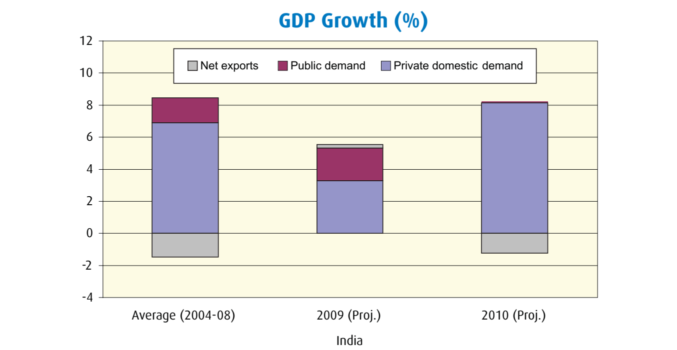
This could be particularly important in 2010 with individual economies around the world in different fundamental conditions, as some will be ready to raise interest rates sooner than others. An uneven interest rate rise across countries could lead to an increase in currency volatility, especially if governments intervene at times to keep exports competitive.

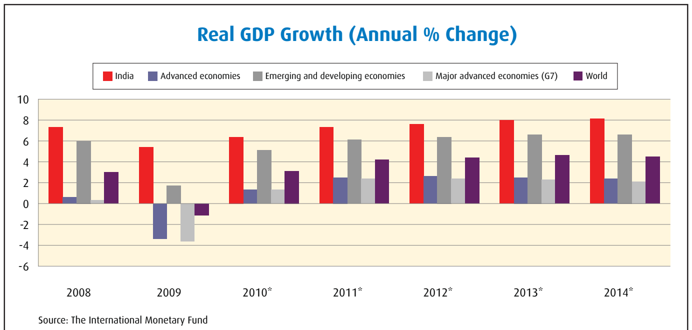
India, a Forgotten Titan

Similar to China, India is touted to be a major economic powerhouse in the making but it is often overshadowed by the "People's Republic." In 2009, India was one of the few countries to largely escape a severe recession. Its predominantly domestic demand-driven economy insulated it from much of the demise of other countries during the crisis. India's GDP did fall year-over-year in 2009 but, despite the heavy monsoons that plagued its agricultural and related industries it still managed a GDP of 5.6% in 2009, a rate higher than most economies during expansionary periods. But it looks like business sentiment is now on the mend, as the Dun & Bradstreet business sentiment rose to 143 from 132, in the three months ended December 2009. Employment also seems to be improving as the Manpower Net Employment Diffusion Index rose for a second consecutive quarter.



Source: International Monetary Fund (Asia & Pacific, Regional Economic Outlook. October 2009)

The outlook for India seems promising as the International Monetary Fund (IMF) projects a healthy recovery for India. The IMF forecasts its GDP growth to be 7.7% in 2010, surpassing its 2008 GDP of 7.3% and nearly double the 3.9% it projects for the world economy this year. The IMF also expects the subcontinent's GDP growth to outpace that of the aggregate emerging markets in each of the next four years.



Source: The International Monetary Fund

Investors looking for a cost-effective way to get exposure to the equity markets of India may want to consider the BMO India Equity Hedged to CAD ETF (ZID) which invests in a diversified portfolio of ADRs and GDRs of Indian companies, providing advantages similar to the BMO China Index ETF Hedged to C$ (ZCH). This ETF is also hedged back to the Canadian dollar, a benefit for investors concerned about currency fluctuations.

Gold Still Glittering

With 2009 now in the rear view mirror, gold bullion prices finished higher for the ninth year in a row, hitting an all-time high during the year of US$1215.70/ounce. In the first half of last year the yellow metal shifted from being a safe haven trade to a trade used to hedge a decline in the U.S. dollar. Falling confidence in the U.S. dollar will likely continue to be the main driver to gold prices as investors are concerned that last year's easy monetary policy will lead to inflation down the road.

While some investors are concerned that the eventual rise of interest rates in the U.S. will put a stop to the gold run there may be some other factors investors may want to consider. First, unemployment rates in the U.S. still sits at 10%. This may be understated when compared to historical levels, as the Clinton administration redefined "unemployment" to exclude discouraged workers and involuntary part-time workers. Raising interest rates could prematurely force its economy to walk on its own, when it may not be able to do so. Moreover, relative interest rates may be more important that absolute interest rates. Other economies such as Australia and Norway have already raised key-lending rates, which could place further downward pressure on the U.S. dollar. Second, central banks have been buying gold to diversify their foreign currency reserves. Recently, India and Mauritius combined, purchased more than a half of the 400 tonnes of gold that the IMF put up for sale and gold bullion ETFs, such as the StreetTracks Gold ETF (GLD – NYSE), continue to snap up gold, helping to fuel its demand. Often referred to as the "People's Central Bank," GLD currently holds more than 1100 tonnes of gold bullion, more than all but five central banks.

While gold bullion has been a good investment, gold stocks have outperformed over the last 16 months. In October of 2008, the AMEX Gold Bugs Index (HUI)/Spot Gold Ratio bottomed, indicating that from this point, it was more favourable to own gold stocks relative to bullion. From this point, the AMEX Gold Bugs Index, which consists of 15 of the most widely held and liquid gold production companies outperformed gold bullion by a cumulative 70.8% (in C$). More impressive, was that small caps even outperformed their large cap peers. The Dow Jones North American Junior Gold Index outperformed the AMEX Gold Bugs Index by a cumulative 62.8% (in C$) over the same period.

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While gold bullion has been a good investment, gold stocks have outperformed over the last 16 months.


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• Investor demands for liquidity, transparency, and fee reductions
• Enhanced due diligence and calls for more independent servicing
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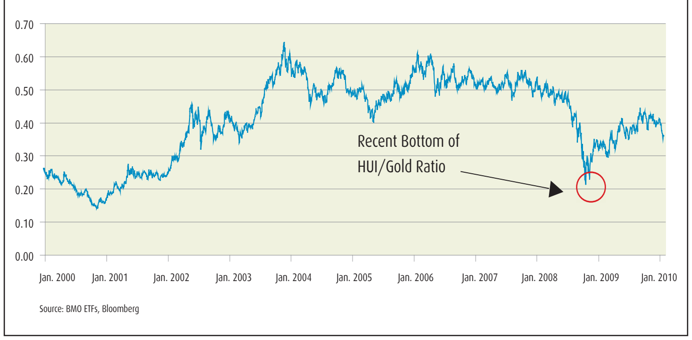
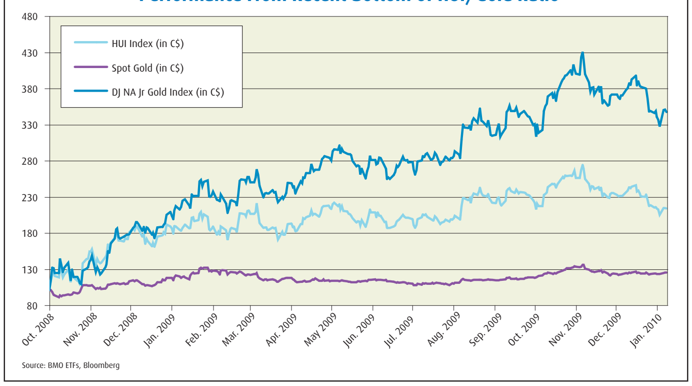
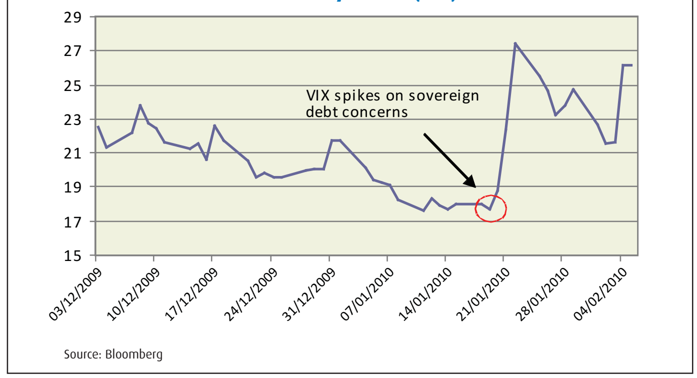
HUI/Gold Ratio



Performance From Recent Bottom of HUI/Gold Ratio

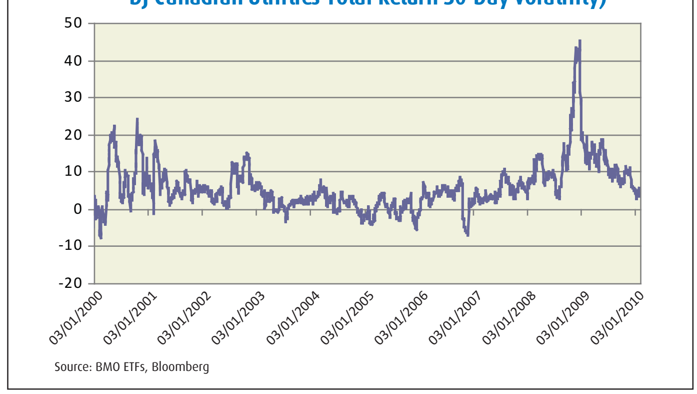


Volatility Index (VIX)



In addition, the news of China and India raising bank reserve ratios and the anticipation of rate hikes will likely cause some near-term softness in the markets. This pre-emptive tightening of monetary policy however will likely help these two countries sustain their impressive GDP growth over the long-term. For investors looking to avoid the short-term market turbulence may want to consider some defensive positions in their portfolios. Utility stocks are a good place to look for stability, as these companies provide required services such as electricity, water and heating – needs and not luxuries. As such, their earnings and dividends will have a tendency to be more stable and predictable.

Volatility Spread (TSX Total Return 30 Day Volatility - DJ Canadian Utilities Total Return 30-Day Volatility)



With gold still trading at historically high levels, many high cost gold producers could now become profitable, which would be reflected in their share prices. Many of these high cost producers tend to be junior mining companies with share prices that tend to have a higher beta to gold prices at these levels.

Investors looking for a broad way to leverage high gold prices should consider the BMO Junior Gold Index (ZJG). This ETF tracks the Dow Jones North American Junior Gold Index, which consists of 25 North American junior gold names. An ETF is especially beneficial in the small cap gold space as it mitigates company specific risk.

Utilizing Utility Sector to Add Portfolio Stability

Although emerging markets may again play a large role in the global economy this year, market volatility may rise in the short-term as investors have become overly sensitive to potential bad news. This has been evident, with the CBOE Volatility Index or the "VIX" shooting up on the recent news of potential sovereign debt defaults in Europe. The VIX is a gauge of market expectations of near-term volatility and often referred to as the "fear index."

Investors looking for opportunities in this area may want to consider the BMO Equal Weight Utilities Index ETF (ZUT). This ETF is the Canada's first defensive-oriented sector ETF and holds 16 Canadian companies in the utilities sector. As its name implies, each company in the portfolio is equal weighted at each semi-annual rebalance date. The ETF tracks the performance of the Dow Jones Canada Select Equal Weight Utilities Index, which had a 6.0% yield as of December 31, 2009. The index's price-to-earnings ratio of 17.7x is also attractive as it's noticeably lower than the S&P/TSX Composite Index's 19.6x.

Alfred Lee, Investment Strategist, BMO ETFs & Global Structured Investments ***alfred.lee@bmo.com***

An ETF is especially beneficial in the small cap gold space as it mitigates company specific risk.

CHARTERED
ALTERNATIVE
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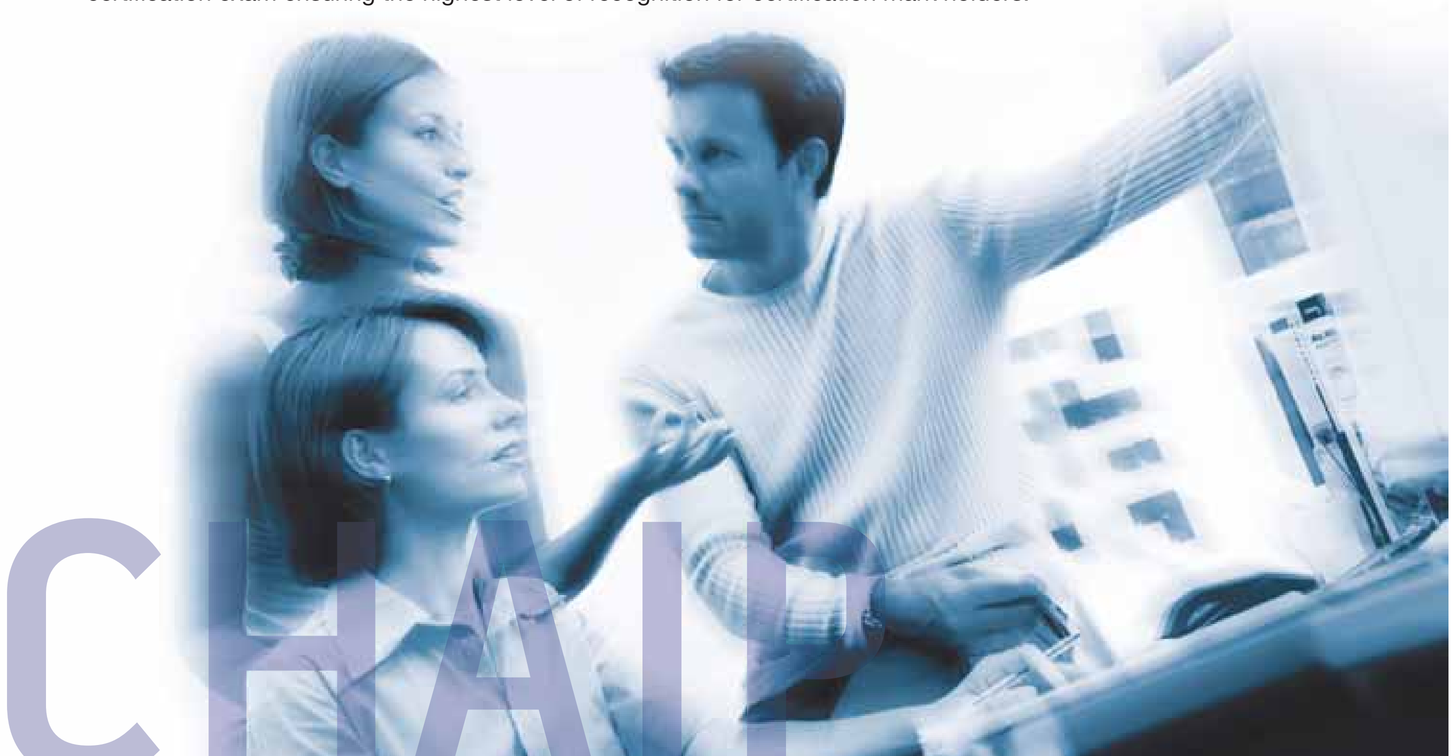
CHAIP™

The **Chartered Alternative Investment Planner (CHAIP)™ Programme** was developed in 2005, in response to the rapidly growing hedge funds market and the large variety of related alternative investment products available. With a higher degree of complexity and challenges facing the hedge fund industry, the programme was updated in 2009, including a tax and legal update from McMillan. **CHAIP™** provides a comprehensive body of knowledge outlining the standards now required by advisors and planners, managers and analysts to make informed decisions on the purchase or recommendation of hedge funds.

Unlike other alternative investment courses, CHAIP is low-cost, can be completed in a short time period and contains specific Canadian content updated with recent data.

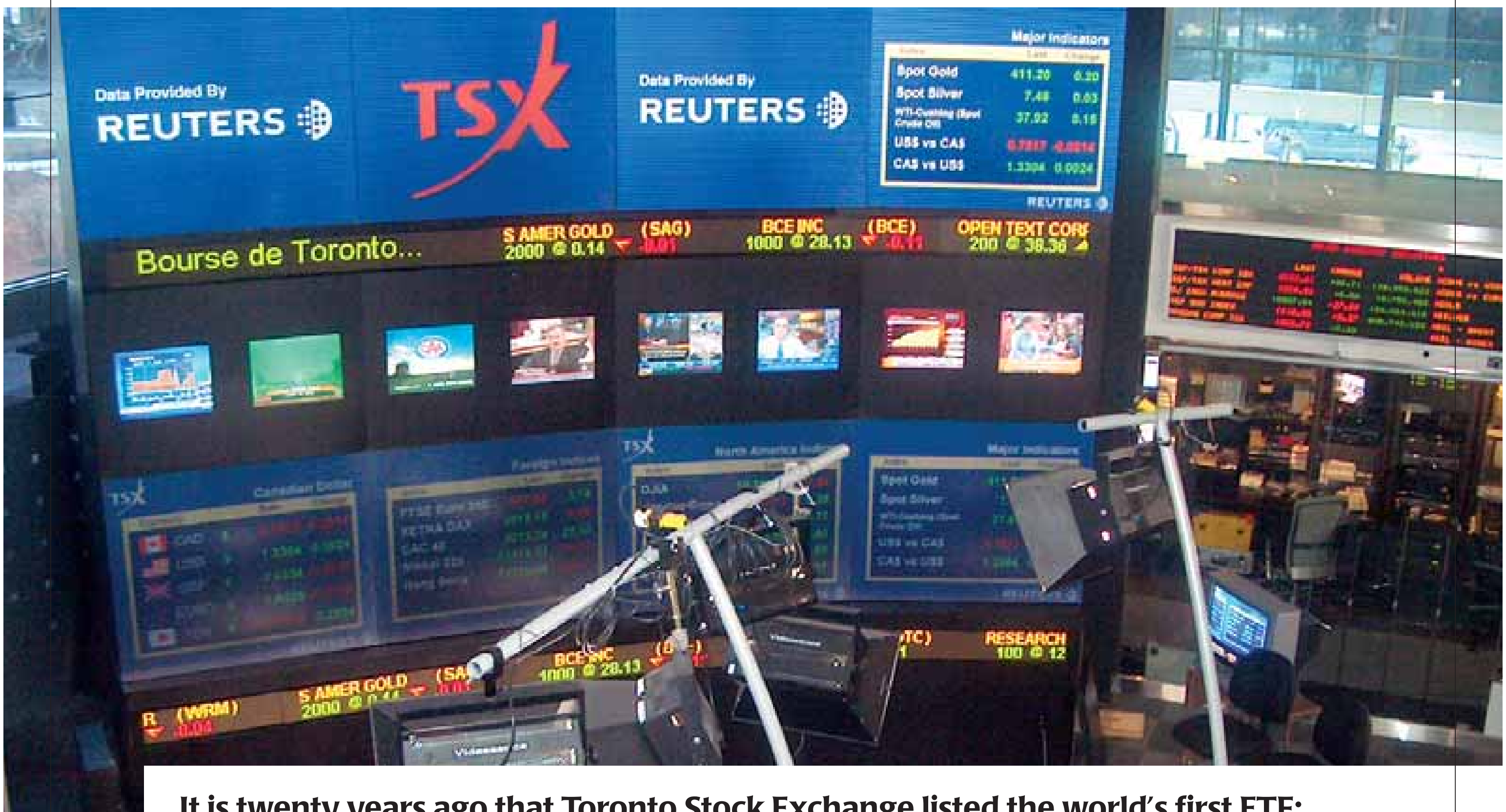
Developed with the direct input of Canadian hedge fund and alternative investment professionals, the **CHAIP™** certification process includes:

1. An independent certification board of academic and practice experts who will certify the **CHAIP™** curriculum and examination, set practice standards and determine continuing education requirements.
2. A comprehensive self-study course (approximately 75 study hours) providing a body of knowledge through theory and applied practice on the parameters, application and risks of hedge funds as an alternative in an investment portfolio, the history and theory of hedge funds, best practices that need to be employed by the Alternative Investment Planner, and a rigorous evaluation through the completion of course unit assignments and case studies.
3. The **CHAIP™** designation can be earned by completing the course and passing the 4-hour proctored certification exam ensuring the highest level of recognition for certification mark holders.



The **CHAIP™** course is available online... for enrolment and qualification details, please go to **www.CHAIP.com**, or call **Sean Datta** at **1-416-306-0151 x2234**

The Fast Growing World of ETFs



It is twenty years ago that Toronto Stock Exchange listed the world's first ETF: the Toronto 35 Index Participation units (TIPs*).

Gary Knight
Vice President Trading, Toronto Stock Exchange

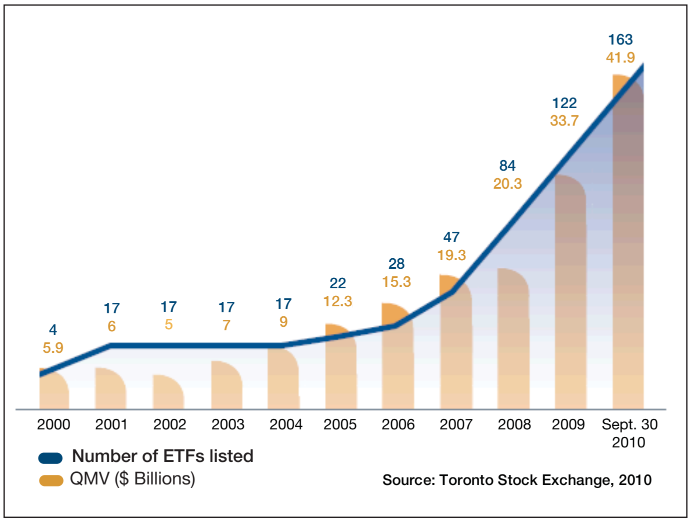
TIPs enabled investors to participate in the performance of the former TSE 35 Composite Index without having to buy shares in each of the index's 35 constituent companies.

As we fast forward to the present day it's remarkable to see how this one innovative product (now universally called Exchange Traded Funds (ETFs)) evolved into a marketplace that now counts over 2300 ETFs listed worldwide, with a total market capitalization of $1.2 trillion USD. In Canada alone we now count over 160 ETFs listed on Toronto Stock Exchange with a market capitalization in excess of $40 billion and trading volume that accounts for about 10% of total TSX volume.

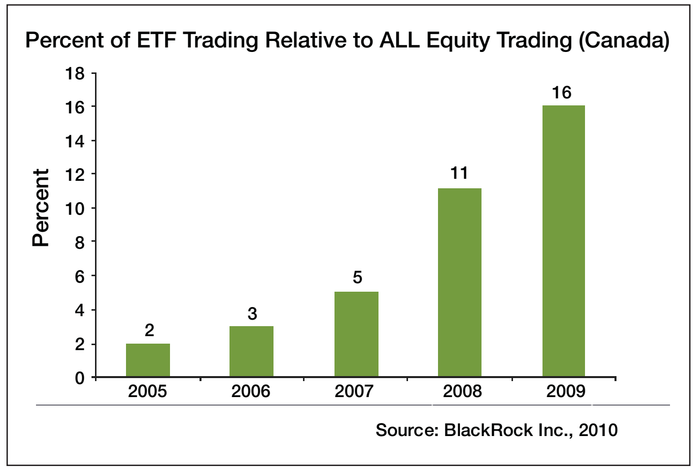
It's clear that this relatively new investment product has grown to become an important part of our business at TSX; further, it's an increasingly popular element of the investment landscape in Canada and around the world.

TMX Toronto Stock Exchange

Listings - A 10-Year Snapshot



ETFs Represent a Significant Portion of all Equity Trading: Canada



The Basics: What are ETFs?

In their most basic form, ETFs are investment products that represent a basket of securities and are designed to replicate the returns of an index or asset class. Essentially, they offer the advantage of trading an entire index portfolio with the ease of trading a single stock.

Investors in ETFs recognize the potential benefits of this product:

- Quick and cost-effective diversification by using products providing exposure to equities, fixed income, commodities and currencies
- Trading flexibility:
  - ETFs are traded at the prevailing market price during the trading day, just like stocks
  - ETFs are eligible for a variety of buy/sell order types such as a limit orders, market orders, short selling or purchasing on margin
  - On derivative markets, investors can also buy and sell options on some ETFs
- ETFs generally have lower price volatility than individual stocks due to their inherent diversification in more than one security
- No minimum investment requirements

In recent months we have also seen a wave of new quantitative, leveraged and actively managed ETFs that are more complex than traditional ETFs. These ETFs generally involve more turnover, less transparency as to the exact holdings of the ETF at any given moment, and there is more frequent rebalancing.

Actively managed ETFs are designed to outperform a specific index rather than track it. Managers of these ETFs have the freedom to trade outside of the benchmark index. This in turn produces investment returns that will not perfectly mirror the underlying index.

There are many strategies that can be used by a wide variety of equity investors – from conservative to speculative, and from relative novices to those that are more experienced.

Liquidity on Demand

All ETFs have Designated Brokers (DBs) that are responsible for the creation and redemption of ETF shares and they create or redeem shares in response to market demand. This is quite unique in the realm of equity securities.

When a client places a large order, DBs can create a huge number of ETF shares instantly when dealing in popular – and therefore liquid – indices, such as the S&P/TSX 60**. Within seconds, they short sell ETFs to fill a customer order and then purchase the underlying stocks of the ETF to instantly offset the short position.

This leads us to another unique aspect of ETF liquidity: the different ways of accessing liquidity in a given ETF. One measure of an ETF's liquidity is to track the average trading volume or number of shares traded in a given day or over a period of time – just as you would evaluate the liquidity of a company's shares, for example. Another measure of liquidity for an ETF is to track the trading volume of its underlying stocks. ETFs that invest in actively traded securities will be more liquid. It is said that an ETF is as liquid or as illiquid as its underlying securities.

It is important to consider other factors that can affect the liquidity of an ETF:

- Composition
  - Asset Class
  - Market capitalization
- Trading volume of underlying basket of securities that make up the ETF
  - ETFs that invest in actively traded securities will be more liquid
  - Risk profile of underlying securities affects liquidity
- Trading volume of the ETF itself
- Market forces / trading environment
  - Trading activity is a direct reflection of supply and demand for securities; hence, the trading environment also affects liquidity

A Wealth of Diversity to Diversify Portfolios

It is widely agreed in the industry that ETFs are quickly becoming an important investment tool for retail and institutional investors alike. The market is providing flexible and cost-effective product options in response to increasing demand, and the diverse range of funds continues to grow.

Individuals should consider speaking with an Investment Advisor to determine if ETFs might be right for their portfolioToronto Stock Exchange also offers an ETF portal with more information on this fast-evolving product: tmx.com/etf.

Continued on page 18

Continued from : The Fast Growing World of ETFs page 17

ETF Snapshot

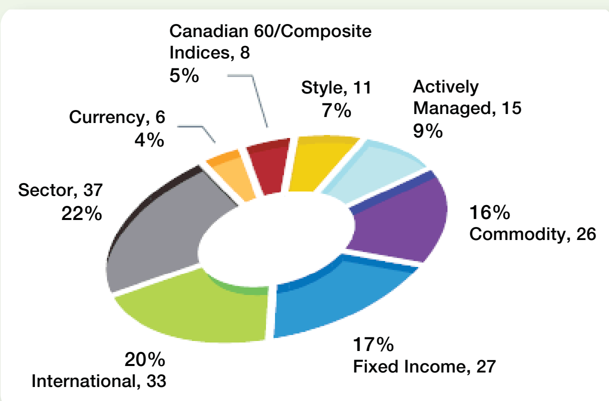
Activity on TSX

- ETF market capitalization has grown 500% since 1999
- 38 new ETFs listed in 2009; 43 in 2010 YTD September
- ETFs represent 11% of TSX issuers and a proportionate amount of trading volume
- Based on 2010 YTD September statistics, the top 10 ETF symbols traded on TSX represented about 80% of the total ETF volume traded

Canadian Facts & Figures

- ETF assets under management increased by $8.5 billion in 2009
- Canadian ETFs have been growing 30% per year between 2004 and 2009; assets surpassed $40 billion in Q3 2010
- There are different types of ETFs in the Canadian marketplace:
  - Equity Index ETFs
  - Commodity ETFs
  - Leveraged ETFs
  - Inverse ETFs
  - Currency ETFs
  - Actively Managed ETFs

ETF Fund Allocation by Type
2010 YTD September



Source: Toronto Stock Exchange, 2010

Global Facts & Figures

- Globally, ETF assets increased 14% YTD at the end of Q3 2010 to hit US$1.18 trillion
- In the US, ETF assets stand at US$797 billion at the end of Q3 2010
- The European ETF industry has assets of US$256 billion at the end of Q3 2010

Source: BlackRock ETF Landscape Industry Highlights, End Q3 2010

END NOTE
*"TIPs" is a trademark owned by TSX Inc.
**"S&P" is a trademark owned by the McGraw-Hill Companies, Inc. and "TSX" is a trademark owned by TSX Inc.

Gary Knight, Vice President Trading, Toronto Stock Exchange
gary.knight@tsx.com

2010/11 CALENDAR OF EVENTS

Brought to you by radius Financial Education radiusfinancialeducation.com

Canadian Society of Technical Analysts (CSTA)/MTA Toronto Annual Conference

Monday, December 6 & Tuesday, December 7, 2010 Toronto

The annual national CSTA and MTA Toronto conference brings together over 200 participants, both full and part-time traders, for in-depth information sharing and dialogue on the latest issues affecting technical analysis in market trading. Some of the foremost names in both national and international trading analysis present their thoughts and ideas through informative presentations and group discussions that are open to both CSTA members and the general public.

csta-conference.com

Exchange Traded Forum

Thursday, May 26 & Friday, May 27, 2011

ETFs, ETNs, Indexing, Structured Products, Closed End Funds

In it's second year, the ETF conference will address the latest trends and developments in this rapidly changing and growing sector. The agenda features industry experts sharing their experiences and forecasts in a format designed for retail and institutional investment professionals.

EXCHANGE TRADED FORUM 2011

exchangetradedforum.com

Niagara Institutional Dialogue

Monday, June 13 to Wednesday, June 15, 2011 Niagara-on-the-Lake

Niagara Institutional Dialogue is an exchange of ideas, knowledge and practices for Canadian Institutional Investors. A selected group of senior representatives from Canadian pensions, will participate in three days of informative discussions, education and networking.
This confidential closed door event is reserved for select industry participants.

Niagara Institutional Dialogue — An Exchange of New Ideas Knowledge Practices For Institutional Investors

institutionaldialogue.com

10th Annual World Alternative Investment Summit Canada

Monday, September 19 to Wednesday, September 21, 2011 Niagara Falls

WAISC is Canada's largest annual gathering of alternative investment professionals and service providers. Featuring panel discussions with top-level international speakers, fund manager showcases and leading service providers, WAISC brings together over 400 delegates to explore every side of the alternative investment space.

WAISC 2011 — 10th Annual World Alternative Investment Summit Canada

waisc.com

Not All Indexes Are Created Equal

A Case for Equal Weight Indexing

Canada can be a great place to invest, but it's possible for investors to lose sight of how concentrated the Canadian stock market is.

The most commonly used Canadian stock index is the S&P/TSX 60™ Index, which uses a market-capitalization weighting ("Cap-Weighted) methodology.

A Cap-Weighted index assigns an index weight to each stock based on its market capitalization ("Market-Cap"). With a Cap-Weighted index, the weight of each security is calculated by first multiplying the number of available shares of the stock by its price, which determines that stock's Market Cap. The Market-Cap of each stock is then divided by the aggregate Market-Cap of all the constituents in the index to determine its percentage weight within the index.

Using a Cap-Weighted index methodology may result in:

- High concentration in larger capitalization stocks
- Low diversification across industry sectors, e.g. the S&P/TSX 60™ Index is dominated by the energy, financials and materials sectors
- High performance stocks having a larger allocation as the index weight is based off an increasingly higher share price

Not only does the Cap-Weighted S&P/TSX 60™ Index tend to be concentrated in a small number of stocks and sectors, but many Canadian investors who invest in the index already have exposure to these stocks and sectors directly or indirectly through other investment funds.

HORIZONS
EXCHANGE TRADED FUNDS

Single Stock Concentration

The S&P/TSX 60 Equal Weight Index should reduce the singlestock concentration risk that exists in the Cap-Weighted S&P/ TSX 60™ Index. With an equal weight index, the weight of each stock is generally split equally when rebalanced. In the case of the S&P/TSX 60 Equal Weight Index (the "Equal Weight Index"), each of the 60 constituents have approximately the same weight on each quarterly rebalancing date. With 60 stocks, at the time of rebalancing the Equal Weight Index has a 1.67% weight (100 ÷ 60) for each stock.

For example, on June 21, 2010 the Royal Bank of Canada was the largest holding in the S&P/TSX 60™ Index with a 7.62% weight while it represented only 1.68% of the Equal Weight Index.

According to a research report by Standard & Poor's, from August 11, 2010 exposure to Royal Bank of Canada in the S&P/TSX 60™ Index was greater than the combined weight of the top three holdings (6.05%) in the Equal Weight Index.

This is not to say that investing in Royal Bank of Canada is a bad decision, however it's a stock that many Canadian investors may already have exposure in their portfolios.

Continued on page 22

Top 10 Holdings

	S&P/TSX60™ Index (%)	S&P/TSX60 Equal Weight Index (%)	Difference	GICS Sector
Royal Bank of Canada	7.62	1.68	5.94	Financials
Toronto-Dominion Bank	6.22	1.70	4.52	Financials
Suncor Energy Inc	5.24	1.67	3.57	Energy
The Bank of Nova Scotia	5.18	1.68	3.50	Financials
Barrick Gold Corp	4.39	1.68	2.71	Materials
Canadian Natural Resources Limited	4.02	1.65	2.37	Energy
Bank of Montreal	3.44	1.66	1.77	Financials
Goldcorp Inc	3.24	1.62	1.61	Materials
Potash Corp of Saskatchewan	2.92	1.58	1.33	Materials
Manulife Financial Corp	2.88	1.63	1.25	Financials

The Nortel Effect

The decline of Nortel's share price between 2000 and 2002 represents a clear example of single stock concentration risk. As of January 31, 2000, Nortel's weight in the S&P/TSX 60™ Index was 21.2%, but as the stock crashed during this period it put significant downward pressure on the performance of this Cap-Weighted index.

A Case For Equal Weight Investing

In contrast, Standard & Poor's back-tested data for the Equal Weight Index shows that Nortel would have only represented a 1.75% weight. As a result, the Equal Weight Index would have delivered a 31.18% return for this two plus year period versus a -11.55% return for the S&P/TSX 60™ Index.

Source: Standard & Poors and Bloomberg, January 31, 2000 to February 7, 2002

Large Financial Stock Concentration May Add Risk

Single stock risk was worthy of concern when index heavyweight stock Manulife Financial lost nearly two dollars per share over the course of two days dropping from a close price of $16.00 on August 4, 2010 to a close price of $14.20 on August 5, 2010.

Manulife's recent stock price decline, which was likely due to its quarterly earnings report that fell short of analysts' expectations, had much more impact on the performance of the S&P/TSX 60™ Index versus the Equal Weight Index.

Over the two days that Manulife lost more than 12%, the Equal Weight Index, with less exposure to both the financial sector and Manulife stock, was able to deliver a 1.19% return while the S&P/TSX 60™ Index (Total Return) returned 0.06%.

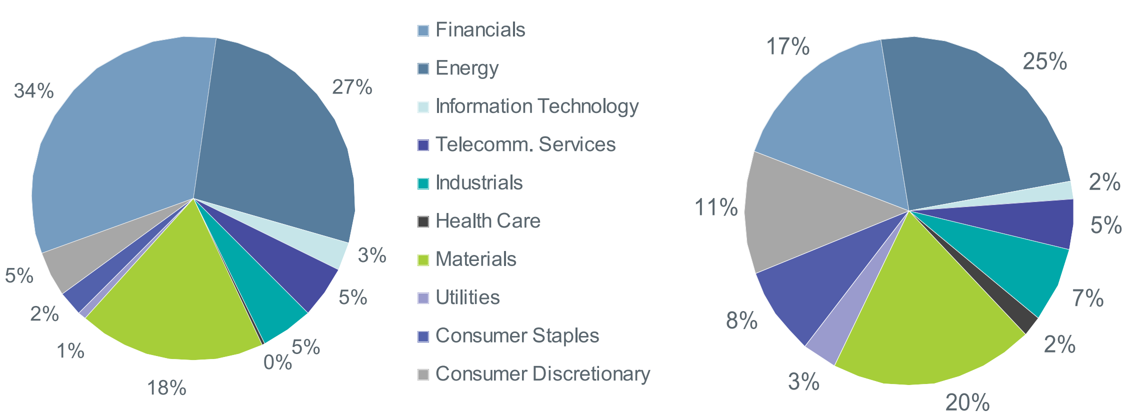
Single stock risk was highlighted again recently by three of the top ten Cap-Weighted socks in the S&P/TSX 60 Index. Bank of Montreal, Royal Bank of Canada and Bank of Nova Scotia third quarter earnings reports fell short of analysts' expectations, which we believe resulted in the significant downward pressure on their stock prices and therefore the Cap-Weighted Index relative to the Equal Weight Index.

Sector Concentration

Applied to the stocks in the S&P/TSX 60™ Index, an equal weight methodology can reduce industry sector concentration. It can also redistribute greater weighting to sectors such as industrials, consumer staples, consumer discretionary and healthcare, which can result in greater diversification within an investor's portfolio.

As of June 21, 2010, the most recent rebalancing date, energy, financial and materials stocks represented nearly 80% of the Cap-Weighted S&P/TSX 60™ Index. The Equal Weight Index had only half the exposure of the Cap-Weighted index to financials and allocated greater weights to sectors such as industrials, consumer staples, consumer discretionary and healthcare.

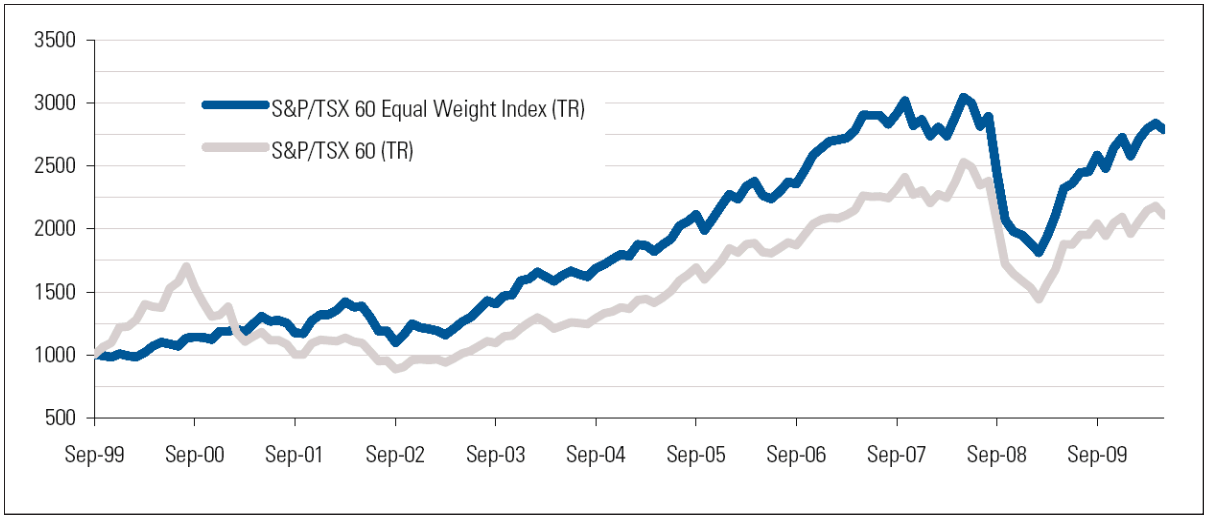
In 2009, the average annual turnover for the S&P/TSX 60™ Index was 9.7% while it was 33.6% for the back-tested Equal Weight Index. Standard & Poor's notes in a report dates August 11, 2010 that the turnover for the Equal Weight Index is still lower than the turnover for many actively managed portfolios, which tend to turnover 50% to 100% of their portfolios on an annual basis.



Source: Bloomberg, as of June 21, 2010

Better Long Term Performance

The differences in performance are subtle, but they can add up over time and compound to the benefit of an Equal Weight Index investor. Standard & Poor's notes, that in back tested performance for the past five years, the S&P/TSX 60 Equal Weight Index has outperformed the S&P/TSX 60™ Index by 0.94% per year on average. As of June 30, 2010, the one-year back-tested total return for the Equal Weight Index was 14.1%, while the one-year total return for the S&P/TSX 60™ Index was 7.9%. Over the past ten years, the historical back-tested total returns of Equal Weight Index show outperformance versus the Cap-Weighted S&P/TSX 60™ Index that is even more pronounced. As of June 30, 2010, the historical back-tested annualized return of the Equal Weight Index was 9.51% versus 2.85% for the S&P/TSX 60™ Index.



Source: Standard and Poor's. The S&P/TSX 60 Equal Weight Index values and returns for dates prior to June 7, 2010 are back-tested total returns calculated and published by Standard & Poor's.

Performance as at June 30, 2010	S&P/TSX 60™ Index (Cap-Weighted)	S&P/TSX 60 Equal Weight Index	Equal-Weighted Outperformance Relative to Cap-Weighted
1 year	7.90%	14.11%	6.21%
3 year	-3.54%	-2.42%	1.12%
5 year	6.06%	7.00%	0.94%
10 year	2.85%	9.51%	6.66%

Source: Standard and Poor's. The S&P/TSX 60 Equal Weight Index returns for dates prior to June 7, 2010 are back-tested total returns calculated and published by Standard & Poor's.

The Horizons AlphaPro S&P/TSX 60 Equal Weight Index ETF is the only ETF that tracks the S&P/TSX 60 Equal Weight Index. It trades on Toronto Stock Exchange under the symbol of HEW.

For more information on Horizons AlphaPro S&P/TSX 60 Equal Weight Index ETF visit: horizonsETFS.com/HEW

Indices are statistical composites and their returns do not include payment of any sales charges or fees an investor would pay to purchase the securities they represent or investments that track these indices. Such costs would lower performance. It is not possible to invest directly in an index. Past performance is no indication of future results. The S&P/TSX 60 Equal Weight Index was launched on June 7, 2010 and was not in existence prior to that date. All data presented for the S&P/TSX 60 Equal Weight Index prior to June 7, 2010 is historical back-tested information. There are inherent limitations associated with back-tested data and these returns do not show the actual trading of investor assets. Prospective application of the methodology used to construct the index may not result in performance commensurate with the back-tested returns shown in these tables and charts.

Commissions, management fees and expenses all may be associated with an investment in the Horizons AlphaPro S&P/TSX 60 Equal Weight Index ETF (the "Equal Weight ETF"). The Equal Weight ETF is not guaranteed, its value changes frequently and past performance may not be repeated. "Standard & Poor's®" and "S&P®" are registered trademarks of Standard & Poor's Financial Services LLC ("S&P") and "TSX®" is a registered trademark of the TSX Inc. ("TSX"). These marks have been licensed for use by AlphaPro Management Inc. The Equal Weight ETF is not sponsored, endorsed, sold, or promoted by Standard & Poor's or TSX or their affiliated companies and none of these parties make any representation, warranty or condition regarding the advisability of buying, selling or holding units/shares of the Equal Weight ETF. Please read the prospectus before investing.

European Innovation on the Growth Path

While exchange-traded funds (ETFs) have a longer tradition in the United States, they have a much younger history in Europe. 2010 marks the 10th anniversary of ETFs in Europe.

Konrad Sippel
Executive Director, Head of Sell-Side Business, STOXX Ltd.

The first European ETFs which were launched on Deutsche Boerse's XETRA platform on April 11, 2000 were based on the EURO STOXX 50 and STOXX Europe 50 indices. At the end of 2000, 3 out of a total 6 European ETFs were based on STOXX Indices. Both of these numbers have grown significantly over the past decade: today, 215 out of approximately 750 European equity ETFs – including the largest in Europe by assets under measurement (AUM) – are based on STOXX Indices.

The success of an ETF depends heavily on the underlying index – an ideal index should be rules-based, transparent and sophisticated to be a top underlying for financial products. The methodology should be clearly outlined and easily replicable, to ensure that investors will always know the index constituents on which they are basing their investment decisions.

Index construction is another issue – while closely related to that of methodology, it is separate nonetheless. An index could have a perfectly acceptable methodology, but that doesn't automatically make it an appropriate underlying for index-based investment. An index designed as the basis of financial products such as ETFs should neither be too broad nor too narrow. The index provider's objective is to find the optimal number of stocks that achieves the appropriate balance between representation and liquidity – the main goal, after all, is to construct a highly liquid, investable index to ensure investors can use it for their means.

STOXX
creating success

With an already very high number of indices out there, innovative index concepts which offer a broad range of investors access to specialist investment strategies and hence also to a variety of risk return profiles are also key when designing an index meant to be used as the basis for financial products such as ETFs.

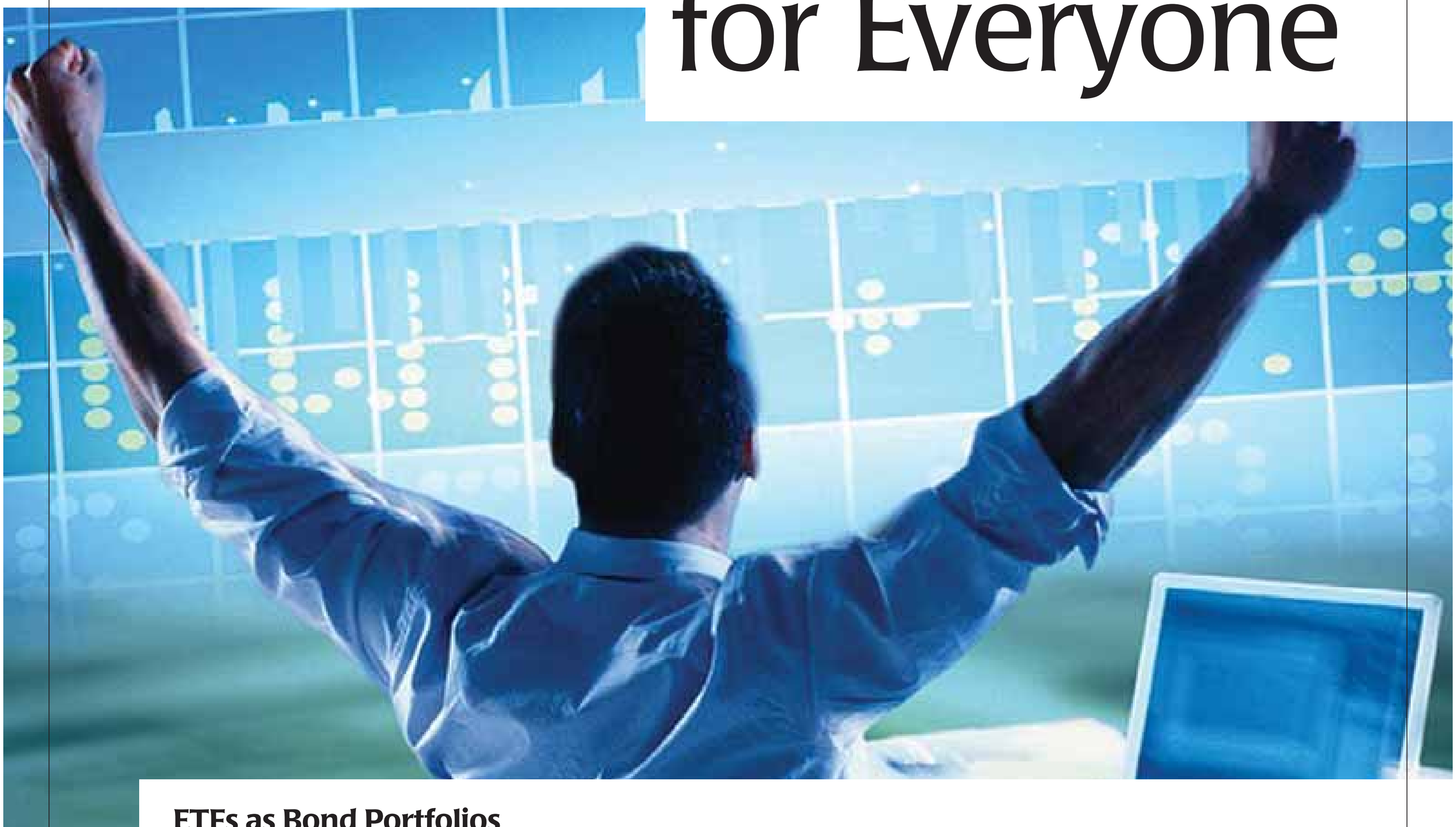
An example for an index concept which combines an innovative idea with the focus on a tradable, liquid equity index is the the STOXX Optimised Index family, which consists of the well-known STOXX Europe 600 Optimised Supersector Indices, as well as the STOXX Europe 600 Optimised Market Quartile Indices which were launched earlier this year. One of the defining features of this index family is that they are the first to take into account the ability to borrow/short a stock in the stock lending market, a key component in facilitating active trading in the underlying index constituents and related products. Moreover, they also implement a specific liquidity screening process in the selection of components. The STOXX Optimised Indices have been designed especially with the investment community and the fast tradeability of financial products based on indices in mind.

Innovative indices are far from being mere measurement tools for performance. They have developed into a flexible investment tool which gives market participants access to a range of investment options. Innovative ETFs – globally as well as in Europe – rely on innovative indices which are rules-based and transparent, offer a strong brand name and a sophisticated index concept.

Going forward, STOXX will expand its European success story on a global level, developing innovative, transparent and rules-based indices not only for all regions but also across all asset classes. Already, STOXX is marketing the index offerings of its owners Deutsche Börse and SIX Group including such well know indices as DAX and SMI together with that of STOXX, offering a well-known and widely used range of indices covering longevity, commodities, fixed-income, as well as a wide range of equity and highly innovative strategy indices.

Konrad Sippel, Executive Director, Head of Sell-Side Business, STOXX Ltd. ***konrad.sippel@stoxx.com***

Bond ETFs: Fixed Income Portfolios for Everyone



ETFs as Bond Portfolios

Mike Bruno
Director of Fixed Income Research, FTSE Group

In the early days of Exchange Traded Funds (ETFs), it seemed they were best-suited only for the equities markets because of the need for liquidity in the holdings of the underlying index. However, the ETF framework has now been extended to include a number of asset classes, such as bonds, commodities, and currencies.

Bonds behave differently from stocks, as befits their ability to pay a regular, periodic rate of interest over a finite lifetime. By the same token, bond ETFs will behave differently from stock ETFs. When evaluating a bond ETF as an investment vehicle, there are a number of unique factors to be aware of.

In most cases, the ETF will behave as the portfolio of bonds behaves. This means that standard bond market valuations and risk measures also apply at the ETF level. For instance, the standard measure of interest rate risk – the risk that a bond's price will move by a certain percentage when market yields move – is called duration. If someone tells you a bond's duration is 5, that means its price is expected to move by approximately 5% from its present level if its yield (which will reflect the market yield for similar bonds) changes by 100 basis points (or, 1 percentage point). Moreover, the price change will be in the opposite direction from the yield change. Bond prices and yields move inversely to each other.

A portfolio of bonds will have a weighted average duration which can be used to predict the approximate change in market value of the entire portfolio. Being a portfolio of bonds, the ETF will work the same way. As yields change, the market value of the ETF units will move in the opposite direction by the percentage represented by the duration. Thus, if you are told that a bond ETF has a long duration (say, anything higher than 7 or 8) its interest rate risk is relatively high. Similarly, short and intermediate maturity bond ETFs will have those durations, respectively. Their price sensitivities relative to changes in yield will be lower than that of the longer maturity bond ETFs.

Interest Rate Risk

Investors should consider the current level of interest rates in the sectors of the bond market represented by the ETF's holdings, before deciding if the ETF fits their investment needs and risk tolerance. Additionally, investors should consider how long interest rates have been at those levels and how likely they are to remain at those levels or to move higher or lower, and when.

A case in point is this year's rally in government and corporate bonds and bond ETFs. Earlier this year, many investors expected a sustainable economic recovery, especially with many governments pumping liquidity into their economies. The natural extension of this was an expectation of decreasing deflationary forces or even a slight increase in inflation by the end of the year. Under those scenarios, - interest rates would have been expected to rise. Anyone holding long maturity bonds, with their similarly high durations, would have seen their market values fall. Thus, many professionals were recommending exposure to short maturity bonds as a bearish move.

Unfortunately, the exact opposite happened. Signs of continued economic recovery in many countries were like the Cheshire cat – there one moment, gone the next. Treasury yields in Canada and the US have remained relatively low. Any bond investor with a contrarian viewpoint, who shifted assets into bond ETFs (especially the longer maturities) would have found herself fairly well-rewarded by the strong performance in bond prices. Indeed, the concern now is not with inflation but with signs of deflation, as lower prices for goods and services keep interest rates low. Low rates make the future fixed payments of bonds more valuable, driving up bond prices. As explained above, the higher the bond's duration, the more its price will increase as rates decrease. This characteristic has benefited longer maturity bond ETFs. Shorter bonds and bond ETFs have also benefited from low interest rates, but as investors seek higher yielding assets in a low rate environment, they have naturally looked at the higher duration bond ETFs.

There is a caveat in all this. Investors who buy long maturity bond ETFs after watching yields fall for months may have already missed most of the price appreciation and return in those securities. In fact, prices of many bond ETFs have fallen in the past month from their highs for the year. This could reflect a renewed concern with inflation in 2011 and a desire to take profits after an unusually good run. Investors looking at bond ETFs should judge the likelihood of continued low interest rates, and what will happen to their principal if rates rise in the future.

Replicating Index Benchmarks

Like most ETFs, bond ETFs are designed to mimic the characteristics of the indices on which they are built. However, many bond indices can easily contain several thousand, or more, constituent bonds. The ETFs that are built to replicate them may contain only a fraction of that number of holdings. The institutional round-lot size for bond trades is $1 million or multiples thereof. Fully replicating all the holdings of a large bond index would clearly be difficult for an ETF creator, from a total funding perspective. The question, then, is: can an ETF accurately and reliably replicate the risk and return characteristics of such a large index with such a limited set of securities.

Active bond portfolio managers often face this same issue. Their chosen performance benchmark may be one of the commonly-used broad bond indices. Most managers hold no more than 100-150 bonds, maximum. If the manager is running a broad active bond portfolio, the benchmark index will be one that comes closest to representing the types of bond in which the manager invests. If the manager is running an index fund, the process is reversed. She will start with a chosen benchmark index and use a sampling or optimization approach to select a limited number of bonds to replicate the index.

Since the latter is very much what an ETF is doing, the same sampling or optimization approach may be used. In general, these methods can and do produce a smaller portfolio that reasonably represents the risk and return of the larger bond index. For purposes of creating an investable proxy for a large bond index, practicality trumps precision.

Liquidity

Another issue with bond ETFs is the liquidity of the underlying holdings. While active bond portfolio managers will trade bonds before they mature, most individual investors will hold bonds until they mature. Part of this is due to liquidity – the vast majority of the several million outstanding bonds are illiquid or thinly traded, at best. Individual investors typically buy and hold bonds for their steady income and capital preservation characteristics. This leaves only several thousand bonds, globally, with which to create relatively liquid, tradable ETFs (remember, the "ET" in ETF means exchange-traded). As we noted above, full replication of a bond index by an ETF may not be possible. Thus, an additional consideration in the sampling approach must be to include the largest and most liquid bonds in the underlying index so that the ETF is as liquid and tradable as practicable. Even then, many individual investors will buy and hold bond ETFs for the long term.

Of course, institutional investors also make use of bond ETFs, just as they would individual bonds and bond mutual funds. Via bond ETFs, institutions can create or change exposures to various bond markets as readily as trading individual securities. Because the ETF represents an index, or bond portfolio, a single transaction replaces the many individual security transactions that would be required to achieve the same result. This results in lower overall transaction costs and concomitantly higher returns.

The Benefits of Bond ETFs

Given the relative illiquidity in the bond markets, the inherent difficulty in predicting interest rates, and the fact that most bond ETFs distribute very little in the way of capital gains (mitigating their tax advantages), they are nonetheless among the most popular ETFs in 2010. Capital has been flowing into bond ETFs and it is estimated that the global market for them will hit $200 billion next year. But, why are investors buying ever more bond ETFs when many sectors of the market (especially US Treasuries) are offering their lowest yields in years? What's driving the inflows to bond ETFs that are yielding just a few percentage points, or less? There are several factors.

Continued on page 28

Investors should consider the current level of interest rates in the sectors of the bond market represented by the ETF's holdings, before deciding if the ETF fits their investment needs and risk tolerance.

Diversification

One factor is diversification. Bonds are considered a good addition to investment portfolios because of low long-term correlations with equities. As more bond ETFs are created investors have gotten used to the concept of investing in fixed income via tradable portfolios, which look very much like the bond mutual funds that have been around for years. Globally, there are more than 200 bond ETFs available to investors, covering a variety of bond types. The first fixed income ETFs ever created were launched in Canada in November 2000 and were traded on the Toronto Stock Exchange.

It should be mentioned, however, that not every bond ETF has proven popular with investors. Some have been launched and subsequently discontinued due to low assets under management. Insufficient diversification in the underlying portfolio and unpopularity in the bond sector represented by the ETF are among the reasons for this.

Expenses and Returns

Another reason that bond ETFs are attractive to investors is their expenses. Total Expense Ratios (TERs) are typically lower for bond ETFs than those of most other asset classes – between 0.05% and 0.60%, with a few specialized bond funds approaching 0.95%.

Finally, there are the disappointing returns to be found in general equities in 2010. To be sure, for the strong-willed with a long-term perspective, this may be one of those few moments in equity markets history where an investment today will produce above-average returns when viewed in hindsight. For those who are not so sure, a small but positive yield or return in bonds and bond ETFs may be a better choice, allowing for a bit more sleep at night. But, do watch for possible changes in interest rates in the coming months.

Conclusion

Overall, the development of bond ETFs makes it possible for individual and institutional investors alike to buy, sell and hold fixed income portfolios more efficiently than before. While there are fewer bond ETFs available than traditional bond mutual funds, gaining a certain amount of exposure to a sector of the bond markets with a single transaction has powerful appeal. Over time, as more bonds are traded more frequently, either on exchanges or on electronic networks designed for fixed income, the number of bond ETFs available should increase.

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Why "Structured Eclecticism" is Now the Golden Approach to Global Strategy

Remember "the Great Moderation" phenomenon?

Tyler Mordy
Director of Research, Horizons HAHN Investment Stewards & Company Inc.

A Harvard economist coined the phrase in a 2002 research paper[1] to refer to the persistent decline in output and inflation variability since the mid-1980s. The slogan attracted a much wider audience when Ben Bernanke entitled a 2004 speech with the same words. Numerous economists took the concept and projected it well into the future. In retrospect, was macroeconomic volatility really a thing of the past?

Enter the Global Financial Crisis (GFC). Since 2008 volatility has returned with a vengeance, and credit markets have continued to contract. Not surprisingly, the validity of a permanent period of moderation is now seriously being called into question. In fact, the relatively benign financial backdrop of the last 25 years has morphed into a different animal altogether… leaving many investors dazed and confused. Many had never witnessed a world where financial markets could collectively rise and fall so dramatically or where economic data could swing so wildly.

While we are not predicting a sustained rise in global volatility, the GFC has radically transformed the macroeconomic landscape. How so and how best to respond? Most important for this new period, is that a thematic top-down, global macroeconomic investment approach will become mandatory (often referred to as "global macro"). This style of investing surveys "big picture" conditions around the world, analyzing investment classes in order to select those that are forecasted to outperform on a risk-adjusted basis. Fortunately, ETFs are tools that lend themselves well to this approach, providing exposure to a wide variety of theme-based asset classes.

HORIZONS
HAHN INVESTMENT STEWARDS

Make no mistake – we are not arguing for the abolishment of traditional bottom-up security selection. Benjamin Graham-style value investing remains a fundamentally valid investment process. And, this bottom-up methodology can also be applied to ETFs where aggregate index valuation levels can be analyzed, (using the same measures employed with individual company analysis). However, given ongoing structural re-alignments, it is clear that macro dynamics will play a more significant role in influencing the direction of global capital markets in the coming years. Of course, many questions are left unanswered. Which particular macro factors will shape the investment topography in the coming years? And, importantly for investors, what portfolio strategies will be appropriate in this new, post-GFC environment?

Expanded Measures of Risk

Risk is perhaps the most misunderstood concept in finance. It certainly cannot be distilled into a single number (standard deviation or VaR measures for the quants out there). But recent large portfolio declines have challenged traditionally held assumptions about risk. During the recent financial market meltdown, many bottom-up forecasting models – that have worked well in the last 25 years –failed to deliver positive results.

ETFs are tools that lend themselves well to this approach, providing exposure to a wide variety of theme-based asset classes.

Why Top-Down, Global Macro?

Renowned global macro investor George Soros once remarked that his investment style did not play according to a set of rules, but rather continually looked for changes in the rules of the game. So it is today: some accepted investing rules having been tossed out the window and replaced with a challenging new game to navigate. Below, we list key reasons for incorporating a top-down, global macro methodology in the investment decision-making process:

Thematic Investing and the New Normal

The GFC has unleashed a number of important macro shifts that will influence trends in global capital markets in the coming years. While the global economic free-fall has passed, the United States and other consumption-driven appendages are likely to settle at a new, lower level of economic activity… experiencing more subdued nominal growth than witnessed since the mid-1980s (where the tailwind of US household debt expansion existed – soaring from 64% of GDP in 1995 to over 100% today). The lingering problems caused by deflating asset bubbles, radical capital misallocations and government debts will constrain overall growth in the wider economy.

How should investors position themselves in this type of low-growth environment in the cash world? Low inflation and economic growth combined make a difficult environment for general profit growth. A broad-based approach, therefore, is unlikely to be a successful strategy. In fact, a high-probability scenario is a secular period of range-bound stock indices in Occidental markets. As such, an opportunistic theme-driven approach to portfolio management will be essential. Rather than allocating investments according to country or region, investors should search for supply-demand mismatches of capital in various sectors, industries and themes… analyzing global macro factors for guidance.

While certain regional economies and financial markets may fare better over this period (primarily in the non-Western bloc), shifting portfolio allocations among developed country investors ensure that these markets will remain highly cyclical. Consider that emerging markets still only account for just over 10% of the all-country MSCI World market capitalization. Therefore, capital re-allocations from developed country investors can create large waves in the smaller capital markets of emerging countries. Macro factors such as market sentiment and fund flow dynamics will be key considerations for calibrating portfolio exposures here.

What went wrong? To begin, it's instructive to recognize that many investment decision-making models used on Wall Street rely on historical data inputs. But can backward-looking data really chart the future? One of our colleagues compares this approach to driving a car while looking solely through the rear-view mirror… believing that the road ahead will be a continuation of the curves and straight-aways just experienced. While the rear-view mirror can provide valuable information, it cannot provide many important signals about the path ahead.

So it is with financial markets. Yes, investors should be avid students of financial history (particularly as it pertains to the cyclical nature of markets and underlying causality… oscillating regularly from risk to recoil). But, relationships among financial and economic variables are continually changing, often experiencing structural shocks that significantly alter their correlations. What's more, since many risk models use historical volatility assumptions (often from a benign period), they seduce their users into a false complacency, leading to a vast underestimation of risk. A top-down framework can help identify risks that would not be readily available from past data.

For example, prior to the GFC, many of our top-down models were signaling unsustainable developments tied to the US banking sector. Profit margins had risen to unrealistically high levels, with a large portion of earnings driven by the packaging and sale of mortgage-backed securities. This profit machine could continue as long as house prices continued their multi-year climb. Optimists pointed out that there was no historical precedent for falling US home prices… and continuing healthy profits should be expected from the banking sector. A top-down approach provided a different view. The supply of unsold homes started exploding higher as early as January 2005… and serious cracks started appearing in affordability measures. A number of other alarming developments surfaced in the housing sector… portending a challenging environment ahead. With the benefit of that top-down view, we were able to reduce risk accordingly and mitigate portfolio losses.

Globalization of Finance

Globalization is not a new phenomenon. For example, consider the expansion of trade links between the Roman Empire and the Han Dynasty over 2000 years ago. Today's globalization is spreading most pervasively in the financial sphere… aligning monetary authorities, accelerating cross-border capital flows and lowering trade barriers. Increasingly, these forces are influencing investments.

Continued on page 32

A number of issues emerge from this progressively synchronized and interconnected financial system. Perhaps the most important point relates to the concept of well-diversified portfolio. During the latest market decline of 2008 and early 2009, classic portfolio diversification did not pass the test. What portfolio malfunction happened here?

It's vital to understand that cross-asset correlations among traditional developed stock and bond markets have been rising for several years now. Research Affiliates has recently shown that the classic 60% stocks/40% bonds asset mix has a 0.97 correlation with the S&P 500 index. This high correlation can be partly attributed to investors taking on too much risk in the stock component (thus overwhelming the positive benefits of bonds as shock absorbers within the balanced construct).

However, the main point is that portfolios should depart from long-accepted balanced portfolio definitions. Two concepts should be noted here. Firstly, diversification is achieved more successfully by tactically allocating investments by risk instead of allocating investments by conventional asset-class categorizations (the latter are often too highly correlated). Consider that during 2008, out of 397 long-only US listed equity ETFs, all of them experienced substantial negative returns. Secondly, an expanded set of global investments should be used. Both these objectives will rely on macro factors and themes to guide the portfolio construction process.

The Advent of ETFs

We remain steadfast advocates of the portfolio-building conveniences and benefits of ETFs – transparent, low-cost, tax-efficient, and flexible trading. Who can argue with that? But these are favorable features of just the wrapper itself – the ETF vehicle. The primary benefit of ETFs has caused a paradigm shift for global asset allocators – that is, ETFs have granted access to a multitude of global investment classes in a single security… the perfect macro tool for top-down, global approaches to investing. According to Barclays Global Investors, there are now 3,182 exchange-traded products around the world with assets of USD 1.2 trillion from 159 providers on 46 exchanges (as of the end of August 2010). And, there are plans to launch many more. Only five years ago, this macro toolbox was not available for the top-down, global investor.

Conclusions and Current Environment

The same economist who coined "the Great Moderation" also issued a stern warning at the end of his 2002 paper: "we are left with the unsettling conclusion that the quiescence of the past fifteen years could well be a hiatus before a return to more turbulent economic times." It was a prescient forecast. Today's private sector deleveraging is being fought at an enormous cost – escalating government liabilities (and, in many cases, the further misallocation of capital). But an important lesson from the GFC is that sustained debt growth in excess of underlying economic growth rates is not a sustainable model. The resulting symptoms – asset bubbles, monetary inflation and imbalances of both excess capital formation and consumption – are ultimately destabilizing forces. It is precisely in these types of unstable macroeconomic environments that the top-down, global macro approach can add substantial value to an investment process. In the post-GFC environment, portfolio policy benchmarks need to adapt… forward-looking, unconstrained mandates with a global perspective will be optimal approaches to investing.

[1] Stock, James H. and Watson, Mark W., "Has the Business Cycle Changed and Why?" (August 2002). NBER Working Paper No. W9127. Available at SSRN: http://ssrn.com/abstract=327153

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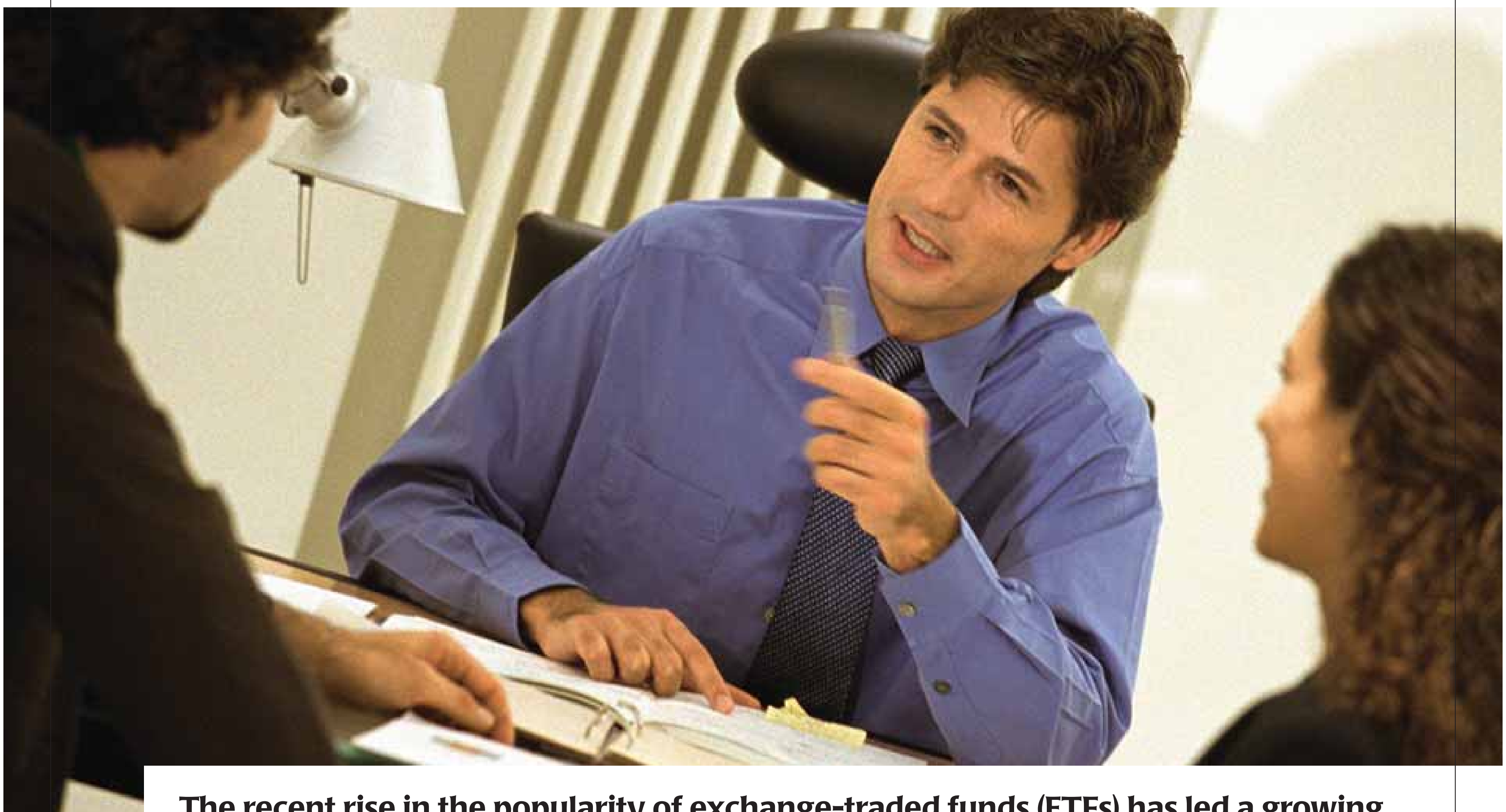
Utilizing ETFs To Increase Portfolio Efficiency



The recent rise in the popularity of exchange-traded funds (ETFs) has led a growing number of investors to gravitate toward passive investing.

Alfred Lee
Investment Strategist, BMO ETFs & Global Structured Investments

This has ignited a debate between the merits of investing in passive instruments such as ETFs against those of active investments such as mutual funds. While the debate of active vs. passive management will likely be an ongoing one, the choice should not be one that is mutually exclusive. ETFs should instead be viewed as yet another tool in portfolio construction. Both active and passive investments should be utilized in portfolio construction in order to increase an investment strategy's overall efficiency.

By combining active management with instruments that provide low cost beta such as ETFs, the risk/return parameters of a portfolio can be better optimized. In addition to improving the investment characteristics of a portfolio, ETFs can also be used to assist in the cost management of a portfolio strategy which may further improve performance. Below we highlight some common methods of how both institutional and retail users alike can employ ETFs in their portfolios to increase an investment strategy's overall efficiency.

Below we discuss how ETFs can improve portfolio efficiency by dividing variables into two categories, those variables that are exogenous and those that are endogenous. We consider exogenous variables to be those that largely relate to the composition of a portfolio. Endogenous variables, on the other hand, are those that are less easily controlled by the portfolio manager and more a function of the market and execution considerations.

BMO Financial Group
Exchange Traded Funds

Managing Endogenous Portfolio Variables

Accessibility

Above all else, perhaps the most important reason why ETFs have become so popular over the last decade is their ability to access different areas of the global market in a cost-effective manner. Originally designed to track broad markets such as the former Toronto 35 Index or the S&P 500 Composite Index, ETFs can now provide access to more exotic investment opportunities which were previously more difficult to gain exposure. Examples of these more exotic areas are emerging markets, gold bullion and even the futures market of agricultural grains. With such a wide array of accessibility, ETFs can be used by portfolio managers and investors to construct more complete and diversified portfolios, allowing investors to round-out their strategy or fill-in any potential gaps that may exist.

Access To	Availability	Access To:	Availability
Broad Equity Exposure In Developed Markets	Yes	Broad Market Bonds	Yes
Broad Equity Exposure In Emerging Markets	Yes	Bond exposure with segmented maturity and/or credit quality	Yes
Local, International and Emerging Market Sectors	Yes	International or Emerging Market Bonds	Yes
Style Funds	Yes	Hard Commodities	Yes
Currencies	Yes	Futures Market	Yes
Small Cap Funds	Yes	Leverage	Yes
Preferred Shares	Yes	Inverse	Yes

Source: BMO ETFs, Bloomberg (*Note that availability of products in above table are based on products from all ETF providers and not just by BMO ETFs)

Strategic Asset Allocation

A portfolio strategy will likely entail a “base policy mix” where an allocation of capital is assigned to each asset class and then rebalanced back to this base policy mix or strategic asset allocation on a set time interval. The innovation and breadth of ETF products now allow portfolio managers to design a complete strategic asset allocation almost entirely with ETFs, depending on the complexity of the strategy. Base policy mixes that include traditional asset classes such as equities and bonds have always been easily satisfied through the use of ETFs. Now with ETFs that access commodities and areas such as emerging market bonds, even the more unique and diversified strategic asset allocation mixes can be constructed with ETFs or exchange-traded products1 (ETPs). Furthermore, by building a strategic asset allocation with ETFs instead of single stocks, rebalancing a portfolio back to its base policy mix is much less cumbersome and costly than rebalancing a portfolio built with single securities, especially where the original portfolio characteristics must be maintained.

Tactical Asset Allocation

Although most portfolio managers adhere to a strategic asset allocation, some policies allow for a tactical shift of a percentage of assets to be temporarily held in various areas in the market. By doing so, the manager is able take advantage of market pricing anomalies or expected outperformance in certain areas of the market. When this pricing anomaly is no longer applicable, the assets can be shifted back to the strategic asset allocation. Whether it’s getting exposure to specific areas in the emerging markets, small cap companies or adjusting the duration and credit characteristics of a portfolio, ETFs are an efficient way to quickly make these adjustments. The growing number of ETFs and their evolving innovation allow portfolio managers to fine-tune their portfolios with increasing precision. Additionally, where a portfolio manager has a good appreciation for the mechanics and risks of leveraged ETFs, more exotic strategies can be executed. For example, a portfolio manager could use the increased beta exposure gained from a leveraged ETF to temporarily free up cash and invest in areas expected to add alpha to the portfolio.

Cash Equitization

The selection of individual stocks or bonds by an active manager requires time to analyze each security. As new capital is added to an investment fund via new or existing investors, idle money can create a cash drag on a portfolio since it could detract from the fund’s overall performance, causing it to underperform its benchmark, should the market appreciate between the time of new investment and selection of securities. To prevent this, cash can immediately be put to work or “equitized” through an investment vehicle that provides beta-like exposure. Traditionally, managers could access this exposure through Delta-One2 products such as futures, forwards or swaps. The development of ETFs however has provided investors with another means of cash equitization. Moreover, with the increased number of ETFs available in the market, the accessibility to different areas of the market has also increased. With ETFs, portfolio managers can now more precisely equitize their cash to better suit their particular investment strategies and can do so, with better liquidity than other Delta-One products in certain cases.

Continued on page 36

Table 1: The Advantages and Disadvantages of Different Delta 1 Products

	Exchange-Traded Funds (ETFs)	Futures	Swaps
Advantages	• Liquidity • Growing universe of access products which allows investors to target their specific exposure • Live pricing • Easily accessible	• Can create tracking error if price of futures is traded at price different than close of cash index • Tracking error can also exist depending on how the contracts are rolled from each period • Commodity futures introduce contango and backwardation issues • Live pricing	• Exposure is fully customizable and may provide more efficient exposure to areas that other delta-one products cannot • No tracking error • Fees may be negotiable
Disadvantages	• Tracking error tends to be higher than other Delta-One products • Fees may be higher than other Delta-One products	• Some contracts may lack liquidity • There may not a be a futures contract that provides the beta exposure required	• Counterparty risk • Lack of price discovery in some cases

Portfolio Hedging

Similar to equities, ETFs can also be sold short should a manager have a bearish view on a market. Since ETFs are a basket of securities, they provide much broader access than a single security. As such, a portfolio or a segment of a portfolio, can be hedged through a single trade with an ETF rather than executing a hedge through a multiple number of trades in single securities. By shorting an ETF, managers can neutralize part, or a good portion, of a portfolio, without having to sell securities within its portfolio, thereby avoiding any resulting capital gains from the sale of securities. At the same time, gains in the short ETF position should at least partly offset any losses from the long positions. Furthermore, the recent development of inverse ETFs creates added efficiency for portfolio hedging as long positions in these vehicles gain when the underlying index falls in value.

Managing Exogenous Portfolio Variables

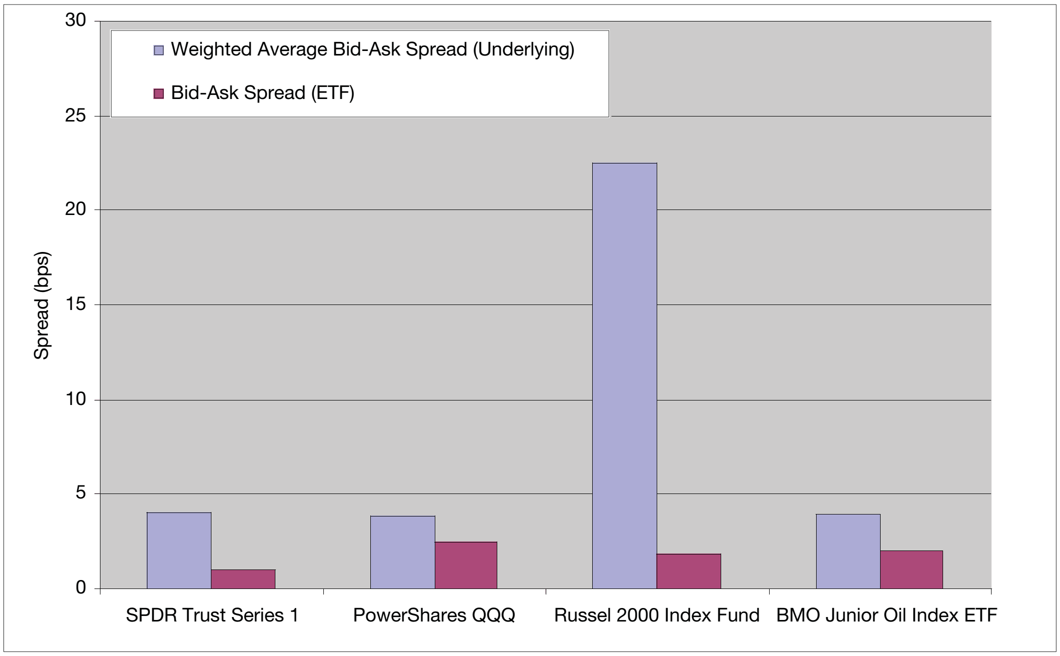
Liquidity Management

Since the last financial crisis, the need for liquidity has become increasingly important as many asset managers discovered the hard way that in times of need, liquidity is not always available. As a result, a growing number of mandates will, or already include, a liquidity policy (LP). An example of an LP may be "to be able to raise $1 million dollars of cash through liquidation in a matter of three-days." However, the level of liquidity for individual securities and thus the portfolio as a whole is not at all static but rather dynamic as it will change depending on economic and market conditions. In addition, securities will have varying liquidity levels that react differently to assorted market stress factors. Given this, using a standard mark-to-market3 measurement of the portfolio's value may significantly overstate the portfolio's mark-to-liquidity4 value. Furthermore, as each security in the portfolio has different marginal supply-demand curves5 (MSDC), raising the necessary cash to meet the LP could significantly alter the composition of the portfolio as the most liquid assets would likely be liquidated first.

The addition of ETFs in a portfolio can dramatically improve its liquidity. Some ETFs may have better liquidity than their underlying constituents because of the trading of the ETF units on the secondary market. As a result, ETFs provide efficient tools for liquidity management. For example, a portfolio manager running a credit strategy may have exposure to an area such as high-yield bonds. For those that may recall, during the depth of the financial crisis, many individual high-yield bond issues became illiquid while liquidity was present for high-yield bond ETFs in the secondary market, although they may have traded at values higher than their net asset values (NAV) during this period. Active managers may want to consider a small allocation in a portfolio to an ETF that provides a similar beta exposure to their particular investment strategy. By maintaining this buffer portion in an ETF, the manager can better meet the LP, while still maintaining the overall characteristics of the portfolio.

Cost Management

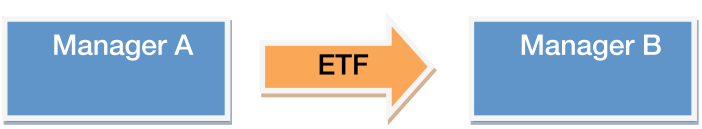
The liquidity of an ETF is determined by its underlying securities, however the secondary trading of ETF units can further tighten its bid-ask spread. In fact, the bid-ask spread on some ETFs can be even tighter than the weighted average bid-ask spread of its underlying constituents. Transaction costs should be of paramount concern to a portfolio manager, as they can significantly reduce alpha. Therefore consideration should be given to the reduction of both broker commissions and other costs, such as bid-ask spreads. Rather than executing a large number of trades in a portfolio to achieve diversified market exposure or to access to a sector, a portfolio manager can allocate a portion of a portfolio to ETFs and transactional costs can be significantly reduced. While the cost savings may be more dramatic on non-liquid asset classes such as small cap equities, the benefit of using an ETF strategy can also been seen on larger cap securities.



Source: Credit Suisse Portfolio Strategy, BMO ETFs

Transition Management

The composition of an institutional portfolio will at times need to be restructured, typically due to the investment management functions being assigned to a new manager. However, the selection of a new manager and the due diligence process involved may require time. During this time gap, the plan sponsor may not want to be sitting in cash and may need to maintain exposure to an asset class. As a solution, the assets in the portfolio, which now sit unmanaged, can be transitioned to an ETF to achieve low-cost beta and avoid cash drag in the overall portfolio. As the ETF market has evolved over the last decade, the number of products has grown tremendously. As such, the plan sponsor can specifically allocate the type of beta that can be targeted until an appropriate manager is assigned.



Bringing International Trading Hours Local

When investing in international areas, managers may at times need to trade in different time-zones which could be inconvenient especially where the time zone difference is significant. As an example, a North-American based manager running a global macro-strategy may want exposure to Asia-Pacific based equities. However, since the manager operates during North American trading hours, it would be necessary to work outside normal hours to get real-time trading. Alternatively, the manager can attain the desired exposure through an ETF trading on a North American exchange, trading in real-time during normal North American working hours. Although the underlying constituents of an ETF may be international securities that trade in a market that has closed for the trading day, the ETF will be priced off of market sentiment, providing price discovery for the underlying market, much like futures.

Conclusion

In this paper, we have only discussed some of the more common methods of the way ETFs can be used to better increase the efficiency of a portfolio. It is by no means an exhaustive record of how ETFs can be applied as portfolio construction tools. As ETF products become increasingly innovative, their uses in building a complete portfolio strategy will only grow. Going forward, as both institutional and retail investors become more educated in understanding the mechanics of ETFs, we expect to see the adoption of ETFs in portfolios to be on the rise.

Alfred Lee, Investment Strategist, BMO ETFs & Global Structured Investments ***alfred.lee@bmo.com***

Footnotes

1 Exchange-traded products (ETPs) are a more broad classification of exchange-traded funds, which also includes products that use commodities, futures, swaps and other non-traditional asset classes to track a benchmark.

2 Delta One products have no optionality and as such have a delta of one (or very close to one). As such a 1% move in the underlying results in very close to a 1% move in the product. Delta one products give the holder an easy way to gain exposure to a basket of securities in a single product.

3 Mark-to-Market is a measure of the fair value of assets that can change over time using existing market rates without taking into consideration the liquidity of particular assets.

4 Mark-to-Liquidity is a measure of the fair value of assets that can change over time while considering the liquidity or lack thereof for particular assets. The mark-to-liquidity value cannot exceed the mark-to-market value.

5 Marginal Supply-Demand Curve (MSDC) compiles the information in a broker's order book: the number of units available for sale (or purchase) at each possible price point. Equivalently, the MSDC summarizes the cash proceeds received from selling any amount of a particular security, or the cash required to purchase any amount of the security.

ETFs: The Next Generation of Investing

Exchange-traded funds (ETFs) have exploded in assets both in Canada and across the globe, and their complexity seems to be increasing just as quickly.

John Gabriel
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That's why we are so excited about this first inaugural Exchange Traded Forum. With a superb lineup of industry experts and investment professionals, we encourage attendees to take this opportunity to learn as much as they can about this new and exciting corner of the asset management industry.

Since the beginning of the year, through September, investors have poured more than $2.1 billion into Canadian-listed ETFs. As of September month-end, total net assets were well over $35 billion invested across more than 160 ETFs, representing year-over-year asset growth of about 32%. Total ETF assets held by Canadian investors, however, is probably more in the range of $70 billion if we consider the assets invested stateside on U.S. exchanges. Based on that, ETF assets held by Canadians stands at around 10% of total mutual fund assets. That's right inline with the ratio of ETF to mutual fund assets in the U.S., which (in some respects) has a more developed ETF industry.

In our view, ETF growth is still in the very early innings of growth in Canada. We expect similar growth rates to persist in the years ahead, both in terms of asset growth and product proliferation. Moreover, increased education and awareness should help drive adoption rates among financial advisors and do-it-yourself investors.

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Upon reflecting, it's easy to understand how investors could be complacent with high mutual fund fees when the markets were consistently posting annualized returns in the mid-teens – everyone was happy because they were all making money. However, now that many are expecting "normalized" returns going forward to be more in the low-to-midsingle digit range, those 2%-plus fees start to matter much more.

Here in Canada, the financial services industry relies heavily on commissions, and has understandably shown resistance to adopting ETFs. With all the tailwinds behind ETFs – low cost, tax efficiency, transparency, access – this resistance by intermediaries serves as a considerable hurdle to further growth. However, I expect that we'll see a shift to predominantly fee-based advisory services. The question is whether it happens gradually (through competitive market forces) over the course of a couple decades – as it did in the U.S. – or, if it is legislated – as is happening in both the U.K and Australia.

ETFs fit into the fee-based advisory model perfectly. Advisors will still collect their 1% fees (or whatever fee they negotiate), and their interests will be better aligned with that of their clients. It's a win-win for all parties. Advisors would be more inclined to put clients into lower cost products with a vested interest for positive performance, as their fees are tied to total assets under management. In this more investor-friendly structure, the investment advisors will be sought after for asset allocation decisions, rather than fund selection (which can lead to conflicts of interest).

After all, perhaps the most important decision faced by an investor is the asset allocation decision – how to allocate assets along the risk-return spectrum. While it is common to spend a great deal of time researching individual stocks or fund managers, studies have shown that asset allocation can add at least as much value as selection within an asset class. The advantages of ETFs are even more pronounced for asset allocators, as ETFs provide a precise tool with which to implement a portfolio.

An Introduction

Although the ubiquitous SPDR S&P 500 (SPY) is perceived by many to be the first exchange-traded fund, the industry actually has its roots right here in Canada. The Toronto 35 Index Participation units (TIPs) listed on the TSX in 1990 – a full three years before SPY made its debut. While exchange-traded products have existed for 20 years, it's fair to say that ETFs are still a fairly new investment vehicle among the investing public. What began as a tool for institutions to easily equitize cash and hedge portfolios in a single trade has evolved into an investment vehicle that has democratized the investment landscape for good.

ETFs, which are most simply described as funds that trade like stocks, started off as passive funds that followed broad stock indexes, allowing investors to track the performance of major equity markets through a single low-cost fund. The next ETFs to strike success bought actual bars of gold, allowing individuals to own this classic diversifier for a very low cost compared to paying retail bullion prices and paying for a safe deposit box or other security measure. Since then, new ETF offerings have blossomed to embrace nearly every aspect of the capital markets. The opportunity set available to investors today has exploded as a result, providing investors with access to asset classes that were previously limited to institutional investors or difficult to access, such as commodities, currencies, emerging market debt, daily leverage, and frontier markets, to name a few.

The Potential Benefits...

The single biggest benefit of this fund type lies in its incredibly low costs. Because ETFs (for the most part) tend to follow passive stock market indices, they do not need to worry about the cost of high-salary analysts working away to pick companies for investment. But this explains only half the cost savings of ETFs. While traditional funds management companies need extensive back-office systems to track purchases or sales throughout the day and track the share balances for their thousands of investors, ETF managers only need to worry about transactions with a small handful of market makers (Designated Brokers) who buy and sell the extra shares on the exchange. This greatly simplifies the management and trading operations of ETFs, and allows individuals to buy these funds at management costs previously only accessible to large institutions such as pension funds or insurance companies.

The next biggest benefit of ETFs has been the opening of new asset classes. Sure, some fund managers would buy into emerging market bonds when they looked cheap, but how could an individual do the same? Or how about currency investment using a carry trade strategy without pouring time into managing a forex account? Now these asset classes and strategies are available in ETFs trading on exchanges in Canada and the U.S. And unlike actively-managed funds, ETFs stick to a single strategy or defined portfolio, so you know that what you buy today will be what you hold tomorrow (i.e. no style drift or portfolio manager turnover concerns).

Of course, the ability to buy all these new asset classes certainly does not mean you should. In fact, many of them tend to be poorer investments over the long run than good old bonds and common stocks. Still, in the hands of a savvy investor, these new asset classes open up a range of new strategies that have their time and place to supplement a balanced traditional portfolio.

The fact that ETFs trade throughout the day on stock market exchanges adds a couple of other differences for those used to investing in mutual funds. Purchases and sales can happen almost immediately, so that investors know precisely what price they pay for the fund shares rather than waiting until the end of the day. This also means that trading in and out of ETFs is not free; investors pay a commission and deal with bid-ask spreads to buy or sell, though it will be the cost of a stock trade and will go to their broker rather than their adviser or the fund company. Keep in mind that the investor who allocates say, $200 a month to their investment portfolio, would likely be better off with a mutual fund that doesn't charge transaction costs. However, for larger lump sum purchases, the cost advantage offered by ETFs can be enormous.

Closed-end funds have offered intraday trading for decades, but were also notorious for the premiums and discounts they could trade at relative to the value of their underlying holdings. ETFs avoid this issue through their constant ability to issue new shares or redeem unwanted shares from the market. If the ETF trading price dips too far below the value of its holdings because investors are selling it, then any number of specialty trading firms (Designated Brokers) will happily buy those cheap ETF shares and sell the fund’s basket of underlying holdings until the discount disappears. The trading firm can then square its books by giving the unwanted shares to the ETF manager, who returns the equivalent basket of holdings from the ETF portfolio in an “in-kind redemption”.

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The same process in reverse will cause any premiums to disappear as trading firms sell ETF shares on to the market while buying up the underlying holdings, and creating new shares of the fund at the end of the day. It's this arbitrage mechanism that keeps an ETF's market price from deviating from its net asset value (NAV).

The "in-kind" process also contributes to another major benefit of ETFs: tax efficiency. ETF managers can flush capital gains out of the portfolio by swapping out lower cost basis shares, thereby continuously raising the cost basis and reducing the potential capital gains exposure. Of course, the lower turnover associated with passive indexes also helps maximize tax efficiency.

Along the same lines, an often overlooked and underappreciated benefit of the ETF structure is the fact that investors will not be affected by the actions of other investors in the fund. This is an important distinction from traditional open-end mutual funds, which create and redeem shares for cash. Even open-end passive index funds need to sell some of their holdings if they face net share redemptions, which can incur capital gains. This caused considerable outcry from investors in 2008, considering that some funds issued tax liabilities to shareholders despite the severe market decline.

...And The Potential Costs

Of course, like all financial innovations, exchange-traded funds are not all roses for the common investor. If misunderstood or used improperly ETFs covering currencies, commodities, and all the rest can be as much of a trap as a boon. ETF portfolios can also court some risk of a major financial calamity leaving them high and dry, whether due to securities lending or reliance on swaps to provide returns. Finally, the costs of trading ETFs should never be ignored, and in some situations can even make them more expensive than traditional fund alternatives.

While ETFs have been touted for their low fees in a country where 2.5% management expense ratios are the norm, it's important to understand some of the nuances and risks associated with the vehicle. Extreme market conditions over the past couple of years have exposed some warts on ETFs, but I'd venture to say that many of those issues were magnified by the unparalleled transparency of ETFs. Just because the curtains are closed (considerably less disclosure) to investors in many traditional mutual funds, does not mean that similar issues do not exist.

The Bottom Line: The Pros Heavily Outweigh the Cons With ETFs

We at Morningstar think that these new funds provide a powerful tool for individual investors to finally match big institutions, both in the breadth of available asset classes and the lowest possible management costs. ETFs have been a powerful force in the democratization of investing, and we see no end in sight for continued growth and innovation from this industry.

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Tracking the Broad Canadian Market

Horizons BetaPro new S&P/TSX 60 Index ETF (HXT) to track the broad Canadian market, competing principally with iShares S&P/TSX 60 Index Fund (XIU), but also BMO Dow Jones Canada Titans 60 Index ETF (ZCN) and potentially other ETFs in Canada as well as iShares MSCI Canada Index Fund (EWC) in the United States.

Benefits

1. Least expensive product for broad Canadian exposure at 7 bps expense ratio compared with 15 bps for ZCN and 17 bps for XIU;
2. Tracking error should be greatly reduced when compared with competing products, improving overall performance;
3. Investors will not receive any regular distributions and may not in general be subject to the tax implications relating to the S&P/TSX 60 common dividends.

Considerations

1. Initially Investors face up to 10% derivative counterparty credit risk and potentially more if additional counterparties are used;
2. Not suitable for investors seeking yield;
3. Other potential tax related events, such as gains from direct redemption of units as opposed to open market sales, may be subject to income treatment.

HXT Tracks Performance of S&P/TSX 60 Index (Total Return)
A total return index reflects the performance of a basket of stocks assuming all dividends and distributions are reinvested back into the basket, as opposed to a price return index that assumes all dividends and distributions are paid out to shareholders. As a result, this ETF, which tracks the S&P/TSX 60 Index (Total Return), will not pay any regular distributions to investors and will have all dividends and distributions reflected in its price on the ex-dividend date.

Derivative (Total Return Swap) Based ETF
BetaPro has structured this product with over-the-counter derivatives, specifically Total Return Swaps (TRS). As a result, the ETF holds TRS instead of the more traditional basket of equities investors may be more familiar with. This improves operational efficiency within the ETF and allows for a very inexpensive product with minimal tracking error. Initially, the ETF contains only one TRS.

Least Expensive Product for Canadian Market Exposure
The Expense Ratio of the product is the lowest available of any ETF on the broad Canadian market anywhere at 7 bps. Products in Europe and the US offering Canadian market exposure range from 30-60bps. In Canada, the ZCN was the least expensive at 15 bps followed by XIU at 17 bps.

Auto-Reinvestment with No Regular Distributions
The total return structure of the product means investors will not receive any regular dividends or any other regular distributions from the ETF. The only time the investor receives any part of the investment is upon physical sale or redemption of units of the ETF. The product is exclusively for investors seeking capital appreciation and not suitable for investors looking for yield. The advantage of auto dividend reinvestment is that investors have immediate compounding in the S&P/TSX 60 Index, beneficial in an up-trending market, not requiring any additional manual trades or costs.

With no regular distributions, investors in general may not be subject to the tax implications relating to the common S&P/TSX 60 dividends. At the time of sale of the ETF, in part or in whole, Canadian investors holding units of the ETF in taxable accounts may realize a capital gain or loss on their net proceeds after costs vs. their adjusted cost base, with the exception of any amount payable by the ETF required to be identified as income.

Other Tax Considerations
Something investors should also keep in mind is that there is the potential for other tax related events to arise. For example a holder of the underlying units that chooses to redeem, as opposed to selling the units in the market, in part or in whole may be subject to income treatment on any gains on their net proceeds.

Investors Face Some Credit Risk
As a result of the derivative based structure, investors do face some credit risk. The credit risk is initially to National Bank of Canada, which is the provider of the TRS to the ETF at the outset, and only relates to any appreciation in value not yet marked-to-market. This can represent no more than 10% of the entire investment initially as the ETF remains structured under Mutual Fund regulations, specifically NI 81-102, which allows a fund to have up to a maximum of only 10% exposure to any single counterparty. Any additional counterparties would raise the maximum exposure potential by 10% increments.

Greatly Reduced Overall Tracking Error
Because the underlying asset is a TRS with a guarantee to pay the total return of the S&P/TSX 60 Index, investors should experience much less tracking error than competing products, Table 1. Further, the lower overall cost of the product also contributes to a tighter performance of the product versus the index. Factors such as bid/ask spread, expected to be small, and discount or premium to NAV will continue to have an impact on performance for investors and depend on live trading characteristics.

Not Subject to Certain Holding Restrictions for Mutual Funds
HXT is classified as an index participation unit under NI 81-102. As a result, Mutual Funds will be relieved of the restrictions regarding control or concentrations and be allowed to own more than 10% of the fund. Further "early warning" requirements will not apply with respect to acquiring units and exemptive relief has been obtained, allowing the acquisition of more than 20% of the units without takeover bid requirements, providing managers do not vote on more than 20% of the units.

Article submitted courtesy of:

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