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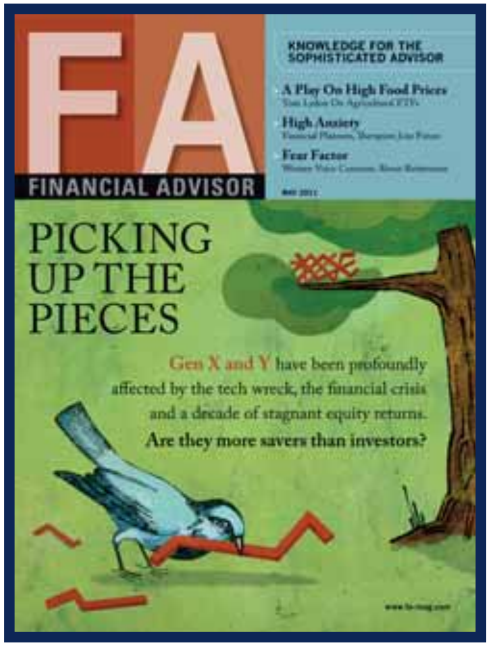

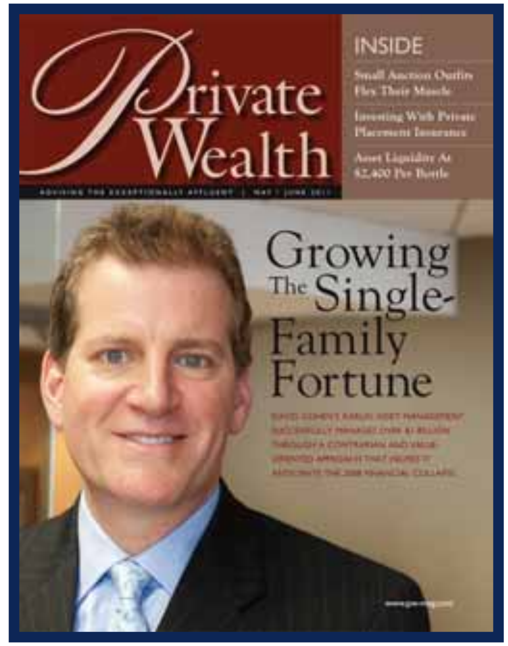

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Dispelling the Myths of ETFs:
Trading, Pricing and Accessing Liquidity

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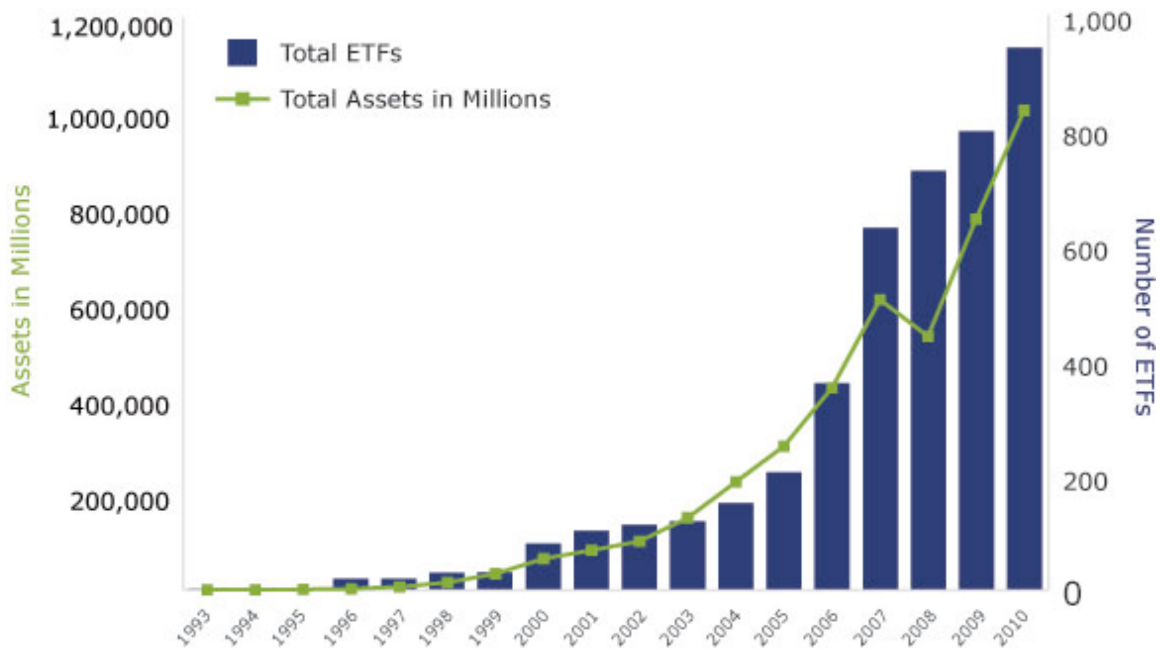
- **The ETF Landscape**
- ETF Pricing
- Creation and Redemption Process
- Trading ETFs
- Accessing Liquidity
- Managing ETF Risks
- Conclusions

The ETF Landscape

- Extensive adoption by institutional and individual investors, RIAs, hedge funds, and traders has yielded an extensive market of ETFs with assets growing by 57% per annum since 1993, according to the ICI January 2011

- Today there are ETFs to manage risk across most asset classes
  - Equity
  - Fixed Income
  - Commodities
  - Currencies
  - Alternative strategies



SOURCE: Investment Company Institute January 2011

Potential Benefits of ETFs

- Provide individuals with access to institutional-quality portfolio-building tools
- Transparency—in holdings, costs and performance attribution
- Provides the ability to leverage advantages of index investing-performance, costs and tax efficiency

Additional Considerations

- **Trading**
  Develop a consistent approach to trading ETFs

- **Liquidity**
  Are there risks of moving the market or of trades not being executed because of limited liquidity?

- **Market pricing risk**
  Can premia and discounts relative to fair value materialize/persist as they do with closed-end funds?

ETFs: Advantages and Disadvantages

Advantages

- Listed on an exchange and allow for intraday trading
- Generally low expense ratios
- ETF structure may offer opportunities for increased tax efficiency
- Liquid
- Access
- May have options

Disadvantages

- Transaction costs
- Bid/ask spread
- Shares may trade below their NAV
- No assurance an active trading market will develop or be maintained
- Brokerage commissions

Different Funds, Different Costs

ETFs tend to have lower expenses than mutual funds

Comparison of ETF expense ratios by fund category

Morningstar Category	ETFs: Prospectus Net Expense Ratio	MF: Prospectus Net Expense Ratio
Alternative	0.82	1.86
Allocation	0.63	0.67
Commodities	0.72	1.27
Fixed Income	0.32	0.80
Tax Preferred	0.27	0.78

Source: Morningstar Direct (as of 10/30/10)

Net expense ratios are average expense ratios for the category.

Relative Value

ETFs:

- Tend to have lower expenses than mutual funds
- Tend to have the lowest costs when they are based on large indices

Average Expense Ratios	
ETF	0.56
Open End Mutual Fund	1.34
Open End Index Mutual Fund	0.98

Investment Objective	Avg. Expense Ratio	
	ETF	**Fund**
Sector	0.54	1.66
Country-Specific	0.65	1.85
International (broad-based)	0.54	1.57
Broad Market Domestic	0.43	1.37
Commodity	0.71	1.40

Source: Morningstar Direct January 2011

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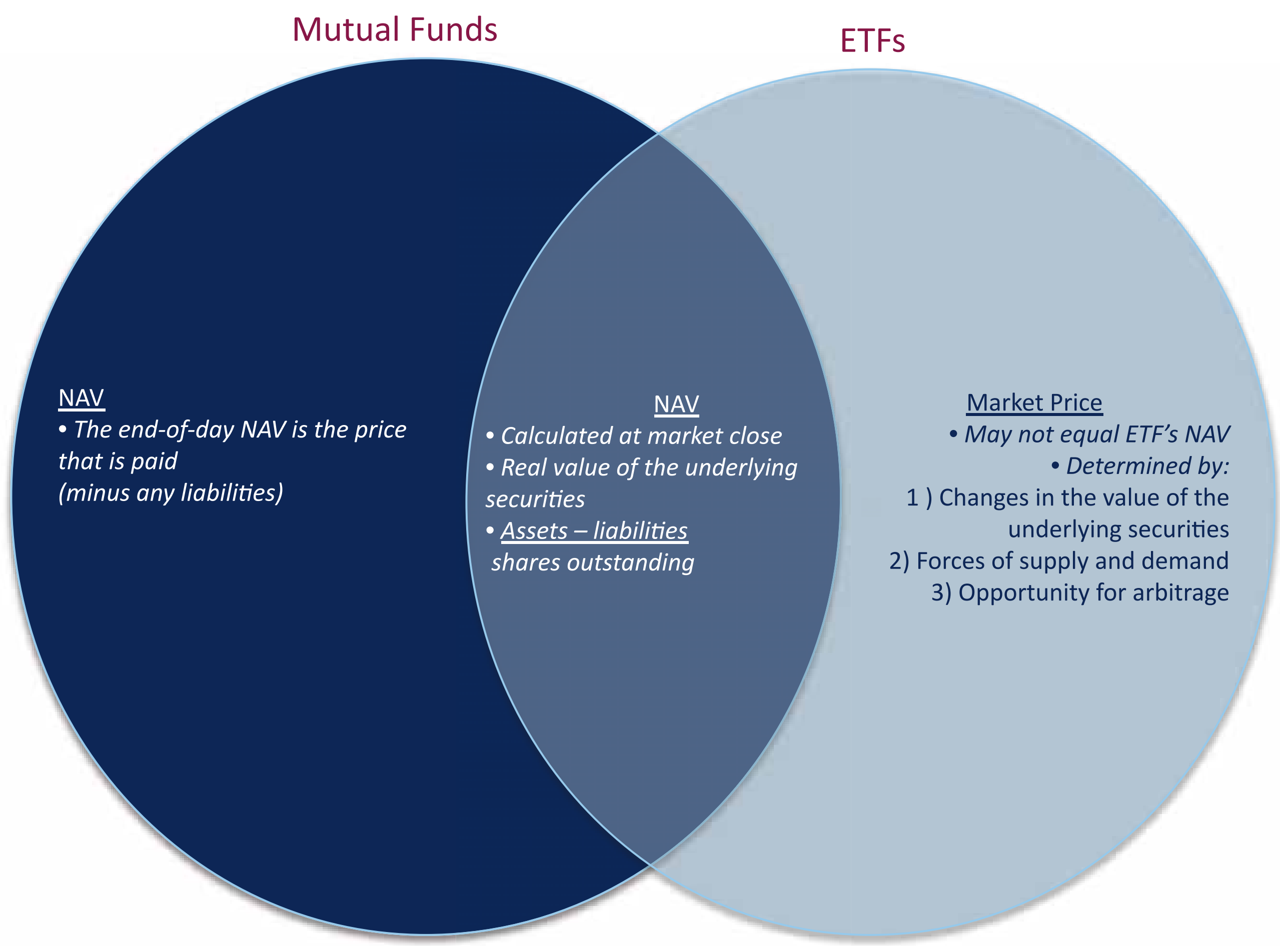
Parting Ways: NAV and Market Price



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Intraday Indicative Value (IIV)

- Approximation of the ETF's NAV
- Also called: Indicative Value (IV), Intraday Optimized Portfolio Value (IOPV), Intraday Portfolio Value (IPV) and Underlying Trading Value
- Published by an exchange every 15 seconds throughout the trading day
- Each ETF has its own Intraday Indicative Value ticker

Gauging Each Price

- **Market price**—tells an investor the last trading price per share
- **NAV**—tells the investor the true value of an ETF; per share value equal the total value of all the securities in a portfolio, less any liabilities, divided by the number of share outstanding
- **IIV**—enables an investor to have a real-time estimate of the NAV

Key Takeaways about Pricing

- ETF market price is determined by price of underlying securities, market supply and demand forces, as well as arbitrage opportunities
- An ETF's net asset value (NAV) represents the value of the ETF's underlying securities as of market close
- Indicative value represents an estimate of NAV throughout the day
- Investors may purchase shares at a premium or discount to the net asset value

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It All Starts with the Authorized Participant

- Authorized Participants (APs)
  - Broker dealers (lead market makers or market makers)
  - Initiate the creation of ETFs when:
    - There is a need to fill an order or to generate inventory
    - There is an opportunity for arbitrage
  - Are the only institutions that create or redeem shares of an ETF

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Understanding the In-Kind Transaction

- Considered an "in-kind" transaction since AP buys baskets of common stock, which are transferred to the ETF Sponsor in exchange for shares of the ETF

- Can lead to potential enhanced tax efficiency of the ETF itself:
  - AP handles the transaction—not the sponsor
  - Shields the fund (and in turn the investor) from trading costs

- Establishes the cost basis or tax basis for the new securities

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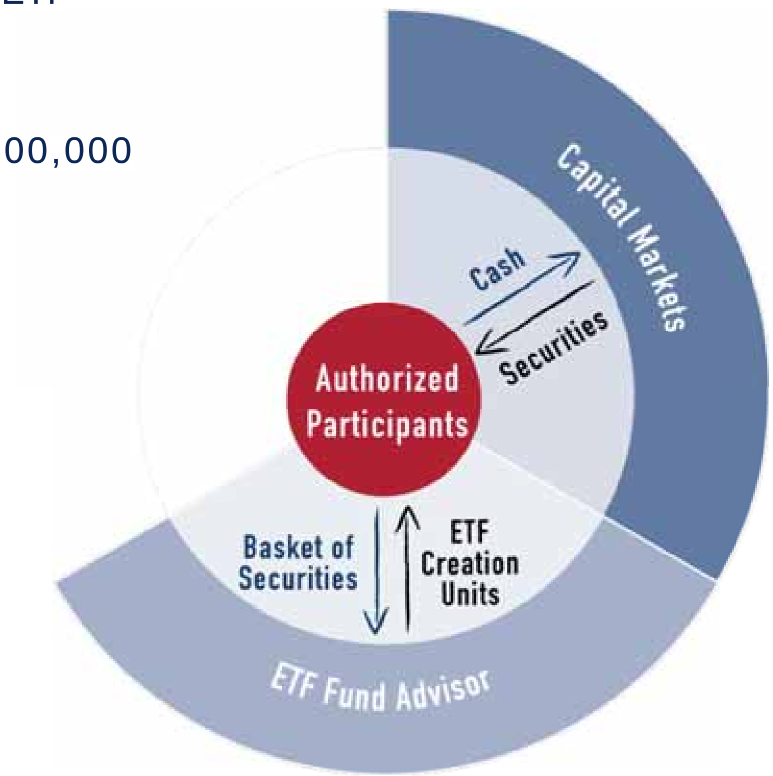
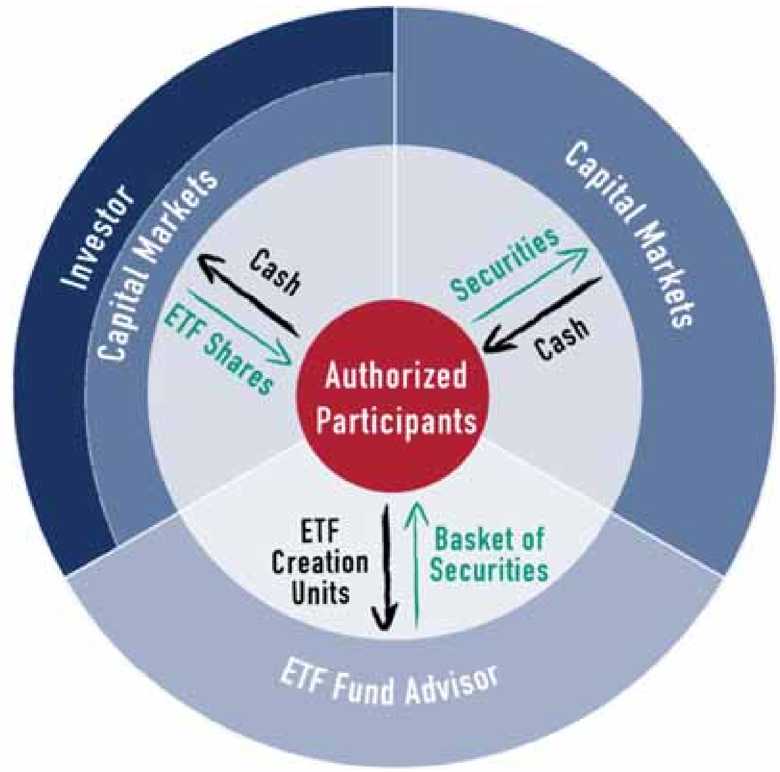
First Things First: The Creation Unit

- A Creation Unit is a basket of stocks that has been purchased or borrowed by the AP to create shares of an ETF
- Typically mirrors a specific index
- Calculated at Net Asset Value
- Usually large enough to purchase 50,000 to 100,000 shares of the ETF



The Redemption Process: The Creation Process Reversed

- To adjust inventory or to take advantage of arbitrage opportunities, the authorized participant can redeem ETF shares
- The AP purchases ETF shares, then redeems or exchanges the shares for the underlying basket of securities and sells them to the market
- The price of the shares of the ETF are calculated as specified in the ETF prospectus
- The stocks that comprise the ETF (plus a cash component as the case may be) are delivered to the authorized participant, after deduction of redemption fees and expenses



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In Review: Creation / Redemption

- Tax Efficiency
  - An ETF's shares are exchanged in-kind for equal value, so there are no taxable gains on the transaction for the fund itself
  - ETFs can have taxable events for reasons such as the following:
    - On dividends from dividend-paying stocks
    - When there are changes to the index, the portfolio manager will need to sell off various stock, which could create a taxable event
    - Investors would still pay taxes on any gains from their investment

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Trading Considerations

- How to determine the fair price to transact in an ETF?
  - All ETFs have an IIV* (intraday indicative value), a secondary ticker meant to reflect the estimated Net Asset Value for an ETF throughout the trading day
  - IIV is calculated from a portfolio holdings file (typically creation basket file) as disclosed each day by fund
  - Investors can evaluate the current ETF market relative to the IIV (Bid/Offers should straddle the IIV with a spread consistent with the spread and costs to transact in the underlying securities)

** Some IIVs may reflect stale pricing. For instance, for ETFs investing in foreign markets the IIV will reflect the last available price, most likely when the foreign market closed. Investors will need to evaluate current market conditions, the behavior of securities trading with high correlations to the underlying (perhaps derivative contracts), an their own estimates of fair value to evaluate the quality of markets being made for these products.*

Trading Considerations

- As with trading securities, investors should develop a rigorous approach to trading ETFs to minimize costs and surprises. Consider the following ideas:
  - Closely evaluate market pricing and liquidity conditions
  - For substantially large orders consider approaching a market maker to tap creation/redemption shares
  - Use limit orders
  - Monitor your trading
  - Avoid trading in the first 15 minutes of market open and last 15 minutes of market close

Large Trades

- In addition to liquidity on the open market, ETF buyers and sellers may request a broker or trading desk to tap into alternative sources of liquidity, including APs, for large orders
    - For example, orders large enough to potentially move the market, or too large to be satisfied by secondary market liquidity
- APs, with their ability to tap into the underlying liquidity of stocks held by ETFs, are in a strong position to extend potentially limited secondary market liquidity to complete trades and reduce market-impact costs

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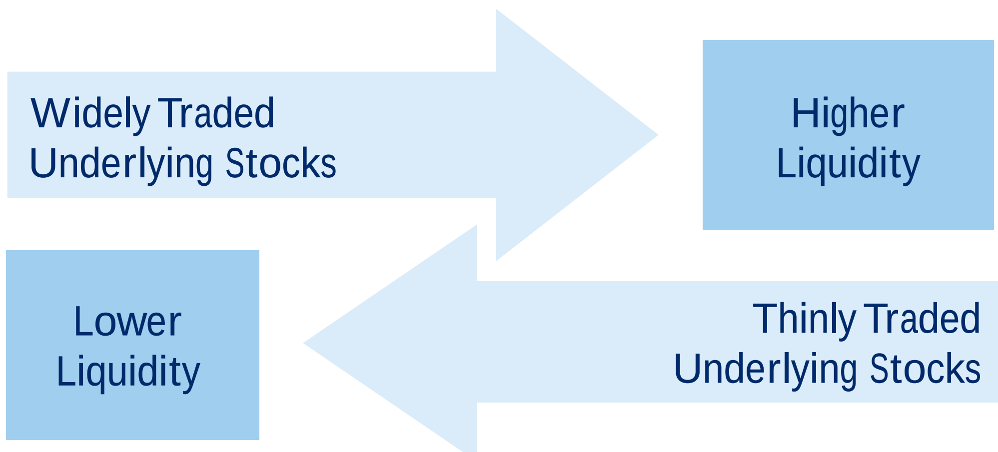
Assessing Liquidity

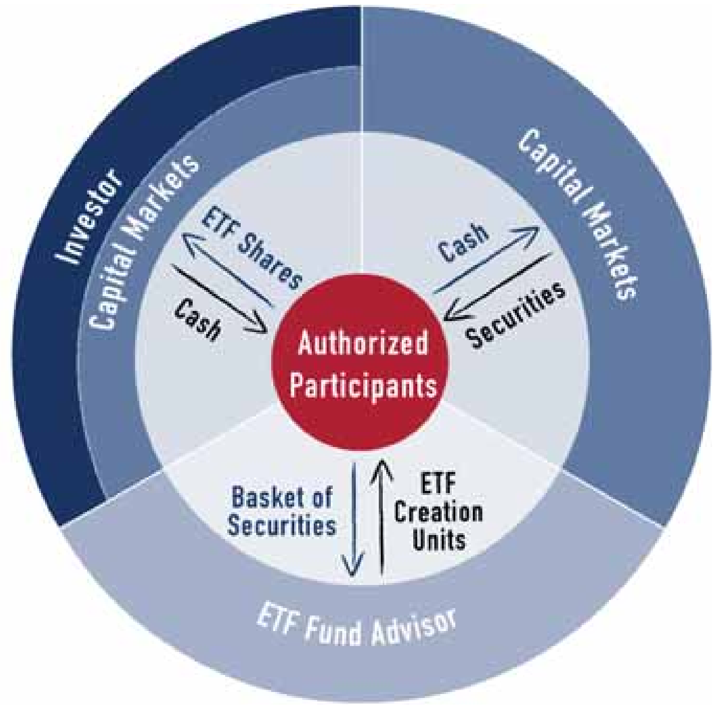
- Liquidity for ETFs is not limited to buyers and sellers on the secondary market
- The ability for market makers to subscribe or redeem ETF shares to cure market imbalances demonstrates that the liquidity for an ETF extends to that of the underlying securities held
- Markets made (spreads and depth) will be a direct function of the underlying liquidity of the underlying basket, the costs to transact in those securities, and the availability of hedging tools for market makers to cover their risk



- **Liquid ETF** = widely traded underlying stocks + narrow spreads
- **Illiquid ETF** = thinly traded underlying stocks + wider spreads

Liquidity & Trading Volume: Creation / Redemption Process

- The reason that ETF liquidity is not dependent on trading volume of the ETF, lies with the ETF creation and redemption process
- As opposed to stocks that have a limited number of shares outstanding, ETF shares can *continuously* be created or redeemed based on market demand



ETF Creation Unit:

- Large block of ETF shares (usually 50,000) is created and sold to authorized participants (APs) by the fund advisor
- APs then *split the creation units into individual ETF shares* and offer them for sale on an open market to individual investors

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Mitigating Pricing Risk

The ability of market makers to create and redeem shares provides a relief valve to mitigate potential for premia and discounts to materialize and persist

ETF Market Price > Basket of Underlying Securities

Authorized Participant (AP):

- Sells ETF short, uses proceeds to purchase basket at market price
- Delivers basket to Fund in exchange for new ETF shares
- Uses ETF shares to close short and realize premium versus basket

ETF Price < Basket of Underlying Securities

Authorized Participant:

- Buys ETF shares at discount
- Delivers ETF shares to Fund in exchange for basket
- Sells basket to realize premium relative to ETF

With buying/selling pressure the price of the ETF approaches market value, minimizing persistence of premia/discounts

Mitigating Pricing Risk

- Unlike closed-end funds, ETFs can issue and redeem shares through market makers* to satisfy demand and supply imbalances
- Subscription (“creation”) or redemption (“cancellation”) orders are satisfied through in-kind security baskets representing the underlying holdings of the ETF
- The ability to subscribe or redeem shares provides an arbitrage mechanism for market makers to eliminate premia or discounts as these materialize

**Technically Authorized Participants (APs). APs are market makers who have entered into an agreement with the ETF sponsor agreeing, amongst other things, to follow the operational procedures for the creation and redemption of ETF shares.*

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Conclusions

- ETFs have brought institutional quality tools to individual investors
- Flexible trading tools to gain and hedge exposures and use as the basis for portfolio and trading strategies
- As with all tools, investors should use them wisely to harness their benefits, while taking the time to understand the risks and limitations of the product as well

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