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Understanding and Using Exchange-traded Products

Finding Your Way Through the ETP Maze



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Blog: www.RickFerri.com

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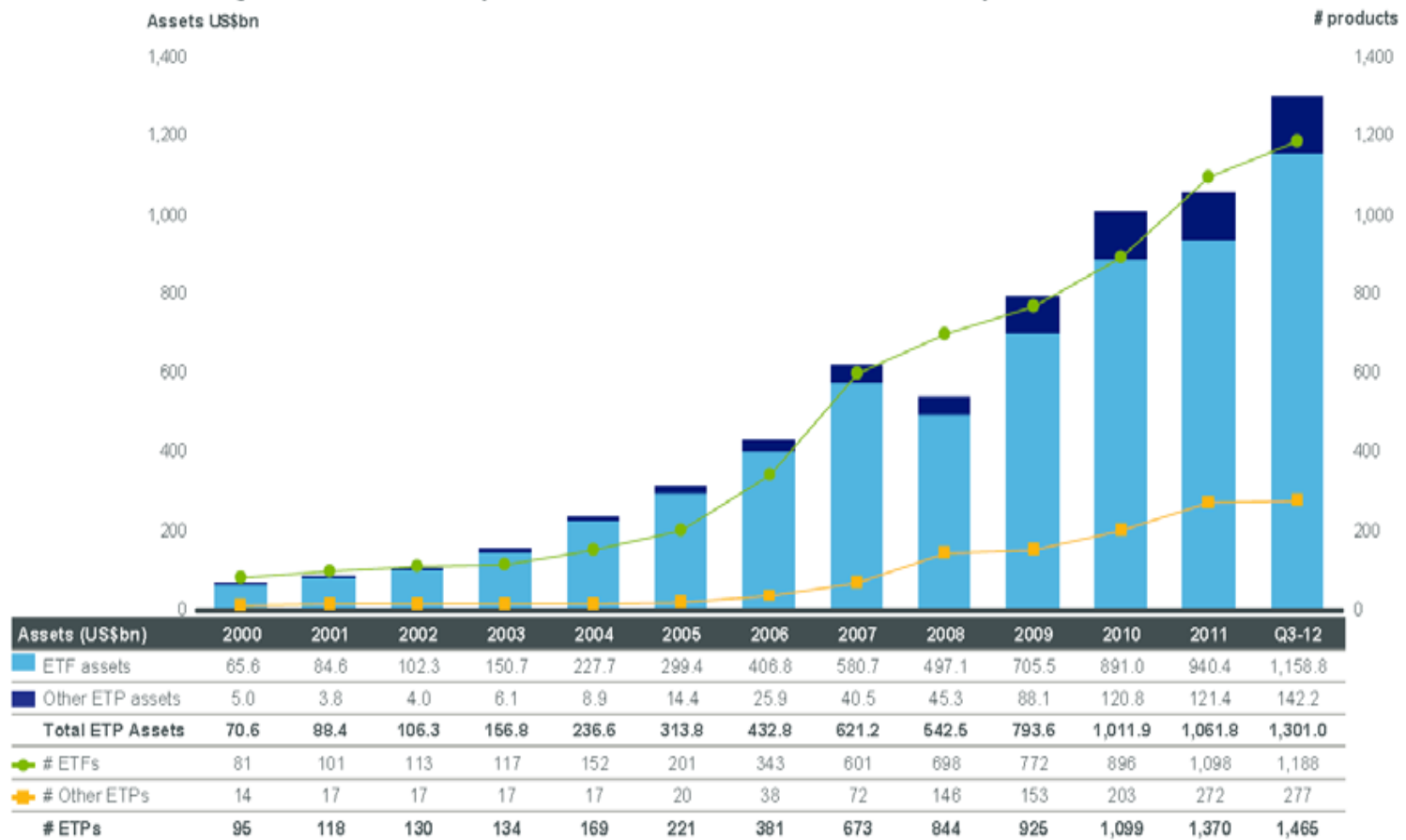
Today's Topics

1. Operating structures
2. Share creation & redemption
3. Product evolution
4. Index classification
5. Portfolio applications

US ETP Growth

1,465 ETPs and \$1.3 trillion in assts

- US accounts for 70.5% of global ETP markets. The 10-year CAGR for United States ETP Assets is 29.3%. The 5-year CAGR is 16.8%.

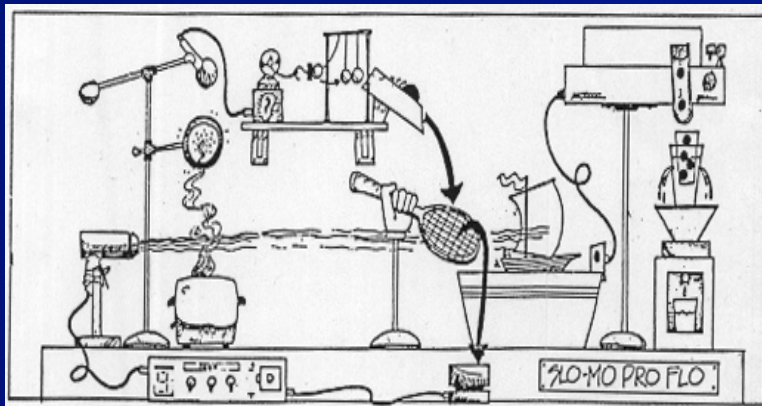


Note: CAGR = Compound Annual Growth Rate. Data as at end Q3 2012. Source: BlackRock Investment Institute, Bloomberg.

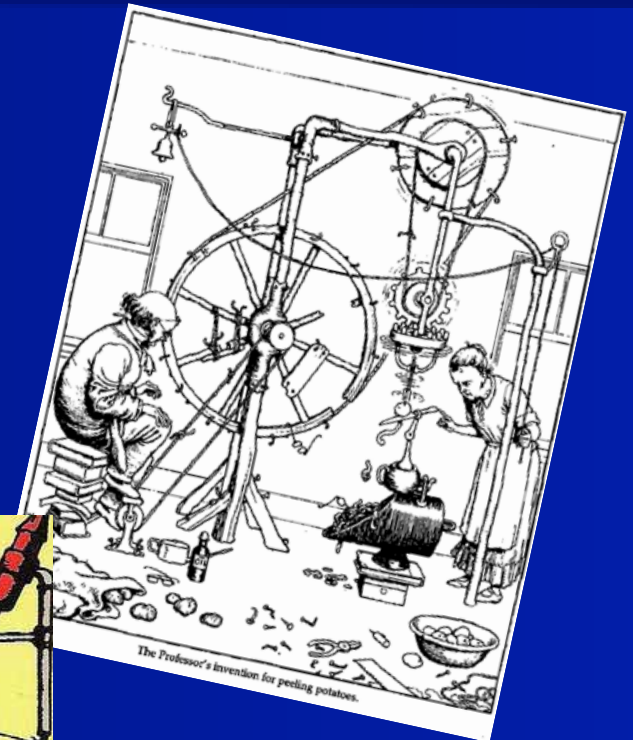
There's No Such Thing as an ETP

- No official ETP companies or ETPs
- Every firm files for "exemptive relief"
 - IA 1940's Act, 1933 Act, 1934 Act
- ETPs files under exemptive relief status
- ETP codification initiatives began in 2008 and are still pending.

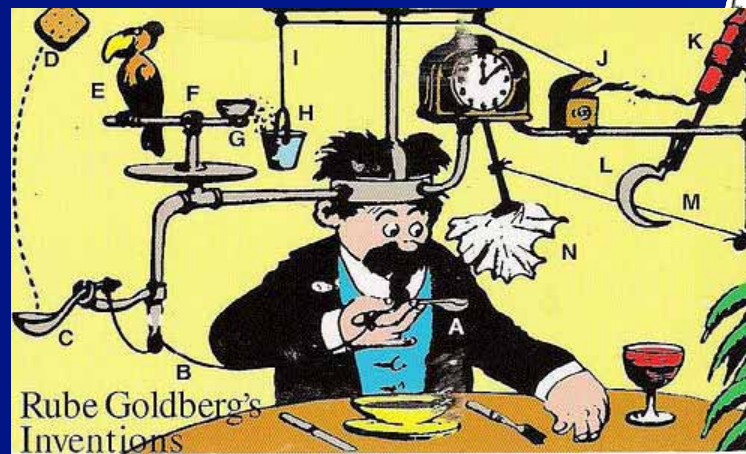
Product Structures



ETFs
ETNs



UITs
LPs

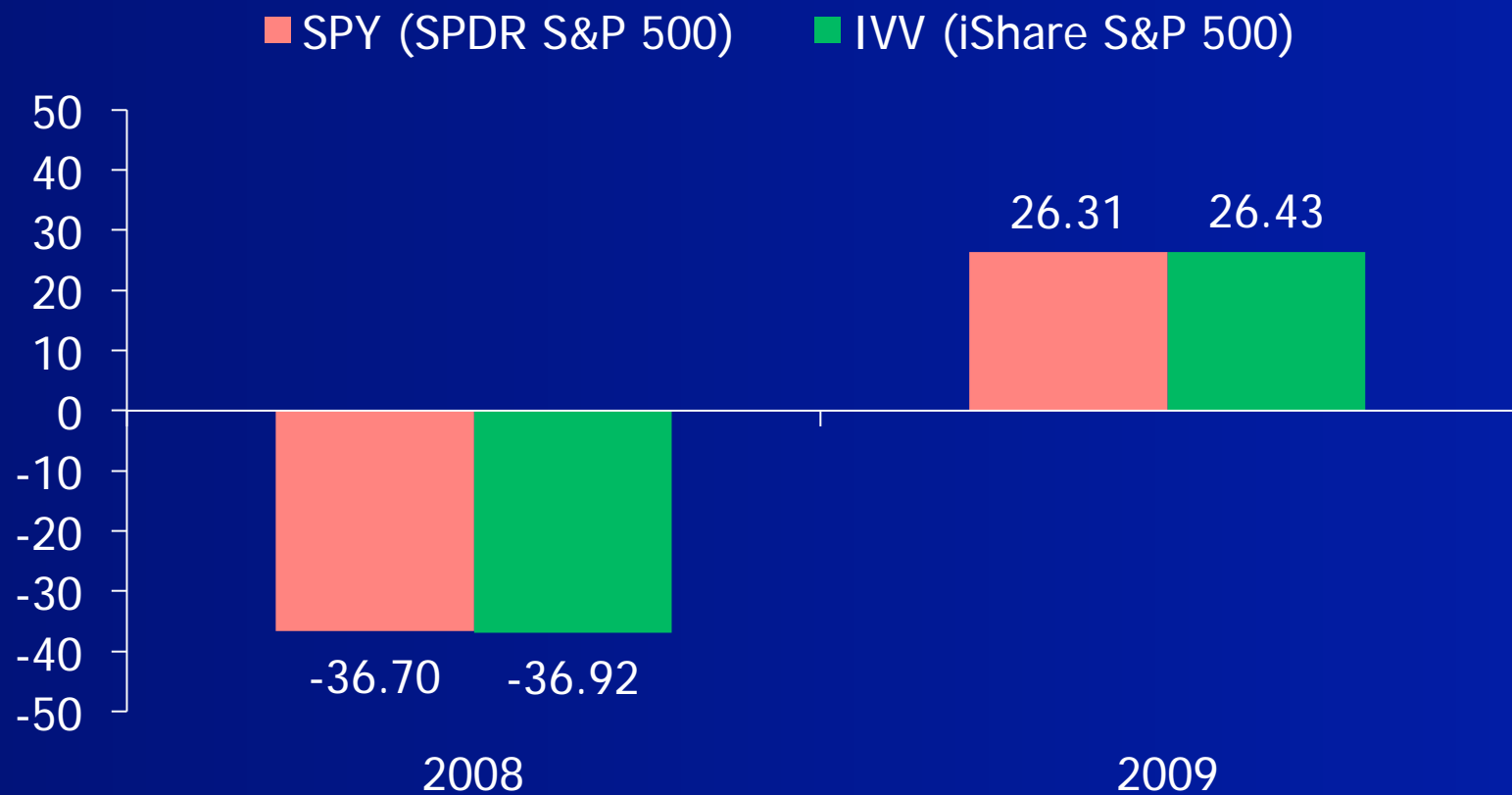


LLCs

Investment Company 1940 Act Filings (ETFs)

- Unit Investment Trust Structure
 - Full index replication
 - All dividends sit in cash until disbursement
 - First 4 ETFs only: SPY, MDY, DIA, QQQQ
- Open-end Structure
 - Less restrictive on holdings
 - Dividends can reinvest within a fund
 - All ETFs issued this way since 1998
- Same tax treatment as mutual funds

'40s Act Structure Matters



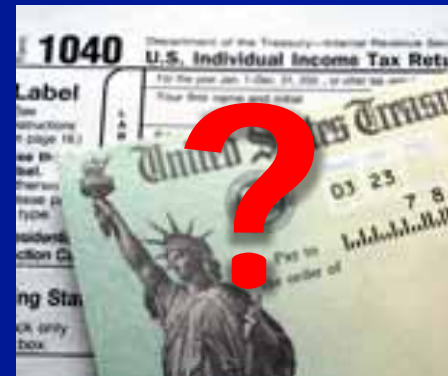
1933 Security Act Filings

- Exchange-traded notes (ETNs)
 - Unsecured debt of a finance company
 - Taxed after sale – Client gets 1099
- Grantor trusts (commodity pools)
 - Gold, silver funds, physical holdings
 - Taxed at 28% currently – Clients get K-1
- Partnerships (LPs and LLCs)
 - Holds futures and other derivatives
 - Taxed annually 60% LT/40% ST via K-1

Two Main Tax Factors

1. Underlying holdings

- Equity
- Fixed income
- Currencies
- Physical commodities
- Future, options, derivatives



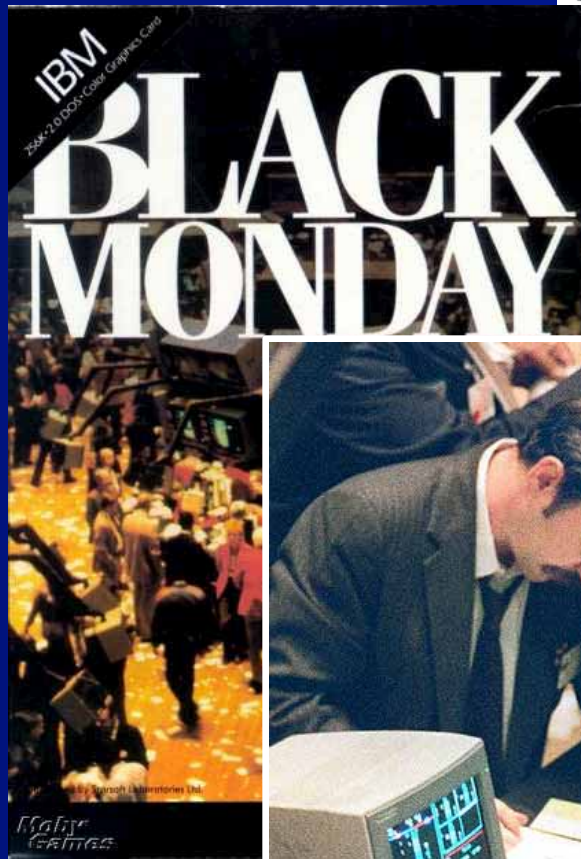
**The Complete
Guide to ETF
Taxation**

IndexUniverse.com

2. Product structure

- 40's Act Fund
- Exchange-traded Note
- Grantor Trust
- Limited Partnership
- Limited Liability Company

A Little History



CRASH
DEREGULATED
FREEFALL
MALEFASANCE



The First ETF

SPDR S&P 500 (Ticker: SPY)

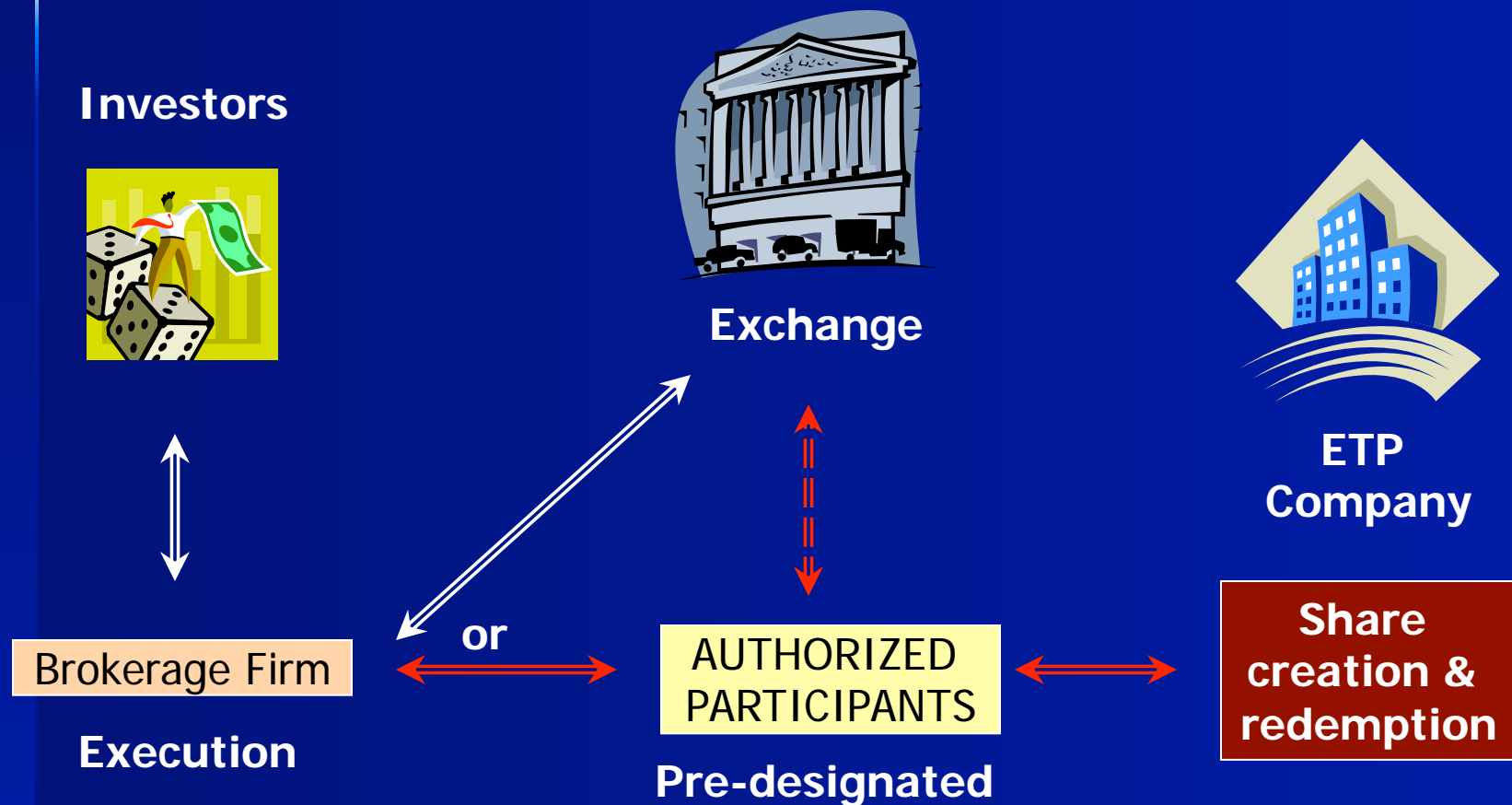


- Filed in 1990 – launched January 1993
- One basket composed of all S&P 500 stocks
- Quoted at 1/10 the S&P 500 index price
- Intraday Indicated Value (iNAV) computed every 15 seconds by the exchange
- Still the largest ETF today ~ \$100 billion

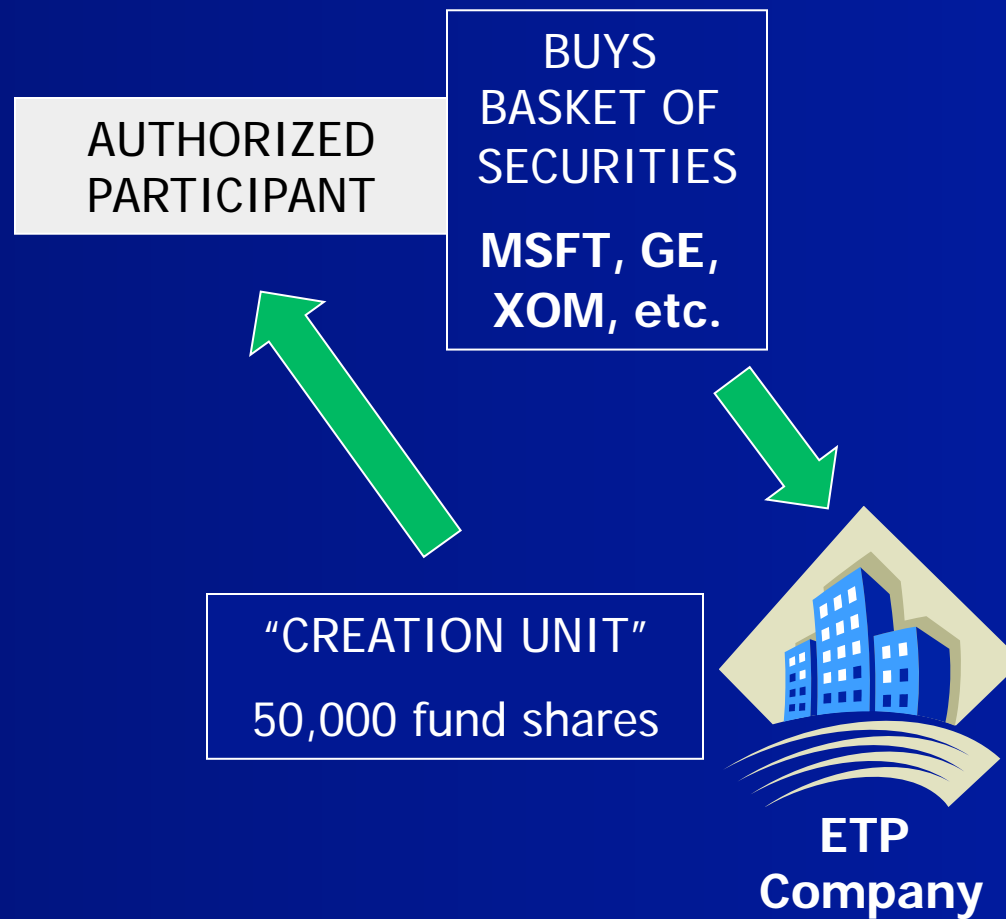
Characteristics

- Held in a brokerage account
- Trades during exchanges hour
- Commissions and trading spreads
- Buy on margin
- Short anytime
- Options available on some

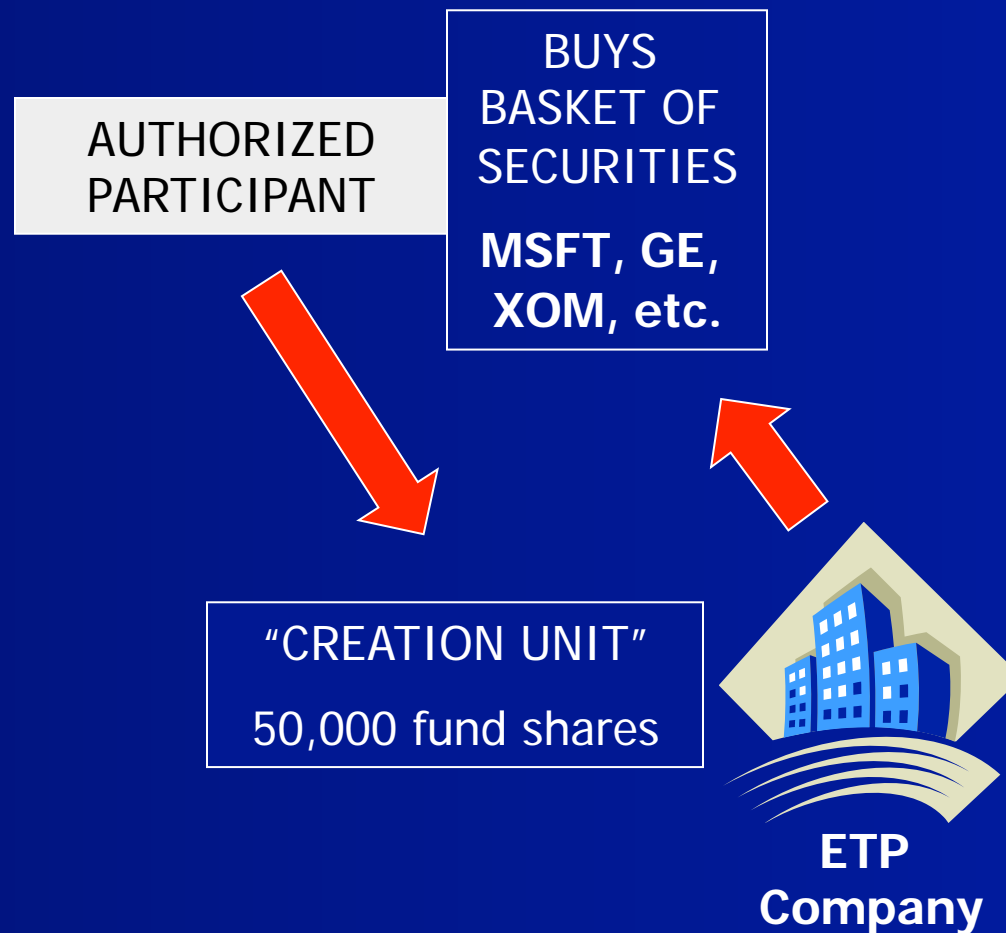
Anatomy of an ETP Trade



Intraday Creation (SPY)



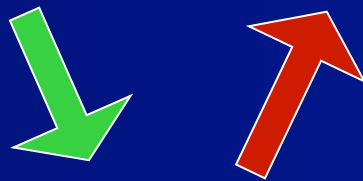
Intraday Redemption (SPY)



AP Price Arbitrage

ETF price is lower
than the underlying stocks

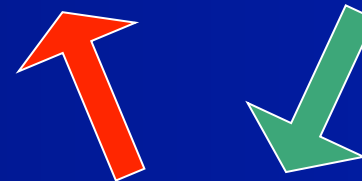
Buys ETF shares	Sells securities
--------------------	---------------------



Redemption

ETF price is higher
than the underlying stocks

Sells ETF shares	Buys securities
---------------------	--------------------



Creation

ETF Tax Benefit

AP turns in stocks
and receives a
creation unit.

MSFT is at 25

AP Turns in
MSFT stock



S&P 500 SPDR

MSFT	10,000 @ 35
MSFT	10,000 @ 30
MSFT	10,000 @ 25
MSFT	10,000 @ 20
MSFT	10,000 @ 15

Fund Managers Book
(tax lot accounting)

The "Cleansing" of Low Cost Basis Stock

S&P 500 SPDR

MSFT	10,000 @ 35
MSFT	10,000 @ 30
MSFT	10,000 @ 25
MSFT	10,000 @ 20
MSFT	10,000 @ 15

AP turns in creation unit and receives stocks.

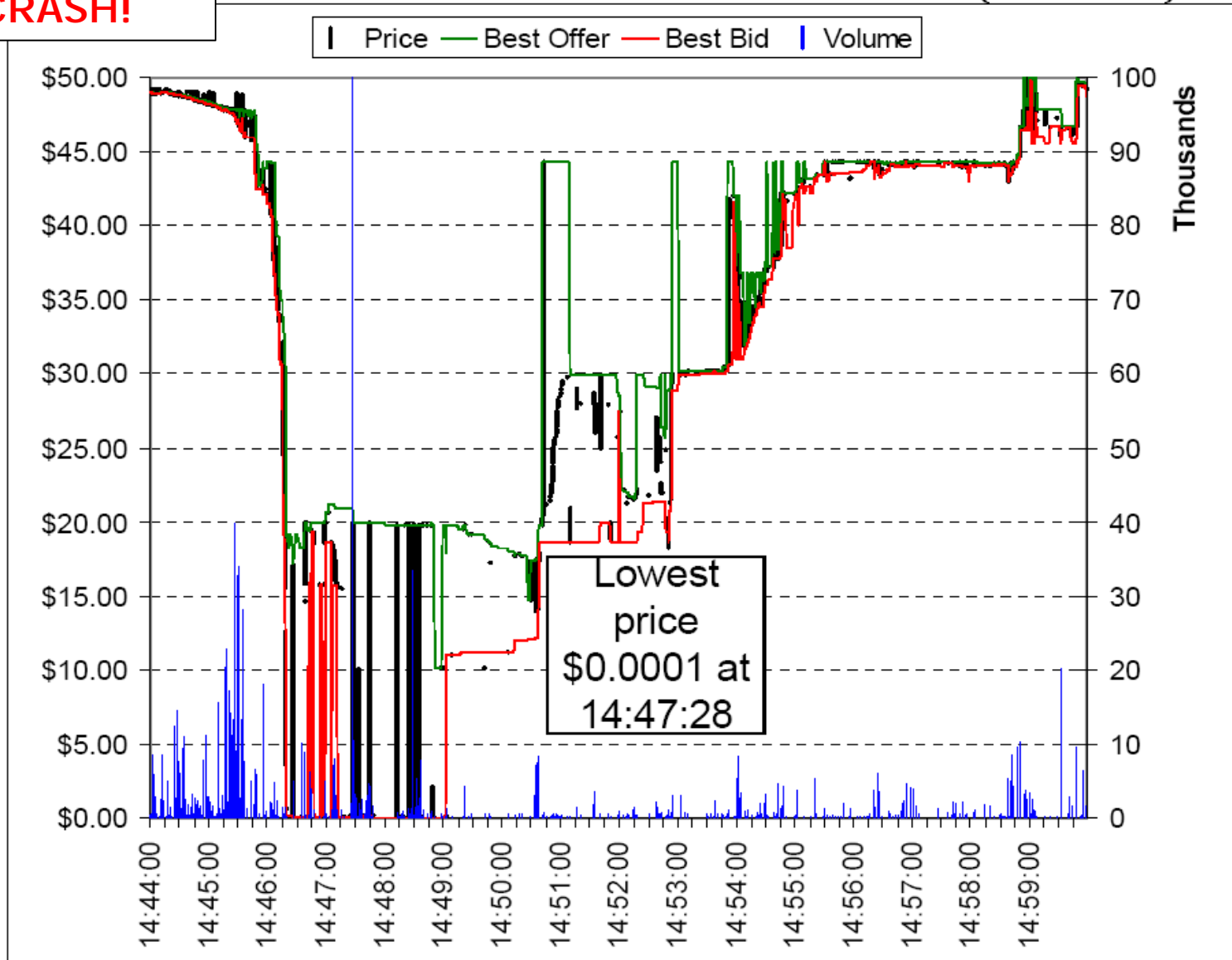
AP receives this lot of MSFT

Fund Managers Book

Distributes lowest cost shares

**FLASH
CRASH!**

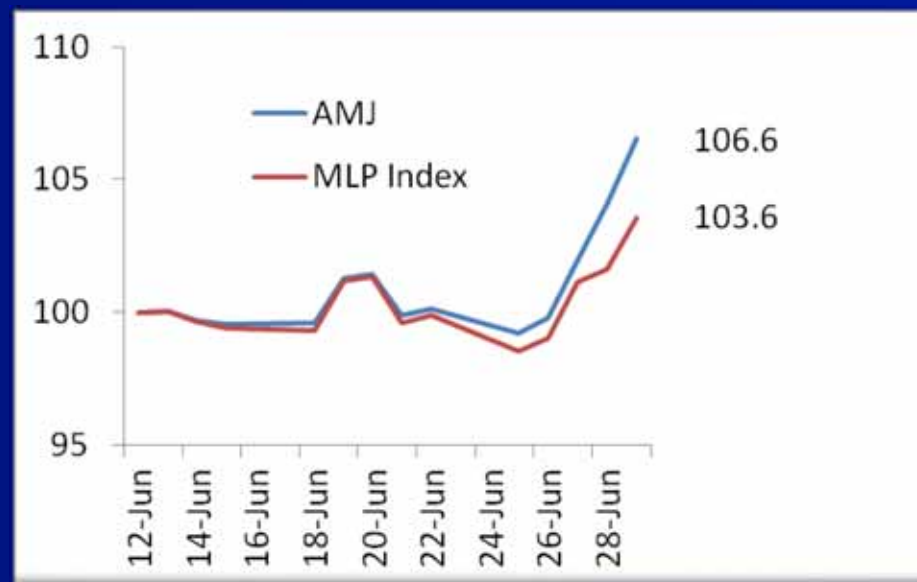
Price Chart for iShares Russell 1000 Growth Index Fund (Ticker = IWF)



Source: NYSE Trades and Quotes

ETN Creation Limits

“The JP Morgan Alerian MLP Index Exchange Traded Notes (ETNs) are subject to a maximum issuance limitation of 129,000,000 ETNs, which may cause the ETNs to trade at a premium relative to the indicative note value.”



ETP Investment Objective



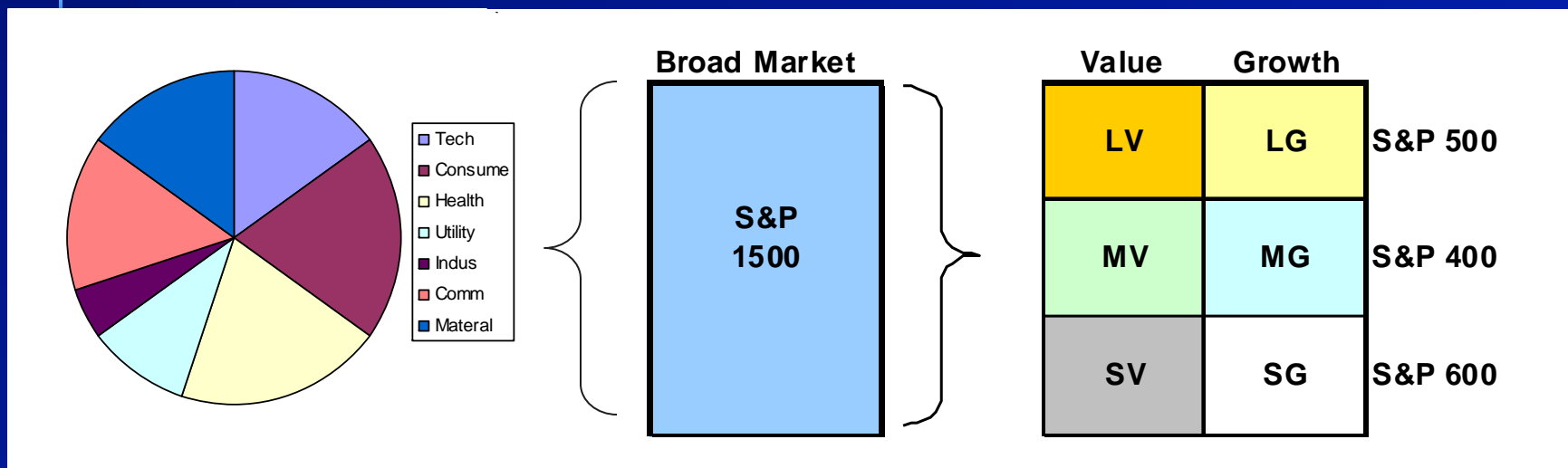
Phase I: 1993

Benchmarks (beta)



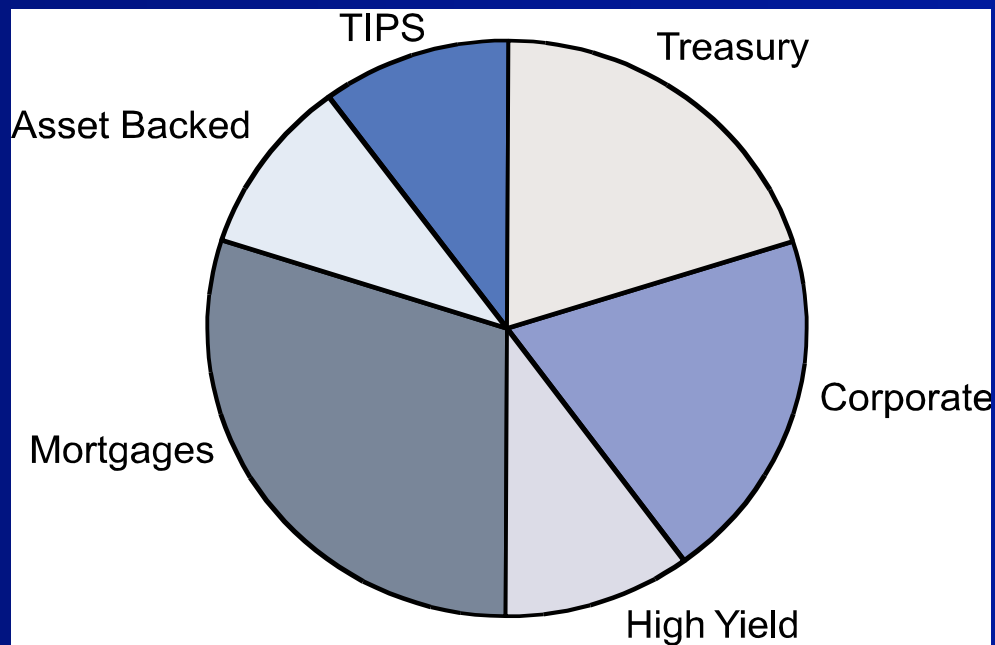
S&P 500
S&P 400 midcap
Dow Jones Industrials
NASDAQ 100
Barclays Aggregate Bond

Benchmark Slice and Dice

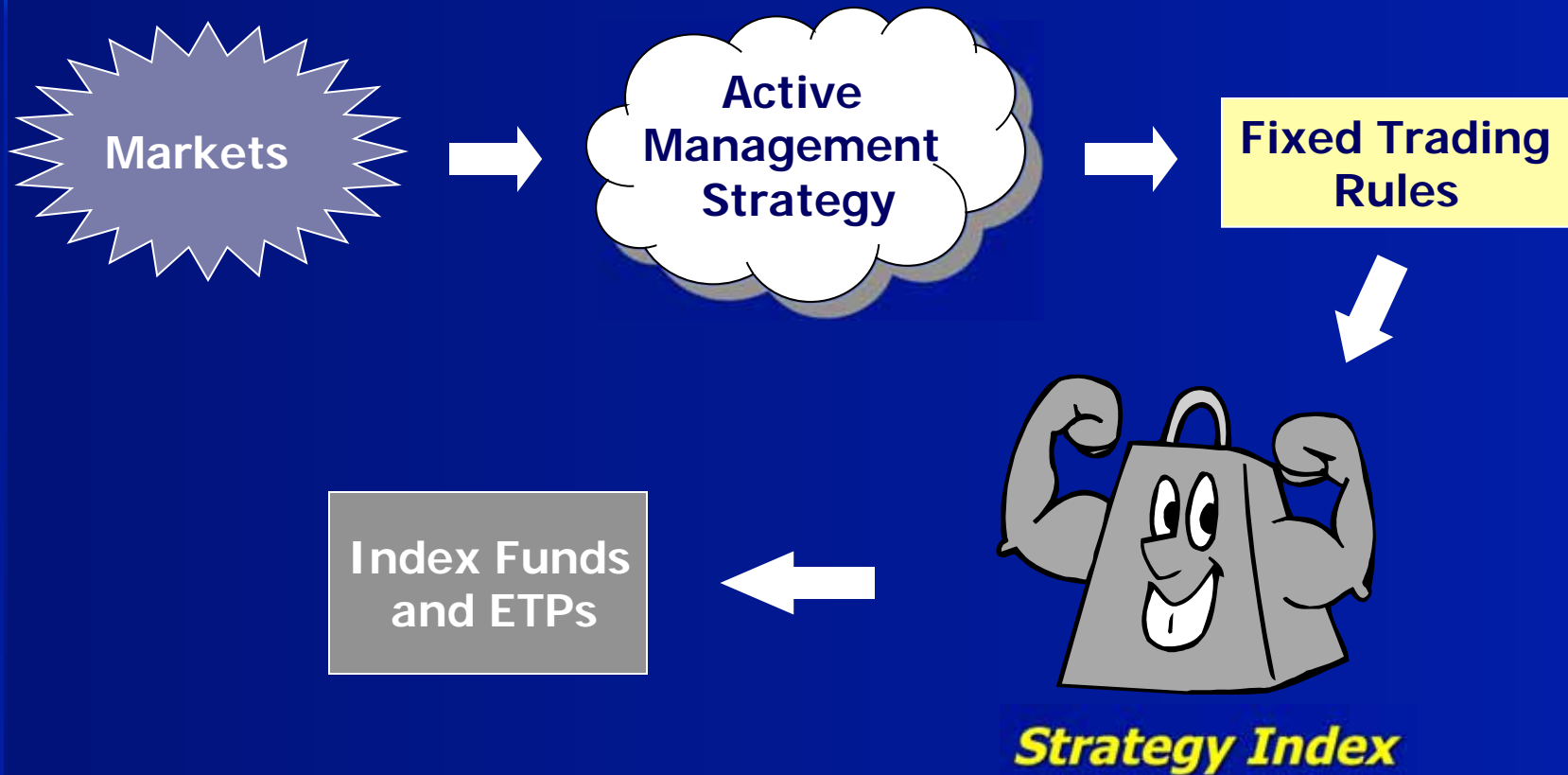


Size, style and industry ETFs

Fixed Income Benchmarks



Phase II: 2003 Strategy Indexes



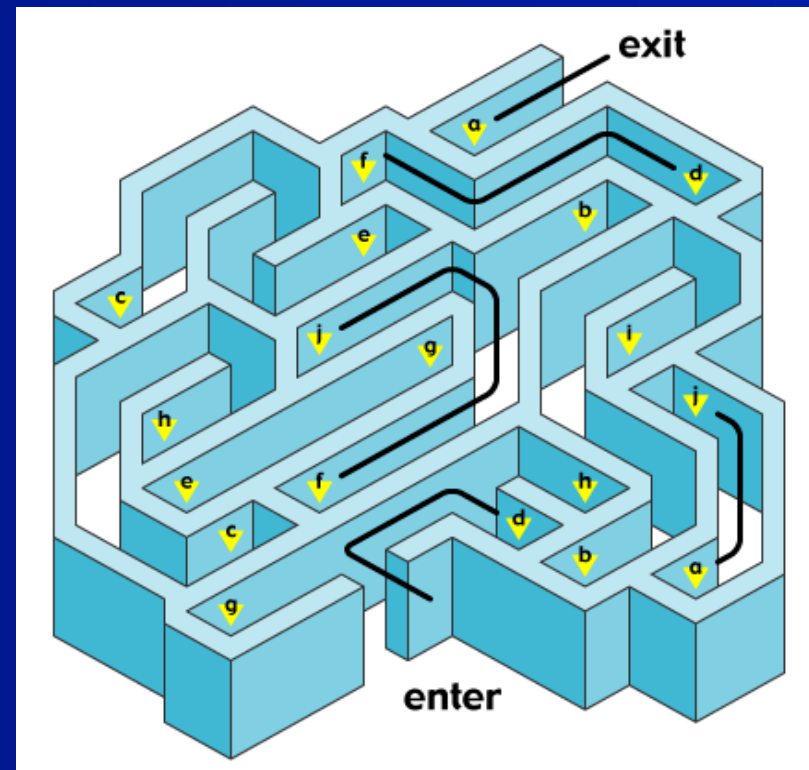
First Strategy Index ETF

- PowerShares Dynamic Market
- Follows an "Intellidex" index
- Quantitative stock selection
 - 100 securities
 - 25 factors (timing, valuation, etc.)
 - Quarterly reconstitution
- Fixed percentage weight
- Management fee 0.60%

A Maze of Strategy Indexes

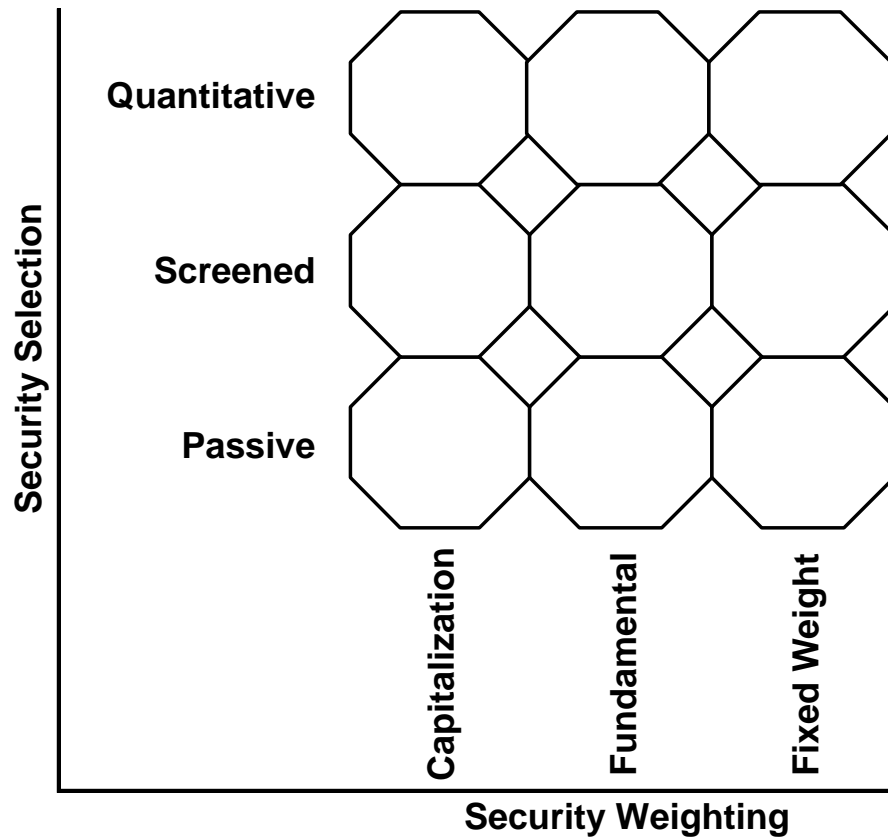
Fundamental indexing
Thematic indexes
Quantitative methods
Hedge fund replication

Alternative beta
Intelligent beta
Beta 2.0
Beta diarrhea

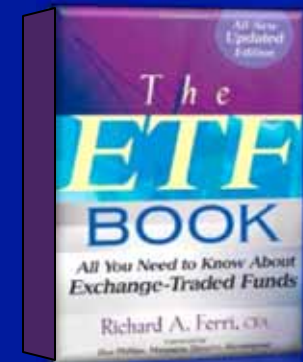


Index Strategy Map

Index Strategy Boxes



As seen in:

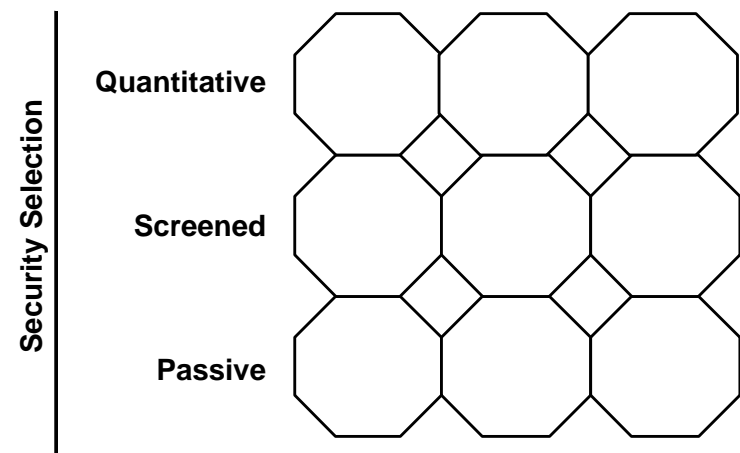


Security Selection

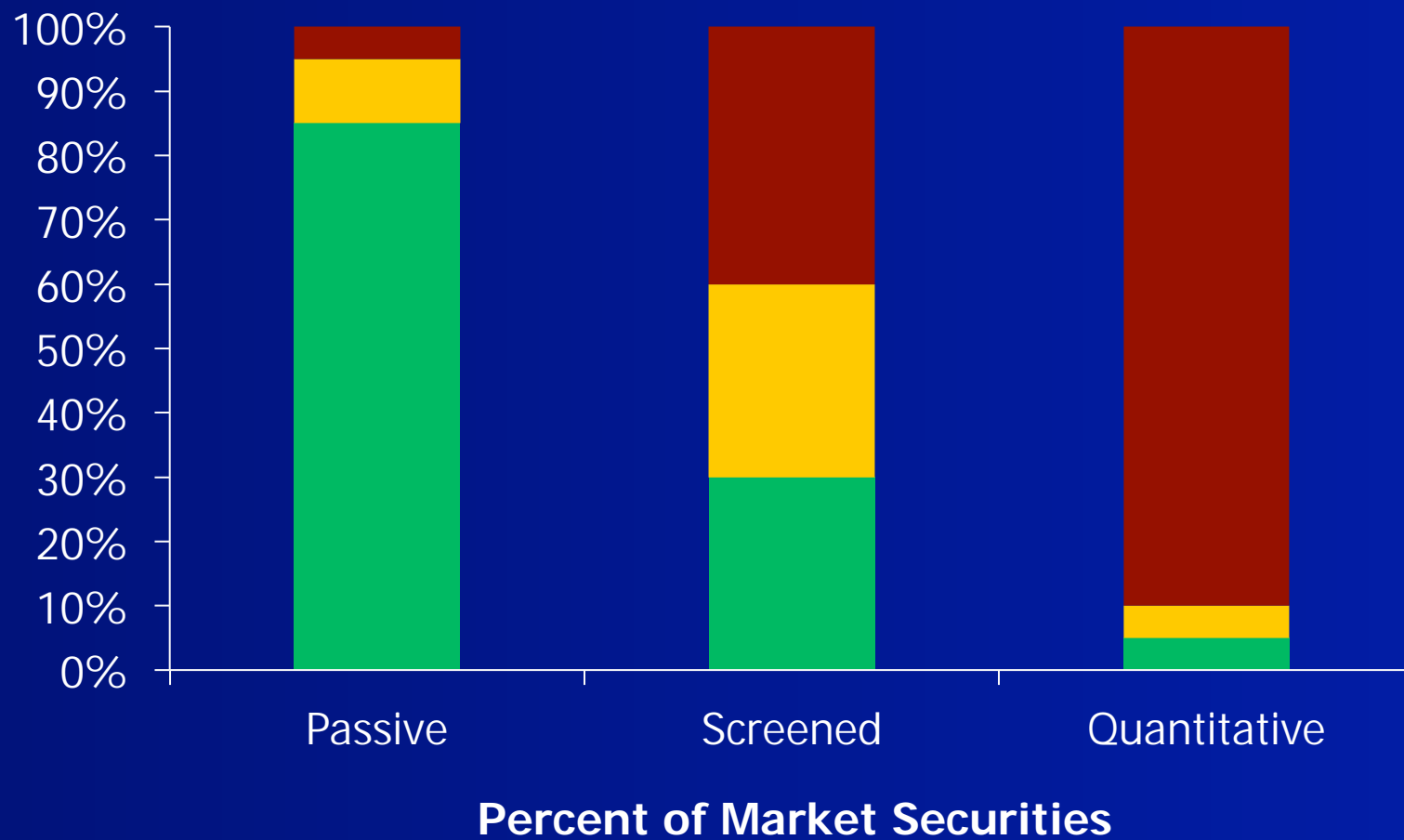
Three basic categories:

1. Passive
2. Screened
3. Quantitative

Security Selection



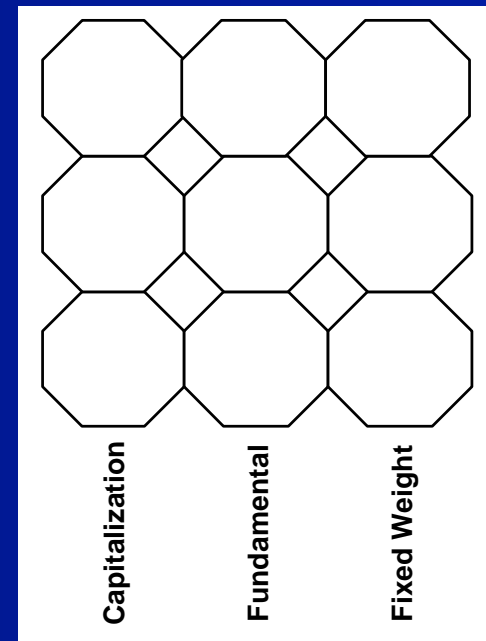
Security Selection Depth



Security Weighting

Three basic methods:

1. Capitalization
2. Fundamental
3. Fixed Weight



Index Weighting

Large
Cap

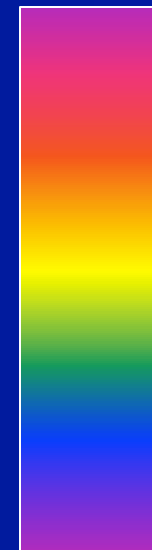
Small
Cap



Cap
Weight



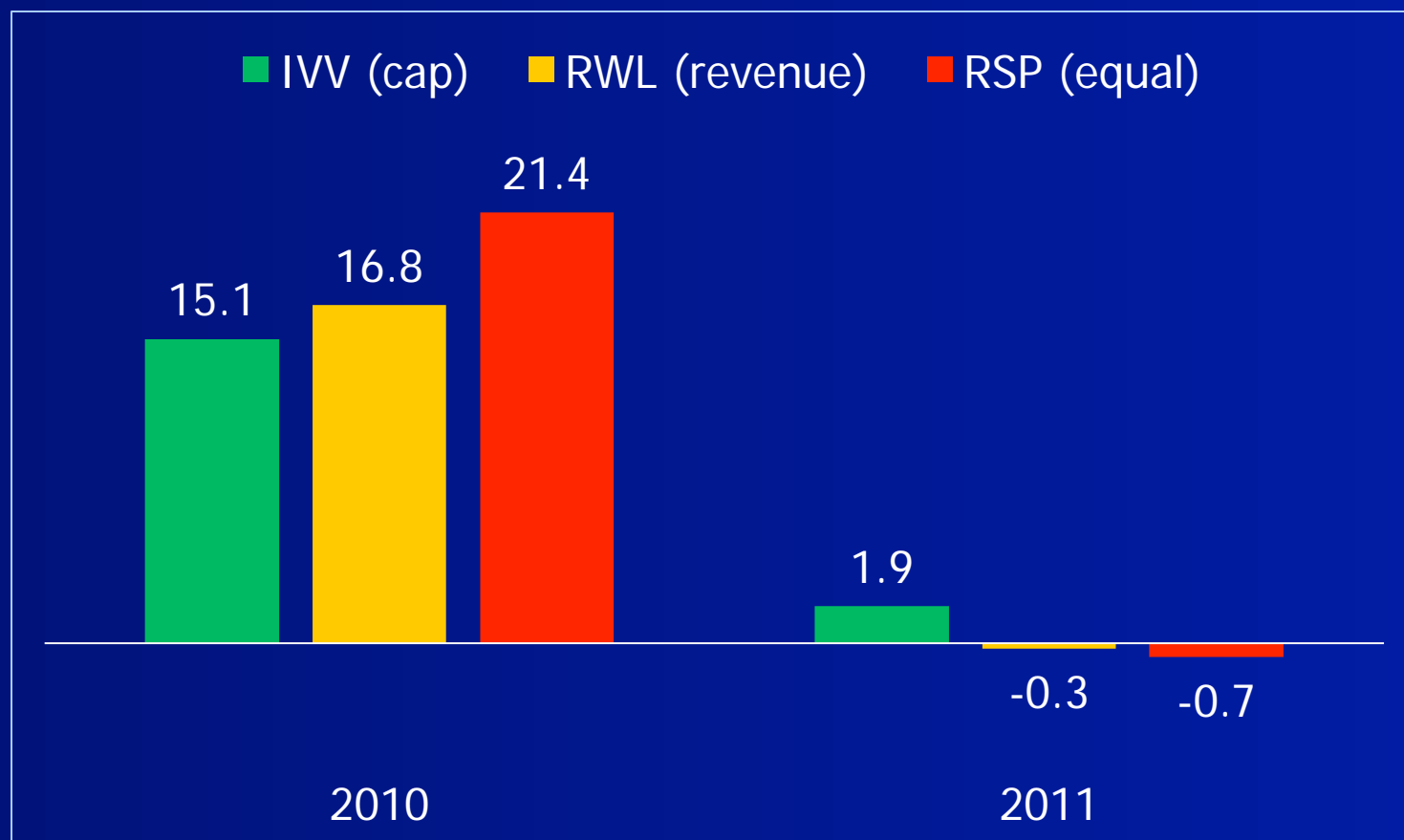
Fundamental
Weight



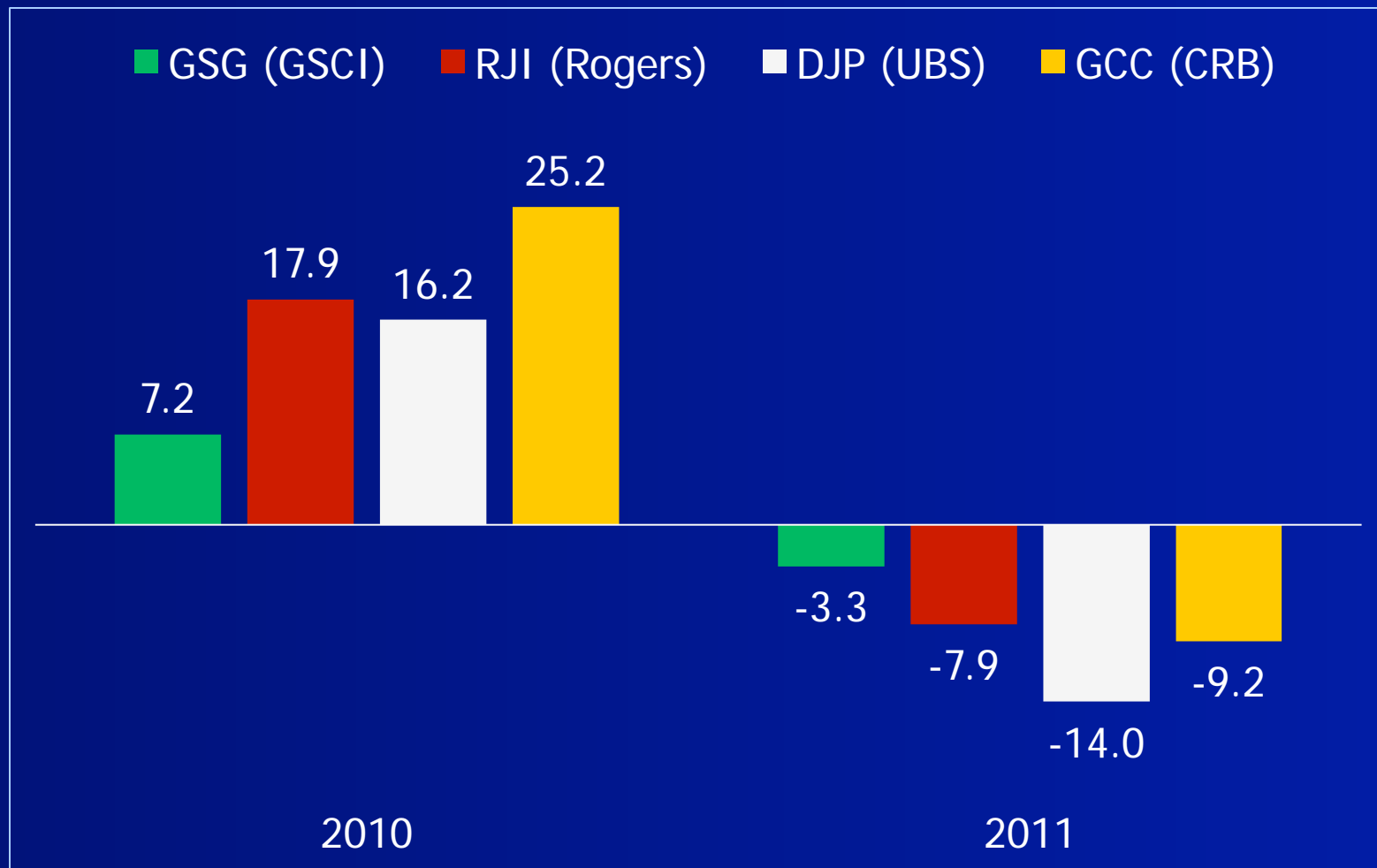
Fixed
Weight

Weighting Matters

S&P 500 ETFs with different weights



Commodity ETP Returns



Phase III: Hedging*

Risk management tools

- **STRICTLY** for short-term holding
 - Leveraged short and long, double leveraged
 - Factor targets, volatility targets, spreads
 - Tend to be derivatives based
 - ProShares was the first in 2006
-
- High fees, high volatility
 - Leveraged long and short can both lose
 - Misunderstood by investors and advisers

*Not to be confused with hedge fund ETPs

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Examples

- 3x bull long and 3x bear short
 - Stocks, bonds, commodities, currencies, sectors, strategies (fundamental weight long/short)
- Market neutral – factor capture
 - QuantShares market neutral, value, size, beta
 - hi/lo volatility, hi/lo momentum, hi/lo beta
- Multi-asset class long/short leveraged
 - FactorShares 2X: Gold Bull/S&P500 Bear
 - FactorShares 2X: S&P500 Bull/T-Bond Bear

Warning: LEVERAGE!

Daily	\$100.00
-2%	\$98.00
2%	\$99.98
-2%	\$97.96
2%	\$99.92

100 Days	\$98.02
----------	---------

Daily x3	\$100.00
-6%	\$94.00
6%	\$99.64
-6%	\$93.66
6%	\$98.92

100 Days	\$83.50
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Phase IV: 2008

Full Active Management

- Fund does not track an index
 - Daily disclosure of fund holdings required
 - PowerShares was first - PIMCO, Fidelity, Legg Mason, T. Rowe Price, Goldman Sachs, JP Morgan and more have filed.
-
- No past performance. No M* rating.
 - No star managers until Bill Gross (BOND)
 - Not much money (PIMCO the exception)



1924
Actively managed funds



1975
Index funds



1993
Index
ETPs

2003
Strategy
ETPs



2008
Actively
managed
ETPs

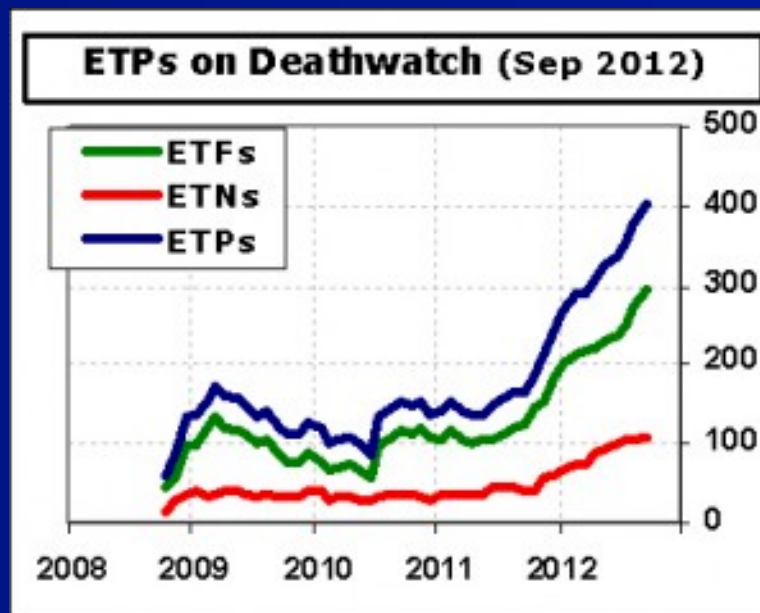
2006
Hedging
ETPs



ETP Pollution

- 1,465 ETPs today - 943 in SEC registration.
- Record fund closings in 2012
 - Scottrade closes FocusShares
 - Russell cuts 25 funds, UBS closes dozens
- New issuers hanging on by a thread
- Throwing Jell-O against the wall doesn't work anymore.

Over 400 on Deathwatch



Ron Rowland's "ETP Deathwatch"

< \$25 million in 6 months

< \$100,000 daily trading value

Adviser ETP Strategies



How Advisers use Funds


Fund Decision

Allocation Decision

	Beta capture (passive index)	Alpha seeking (active strategy)
Strategic allocation (passive mix)	Passive allocation Passive funds	Passive allocation Active funds
Tactical allocation (alpha seeking)	Active allocation Passive funds	Active allocation Active funds

The Alpha Shift

		Fund Decision	
		Beta capture	Alpha seeking
Allocation Decision	Strategic allocation	Passive allocation Passive funds	Passive allocation Active funds
	Tactical allocation	Active allocation Passive funds	Active allocation Active funds



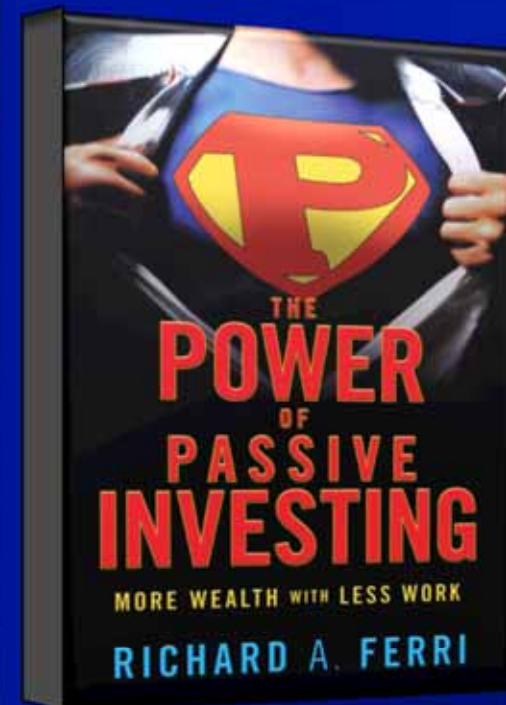
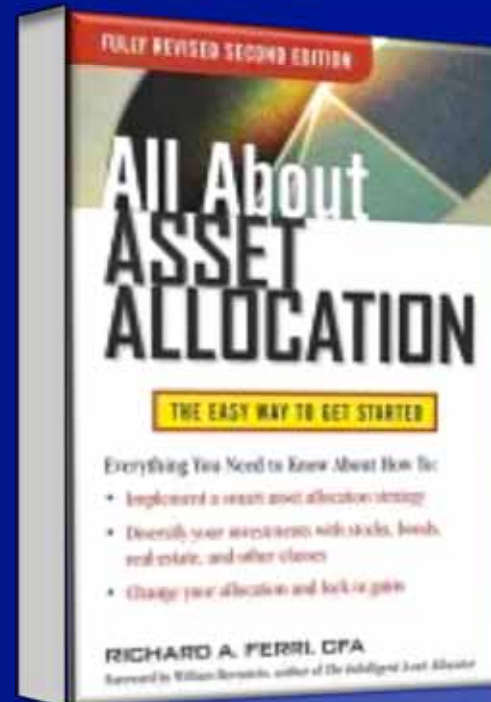
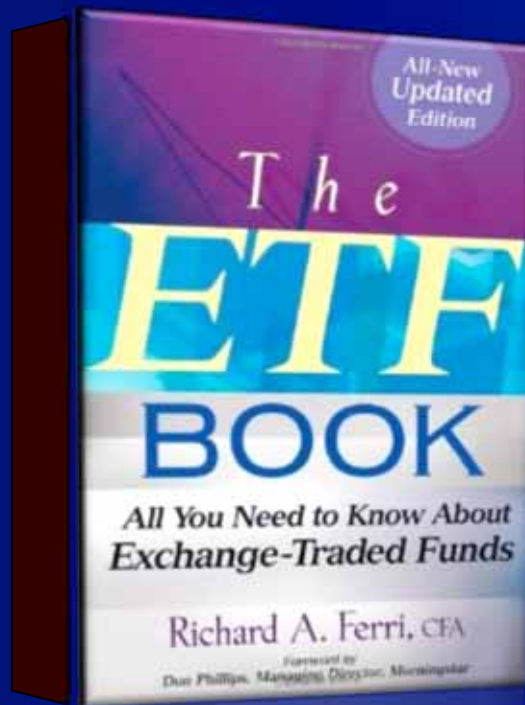
Summary

- ETP operating structure
- Creation, redemptions and trading
- Evolution of fund strategy
- Index classification
- Adviser use is growing and strategy is shifting



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