



ETF STRATEGY BRIEF SERIES: THE CURRENT ETF LANDSCAPE

The Current ETF Landscape

This strategy brief is the first in a two-part series of insights regarding exchange traded funds (ETFs). This brief provides an overview of the ETF landscape, describes the key features of ETFs, compares ETFs to index mutual funds and addresses current and future product usage. The second brief in this series explores the latest ETF innovation – actively managed ETFs – in detail.

KEY TOPICS EXAMINED

ETF LANDSCAPE

KEY FEATURES OF ETFS

ETFS VERSUS INDEX MUTUAL FUNDS

ETF USAGE

ETF LANDSCAPE

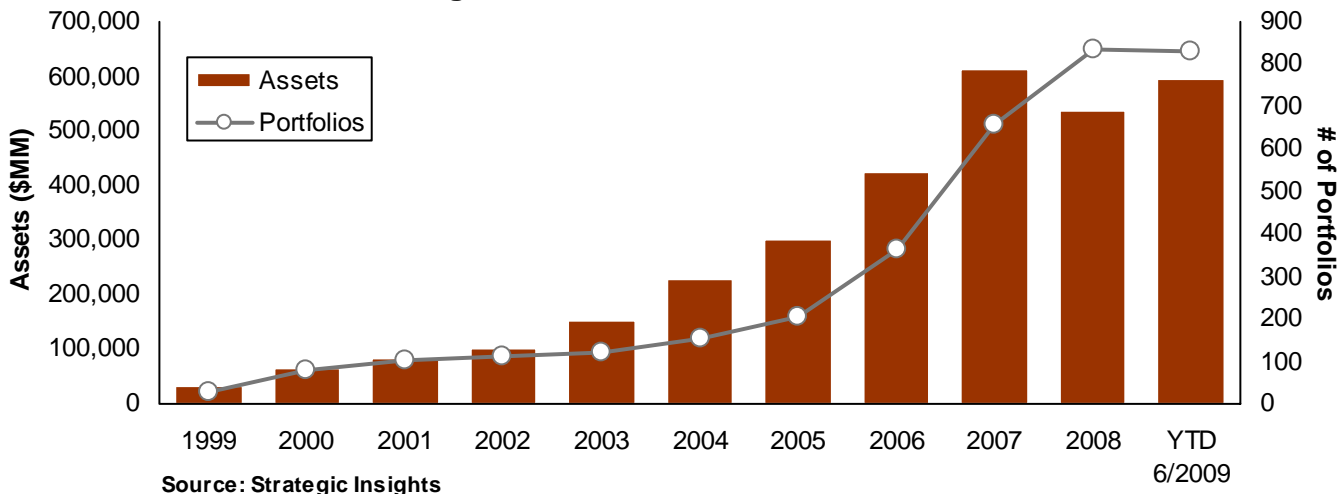
RAPID GROWTH

Today, there are nearly 800 ETFs traded in the United States with approximately \$600 billion in assets. Globally, ETF assets grew from \$310 billion in assets in 2004 to \$750 billion in 2008 representing a compound annual growth rate of 25%, and in spite of a plummeting stock market, ETF assets globally dipped less than 10% in 2008.¹ This growth rate has attracted the interest of sponsors across the spectrum of investment managers – from start-ups launching niche ETFs to established managers with significant assets under management, such as Pacific Investment Management Co., incorporating ETFs into their diverse product lineups.

Despite the tremendous market volatility and investor risk aversion of 2008, ETFs traded in the US experienced net inflows of approximately \$140 billion in 2008 while Asian and European traded ETFs captured approximately \$90 billion in 2008. Forecasts predict worldwide ETF assets will double over the next five years to reach \$1 trillion.² Further, in light of inflows and asset appreciation during the first half of 2009, some predict ETFs will reach the \$1 trillion mark in fewer than the previous five year prediction.



Exchange Traded Funds 1999- YTD June 2009



HISTORY OF INNOVATION

Not only have ETF assets grown at an impressive rate but also the number of ETFs being offered has grown rapidly. In fact, ETFs launched only since 2006 account for approximately three-quarters of all ETFs currently offered.

Moreover, ETFs have a history of innovation. They cover every major index and sector, as well as several niche indices and sectors. While nearly all ETFs currently track an index, there are some fundamentally weighted ETFs (defined below) and several commodity and currency ETFs, as well as inverse and leveraged ETFs. There are even target-date ETFs and ETFs that seek to replicate hedge fund strategies. As noted, active ETFs, the latest ETF innovation, is the subject of the second brief in this two-part series.

As a general matter, barriers to entry are increasing for new ETF entrants due to: the declining revenue and margin environment in the investment management industry generally, the scarcity of seed capital, and, in the index-ETF space, product saturation. For new ETFs, first to market advantage remains critical. Other factors necessary for a successful ETF launch include: a recognized index provider in the case of index-based ETFs and secondary market liquidity which reduces trading spreads.³

Product Development Process – Lengthy and Costly

This history of product innovation and robust product development is even more impressive when one considers the time and expense associated with launching an ETF. Because ETFs require exemption from various provisions of the Investment Company Act of 1940, ETF sponsors must file an exemptive application with the US Securities and Exchange Commission (SEC). Based on the experience of several ETF sponsors and legal counsel, the typical exemptive application process can take

between nine (9) to 18 months. Depending upon the complexity of product, the legal costs can range from \$50,000 to \$100,000 for a relatively simple product and up to \$300,000 for a more complex ETF. Although there are pending SEC rules that would significantly reduce the time and expense associated with the launch of new ETFs, the adoption of the rules has been delayed.⁴

ETF Innovation Milestones

- 1993: First ETF launched – State Street Global Advisor’s SPPR® S&P 500 ETF (SPY)
- 2000: Barclays Global Investors (BGI) introduces a broad, diverse suite of ETF products to allow investors to build an entire asset allocation using ETFs
- 2005: PowerShares launches first fundamental ETFs
- 2006: ProShares introduces inverse and leveraged ETFs
- 2009: First actively (i.e., qualitatively) managed ETF by Grail Advisors begins trading⁵

ETF CLASSIFICATION

ETFs can be classified into three main types: traditional, passive ETFs; fundamental ETFs; and actively managed ETFs.

Traditional, passively managed ETFs are designed to track established indices. Some examples of these types of ETFs are the iShares S&P, Russell, and MSCI series of ETFs. Inverse and leveraged ETFs based upon traditional indices also fall into this category.⁶ In some cases new indices are created to be tracked by ETFs using traditional passive methodology.

Fundamental ETFs limit their investment universe to the holdings within an index but the weightings of those holdings within the ETF do not correspond to the index weightings of such holdings. Rather, ETF managers weight the index holdings based on their dividend yields, cash flows, P/E ratios, earnings expectations, etc. PowerShares and Wisdom Tree currently are the two main providers of fundamental ETFs.

Actively managed ETFs do not passively track an index, but have a portfolio manager or team of investment professionals actively trading the ETF portfolio. They seek to outperform a benchmark on a relative basis. Until the launch of the Grail Advisors ETFs, there were only two fund families to launch active ETFs: PowerShares and WisdomTree. However, when originally launched the ETFs from PowerShares and WisdomTree either placed restrictions on the timing and frequency of portfolio trades or were in highly liquid investment classes, effectively limiting front running opportunities. *Please see the second brief in this series for a detailed analysis of active ETFs.*

WHAT ARE ETNS?

ETNs, exchange traded notes, are debt instruments that offer returns tied to specific indices or reference assets (e.g., commodities, currencies).⁷ Unlike ETFs, investors in ETNs do not own an interest in an underlying pool of assets. Rather, the ETN is an unsecured debt obligation of the ETF issuer. As a result, while they offer tremendous flexibility and customization from product innovation and investor solution standpoints, investors have been concerned with the credit risk associated with ETNs in light of the financial crisis.⁸

There are approximately \$5.9 billion in outstanding ETNs, the vast majority of which is in commodity- or currency-based notes. BGI currently dominates the ETN space with just over \$3.4 billion in assets as of June 30, 2009.⁹ Apparently, Barclays iPath ETNs will not be included in the sale of BGI to BlackRock.

ETF SPONSORSHIP – CONCENTRATED

Approximately 85% of US ETF assets are managed by three firms: BGI (approximately 53% market share), State Street Advisors (22%) and Vanguard (10%).¹⁰ Nonetheless, ProShares, an early innovator of leveraged and inverse ETFs, doubled assets to over \$20 billion in 2008. In addition, the sale of BGI and its iShares® unit to BlackRock, an active management firm, will certainly have an impact on the ETF landscape.

Not only are the assets concentrated amongst ETF sponsors, assets are concentrated amongst a limited number of ETFs. Based on SEI analysis, the 20 largest ETFs or roughly 2.5% of all ETFs account for just over 50% of total ETF assets. The table below illustrates the asset concentration in the 10 largest ETFs as of June 30, 2009.

Rank	Portfolio Name	AUM 06/09 (billions)
1	SPDR® S&P 500 ETF	61.8
2	SPDR® Gold Shares	33.7
3	iShares® MSCI EAFE Index	29.4
4	iShares® MSCI Emerging Market Index	28.4
5	iShares® S&P 500 Index	18.4
6	iShares® Barclays TIPS Bond	14.1
7	PowerShares® QQQ	14.0
8	iShares® iBoxx \$ Investment Grade Corp Bond	12.1
9	Vanguard Total Stock Market Index	10.3
10	iShares® FTSE/Xinhua China 25 Index	9.9
	Total	232.0

Source: Strategic Insights

KEY FEATURES OF ETFS

ETFs generally have four key features that have attracted financial advisors and institutional investors: (i) intraday trading; (ii) portfolio transparency; (iii) tax efficiency; and (iv) low cost. ETFs trade on exchanges so they can be bought and sold throughout the trading day while mutual funds are bought and sold once per day as of the close of trading. Currently all ETFs, including the few active ETFs available, are required to disclose their portfolio holdings on a daily basis so they are considered highly transparent products.¹¹

From a tax perspective, because most ETFs currently track an index, their portfolio turnover is low – that is, they only buy and sell positions when the relevant index is rebalanced either quarterly or annually. In addition, because most ETFs satisfy

redemptions in-kind, they do not have to sell portfolio positions to raise cash to satisfy redemptions – thereby significantly limiting the potential for capital gains distributions. *More on tax efficiency below.*

Finally, because nearly all ETFs currently track indices and are passively managed, they tend to have low management fees. Additionally, ETFs do not have transfer agency expenses because shares are held in street name at various broker-dealers. In light of these factors, ETFs generally have low expense ratios compared to actively managed mutual funds.¹²

ETFs VERSUS INDEX MUTUAL FUNDS

TRADING FLEXIBILITY

Depending on an investor's strategy and perspective, the most significant advantage of ETFs compared to index mutual funds may be trading flexibility. As noted, ETFs are listed on exchanges and trade like traditional stocks and bonds. Consequently, they can be traded intraday for speculative purposes – permitting investors an ability to capitalize on short-term, intraday market movements. In addition, ETFs, unlike most mutual funds, can be sold short and purchased on margin – providing investors with additional hedging and leverage capabilities. However, these trading strategies do come with additional costs, risks and the potential for significant asset loss.

POTENTIAL LOWER COST

The expense ratios of ETFs generally run lower than their index-based mutual fund counterparts. However, as discussed below, there are transaction costs associated with ETFs that should be considered. The following chart illustrates the expense ratios of selected index mutual funds and S&P and Russell index-based ETFs.

S&P 500 Index

Vanguard 500 Index Investor Shares	.18%
SPDR® S&P 500 ETF (SPY)	.10%
iShares® S&P 500 (IVV)	.09%

S&P MidCap 400 Index

Vanguard Mid Cap Index Investor Shares	.27%
SPDR® S&P MidCap 400 ETF (MDY)	.25%
iShares® S&P MidCap 400 Index (IJH)	.20%

S&P 600 SmallCap Index

Vanguard Small Cap Index Investor Shares	.28%
iShares® Russell 2000 (IWM)	.24%
iShares® S&P SmallCap 600 (IJR)	.20%

Additional fees factored into the total cost of an ETF investment include the brokerage commission investors pay when purchasing ETF shares. The ETF bid and ask spread also impacts the cost of investing in an ETF as the investor effectively pays a fee equal to one-half of the ETF's bid-ask spread when buying or selling an ETF. The bid-ask spread is the difference

between the market price for buying the ETF and the market price for selling the ETF. For ETFs with high trading volumes, the trading spread typically is narrow and less of a consideration.

TAX EFFICIENCY

Both index ETFs and index mutual funds have low portfolio turnover. However, ETFs have a structural advantage when it comes to tax efficiency. While ETFs may pay capital gains, it is unusual because ETFs generally satisfy redemptions-in-kind as opposed to in cash.¹³ In the case of ETFs in less liquid asset classes such as emerging markets, cash instead of in-kind baskets may be used in the purchase and redemption process, *which may result in less tax efficiency and higher tracking error.*

With ETFs, capital gain taxes typically would be realized by investors only when they sell the ETF for a gain – similar to stocks or bonds. This tax result generally is different from mutual funds, which must distribute gains when securities within the portfolio are sold either at portfolio manager direction or to satisfy redemption activity. As a result, the actions of other mutual fund investors can potentially cause a tax consequence for remaining investors.¹⁴

A recent analysis by Morningstar compared the capital gains distributions of ETFs and open end index funds for 27 broad-based indices over five-, 10- and 15-year periods. The results support the greater tax efficiency of ETFs, finding that 25 of the 27 mutual fund families made taxable distributions within the past five years. Additionally, the capital gains distributed by 171 S&P 500 tracking mutual funds reviewed by Morningstar averaged over 1% of the funds' respective net asset values in each of the three periods measured. By comparison, two ETFs made distributions in the past five years and one only in the past 10 years (although few ETFs have been available for 10 years).¹⁵ It is important to note this study was focused on broad-based index ETFs not leveraged, inverse, currency or commodity-based ETFs, which may have different tax profiles.

ETF USAGE

While institutions were early users of ETFs, the perceived advantages of ETFs have broadened their appeal to the retail channels – both advisor-driven and direct retail. According to a 2009 report from Strategic Insight (SI) and based on figures from leading ETF sponsors, it is estimated that roughly 40-50% of ETF assets are held by institutions defined as hedge funds, mutual funds, proprietary trading desks, pension funds, endowments and foundations. Financial advisors and the direct retail channel represent the 50-60% of ETF assets, with new ETF sales trending toward these channels as opposed to the institutional channel.¹⁶

A recent survey of financial advisors illustrates the degree to which they have embraced ETFs. Of the 840 financial advisors surveyed, 96% use ETFs to some extent, with 20% using them in over 50% of their portfolios although over half the respondents had less than \$5 million in ETF assets. Registered independent advisors (RIAs) – also early adopters of ETFs – continue to be active users with 12% integrating ETFs in over 80% of their portfolios. Interestingly, according to the survey, 98% of financial advisors employed by broker/dealers are using ETFs in their portfolios. These are advisors who historically have been ardent active management proponents.¹⁷

Advisors are integrating ETFs into portfolios for both tactical and strategic allocations. Tactical uses commonly employed by advisors include: tax loss harvesting (i.e., avoidance of the “wash sale” rules); short-term tactical trading strategies; and

opportunistic “bets.” In October/November 2008, SI surveyed 85 RIAs and the results indicate the core usage of ETFs slightly outweighed the satellite usage by advisors.¹⁸

FUTURE ETF USAGE

In the SI survey of RIAs, over 70% of those surveyed indicated they would use ETFs “a little more” or “much more” over the next two years. Meanwhile, ETFs accounted for more than 43% of all US equity trading during November 2008, the height of the financial crisis, evidencing that the intra-day trading aspect of ETFs is valued – at least by institutional traders.¹⁹ Further, in light of the Madoff scandal, transparent products such as ETFs, as well as mutual funds, should benefit from investor desire for increased transparency.²⁰

Further integration of index-based ETFs into wrap programs is likely given their low cost and the continuing adoption of fee-based platforms. According to Cerulli Associates, as of June 2008, ETFs represented only \$18 billion of the \$1.7 trillion in all wrap accounts. However, newer UMA programs have featured a higher concentration in ETFs than found in older UMA programs, according to Cerulli.

An untapped growth area for ETFs is the 401k space. Historically, the 401k channel has been problematic for ETFs given: (i) that the intraday trading feature generally is not supported by 401k recordkeeping platforms; (ii) the impact of commissions on small ETF purchases typical of 401k participants; and (iii) from a distribution perspective, the lack of revenue sharing arrangements. However, ETF expansion into the 401k space may be more likely with recordkeeping platforms beginning to retool their systems to support the product, coupled with the November 2008 launch of target date ETFs and an educational push by industry leader BGI.²¹

CONCLUSION

The ETF story to date is one of innovation and rapid growth. Continued growth in terms of asset gathering is likely while rapid product growth is less likely – although there will continue to be ETF product launches. Moreover, despite the fact most ETFs currently track indices and the growth rate of ETF assets has been impressive, actively managed products are still in demand and can coexist with ETFs. The pending BlackRock acquisition of BGI demonstrates this point. One of the key questions prospectively will be to what extent active ETFs gather assets. This question is the subject of the second brief in this two part series.

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For ETF sponsors, SEI offers a flexible and scalable solution that provides managers the ability to focus on revenue and growth while SEI manages key outsourced functions. SEI's integrated, one-stop solution includes:

- Fund accounting and administration
- Authorized Participant (AP) processing
- Custody and transfer agent
- Distribution services
- Compliance support

¹ Cerulli: The Global Edge ETF Issue June 2009. SEI calculates a 29.6% CAGR for US-based ETFs from 2000, when BGI began actively promoting iShares, through June 2009 compared to a growth rate of 2.6 % for mutual funds over the same period.

² Strategic Insights, ETFs: Growth, Innovation, Competition 2009.

³ Investors pay a trading spread, higher trading volume narrows the trading spread to help lower the transaction costs investors pay when investing in an ETF.

⁴ Vanguard's ETFs are issued as a separate share class of some of their index mutual funds as opposed to separate legal entities, as is the case with all other ETF providers, reducing the timing and cost associated with launching ETFs. Vanguard has patented this structure referred to as: an investment company that issues a class of conventional shares and a class of exchange traded shares in the same fund. Apparently, Vanguard is willing to license this patent but no ETF sponsor has done so to date. Neither has the patent been challenged.

⁵ Bear Stearns launched the first actively managed bond ETF in May 2008 but it was liquidated in October 2008.

⁶ Inversed and leveraged ETF sponsors provide prospectus disclosure regarding holding periods and related tracking issues. Recently, a few influential intermediaries ceased selling these specific types of ETFs to their retail customers related to tracking issues.

⁷ In Europe, notes tracking commodity indexes are referred to as exchange traded commodities or ETCs.

⁸ Further complicating sales efforts in the US, the Internal Revenue Service concluded in 2008 that all gains (including long-term gains) from currency-based ETNs should be treated as ordinary income. Currently, it's unclear whether long-term gains from other ETNs also will be treated as ordinary income.

⁹ National Stock Exchange June 2009 ETF/ETN Report.

¹⁰ ProShares and PowerShares each control approximately 5% of the US ETF assets while WisdomTree, Van Eck, Bank of New York and others split the remainder. In Europe, the market is dominated by three main players as well: BGI (approximately 40%), Lyxor Asset Management (22%) and Deutsche Bank (18%). Source: BGI.

¹¹ Disclosure of holdings is intended to prevent premium/discounts to an ETF's net asset value (NAV).

¹² According to a report by Lipper, actively managed mutual fund had an average expense ratio of .712% in 2008 while index funds, including ETFs, had an expense ratio of .262%.

¹³ Most ETF investors cannot purchase or redeem ETF shares directly with the ETF but must transact in the secondary market (i.e., purchase on an exchange) – one of the reasons ETFs need exemptive relief from the requirements of the Investment Company Act. Conversely, broker-dealers, market makers and some large institutional investors may trade large blocks (i.e., creation units) of the ETFs' shares directly with the ETF. For index-based



ETFs, these investors deliver the basket of securities representing the index being tracked by the ETF when they purchase ETF shares. When selling a large block of ETF shares, these investors accept the basket of securities in exchange for their ETF shares. It is this redemption-in-kind process in particular, that results in index-based ETFs being highly tax efficient. The ability of institutional investors and dealers to transact directly with the ETF also is key to minimizing the premium-discount between the ETF's NAV and its market price.

¹⁴ Research by Prof. Roger Edelen of the UC Davis Graduate School of Management in conjunction with Reflow found that 30 percent of all mutual funds trades were flow-induced, and that while discretionary trades increased portfolio value by 22 cents for each dollar of transaction cost, flow-induced trades lowered it by 53 cents per dollar. They acknowledge these specific results may not fully represent today's environment but are indicative of the destructive dynamics of flow.

¹⁵ Morningstar Corporate Research, ETFs Deliver on Their Tax-Efficiency Promise, May 19, 2009.

¹⁶ Strategic Insights, ETFs: Growth, Innovation, Competition 2009.

¹⁷ SPDRUniversity & Knowledge@Wharton, The Impact of Exchange Traded Products on the Financial Advisory Industry 2008.

¹⁸ Strategic Insights, ETFs: Growth, Innovation, Competition 2009.

¹⁹ National Stock Exchange: November ETF/ETN Data Report.

²⁰ In addition, ETFs provide access to alternative asset classes previously difficult or costly for retail investors to access – including hedge-like strategies, selected countries, regions or sectors, commodities and currency management. The recent broad market downturn may highlight the need for alternative investment classes within a diversified portfolio. To the extent an ETF or even an index mutual fund does not fully replicate the index it tracks but instead utilizes other instruments (particularly derivatives such as swaps), the transparency aspect of those products may be overstated to some degree and they introduce tracking error and counterparty risks for consideration by investors and financial advisors.

²¹ With respect to commissions, plan sponsors and record keepers are seeking to aggregate and net ETF orders at the end of trading in order to minimize the impact of commissions.