

White Paper*
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Investing in Exchange-Traded Funds

In recent years, exchange traded funds (ETF's) have become a very large and diverse segment of the financial markets. The first ETF, issued in 1993, was designed to track the S&P 500 Index. Known as Spiders (for its ticker symbol, SPDR), this ETF now has assets of almost \$100 billion. Over the last few years the number of ETF's has exploded; there are currently about 1000 active in the US, with at least another 700 in development. Most ETFs, like the SPDRs, are designed to track particular indices, sectors, or industry groups. For example, there are global, regional, and country index ETFs. Conversely, some ETFs have a very narrow focus, such as the recently issued Smart Phone ETF or the White Metals ETF.

ETFs offer a number of benefits to both individual and professional investors. Their relative ease of use, generally high liquidity, and low transactions costs and expenses have made them very popular. They can be a quick and convenient way to obtain or adjust exposure to a market or sector. The growing interest in international markets has been a particular boon for country-specific ETF's. For money managers, they are an added tool along with futures and derivatives to help us manage portfolios and control risks. Yet it is important to realize their limitations.

Most of these limitations, such as tracking error (i.e., their ability to fit the index they represent), have been addressed in a number of articles. Therefore we will spend no time discussing these aspects. Instead, our focus in this paper is on the investment side. Our general advice is to always check out what you are getting when you buy an ETF. As you will see from some of our examples, a fund named after some country, region, sector or concept may not give you the exposure that the name implies. Moreover, you could end up with more country, sector, or stock concentration than you expect or want.

What's in the ETF?

Most ETF's are not actively managed, so before investing, it is important to understand how its holdings are selected and weighted. If the ETF is designed to track a particular index, then the analysis should be on the underlying index. (Obviously, the ETF's ability to track the index should be considered as well.)

Selection:

Inclusion of a stock can be based on arbitrary selection or determined by a set of rules. For example, the 30 stocks in the Dow Jones Industrial Average and the 500 stocks in the S&P 500 Index are selected based upon subjective criteria. Similarly, the 30 Indian stocks in the Bombay Stock Exchange Sensitive Index (the Sensex) are selected based on factors such as liquidity and industry representation. On the other hand, inclusion in the Russell 1000 Index is based on market capitalization, while the Kospi, a Korean Index, includes all common shares on the Korean stock exchange. Stocks in some ETFs are selected by the issuer of the ETF to represent a particular concept. For example, a green ETF may include stocks of companies involved in fuel cell technologies or solar power.

Regional and global Indices may have very high concentration of a few countries or eliminate countries altogether. EFA, the most popular ETF for developed markets, does not include Canada. (The name of the underlying index, EAFE, stands for Europe, Australasia, and the Far East.) Likewise, country funds may not include stocks you might think are included. For example, Royal Dutch Shell, 17% of the AEX (Amsterdam Index), is not in EWN, the iShare for Netherlands; Hong Kong & Shanghai Bank, 17% of the Hang Seng Index, is not in EWH, the iShare for Hong Kong.

Weighting:

Indices use a variety of methods to weight stocks. The most common method today is by float-adjusted market cap, where the stock with the largest free-float market cap, will have the largest weight in the index. For example, in the S&P 500, which now uses this method, Microsoft is larger than General Electric by market cap but has a smaller weighting because it has a lower float. Some indices are equal weighted, meaning that a company with a \$1 billion market cap would get the same weight as a company with a \$300 billion market cap. A few indices are price weighted, such as Japan's Nikkei 225 or the Dow Jones Industrial Average, where IBM, a \$160 stock, has twice the weight of Exxon, an \$80 stock. Some indices use multiple weighting methods, such as the DJ US Select Oil Equipment & Services Index (available as the iShare IEZ), where 3 different rules apply to calculate weightings. In this index, Schlumberger, Halliburton and Baker Hughes represent respectively 23%, 9% and 8%, even though Schlumberger is over three times the size of Halliburton and four times the size of Baker Hughes. (Anybody confused can always use OIH (the Oil Services Holders Trust) where Baker Hughes and Schlumberger are equal weighted.)

Are you getting the exposure you think you're getting?

Many stocks have greater exposure internationally than they do in their country of domicile. Thus, you cannot assume that because you have acquired a country fund, you have a diversified exposure to that market: for instance EWL, the Swiss iShare, includes 20% Nestle, 12% Novartis, and 11% Roche, three global companies that derive the vast majority of their sales outside of Switzerland. EWS, the Spanish iShare, includes 22% Banco Santander and 19% Telefonica, both of which derive only a third of their revenues from Spain. EWZ, the Brazilian iShare, has 11% Petrobras and 10% Vale, global natural resources companies whose fortunes depend more upon global growth rather than what is happening in Brazil. Infosys, an

Indian outsourcing firm which gets about two-thirds of its revenues from the US, makes up almost 10% of INDY, the S&P India Nifty Fifty Fund.

Concentration in stocks or sectors may result in limited diversification or high exposure to some stocks or sectors. To illustrate this point, we look at two popular ways for obtaining emerging markets exposure.

The first is the ETF which tracks the MSCI BRIC Index and is available as iShare BKF. BRIC is the popular acronym for Brazil, Russia, India and China, the four largest and to some the most promising economies and markets. So this ETF should be quite a convenient way to invest in these markets. Table 1 breaks down this ETF by country and by sector.

Table 1

iShare MSCI BRIC Fund					
2/25/2011	<u>China*</u>	<u>Brazil</u>	<u>India</u>	<u>Russia</u>	<u>Sector Total</u>
Financials	13.3%	7.9%	4.0%	2.0%	27.2%
Energy/Materials	8.9%	17.6%	3.4%	11.6%	41.5%
Information Technology	1.9%	0.6%	4.3%	0.0%	6.8%
Consumer Products	4.1%	4.3%	0.0%	0.6%	9.0%
Health Care	0.0%	0.0%	1.2%	0.0%	1.2%
Industrials	3.4%	1.0%	0.7%	0.0%	5.1%
Utilities/Telecoms	<u>4.5%</u>	<u>3.0%</u>	<u>0.2%</u>	<u>1.1%</u>	<u>8.8%</u>
Country Total	36.3%	34.4%	13.8%	15.3%	100%

*includes stocks of Hong Kong-listed Chinese companies

As this table illustrates, about 36% of the fund is invested in China, followed by 34% in Brazil and roughly 14% and 15% in India and Russia, respectively. Looking at sector concentration, we see that over 40% of the fund is in energy or basic materials, such as iron ore and nickel, while 13.3% is in Chinese banks and insurance companies, which are essentially controlled by the Chinese government. The finance sector in Russia is dominated by Sberbank, 60% owned by the Central Bank of the Russian Federation. When we think of investing in these countries, we do not think of commodities or government instrumentalities (such as Fannie Mae or Freddie Mac in the US). Rather, we think of those industries that benefit from improving standards of living, such as food, beverages, mopeds, cars, and consumer services, such as telecom. These types of companies make up less than a third of the total fund and less than 2% out of 15.3% of the Russian exposure. In fact, 75% of the Russian exposure and over half of the Brazil exposure relate directly to commodity prices. Obviously, we are not saying that investors should not use such a fund; far from it. It's just that the mix is quite different from what we would like to own in these particular markets.

A broader emerging markets ETF is EEM, which tracks the MSCI Emerging Markets Index. A breakdown of this ETF is shown in Table 2. Interestingly, the third and fourth largest weights are in South Korea and Taiwan, which make up about 25% of the total. These countries, like Hong Kong and Singapore, are often considered to be past the emerging stage. Over 10% of the 25% weight of these two countries is in technology companies, which manufacture a number of components for developed world tech products. India has a relatively small weight

of just over 5%. Two of the best performing emerging markets in 2010 were the Philippines and Thailand (not shown), up 43% and 47%, respectively. The combined weight of these two countries is only 0.14% of the total fund.

The sector breakdown is somewhat similar to that of the BRIC ETF, in that over half is Financials, Energy and Materials. Consumer products have only a 14% weight, and Health Care is less than 1%.

Table 2

iShare MSCI Emerging Markets Fund-20 Countries									
2/25/2011	<u>China*</u>	<u>Brazil</u>	<u>South Korea</u>	<u>Taiwan</u>	<u>South Africa</u>	<u>Russia</u>	<u>India</u>	<u>Other Countries</u>	<u>Sector Total**</u>
Financials	6.5%	3.9%	2.2%	1.3%	1.7%	1.0%	1.8%	5.4%	23.8%
Energy/ Materials	4.3%	8.6%	2.3%	1.8%	2.8%	5.5%	1.2%	3.8%	30.3%
Information Technology	1.1%	0.3%	3.8%	6.6%	0.0%	0.0%	1.6%	0.0%	13.3%
Consumer Products	1.9%	2.2%	2.7%	0.8%	1.9%	0.3%	0.0%	4.0%	13.8%
Health Care	0.1%	0.2%	0.1%	0.0%	0.1%	0.0%	0.2%	0.2%	0.9%
Industrials	1.5%	1.0%	2.2%	0.4%	0.3%	0.0%	0.5%	1.0%	6.9%
Utilities/ Telecoms	2.2%	1.3%	1.0%	0.2%	0.8%	0.6%	0.2%	4.1%	10.4%
Country Total**	17.5%	17.0%	14.4%	11.1%	7.5%	7.5%	5.4%	27%	100%

*includes stocks of Hong Kong listed-Chinese companies **includes unclassified stocks.

Conclusion

Make sure you check the label before drinking the Kool-Aid...

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