

THE ETF REVOLUTION

BY INDEX RESEARCH GROUP

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INTRODUCTION: THE ETF REVOLUTION

The conventional mutual fund has stood at the center of the investment management industry for more than 80 years. Its popularity is driven by a simple idea: Allow investors to purchase a managed basket of securities as a single product, providing instant diversification at a relatively low cost.

Mutual fund management companies have translated this simple idea into an enormous business: The mutual fund industry managed \$21.66 trillion in assets worldwide heading into the fourth quarter of 2008, nearly \$11 trillion in the U.S. alone.¹ Recently, however, a new product has emerged that has mounted a significant challenge to mutual funds around the world: the exchange-traded fund, or ETF.

ETFs are similar to mutual funds, in that they hold a basket of securities in a single wrapper. But unlike mutual funds—which can be bought and sold just once per day—ETFs can be traded on an intraday basis on an exchange, just like any stock. They may also have cost advantages over conventional funds, and can be more tax efficient, more flexible and more transparent.

Investors seem to have responded to these advantages. In the U.S., investors poured more than \$100 billion in net new money into ETFs in 2008, even as they pulled a record \$320 billion from traditional mutual funds.² Globally, ETFs held more than \$711 billion in assets at the end of 2008, more than double the size of the ETF industry in 2004.³

Many industry experts believe that the ETF industry is still in its early stages of growth. This paper explores the role ETFs are playing in the investment market, what opportunities remain for firms looking to enter the ETF market and the challenges they face.

¹ Investment Company Institute

² IndexUniverse.com

³ Barclays Global Investors

A GROWING INDUSTRY

From Mutual Funds to ETFs

The growth of the ETF industry has been astonishing. Over the two-year period ending December 2008, the number of exchange-traded funds worldwide doubled to 1,590. Perhaps most impressively, while the traditional mutual fund market saw net outflows of over \$250 billion (on top of market declines), ETFs had net inflows of \$187 billion, keeping assets ahead of \$700 billion even in the face of a 42% decline in global asset values as measured by the MSCI World Index.⁴

To put that figure in perspective, it took conventional mutual funds 41 years to gather \$600 billion in assets after the first fund was launched in 1924;⁵ ETFs achieved the same just 14 years after the debut of the first ETF in 1993.

Growth has been particularly impressive in Europe. European ETF assets rose by 11% in 2008 to \$142 billion, and 277 new funds were launched, again, in the face of a crippling market.

The story is the same in every major financial market: Japan saw the launch of 46 new ETFs in 2008, and assets are nearly \$30 billion. Asia Pacific (ex-Japan) saw 27 new ETF launches, to 95 total, with nearly \$25 billion under management.⁶

To understand why ETFs have had such tremendous appeal across international borders, it helps to understand exactly how they differ from mutual funds, and how they are used by investors, traders and institutions. To do that, the place to start is with the very first ETF: the Standard & Poor's Depository Receipt, or SPDR.

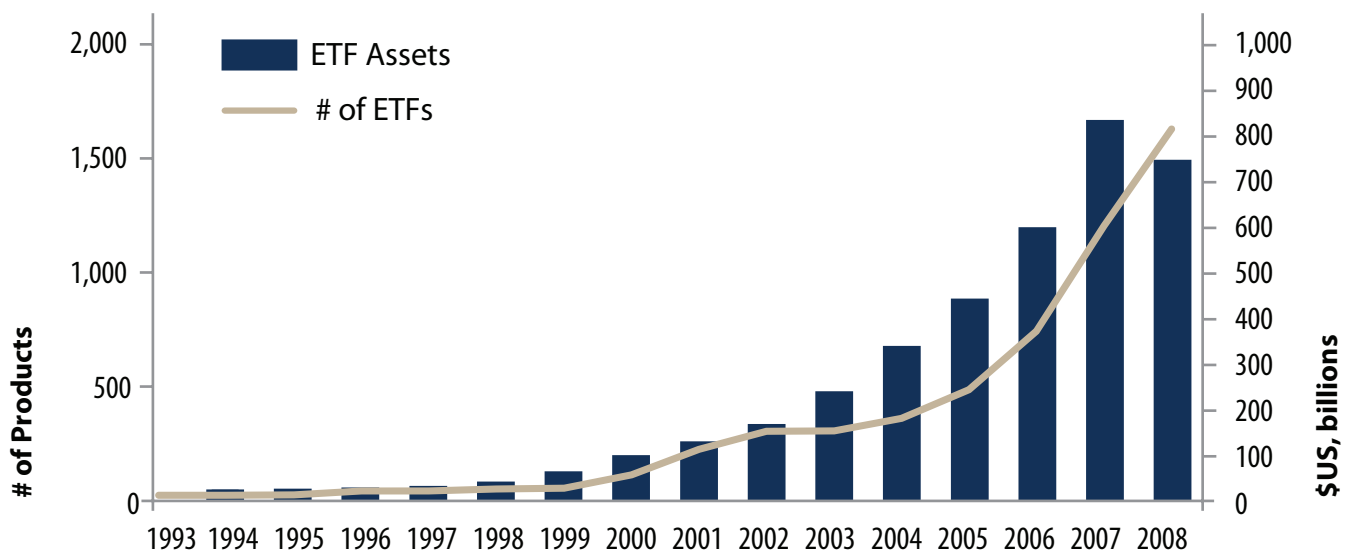
A Breakthrough Idea

The Standard & Poor's Depository Receipt, better known as the SPDR, launched on the American Stock Exchange in 1993. The idea behind the world's first major ETF was simple: Package together all the stocks in a familiar market index and allow traders to buy and sell that package as a single unit. The SPDR tracked the performance of the S&P 500 Index through full replication, holding all 500 stocks in that index.

The appeal was and is obvious: Investors or traders who want to buy or sell "the market" no longer need to buy each stock in the index, with the related brokerage fees, custodial hassles, rebalancing, shifting spreads, etc. Instead, they can make just one trade and gain instant access to the entire basket.

The initial audience for the SPDR consisted of traders, institutions and other professional users. The uses were varied. Institutional investors and hedge funds

Global ETF Growth



Source: Barclays Global Investors

realized that a stock that tracked an entire index had great potential as a hedging instrument. Mutual fund portfolio managers discovered they could eliminate cash drag by buying ETFs to “monetize” their cash positions intraday. As options linked to the ETF emerged, sophisticated traders found new ways to manage risk in a portfolio.

Over time, however, the audience for this “trader’s product” broadened to include retail investors, and financial advisors focused on long-term asset allocation. It is this “retail” investor class that has driven much of the recent growth in the market.

Indexing Evolved

One reason ETFs became popular with retail investors was coincidental: Their debut in the 1990s came amidst a wave of interest in index-based strategies. Although the first index mutual fund launched in the 1970s, it was only during and after the Technology bubble of the late 1990s that investors turned to indexing en masse. According to John Bogle, founder of the Vanguard Group, in 1990, there were barely \$1 billion in total assets in all equity index mutual funds. By 2004, that had soared to more than \$550 billion, or one-sixth of all equity fund assets.

Indexing’s key advantage is efficiency. Indexing is a passive investing style, because like the index, the fund’s components don’t change often, and changes occur from predictable, transparent rules. With less portfolio turnover than an actively managed fund, the fund incurs fewer transaction and management costs. Without pools of fundamental analysts making decisions on individual stocks, ETF providers can charge commensurately less for their services.

According to Morgan Stanley, the average expense ratio for a U.S. equity index fund is 0.70%. But the average actively managed U.S. equity funds charge 1.45% a year, and more for non-U.S. equities.

ETFs take indexing’s core advantage and amplify it. The average equity ETF charges just 0.53%, and on an asset-weighted basis, that figure drops further. ETFs are able to deliver this larger cost advantage because they externalize many of the costs of running a conventional mutual fund.

Expense Ratios of ETFs vs. Open-End Mutual Funds (bps)

| | Average | Range | Weight Average |
|---------------------------------------|---------|-------|----------------|
| Exchange-Traded Funds | | | |
| US Major Market ETFs | 34 | 7–70 | 15 |
| US Specialty Market ETFs | 77 | 25–95 | 66 |
| US Style ETFs | 36 | 11–70 | 22 |
| US Sector/Industry ETFs | 52 | 12–75 | 34 |
| All US Equity ETFs | 53 | 7–95 | 29 |
| International Equity ETFs | 55 | 18–95 | 48 |
| All Equity ETFs | 54 | 7–95 | 34 |
| Fixed-Income ETFs | 39 | 11–60 | 19 |
| Open-end Mutual Funds | | | |
| Actively Managed Domestic Equity | 145 | | |
| Actively Managed International Eq. | 167 | | |
| Passive/Indexing Domestic Equity | 70 | | |
| Passive/Indexing International Equity | 95 | | |
| Passive/Indexing Fixed-Income | 43 | | |

Source: Morgan Stanley ETF Quarterly Report, Nov. 2008

Changing The Way Investors Invest

While the structural advantages of ETFs set the stage for the product’s growth simply as a tool, it is likely that ETFs have actually changed the way retail investors approach investing itself, if for no other reason than the number of options available to them has increased.

In the past, investors and advisors focused much of their energy on absolute performance. However, because of the ETF revolution, many investors (and their financial advisors) have adopted core-and-satellite asset allocation strategies. While individual managers with active, alpha-generating strategies are still used, they are selected for their specific expertise, not simply because they provide exposure to a particular asset class. Increasingly, the job of alpha generation has shifted from the traditional active mutual fund manager toward the advisor, who is ever-more careful in making asset allocation recommendations, and selecting active managers.

This is the way that large institutions and endowments have managed money for decades, blending portfolios of different equity styles, countries, sectors, bonds, commodities and currencies to achieve the maximum risk-adjusted returns, with additional alpha added from individual, carefully screened active managers.

The breadth of ETFs in the market has made this shift toward generating returns at the asset allocation level both easy to implement and economically feasible for individual investors and advisors for the first time. By providing focused, targeted access to individual asset classes, and by opening up new markets like commodities, currencies and international fixed income to retail investors for the first time, ETFs have improved asset allocation strategies, lowered costs and reduced barriers to entry. Individual investors can now invest like the smartest, largest institutions in the world ... and they are increasingly doing so.

⁴ Barclays Global Investors

⁵ Investment Company Institute

⁶ Barclays Global Investors

NEXT-GENERATION GROWTH DRIVERS

As impressive as the ETF industry's growth has been over the past 14 years, many believe the industry is poised for even greater growth in the years to come. Barclays Global Investors expects ETF assets to top \$1 trillion by 2009, and \$2 trillion by 2011.⁷

Achieving close to 300% cumulative growth over the next three years would be an impressive feat, but a number of factors are coming together to drive the market forward.

A Desire For Transparency

The financial crisis of 2008 presented clear evidence of the risk of inadequate transparency. Many mutual fund investors experienced this firsthand: Unable to see in real time what their fund managers were buying, many discovered too late that they were invested in risky firms like Lehman Brothers, AIG and Fannie Mae.

It's not the first time that transparency has come to the fore. Each financial crisis over the past decade has driven a sharp uptick in ETF assets: the Internet bubble of the late 1990s, the mutual fund market-timing scandal of the early 2000s. Each time, investors seemed to realize that having full transparency into which stocks or bonds are held on their behalf is fundamental. The financial crisis of 2008 appears to be no different, and the most recent data on relative asset flows support this.

The 401(k) Market

Retirement investing remains the great unconquered frontier for ETFs. Heading into the third quarter of 2008, Americans held \$4.3 trillion in employer-sponsored defined contribution plans, with more than half of that being allocated to conventional mutual funds.⁸

ETFs currently make up only a tiny part of the 401(k) universe. There are various technological impediments that have prevented them from establishing a foothold, highlighted by the brokerage costs involved in purchasing a small number of shares on a regular basis. Further, many 401(k) programs are financed through fees unique to mutual funds: sub transfer-agency, and 12(b)1 marketing fees.

However, some ETF sponsors are making significant changes to their business in order to tap this tremendous pool of assets. WisdomTree, for example, has established its own dedicated 401(k) platform that circumvents both the funding and the commission issues, using omnibus trading and a separate fee structure. ETF providers are keenly focused on tapping into this market, where its lower costs would convey significant long-term return advantages for retirement investors.

Innovative Product Developments

Since its beginnings in 1993, the ETF industry has been a hotbed of innovation. It continues that tradition to this day. Actively managed ETFs, leveraged commodity funds and emerging market bond exposure are just a few of the nonmainstream products coming to market. Funds in development include hedge fund replication ETFs, credit default swap ETFs and emerging market sector funds.

With just 698 ETFs in the U.S. at the end of 2008, compared with over 8,000 mutual funds, according to the Investment Company Institute, the ETF industry appears to have room to grow. There are even more opportunities internationally, where many markets are "greenfield."

In the U.S. alone, at the end of 2008, more than 500 exchange-traded products were in registration. And yet 2008 was also a year of retrenchment for the industry. Fifty-eight ETFs in the U.S. closed their doors, and over 200 had assets under management of less than \$10 million. The lessons learned have been stark—in order to gain critical mass, new products have to make sense, they need to be structured to maximize liquidity and minimize spreads, and they need to be marketed well.

Established Managers

As ETFs become mainstream, more and more asset management firms that had previously focused exclusively on mutual funds have targeted the ETF space. For smaller companies, such as Van Eck Global, the shift to ETFs has been relatively obvious. But for many companies, there is both a business model and a cultural shift required.

In 2009, PIMCO—the world’s leading bond fund manager—is entering the ETF space for the first time. Charles Schwab, long in the position of selling its own index mutual funds alongside competitors, has announced its own plans to launch a broad U.S. equity ETF. Mutual fund manager Dreyfus established a partnership with ETF company WisdomTree in 2008 to manage and distribute international cash and fixed-income products.

Others, from Eaton Vance to the socially responsible mutual fund company Pax World, are eyeing the space as well. In some cases, these moves may simply be to stem the flow of funds leaving for other ETFs. However, the increasing potential for higher-fee, actively managed ETFs (which disclose holdings at least daily), make them an option for viable transition to an ETF-dominated product set, even for traditional mutual fund managers.

As these entrenched asset managers move into the market, ETFs will continue to gain mind share among investors, and fund flows and asset growth should accelerate.

⁷ Barclays Global Investors

⁸ Investment Company Institute

THE FUND SPONSOR'S VIEW

Companies looking to enter the ETF market must understand that the unique features of ETFs also put unique requirements on the investment manager from structural, regulatory and operational perspectives.

In the U.S., ETFs are regulated by the Securities and Exchange Commission as registered investment companies, or RICs—the same regulatory structure that governs conventional mutual funds.

A RIC's primary purpose is to make a profit by investing in securities. They offer investors—with a minimum initial investment—the opportunity to own a diversified portfolio of securities, typically stocks or bonds, run by a professional manager. These highly regulated investment vehicles are governed by the U.S. Investment Company Act of 1940, also called the '40 Act.

To operate as an ETF, however, a product must receive "exemptive relief" from certain parts of the '40 Act from the SEC prior to commencing operations. Without such relief, a mutual fund cannot trade on a stock exchange—a key feature of ETFs. Similarly, mutual funds are only allowed to trade and conduct transactions with shareholders at their exact net asset value, a rule designed to ensure that investors are treated fairly. But in order to trade on an intraday basis, ETFs require an exemption from this rule as well, and must be allowed to trade on a stock exchange at prices other than the exact net asset value. And because it's impossible for the fund sponsor to track who owns the shares at any given moment, they cannot provide a prospectus to every investor, another requirement of the '40 Act.

Receiving exemptive relief from the SEC on these measures is not a simple process, and can take upward of two years. Although the commission is considering ways to streamline the process for "plain vanilla" ETFs, it is currently a significant roadblock for companies looking to "go it alone" in the ETF space. For fund sponsors seeking to do business on non-U.S. exchanges, the regulatory hurdles are substantially different in each market, but no less complex.

Further afield, exchange-traded vehicles (ETVs) that track alternative asset classes by holding futures and options contracts, actual commodities or foreign currencies have different structures. While they are similar to ETFs, they are not strictly RIC funds, and thus they are not regulated by the '40 Act. These products are generally structured as grantor trusts, commodity pools or exchange-traded notes. These can come under the regulatory control of other U.S. agencies, such as the Commodity Futures Trading Commission.

ETFs and ETVs also need exemptive relief from various parts of the U.S. Securities and Exchange Act of 1934 in order to allow the creation and redemption process.

No ETF can come to market without these exemptive reliefs in place.

Even after a company gains exemptive relief, launching an ETF can be daunting. As with traditional mutual funds, there are many tasks involved in operating an ETF, many of which are often outsourced to third parties. Creating the right relationships and understanding the roles of each player is key.

(See Appendix B for more detail on the various roles involved in managing a typical ETF.)

ENTRANCE STRATEGIES

Companies looking to enter the ETF market can follow one of two models: independent development, or partnerships.

Independent Development

At the dawn of the ETF industry, every ETF sponsor had to build its products from the ground up. Large banks such as Barclays, State Street and the Bank of New York came to the market with experience managing index funds for institutional investors and the infrastructure systems to support and manage many of an ETF's operations in-house. Their biggest challenges were navigating the regulatory maze to create the products, and to then convince the investing public to purchase these new investment vehicles.

While much groundwork has been laid, these challenges remain for new entrants.

For established companies that are not currently ETF sponsors, the challenge is one of focus. The complexity of managing the ETF infrastructure is often not a core competency even in a large firm.

The advantages of building an independent ETF platform aren't insignificant for a company with an existing brand. Investment management companies with long track records in traditional mutual funds can have instant credibility both with investors as well as financial advisors (the dominant distribution point for ETFs). They can convey a feeling of "establishment" and help persuade investors that both the fund and the strategy are sound, strong and designed for the long haul.

The smaller end of the market has seen some do-it-yourself start-ups succeed as well. Before it was acquired by the mutual fund giant Invesco, for instance, PowerShares was the largest independent ETF provider, and is widely credited with driving much of the recent innovation in the ETF market. WisdomTree Investments, a company that offers primarily dividend-screened ETFs, is now the largest independent ETF company.

Even the most die-hard independent will need to establish effective partnerships, however. Many of the roles in running an ETF (some of which are outlined in Appendix B) are necessarily outsourced even in the largest investment management companies. And

even independent WisdomTree has begun partnering with traditional mutual fund companies such as Dreyfus for new products.

But the bigger challenge lies with handling distribution. The distribution mechanism for ETFs differs sharply from that for traditional mutual funds. Whereas mutual funds keep detailed records of each investor that owns their funds, ETF companies only have partial snapshots, so the challenges of building, monitoring and incentivizing a sales force become large. In addition, ETFs do not come with sales loads, commissions or 12(b)-1 fees, all of which play a major role in the mutual fund distribution apparatus. Navigating these differences while still building mind share is a major challenge.

Partnerships

In today's market, companies entering the ETF market face many uphill battles. A de novo fund sponsor must create new infrastructure to maintain its funds, develop distribution channels in both the retail and institutional markets, and then market heavily to gain mind share. Larger companies may have expertise in one or more of these areas, but will inevitably need additional resources.

The solution is often to develop partnerships or joint ventures that take advantage of each party's strengths. The most innovative approach is to partner with a full-fledged ETF provider.

One leading example of this is the TDX Independence ETFs, a family of target date ETFs launched through a partnership between discount broker TD Ameritrade and ETF sponsor XShares. In this agreement, TD Ameritrade provides the marketing, index construction and portfolio management of the funds, while XShares provides a standing exemptive relief order from the SEC and back-office experience managing the details of ETF operations. By partnering with XShares and leveraging its existing relief order with the SEC, TD Ameritrade was able to leapfrog other competitors and launch the first family of target date ETFs ever, relatively quickly.

In Europe, a slightly different arrangement partnered Caixa, the largest bank in Portugal, with international ETF company SPA ETF. Together, the pair created the first ETF to list on the Portuguese

market, tracking the benchmark PSI-20 Index. SPA ETF is responsible for developing, launching and managing the fund, while Caixa is responsible for marketing and distribution of the product.

But other models do exist. A company with an established distribution model could create a pure sales and profit-sharing arrangement for an existing line of ETFs. Those same ETFs could be re-branded or co-branded for new distribution. Or separate ETFs could be established where the fund sponsor provides minimal support beyond distribution.

The advantages of these partnerships are that each firm brings its skills and necessary infrastructure, speeding the process of launching new funds and preventing fund sponsors from “reinventing the wheel.” This creates a critical time-to-market advantage: Typically, the first ETF to enter a given market captures the majority of market interest, assets and liquidity. While profits must inevitably be shared among partners, start-up and operational costs are reduced.

THE OPPORTUNITY LANDSCAPE

New entrants to the ETF market face challenges far different from those encountered by the industry's early pioneers.

Over the past year, companies have created ETFs for asset classes previously difficult for the small investor to reach. ProShares, with its leveraged and short ETFs, opened up new markets and trading styles to the average investor, and has accumulated more than \$20 billion in assets. Newcomer Direxion, which also offers leveraged ETFs, garnered \$80 million in assets in its first month of trading.

In 2009, at least 10 new ETF companies are waiting in the wings, lining up products for launch despite challenging market conditions.

In Europe, the markets are at an earlier point in their growth. The first ETF didn't launch in Europe until 2000. Although internationally listed exchange-traded products tend to target a slightly different audience—they are more often the province of traders and institutions than independent financial advisors—the situation is evolving rapidly. In an effort to increase the level of consumer trust, the U.K.'s Financial Services Authority is seeking to raise professional standards, improve clarity on independent advice and sales advice, and reduce conflicts of interest. These and other new regulatory proposals in the United Kingdom would, if approved, significantly increase the use of ETFs by independent financial advisors.

Outside of the U.S. and European markets, the market for ETFs is younger still. Some countries with established exchanges and established mutual fund industries do not yet have ETFs, although history suggests that demand would emerge if they were launched. In other markets, investors may have access to one or two funds, but nothing like the depth and breadth of funds they need to create and implement a successful asset allocation strategy.

Looking Ahead

The rise of ETFs has indeed been a revolution for investors. However, it would be a mistake to think that the market is mature. New entrants—especially those with established distribution channels, brand and marketing savvy—will no doubt emerge, and be successful. “One size fits all” has never worked in the investment management industry, and there's no reason to suspect it will with ETFs either. ETFs and traditional mutual funds are different distribution mechanisms for investment products—different pathways to an ultimate goal of investment returns. There *are* applications where mutual funds may be the logical choice, and applications where ETFs make more sense.

What is clear, however, is that the surge in ETF assets is not a flash in the pan, but rather, a once-in-a-generation breakthrough that is reshaping the way investors invest. ETFs will continue to gain assets, and will continue to gain a greater share of assets, as more and more investors discover the transparency, liquidity, flexibility and low costs they provide.

For companies seeking to enter the ETF market, the window is still open. Opportunities remain for companies that are nimble and can attack quickly and smartly. New fund sponsors have options in their approach: build vs. buy, solo vs. partners, active vs. passive. These options all have their pros and cons.

What is certain is this: With ETF assets under management expected to top \$2 trillion within three years, the business opportunity is large, and the revolution is far from over.

APPENDIX A: UNDERSTANDING ETFs

The Creation/Redemption Mechanism

The key distinguishing feature that separates an ETF from a conventional mutual fund—and the key to its cost advantage—is the “creation/redemption mechanism.”

Imagine an investor who wants to buy \$10,000 worth of a particular mutual fund. He submits a buy order through his broker, and \$10,000 in cash is transferred from his account to the mutual fund. In return, he receives shares of the mutual fund. The mutual fund doesn't want to sit on cash, however, so it goes into the market and buys new stocks or bonds.

When the investor wants his money back, the situation is reversed: A sell order is placed, the fund sells some of its stock and bond holdings, and distributes cash to the shareholder.

Each time the fund must buy or sell securities in the market, there are costs: Commissions are paid, bid/ask spreads are negotiated, there is market impact, etc. These costs are borne by the fund itself, and reduce the fund's returns. To make matters worse, mutual funds regularly carry cash on their balance sheets, as they manage the flow of purchases and redemptions.

In the ETF, these costs are externalized. That is, an ETF is bought and sold just like a stock. If an investor wants to buy \$10,000 worth of an ETF, they must purchase that ETF from another shareholder who wants to sell. No money is sent to the investment management company, so no additional securities need to be bought or sold.

If there is significant new demand for an ETF—or significant demand to sell an ETF—new shares of the ETF must either be manufactured or dismantled. If this were not possible, an ETF in high demand would rise in price out of proportion to the actual value of its underlying holdings. This manufacturing and dismantling is done through a process of creation and redemption. This process, however, operates outside of the ETF itself.

Each ETF has one or more institutional investors who act as Authorized Participants (APs) for the fund. If an AP sees strong buy interest in an ETF, they can manufacture new shares in the ETF to meet that demand. To do this, they buy up a basket

of all of the underlying securities in the ETF and deliver them to the fund company. Using the SPDR as an example, an AP would buy up all the stocks in the S&P 500 in exactly the right proportion and deliver them to the ETF provider in exchange for shares in the ETF. Typically, these transactions take place in baskets of 50,000 ETF shares.

In the redemption process, the transaction is reversed, and the AP trades 50,000 ETF shares in exchange for a basket of the underlying securities.

The AP will create/redeem shares when the price of the ETF is below/above the price of the underlying securities, creating an arbitrage profit opportunity.

This “in-kind” trade provides the foundation for the ETF's cost savings because the AP bears all of the costs of buying and selling securities.

Additional Advantages

The creation/redemption mechanism also conveys a sizable tax advantage on ETFs. Because the ETF itself doesn't typically have to buy or sell securities, conventional equity ETFs rarely accrue capital gains inside the fund, meaning they are more tax efficient for investors. In 2007, just 0.2% of U.S. equity ETFs paid out a capital gains distribution, versus more than 3% of mutual funds.⁹

Additionally, because the holdings of the ETF must be fully transparent for the creation/redemption mechanism to function, ETFs are accepted as trusted tools by advisors and investors. Whereas mutual funds disclose their holdings only once per quarter, ETFs disclose their full holdings daily: What you see is what you get. This transparency has been cited as a key factor for ETFs' success, especially during market crises, when investors want to be sure there are no surprises in their portfolio.

Other attributes of the ETF process benefit the funds as well. For instance, because ETF investors buy shares on an exchange, and not directly from the ETF company, the ETF doesn't need a transfer agent to record and manage the transaction, creating additional cost savings.

⁹ Investment Company Institute

APPENDIX B: FUND OPERATIONS

While many of the roles and responsibilities of an ETF would be familiar to any asset manager, the differences are worth noting. Establishing the right relationships is often the difference between success and failure with an ETF launch.

Fund Sponsor

Mutual funds as well as ETFs are created by a fund sponsor. Sponsors typically create families of funds and provide the main distribution network for the funds. Sponsors are responsible for creating the fund, registering it with the SEC and filing corporate documents. Mutual fund sponsors provide the seed money necessary to purchase the initial portfolio. ETF sponsors typically pass that responsibility on to market specialists.

In most cases, mutual fund sponsors have large distribution networks ready to market the funds through a variety of channels. ETF sponsors do not sell directly to investors, but instead rely on a distribution system that often emphasizes educating investment advisors about a particular ETF's benefits and working with institutions and hedge funds on trading issues.

Having an effective sales strategy from launch on is the key to an ETF's success: The more rapidly an ETF can gain market share, the quicker it will attract trading volume in the market. The more trading volume it attracts, the lower the bid/ask spread that investors pay when buying or selling the ETF, and the deeper the market is for shares. Throughout 2008, several smaller ETF providers were forced to close innovative ETFs because of their inability to market the funds.

Board of Directors

Funds, whether mutual funds or ETFs, are legally companies owned by their shareholders. The board of directors governs the operation of the fund, providing fiduciary oversight for shareholders and negotiating all fund contracts. Typically, 50 percent of a fund's board will come from the fund sponsor, with the remainder independent.

Investment Advisor

The investment advisor, or fund manager, runs the portfolio in accordance with the fund's objective. ETF fund managers also manage the fund's day-to-day operations. Fund sponsors may outsource that function to a separate administrator, although quite commonly, this is a function of the fund sponsor.

Custodian

Mutual funds as well as ETFs typically use a custodian bank to hold the fund's underlying securities. This is a form of protection for shareholders. Funds pay a fee to the custodian. Mutual funds also use a transfer agent—a third party is responsible for maintaining records of shareholder transactions. Transfer agents also send account statements and other important documents to shareholders. ETF companies also rely on back-office support to manage complicated topics like tax lot management, securities lending, etc.

Index Provider

Like a mutual index fund, the index provider calculates the daily value of the index, and provides the benchmark that the fund manager tries to match. For traditional, cap-weighted indexes, the role of the index manager is limited to overseeing the application of a core methodology.

The further away from plain-vanilla equity indexes you get, however, the more complicated the index provider's role becomes. For tactical and strategic indexes, index providers are deeply involved in designing the strategy and methodology behind the indexes. In the fixed-income market, and for international equities, the index provider must create a methodology for assigning fair market valuations to illiquid securities. The quality of these measures can have a huge impact on the functioning of the ETF.

Authorized Participants

As covered in "Appendix A: Understanding ETFs," all ETFs establish relationships with market-makers who manage the creation and redemption process.

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