ETP Quick Reference: safe investing with exchange traded products

As exchange-traded products (ETPs) have multiplied in number and complexity, so too have concerns over the risks they carry. This document provides an overview of the types of ETPs, their regulation, and risks associated with each. For perspective, we also compare these risks to those of traditional managed funds.

Our biggest risk is market risk

AltaVista only uses non-levered, "plain-vanilla" equity exchange traded *funds* (ETFs; not notes or commodities) in its model portfolios. We believe that the biggest risk associated with these regulated investment companies is market risk, i.e., the risk that fund holdings could decline in value. So selecting those with the best *investment* potential—the focus of our research—is by far the most important consideration.

Types of Exchange-Traded Products (ETPs)

Exchange Traded Funds (ETFs): Most ETPs are either open-ends funds or unit investment trusts (UITs), regulated by the Investment Company Act of 1940. In a few older cases, namely HOLDRs, the funds are non-registered Grantor Trusts.

Exchange Trade Notes (ETNs): Debt instruments linked to the performance of an index, commodity or currency. Often used with exotic indices or where ownership restrictions are an issue.

Exchange Traded Commodities (ETCs): Vehicles for investing in commodities, organized as Grantor Trusts or Limited Partnerships.

Risks & Regulation

As all ETPs are, by definition, publicly listed securities, they are regulated by either the Investment Company Act of 1940 or Securities Act of 1933. Each allows several types of organization, summarized on the following page, that govern their management, types of investments allowed, and reporting requirements. These in turn determine the types of risk that an ETF can assume.

Table: Sources of Risk

Non-leveraged ETFs are the only type used in AltaVista portfolios

	Investment Company Act 1940			Securities Act 1933	
	Non-levg'd ETF	Leveraged ETF	Trad. mng'd fund	ETN	ETC
Liquidity	O	O	O	O	O
Closure, mgmt. change, early call	O	O	O	O	O
Securities lending	O	O	O	O	O
Tracking error	O	O		O	O
Style-drift/non-transparency			O		
Taxes (unplanned events, distributions)		O	O	O	O
Leverage		O		O	O
Backwardation/Contango					O
Issuer insolvency		O		O	O
Counterparty risk (underlying security)		O			O
Counterparty risk (custody)	O	O	O	O	O

Note: Not all ETPs of a given type have the same risks as others of the same type, the magnitude of any risk may be different across product types.

ETP Structures & Regulation

Open-End Fund

SEC-registered investment company (RIC) under the Investment Company Act of 1940. Most ETPs are open-end funds. The portfolio is managed by an advisor and can hold equity and fixed income securities as well as derivatives, but they are generally prohibited from issuing debt (leveraged & inverse ETFs multiply their exposure using swaps, futures and other derivatives). The fund's advisor has discretion in how an index is replicated. Capital gains and income may be re-invested in the fund.

Assets of RICs are held by custodial institutions, so the failure or insolvency of the RIC would not encumber shareholders' assets. As a result, counter-party risk is limited primarily to any underlying assets that have counter-party risk themselves, such as those holding swaps.

Unit Investment Trusts (UITs)

Some of the earliest ETFs such as the S&P500 Trust and the Sector SPDRs Trust are structured as UITs, another type of investment company. UITs are managed by a trustee and limited to a specific type of security (i.e., stocks *or* bonds, but not both), and are relatively fixed portfolios, with certain exceptions, for the life of the trust. Exchange-traded UITs must replicate the indices they track and cannot employ a sampling methodology. Capital gain and income *cannot* be re-invested.

As with open-ended RICs, assets of UITs are held by custodial institutions, so the failure or insolvency of the company would not encumber shareholders' assets. As a result, UITs do not have counter-party risk except in the narrow sense of custodial risks (clearing, settlement and holding of securities) which may be a bigger risk in less developed markets.

Exchange Traded Notes (ETNs)

ETNs are debt instruments tied to the performance of an index, commodity or currency. Like an listed debt instrument, they are regulated by the Securities Act of 1933; they are NOT registered under the Investment Company Act of 1940 and provide no ownership interest in the underlying asset. As a result, ETNs have risks tied to the credit worthiness of the issuer.

Grantor Trust

This structure is used often used with commodities and currencies, where the trust holds a fixed portfolio of assets and issues shares based on the value of those assets. The trust's holdings are fixed for the life of the trust, and have no diversification requirements. Grantor Trusts are regulated by the Securities Act of 1933. Investors in grantor trusts are shareholders in the underlying assets of the trust.

Limited Partnership (LP)

Most commonly used for commodity ETPs, limited partnerships can hold physical assets, regular securities and derivatives. Partnerships are pass-through entities for tax purposes—which can be advantageous—but are often quite complex. LPs are NOT registered under the Investment Company Act of 1940, and should not be confused with some MLP, or Master Limited Partnership, ETFs, which are organized as corporations under the laws of a state.

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Discussion of Risks

Liquidity
Liquidity is perhaps the single most misunderstood risk related to ETPs. Since shares of an ETF can be created/redeemed at will, the liquidity of an ETF is determined primarily by the liquidity of the underlying shares, *not* the average trading volume of the fund itself. Market makers routinely handle orders for many times the average daily trading volume with little or no widening of bid/ask spreads.

While ETFs with little volume holding relatively illiquid securities may experience higher spreads, some critics claim that ETFs can provide too *much* liquidity, enabling investors to trade huge volumes in illiquid securities. Whatever the issues with ETFs, liquidity is *always* an issue with traditional managed funds, which trade only once at the end of the business day, at a price unknown to the investor at the time the order is placed.

Securities lending
Many RICs (including traditional mutual funds) engage in securities lending, in exchange for collateral and interest payments, which earn income for the fund. Risks derives from the possibility that the borrower may fail to return the securities in a timely manner, or at all, and collateral may lose value. However, custodial institutions typically serve as lending intermediaries and provide liquidity, thus reducing the risk of any single borrower failing to return borrowed securities.

Closure, management change, early call
As the ETF market becomes more competitive, funds that fail to gather enough assets to make them commercially viable for the sponsor risk closure (even if the sponsor remains in business). The portfolio is liquidated and cash is returned to shareholders, possibly creating a taxable event. Similarly, some ETNs are “callable,” allowing the issuer to pay them off prior to maturity, creating pre-payment risk, not to mention possible tax consequences.

Management teams, including the portfolio manager, can also change. Generally, this risk is more consequential for traditional managed funds, where managers have more discretion over how funds are invested, as opposed to ETF managers who simply are tasked with tracking a given index as closely as possible.

Issuer insolvency
Primarily relates to exchange traded notes (ETNs), which are debt obligations of the issuing institution and do not represent ownership interest in any underlying securities. Therefore deterioration in the credit worthiness of the issuer is likely to have an adverse affect on the value of the ETNs, regardless of the performance of the linked index.

However, exchange traded *funds,* which are regulated investment companies, have third-party custody requirements for fund assets which protect investors from the business problems of the fund sponsor, as well as from fraud as has happened with unregulated vehicles such as hedge funds.

Counterparty risk (underlying security)
Funds which hold securities that themselves have counterparty risk, such as those that use swaps, futures and other derivatives, may be said to have a type of counterparty risk. **AltaVista does not cover or recommend any such funds in its model portfolios.**

Counterparty risk (custody)
Custodial issues such as failures in clearing, settlement and holding of securities could arise in the course of operations. Though such risks are considered minimal in well-regulated markets, they may be higher in less developed markets.

Tracking error
All ETPs entail some risk of tracking error. However this is not a traditional risk in the sense that a) tracking error can also accrue to an investor’s favor, and b) it is irrelevant to our analysis of the ETF as a long-term investment (as opposed to a short-term trading or hedging vehicle, where such concerns are more important). It should be noted however that when held to maturity and redeemed, by definition ETNs have no tracking error after for fund expenses.

Further, tracking error can reflect outdated information, such as when securities on foreign exchanges are closed for trading, causing the intraday NAV—calculated during New York trading hours—to reflect stale prices. In such cases, the market price may be a better reflection of where foreign shares will open the following session, but still register as tracking “error.”

Style drift/non-transparency
If tracking error is the risk of “not getting what you thought,” style drift would be an analogous, though much bigger, risk with traditional managed funds due to their lack of transparency. Sector and Geographic exposures may be far different from what investors expect, and the impact of these differences on performance is likely to be far greater than any tracking error. For investors, not knowing what one owns—with the obvious complications to portfolio construction—would seem to pose a substantial risk to one’s financial health.

Backwardation/Contango
Describes the shape of the price curve for a series of futures contracts. Because many commodity ETPs use futures contracts to achieve exposure as opposed to holding the physical commodity, tolling over these future contracts when markets are in backwardation or contango means returns of the fund will deviate from the price returns of the related commodity. Over time with successive rollovers, these differences in return can be quite substantial.