

The Top Trends to Follow in ETF Investing

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We spoke with Tom about the important trends in the ETF industry.

Active ETFs

“The most visible trend, although not necessarily the most important, has been the introduction of active ETFs,” said Lydon. Since the launch of the first one in March, Bear Stearns Current Yield (YYY), investors gave the funds a tepid response. “This is likely largely because of their lack of a track record – as actively managed products, there is no back-tested data, and investors wanted to see how they’d perform before they dove in,” he said. From March to May of this year, YYY picked up \$50 million in assets.

The second entrant into the active ETF game was PowerShares, who introduced three active equity ETFs and one active fixed income ETF in April. “The three-month anniversary numbers for these funds are in, and they’re good: they’ve actually outperformed their indexed counterparts,” said Lydon. “Three months isn’t long enough to establish a 200-day moving average, of course, but with promising initial numbers like that, investors might find themselves more willing to give active ETFs a try,” he added.

Active ETFs have attracted only about \$65 million of assets across all products, according to a recently released study by State Street Advisors. Tom Anderson, the author of the study, said that ETFs have failed to achieve both of two key benchmarks required for success – attracting assets and establishing a high trading volume.

“New launches could very well follow if investors begin moving assets into these funds, and providers feel more assured that the markets will welcome them,” says Lydon.



Lydon added that State Street's numbers do not include WisdomTree's line of six currency funds, which now have \$120 million. They've been classified as active by the SEC, since they seek to earn current income reflective of money market rates available to U.S. investors in the country/region of the fund.

Frontier Markets

As global markets are developing at a rapid clip and correlating more with already-established markets, investors are looking to see where they can put their money. Frontier markets are largely uncorrelated with developed and emerging markets, and tend to be less correlated with one another. (See our [article](#) on this topic.)

"Recent market performance has shown that frontier markets have not been as badly hit as emerging ones in the downturn," says Lydon. Emerging market equity outflows hit \$22 billion in the year-to-date mid-July. Meanwhile, inflows to Africa regional equity funds have totaled \$247 million. Since the start of the year, MENA (Middle East and North Africa) funds have seen inflows every week, with net inflows totaling \$1.3 billion year-to-date. Lydon believes that the key countries to follow in among the frontier markets include Kuwait, United Arab Emirates, Poland, Croatia, Ghana, Pakistan, and Bulgaria.

Commodities/Currencies

"Until ETFs came along, it was difficult and/or expensive for investors to access the currency and commodities market," says Lydon. Lydon believes ETFs have made some concepts, such as futures, easy for investors to grasp. "ETFs do the legwork for investors by rolling over contracts so investors can just sit back and watch the performance," he says.

ETFs also provide a level of diversification that would have been expensive or tricky to come by before. For example, Lydon cites the PowerShares DB G10 Currency Harvest (DBV), which is made up of long and short futures positions for a basket of currencies. It is designed to exploit the trend that currencies associated with relatively high interest rates, on average, tend to rise in value relative to currencies associated with relatively low interest rates.

Lydon also sees a heightened interest in certain commodities, in anticipation of rising inflation. "Gold, silver and other metals-related ETFs drew massive investor attention as inflation skyrocketed for the first half of this year," he said. Lydon believes investors found a safe haven in these metals, and ETFs made access easy.



ETNs

Once just a small segment of the exchange traded market, ETNs have rapidly grown in number in 2008. Last July, there were 10; at the end of July 2008, there were 89. But Lydon says, "Investors haven't been rushing toward them at the same pace. In July, assets in them totaled \$7.2 billion."

Lydon says the primary advantage ETNs offer is access to hard-to-reach markets, such as India (prior to ETFs being launched) and other countries with tight controls on foreign investment. ETNs also offer access to certain commodities, such as platinum, which is in very tight supply, as well as certain currencies. But ETNs also involve credit risk, since they are backed by the issuer, rather than by a pool of underlying assets. "This is something that makes investors skittish in today's markets," says Lydon.

Alternative Energy

Even though oil has come off its highs, Lydon says it is still expensive and a shortage is still going to be a problem. Many ETF investors are thinking alternative energy will be the next big thing. "There's also the threat of global warming, which is only going to get worse if we don't change our ways," says Lydon.

Four alt-energy ETFs have launched this year – two each for wind (PowerShares' QMX Clean Edge Global Wind and First Trust's ISE Global Wind Energy) and solar (Claymore's MAC Global Solar Energy and Van Eck's KWT Market Vectors Solar Energy). While these funds might be down so far, Lydon says analysts and others think this sector is going to have big potential. U.S. electrical demand is expected to grow 39% through 2030, and wind/solar power could help meet the demand in a cost-effective and environmentally friendly way.

401(k)s

The push to make ETFs a regular feature of 401(k) plans is getting stronger. The Department of Labor has given a deadline of Jan. 1 for plan sponsors to disclose fees and performance numbers in plain English. (See our [article](#) on this topic.) Lydon says some 401(k) plan sponsors are already lowering their fees in anticipation. A recent study by Deloitte of 436 plan sponsors shows the average expense fee is 0.63%, down from 0.75% two years ago. Additionally, 18% of funds have average fees of 0.50% or less. ETF providers are pushing for a piece of the pie, because the total defined contribution market is \$4.5 trillion



Broader Industry Trends

On a broader level, Lydon expects the ETF industry to be dominated by large issuers and the very largest funds, such as State Street's SPY and Barclay's EFA. "These funds are the largest and most liquid in the entire ETF industry, and despite global outperformance in recent years, the fact is that investors are drawn to domestic large-caps such as those held by SPY," said Lydon, adding that "EFA gives investors global diversity and makes it easier for them to gain broad exposure."

Lydon also expects the ETF industry to become increasingly commoditized for funds based on these highly visible indices, with issuers forced to compete based on price. "More competition leads to better pricing between funds that focus on similar areas, whether they're broadly or narrowly focused, and it's already happening. A little more variety gives investors more choices and keeps providers on their toes," he said

Lydon still sees opportunities for smaller ETFs and does not expect the pace of new issuance to diminish significantly. "As in any industry, there are funds that will survive, while others are killed off for any number of reasons, such as lack of investor interest," says Lydon. Since it doesn't take much money to run an ETF, providers can keep an ETF going for a long time. "Some niche ETFs are great for investors, because they offer a chance to get exposure to small segments of the markets that may be moving while others are trending down," says Lydon.

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