

December 2006/January 2007

New Kid on the Block Here to Stay

By now, most investors have noticed the emergence of the latest investment vehicle on the block. Enter the exchange-traded fund (ETF) – an exciting new investment instrument that offers exposure to several different asset classes at the lowest cost. The wild proliferation of ETFs in the last few years, as well as many recent product innovations, has made them impossible to ignore. This monthly column aims to keep our readers abreast of global developments in this growing industry and provide investment insight applicable to portfolios utilizing ETFs.

With ETF providers churning out new products every week, even industry followers may be feeling overwhelmed. From less than USD 100 billion in 2000, Morgan Stanley forecasts that ETF assets under management will surpass USD 2 trillion by 2011. There are now over 600 ETFs trading on 36 exchanges worldwide. As more ETF manufacturers join the mania (*yes, it can be called that at this point*), investors need to be more cautious when selecting ETFs. Importantly, investors should be better aware of how to effectively incorporate them into a portfolio. This is becoming more difficult. The following themes are paramount to keep in mind:

Embrace Active Asset Allocation - While not heralding the end of active management, the arrival of ETFs argues enthusiastically for avoiding high-priced stock selection fees and embracing active strategies where it counts most: asset allocation. Asset allocation, the practice of dividing investments among varying asset classes and types, has been shown to be the most important and effective part of an investment process that aims to secure higher returns while managing risk. Therefore, a core portfolio should focus on establishing an asset mix that corresponds to the desired level of risk.

By using ETFs, investment managers can achieve an active asset mix with broadly diversified investments that have transparent holdings, no specific equity or corporate fixed-income risk, intra-day pricing and greater tax efficiency. To be sure, we are not arguing for eliminating stock selection altogether. There are many investment classes where a management fee in exchange for savvy stock selection can be beneficial — many smaller capitalization stocks, junior mining, biotechnology and other specialty situations are among eligible candidates. With indexing strategies forming the core

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Tyler Mordy

tmordy@hahninvest.com

250-861-6562

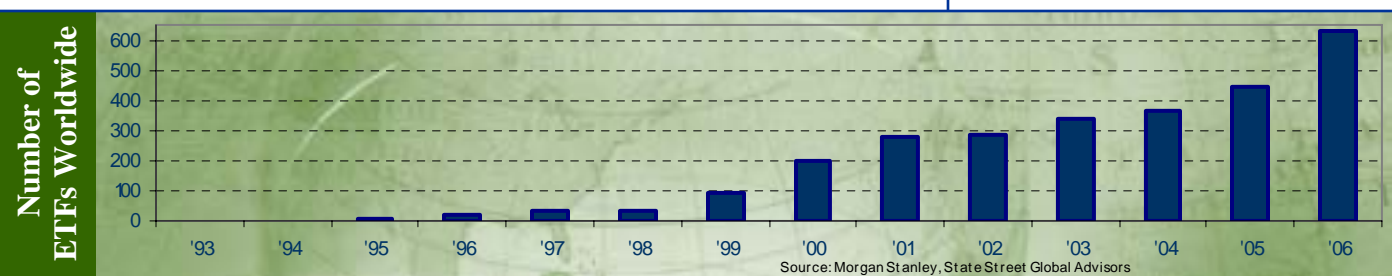
“ETFs are an evolutionary advance, bringing institutional-quality products to all investors”.

Steven Schoenfeld, Chief Investment Strategist, Northern Trust Global Investments

New Evolution: Commodity Classes Launched

Seven new commodity funds by Powershares and Deutsche Bank were launched on the AMEX on January 5, 2007. The funds invest in actively-traded futures contracts, using their unique Optimum Yield™ methodology. These ETFs not only track the related commodity index, but also generate interest on the collateralized futures contracts (primarily investing in short-term US money market instruments).

“ [...] the tables are turning as ETF offerings are becoming more complex with new risks, not to mention the challenge of weeding through what is becoming an unwieldy and woolly universe.”



portion of a long-term portfolio, these other investments may be appropriate for the “satellite” portion of a “core and satellite” approach.

Go Global - The Canadian government’s elimination of the foreign content restriction in registered accounts is certainly a boon to Canadian investors. But the latest evidence shows that many Canadian investors still opt for a homeland bias, not yet fully embracing many international investment classes. In many developing countries, favourable demographics, healthy country balance sheets, bulging foreign exchange reserves and attractive relative valuations, all bode well for long-term future returns. ETFs with low expense ratios that track foreign markets, but trade on a domestic exchange, are an easy, cost-effective way to achieve exposure for these areas.

Employ Non-Correlated Assets - Taking advantage of diversification in a global portfolio context means holding assets that exhibit different correlation characteristics among each other in all investment climates. With money market vehicles currently offering low real returns and developed equity markets clinging to expensive valuations (*based on record corporate profit margins*), securing long term healthy returns will be more challenging than ever. ETFs have granted investors the opportunity to divert holdings from conventional investments into asset classes with more attractive valuations and greater growth prospects.

In an increasingly globalized world, many asset classes are exhibiting higher correlations than they have in the past. This phenomenon highlights the need to seek enhanced returns in less traditional investments while maintaining the lowest cost exposure in conventional investment classes (developed market large caps, domestic bonds, etc.). Many investment mandates have avoided these categories due to the high costs and difficulty accessing specific markets (such as foreign equity or futures markets), regulatory constraints, or merely a lack of coverage in the mainstream media.

ETFs equip investors with a comprehensive range of alternatives to accessing low or negatively correlated asset categories including overseas bond markets and alternative assets ranging from precious metals to agricultural commodities. European bonds (including the attendant Euro currency gains) served as a great respite for Canadian denominated portfolios in the last economic downturn. Which investment classes will serve as a great diversifier in the next market decline? (*We view Asian fixed income as one likely safe haven — see the*

January 2007 Global Spin at www.hahninvest.com).

Emphasize Strategic and Secular Shifts – Many current ETF investment trends are emphasizing “momentum” and “tactical” investing — approaches that attempt to capture shorter term market movements. This style of investing often leads to excessive turnover. Studies show that portfolios with higher turnover experience returns that are, on average, below portfolios with lower turnover rates. Most experienced investors also recognize that short-term timing is a haphazard exercise at best. Having a disciplined framework for the implementation and monitoring process will limit unnecessary rebalancing and ensure that minimal total expenses are maintained. Over time, these activities provide a sure way of improving returns. After all, costs can be controlled much more easily than future returns.

Select Best in Class - Originally, ETFs were a direct response to some of the common vices seen in the mutual fund industry, namely bloated management costs and underperformance. Most ETF providers appear determined not to repeat the same mistakes as their pooled brethren. However, as with all investment trends, some will betray the core benefits that initially made the vehicle attractive. ETF issuers will react to fad investments and last year’s hot investment sectors. Attempts will be made to segment the market in as many ways as possible, introduce new indexing methodologies and pioneer questionable “asset classes”. We will focus some future commentary on selected ETFs and ask the same questions: Are they sufficiently diversified? (*Single security holdings often represent a disproportionately large weighting in an ETF*). Which methods of indexing are preferable? Are the fees competitive and reasonable? Does a particular ETF represent the most effective way to gain exposure to an investment class?

Benefit from the New Frontier – There are great advantages to ETFs — low expense ratios, diversification, tax efficiency, trading flexibility, and asset class accessibility. However, the tables are turning as ETF offerings are becoming more complex with new risks, not to mention the challenge of weeding through what is becoming an unwieldy and woolly universe. The focus now moves to the specialists who are experienced global portfolio managers, trained in portfolio construction.

As new lineups are introduced and a burgeoning industry takes shape, seeking sanity amid the rush will be more challenging than ever. But, make no mistake, the ETF revolution is here to stay.



HAHN INVESTMENT STEWARDS & COMPANY INC.

Global Fund Management & Investment Counsel



HAHN
INVESTMENT

Ontario • British Columbia

Phone: (888) 957-0602

e-mail: information@hahninvest.com

www.hahninvest.com