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Attack of the hedge funds may roil ETF Markets

The last thing the exchange-traded-fund world needs is more craziness, and yet that's what it's going to get in April from hedge funds.

Hedge funds, basically mutual funds that use more sophisticated strategies, are already using ETFs when they want to gain exposure to major stock markets like the S&P 500, the Nasdaq 100, the Dow Jones industrial average and so on. But the current rules prevent hedge funds from being quite as aggressive as they'd like to be when they use ETFs.

Starting April 2, however, the leash comes off. Hedge funds will be able to buy ETFs by putting down a minimum of just 15 per cent of the actual cost and borrowing the rest, down from the current 50 per cent. Many hedge funds love to buy on margin because it magnifies their potential gains -- and losses, of course.

The net result of more hedge fund involvement in ETFs is increased volatility. "The return will be the same over the long haul," said Tyler Mordy, director of research at Kelowna, B.C.-based money managers Hahn Investment Stewards. "But this makes for more volatility and it makes ETFs riskier."

Investors who buy any of the 29 ETFs listed on the Toronto Stock Exchange shouldn't have to worry much about this. But it's a different story if you're one of the many Canadian investors who have dipped into the ever-expanding U.S. market for ETFs. There are currently about 380 ETFs listed on the American and New York stock exchanges, and hundreds more are in development.

"It's wild and wooly out there now," said Mr. Mordy, who has just begun writing a new monthly publication called *ETF Focus* (you can download it at hahninvest.com).

"There are increasing risks, and some investors are going to get burned."

Hedge fund involvement could make owning U.S. ETFs a more stressful experience, though more for obscure, newer products than for the well-established funds that track broad, widely followed stock indexes. For example, hedge funds might decide to use ETFs to capitalize on a particular sector and then bail out en masse when they move on to the next hot trend. Small investors could get trampled in the rush.

A bigger problem for individual investors is that the newer ETFs are starting to stray from the core strengths that make these products such an appealing alternative to mutual funds and picking your own stocks.

One example is low fees. You can buy an ETF that gives you the returns of the S&P 500 with management expense ratios as low as 0.09 per cent, while the ETF tracking Canada's S&P/TSX 60 index runs at 0.17 per cent. Mr. Mordy said the MERs of some of the newest exchange-traded funds in the U.S. market are coming up close to 1 per cent.

Another example is tax efficiency. ETFs generally do very little of the sort of stock trading that generates taxable capital gains because they mirror stock indexes, which themselves tend to make only minor additions and subtractions each year. Mr. Mordy said some of the new ETFs have increased portfolio turnover, which will eat into their tax efficiency.

Still another example is diversification, which you get automatically when you buy an ETF that follows a big index like the S&P 500. With some of the new ETFs, however, one holding can account

for close to one-third of its assets. Moreover, some of the new indexes are oddities that have no real-world track record and almost seem to have been created simply as a framework on which to build an ETF. "It's the elemental problem -- the sales-driven investment industry versus the uninformed investor," Mr. Mordy said.

Richard Kang, an independent investment and risk consultant, speculated that the raft of new exchange-traded products is partly a function of the deal making that is starting to occur in the U.S. ETF market. Smaller ETF players are pumping out new product to build their asset bases in order to make themselves more attractive as acquisition targets and to fetch higher prices from buyers.

Hedge fund demand may also be driving new product introductions, a possibility that worries Mr. Kang, a frequent blogger on ETFs on the website SeekingAlpha.com.

"Hedge funds have to go into every corner of the world to find returns, and this search is synonymous with ETFs getting into global real estate, into water, into nanotechnology," he said. "The question is, are we going to be in a situation where you get ETFs being created in various assets classes that are near their peak to supply the demand from hedged funds and active investors?"

There are now about 732 ETFs worldwide with assets of around \$573-billion (U.S.). Investors who make the rational decision to use ETFs in their portfolios should focus primarily on the biggest and best-established funds until the newcomers prove themselves and the market shakes itself out.

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