

### Exchange Traded Funds: A Good alternative

Despite the last week's rebound, this October punished investors with the worst monthly losses in 21 years (FT, 2008).

Given the very poor results in almost every asset class, it might be a good time to review the performance of investment in mutual funds and consider some alternatives like exchange traded funds.

The worldwide mutual fund industry has attracted over 26.20 trillion dollars in assets under management (ICI, 2008). In Switzerland alone mutual funds manage over 510 billion francs (Swiss Fund Data, 2008). Even if you think that you are not directly contributing to this industry you might be involved indirectly, via your pension fund.

It is not difficult to understand why mutual funds are so popular. According to Mobius (2008), five primary reasons are in favour of participating in a market via a mutual fund, viz., "Professional Management, Diversification, Lower Cost, Convenience and Liquidity".

In theory this makes a lot of sense. With a small amount it is practically impossible to achieve high diversification and professional management. Even with a large amount it is doubtful whether picking your own shares will do better than a professional money manager. It also requires a lot of time that probably costs you more than the commission charged by a mutual fund.

In practice, a successful mutual fund should outperform its given benchmark ( in the case of an equities fund it is usually an index like the S&P 500, the Dow Jones Industrial Average or the Swiss Market Index), but several mutual funds have been accused of more focus on increasing their assets under management, hence their commission, than on providing investors with above average returns (Lowenstein, 2008).

A recent study by Barras, Scaillet and Wermers (Hilbert, 2008) suggests that talented managers are very few and even fewer than 16 years ago. The number of talented managers was a mere 14.4% in 1990 and only 0.6% - almost zero in 2006.

Some funds might indeed outperform the index, but they are clearly a very small minority.

Why is it so ?

A paper written by Nobel Prize Laureate William F. Sharpe (1991) helps with a clear answer: costs "the costs of actively managing a given number of dollars will exceed those of passive management. Active managers must pay for more research and must pay more for trading. Security analysts (e.g. the graduates of prestigious business schools) must eat, and so must brokers, traders, specialists and other market-makers."

Whilst there are several ways to measure performance it is fairly easy to determine whether a mutual fund outperformed an index -after all the expenses. It is sufficient to review the latest fact sheet to find out. Even if it did outperform, it does not follow that it will do so in the future. According to Lowenstein (2008) not every fund is under performing. There are some exceptions. A well confined number of funds with consistent above average performance can be found in small and well managed value funds that have proved, with actions like closing the funds to new investors and having the managers "eating their own cooking" by investing in their own funds, to be more concerned about their fund performance and well being than their commissions. That said, with the majority of fund managers under performing their benchmark index, the likelihood to pick the wrong one is fairly high.

*"A low-cost index fund is the most sensible equity investment for the great majority of investors. My mentor, Ben Graham, took this position many years ago, and everything I have seen since convinces me of its truth."*  
Warren Buffett.

*"Of the 355 equity funds in 1970, fully 233 of those funds have gone out of business. Only 24 outpaced the market by more than 1% a year. These are terrible odds."* Jack Bogle

*"They're just not going to do it (beat the market). It's just not going to happen. Daniel Kahneman, Nobel Laureate*

## **If you can't beat the market, join it**

The same benefits given by a mutual fund namely "Diversification, Lower Cost, Convenience and Liquidity" (Mobiuss, 2008) are now available through Exchange Traded Funds or in short ETFs. An exchange traded fund has no investment manager. The real manager is a computer entrusted to follow a specific index of shares, bonds or commodities. Index investing provides you with a wide diversification at a low cost (computers aren't so concerned about annual bonuses !).

As the name suggest an ETF is traded on a stock exchange exactly like shares. It can be held alongside with shares and can be shorted and subject to a stop loss order exactly like a share. You can monitor its price continuously as in the case of shares - whilst mutual funds report their net asset value once a day or in some cases once a week/month.

For instance you can participate in the Swiss market through an ETF linked to the SMI (Swiss Market Index) like the XMTCH issued by Credit Suisse (Six Exchange, 2008). This ETF is traded daily on the Swiss Exchange under the symbol "XMSMI" and has a total expense ratio of a mere 0.35% vs. the 1.0% per annual charged on average by a Swiss equities fund (Cash, 2008). In addition to the higher annual expenses the majority of funds also charge an entry (and at times even an exit) fee. In Switzerland this is usually between 0.75 and 2.5% (Cash, 2008). An ETF does not charge any entry/exit fee, but is, like shares, subject to the brokerage fees.

Additionally, an ETF allows you to access remote markets like China, Taiwan, South American and even different asset classes like commodities. An ETF can also protect you from the mistakes human are so prone to make.

## **Commodities ETFs**

Investing in commodities directly through futures is, to say the least, dangerous. The first issue is leverage. A future contract is an agreement to deliver a given commodity in the future and only requires a 10-20% margin or deposit. Under these circumstances your investment is always magnified by the leverage factor. Let us not forget that the main cause of this financial crisis is leverage. Without any leverage no bank would have had to find more capital as their losses would have been well confined to a small percentage of their assets.

An investment in commodities through an index is by definition fully collateralised and hence without leverage. This means that a total return commodity index deposits only the required margin but invests the excess capital in a collateral such as treasury bills. This not only reduces risks but influences positively the index that will benefit from both the commodity price appreciation and return earned on the collateral. Under these premises your investment is not magnified but consistent with the real performance of the commodity prices.

**Why dangerous?**

Even expert Commodity Hedge Funds managers failed to outperform commodity indexes, but incurred huge losses. The Ospraie fund was widely respected as one of the most successful commodity hedge funds. It had USD 7 billion under management achieved from 2000 to 2007, an average annual after-fees return of 15% (Burton, 2008 p.125). Despite this impressive track record the fund lost 38% in 2008 and closed in September (CNBC, 2008).

Similarly the BP Capital Fund, managed by the widely respected oil expert Boone Pickens, with a track record of 38% annual average return (Burton, 2008 p.86) recently announced a USD 2 billion loss in oil trading and, overwhelmed by redemptions, moved its remaining assets to cash. (CNBC, 2008).

This is certainly clear evidence that even the most experienced investor can lose significantly when the market turns against him.

**Why Commodities now and how**

Unlike stocks, commodities are governed by supply and demand forces. According to Jim Rogers (Bloomberg, 2008) commodities dropped due to forced liquidation, but, as stocks in Agricultural commodities are very low and oil reserves are declining, we will still have more demand than supply that will drive the prices higher. Fundamentals will eventually drive the commodity rebound. A share can certainly go to zero or trade a very low valuation. But in commodities a strong drop in price will affect supply: farmers will plant less, no money will be spent on new oil/mineral exploration. This will translate into less availability in the future and therefore higher prices.

With a loss of over 40% in many commodities, this might be a good opportunity to enter the market. There are some interesting commodities ETFs listed on the SIX Exchange - Swiss Stock Exchange:

Market Access Jim Rogers International Commodity Fund (ticker MRIC) total annual expense ratio 0.85%. This fund, as the name suggests, tracks the RIC index. It is down 32% year to date (Six Exchange, 2008) but, even with this substantial loss, the Index returned an impressive 31.7% per year over the last 10 years. (Rogers, 2008). As per figure A the RIC index is very international and includes 35 commodities.

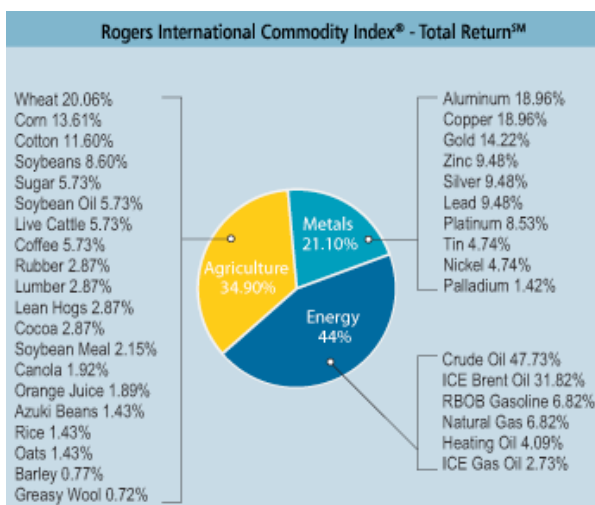


Figure A Source:Elements ETN

If you are more positive toward a particular commodity sector, you might also consider the Market Access RICI Agriculture Index Fund (ticker MRAI down 32.2% YTD), or even bet on industrial metals with the Market Access RICI Metals Index Fund (ticker MRMI, down 36.07% year to date).

Lyxor ETF Commodities CRB (ticker CRB) total annual expense ratio 0.35%. This fund tracks the oldest commodity index, the Reuters/Jefferies CRB Index. Started in 1957 by the Commodity Research Bureau it has been revamped in 2005 by Reuters/Jefferies. It maintained a wide diversification but at the same time adopted a different and more modern methodology (Jefferies, 2008). Interestingly enough this index is down less than the RICI at -26.50% YTD. The different composition of this index (Figure B i.e. more weight on soft commodities like Sugar and even Orange Juice) obviously played a role. Despite the significant year to date loss, this index returned 61.59% in the last five years or 12.31% per annum. (Lyxor, 2008)

**Reuters / Jefferies CRB**

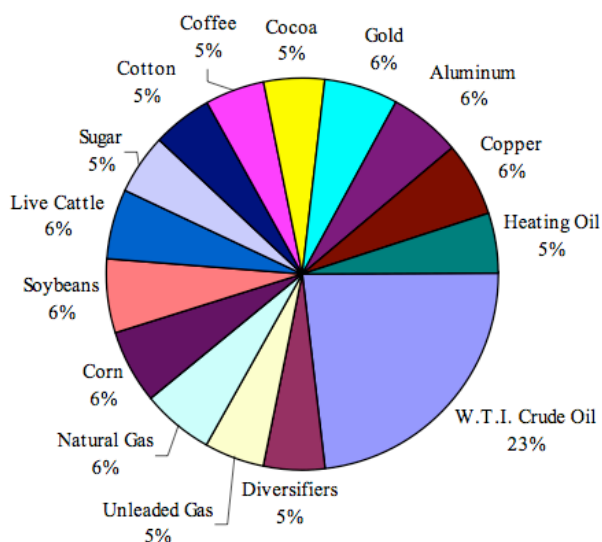


Figure B Source: Jefferies

An even lower loss (-22.78% ytd) influenced the Lyxor ETF Commodities CRB Non-Energy Index as this index does not include any energy component and therefore tends to be less volatile. Despite the loss this sub-index returned a total of over 40% in the last five years or 7.8% per annum. (Lyxor, 2008). This sub-index includes all the components of the main CRB like Agricultural commodities (Corn, Soybeans, Sugar, Cacao, Cotton) and even Industrial Metals (Aluminium, Copper) previous metals (Gold and Silver), but intentionally excludes Crude, Natural Gas and energy-related components.

**Commodities vs. Shares**

As illustrated in figure D, virtually every commodity index experienced a substantial correction that started in July but small sign of rebound are already present in October



Figure D Source: Bloomberg.com

Despite this huge correction commodities did better than shares: In figure E you can clearly see that in the last 12 months both ETF's outperformed the Swiss Market Index and Dow Jones Industrial Average Index:

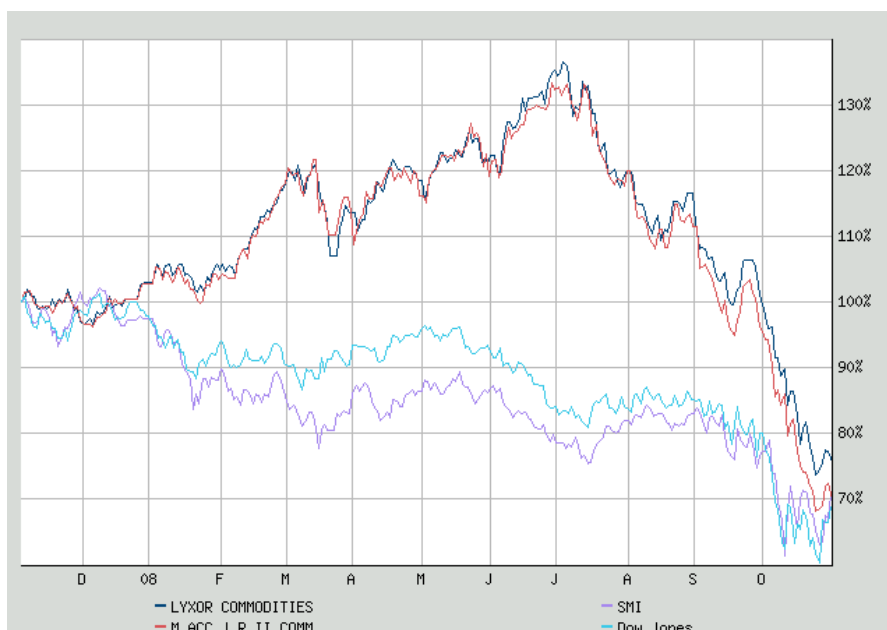


Figure E Source: Tradejet.ch

### Final Words

In a time of high volatility and big losses keeping an eye on costs and performance is highly recommended. One of the few benefits of a bear market is the possibility of separating the mediocre fund managers from the good ones. Every fund can produce good returns during a bull market, but few can minimise the losses in a bearish one.

ETFs are an excellent vehicle to keep costs low and avoid the great majority of poorly performing fund managers. The access to commodities through an ETF is particularly simple: you gain access to a wide access of commodities through a proven index that gives you a wide diversification at a very low cost.

Despite the commodities correction being seen by many investors as another bubble bursting, I concur with Rogers: with agricultural costs on the raise, and oil reserves decreasing, commodities are set to raise in the future. Just when is difficult, if not impossible, to predict. This is why gaining exposure to commodities through an exchange traded fund allows you to minimise losses and continue investing in the best time: that is when prices are disconnected from the reality and, despite the fundamentals, are falling, due to forced liquidation.

Zürich, 3 November 2008

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