The 3 “E”s: Evolution, Emerging Markets and ETFs

CFA Institute Asia Pacific

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Summary

• Evolution: Things have changed
• Emerging Markets: The future
• ETFs: The means to deal with the ongoing change and access to the future potential
• Outlook for the industry, emerging markets and ETFs
• My firm and the work we do
Who am I?

• Unique perspective: Formerly of hedge fund industry now managing exchange traded funds ("ETFs"). A user of ETFs for over 15 years
• Canadian so my thought process is more global and less US-centric
• Trained mathematician so I have a classic understanding of risk/uncertainty
• As you can see, I am a product of emerging markets. Korean/Filipino so I have had a unique view of two different emerging economies
Challenges for Global Investors

• We are in a low yielding, low return, high correlation world
• Liability side of investor’s balance sheet remains a concern. The present value of liabilities increase with lower interest rates
• Investors have little choice but to take on greater risk in hopes of achieving commensurate return benefits.
• What’s the solution? The Yale Model? What risks increase in this example? Lack of liquidity.
What motivates evolution: A double dip recession?

Emerging Global Advisors, LLC
470 Park Ave South – 8th Floor
New York, NY 10016
888.800.4EGS
www.egshares.com
Evolution is a longer term concept

Mega-Bear Quartet
The Dow Crash of 1929 and Great Depression
The Nikkei 225 Collapse in 1989, The NASDAQ post Tech Bubble
and Today's S&P 500

Now let's toss in the NASDAQ from the top of the Tech Bubble in 2000.

Emerging Global Advisors, LLC 470 Park Ave South – 8th Floor New York, NY 10016 888.800.4EGS www.egshares.com
Confusion and Uncertainty

A new age of risk management came about during the bear market and the few years thereafter (2001-2004) due to many diverse yet painful events:

- 9/11 and a focus on homeland security
- Icelandic volcanos
- Hedge fund blowups or Madoff risk
- Eurozone or political risk

We have seen:

- Wild swings of risk aversion and risk acceptance (VIX)
- Thus wild fund flows based on crowd psychology into and out of risky assets. Low yielding cash/fixed income incentivizes investors to return quickly to risky assets.
Evolutionary view of value versus growth

In this low growth world, investors are looking for practical means to gain exposure to high growth areas like the emerging markets.
Where is the growth today?

<table>
<thead>
<tr>
<th>Country</th>
<th>Estimated GDP Growth 12/31/08-12/31/09</th>
<th>Estimated GDP Growth 12/31/09-12/31/10</th>
<th>Compounded 2-Year Growth Rate 12/31/08-12/31/10</th>
<th>Broad Index</th>
<th>Broad Market Index Return 12/31/08-12/31/09</th>
</tr>
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<tbody>
<tr>
<td>China</td>
<td>8.20%</td>
<td>8.6%</td>
<td>16.8%</td>
<td>FTSE/ Xinhua</td>
<td>54.23%</td>
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<tr>
<td>India</td>
<td>5.50%</td>
<td>6.3%</td>
<td>11.8%</td>
<td>SENSEX</td>
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<tr>
<td>Brazil</td>
<td>0.00%</td>
<td>5.8%</td>
<td>5.8%</td>
<td>Bovespa</td>
<td>128.06%</td>
</tr>
<tr>
<td>Taiwan</td>
<td>-3.60%</td>
<td>3.5%</td>
<td>-0.1%</td>
<td>Taiwan Weighted</td>
<td>79.21%</td>
</tr>
<tr>
<td>Korea</td>
<td>-1.00%</td>
<td>2.8%</td>
<td>1.8%</td>
<td>KOSPI</td>
<td>71.35%</td>
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<tr>
<td>US</td>
<td>-2.40%</td>
<td>2.6%</td>
<td>0.2%</td>
<td>S&amp;P 500</td>
<td>26.46%</td>
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<tr>
<td>Russia</td>
<td>-7.00%</td>
<td>2.5%</td>
<td>-4.5%</td>
<td>MICEX</td>
<td>136.69%</td>
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<tr>
<td>Japan</td>
<td>-5.70%</td>
<td>2.0%</td>
<td>-3.7%</td>
<td>Nikkei 225</td>
<td>6.25%</td>
</tr>
</tbody>
</table>

Past performance does not guarantee future results.
Correlation risk: The meaning of diversification

The time of broad emerging market exposure may be done. Selectivity matters for optimal risk-adjusted returns.
Key points

• Growth story for the next 25 years

• Investors realize the limited opportunity in developed markets and are concerned with the liability side of their balance sheet (demographics hurt them so use demographics as a bonus on the asset side by adding exposure to EM)

• Weak USD and concern of future inflation

• US markets – cut in half twice in the past ten years … are domestic markets the real risk?

• Correlation and the need for real diversification

• Pure exposure – access to direct markets and compensation for currency and other risks. Also removing countries that have evolved to developed status and thus provide less potential for future growth and returns
Challenge with emerging market valuation

Economics
• Example: GDP
• Drivers: **Macro** such as demographics, monetary policy, trade (im)balance, tax laws, war, natural disaster.

Valuation
• Example: P/E Ratio
• Drivers: **Micro** such as corporate leadership, dividend policy ... pretty much everything taught in CFA level 2 which most investors generally believe is worth nothing. Consider DDM applied to dot-coms or Chinese stocks.

Capital Markets
• Growth of S&P 500
• Drivers: Although debatable, many today believe highly **behavioral**. Group-think, herd mentality. Are stock markets a voting mechanism?
Therefore:

- There are some disconnects between economic growth (like GDP numbers), versus the valuation of securities in US versus China and what the world of investors believe is the right market price.

- The obvious question now is where are we (or prices now) in the bigger picture? Is there an emerging market bubble at this time or on the way?

- Emerging market investing being driven hard by macro factors. This leads to important connection with ETFs.
### Country Stock Performance

**Source:** Bespoke Investment Group

<table>
<thead>
<tr>
<th>Country</th>
<th>% Chg Since 3/9/09</th>
<th>% Chg Since 10/9/07</th>
<th>Country</th>
<th>% Chg Since 3/9/09</th>
<th>% Chg Since 10/9/07</th>
<th>Country</th>
<th>% Chg Since 3/9/09</th>
<th>% Chg Since 10/9/07</th>
</tr>
</thead>
<tbody>
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<td>Ukraine</td>
<td>278.38</td>
<td>-31.91</td>
<td>Mauritius</td>
<td>70.02</td>
<td>4.39</td>
<td>Australia</td>
<td>52.41</td>
<td>-28.00</td>
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<td>Romania</td>
<td>181.91</td>
<td>-46.06</td>
<td>Netherlands</td>
<td>69.72</td>
<td>-38.59</td>
<td>Venezuela</td>
<td>51.79</td>
<td>48.02</td>
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<td>Russia</td>
<td>151.66</td>
<td>-29.58</td>
<td>Finland</td>
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<td>Tunisia</td>
<td>51.69</td>
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<td>Argentina</td>
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<td>0.72</td>
<td>Croatia</td>
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<td>50.36</td>
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<td>Sri Lanka</td>
<td>135.18</td>
<td>49.81</td>
<td>Austria</td>
<td>68.72</td>
<td>48.27</td>
<td>Japan</td>
<td>49.39</td>
<td>-38.31</td>
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<td>Turkey</td>
<td>131.17</td>
<td>-7.97</td>
<td>United States</td>
<td>68.74</td>
<td>-27.76</td>
<td>Lebanon</td>
<td>46.71</td>
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<td>-35.12</td>
<td>Taiwan</td>
<td>67.72</td>
<td>-19.48</td>
<td>Puerto Rico</td>
<td>49.29</td>
<td>-38.25</td>
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<td>123.16</td>
<td>-19.29</td>
<td>Belgium</td>
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<td>-42.19</td>
<td>China</td>
<td>44.11</td>
<td>-45.36</td>
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<tr>
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<td>110.26</td>
<td>-52.31</td>
<td>Poland</td>
<td>65.32</td>
<td>-37.60</td>
<td>Qatar</td>
<td>43.30</td>
<td>-19.10</td>
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<td>Peru</td>
<td>109.92</td>
<td>-34.33</td>
<td>Philippines</td>
<td>63.70</td>
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<td>Greece</td>
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<td>Botswana</td>
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<td>-22.17</td>
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<td>94.56</td>
<td>-25.71</td>
<td>Saudi Arabia</td>
<td>58.69</td>
<td>-15.15</td>
<td>Abu Dhabi (AE)</td>
<td>16.06</td>
<td>-25.72</td>
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<td>Hong Kong</td>
<td>86.85</td>
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<tr>
<td>Czech Republic</td>
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<td>Ireland</td>
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<td>-64.06</td>
<td>Dubai UAE</td>
<td>8.07</td>
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<tr>
<td>Norway</td>
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<td>Italy</td>
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<td>France</td>
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<td>Bahrain</td>
<td>-5.60</td>
<td>-41.48</td>
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<td>South Korea</td>
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<td>South Africa</td>
<td>54.89</td>
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<td>Ecuador</td>
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<td>-27.21</td>
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<td>Malaysia</td>
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<td>Bermuda</td>
<td>-31.48</td>
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<td>Pakistan</td>
<td>72.03</td>
<td>-32.75</td>
<td>Ghana</td>
<td>-35.30</td>
<td>2.37</td>
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<td></td>
<td></td>
<td></td>
<td>Source: Bespoke Investment Group</td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>
Why Emerging Markets?

Key points

• Emerging markets are rebounding better than developed markets (getting back “above water”). Given the brighter outlook for emerging markets, will the consensus trade be to buy on major dips? **If so how?**

• Today, it’s less about making a strong case about emerging markets. It’s almost unnecessary given the obvious strong case against developed markets.

• Safe havens in developed markets like US or German paper have brought yields to near zero in times of crisis as investors are willing to just have simplest capital preservation as VIX spikes.

• As developed markets take on greater risks normally associated with emerging markets, more investors will want to gain further EM exposure. **Safe haven?**
Political and Currency Risks

- Tax levy on Financial sector
- Windfall profit tax on Energy sector
- Reform to Health Care sector
Emerging Markets: The opportunity cost

“Are you a participant or a spectator in the greatest movement of people into the modern middle class in the history of the world?”

But to participate, the next question is: How?
Defining Alpha and Beta … and Trends

β (pure passive; market risk)  α (pure active; manager risk)

Trend to push →  ← Trend to push

ETFs evolving towards:
1. Niche exposures (sector, region, strategy)
2. Higher costs (fees, trading, tax)
3. Rules based strategies and active management

Hedge funds evolving towards:
1. Allowing more beta !!!
2. Increased correlation w/ various markets
3. HF Replication and Alternative beta? Where’s the alpha?
An exchange-traded fund ("ETF") is an investment product that normally replicates an underlying basket of securities. Think of a portfolio that trades like a stock.

Most have underlying index based portfolios (S&P 500, MSCI EAFE).
- The most popular track broad indices
- More niche exposure now available based on sector and thematic ideas etc...

Latest innovations have included:
- levered and long indices
- bond indices
- commodity-linked indices
- hedge fund replication and other rules based strategies.

Main advantages are low fees, diversification, tax benefits but most importantly…the ability to be easily used with a wide variety of strategies for various objectives.
ETFs Are Expanding At A Record Pace

• Global ETF assets under management has grown over the past 16 years from $800 million in December 1993 to $1.08 trillion as of March 31, 2010

• At the end of March 2010 the global ETF industry had over 2,100 products from over 120 providers on over 40 stock exchanges around the world

• Globally, the average daily trading volume in USD has been roughly US$60 billion over the past few years.

• ETF growth has mirrored growth in the hedge fund industry: Rise of Alpha and Beta

• First ETF was listed in Toronto, Canada on March 9, 1990.
High growth in Both ETFs and Hedge Funds: Remain High Growth? Cost Convergence?

The Growth Stories

Figure 122: New asset classes will continue to squeeze the traditional core of actively managed funds

Source: Deborah Fuhr, Blackrock Global Investors, (May 2010)
Higher Fees: Evidence the business of indexing has changed

Less focus on purely “passive” investing by both index providers and investors: think market environment

Does true “buy-hold” mentality still exist, especially after 2008?

For asset categories such as commodities and specifically metals, its likely that shorter-term tactical trading is warranted and the liquidity that ETFs provide is attractive

Indexing and the use of ETFs no longer is associated with the term PASSIVE
Why ETFs matter for emerging market exposure

- Emerging markets are an important category but provide a variety of challenges for investors:
  - Ease of access and costs
  - Stock picking difficult or impractical. Diversification is of greater importance.
  - Transparency
  - Liquidity
  - Tax complexity
  - Need for FX transaction
  - Can not short

- ETFs are the best solution to dealing with **ALL** these issues
Why ETFs matter for emerging market exposure

- Many of the largest ETFs focus on emerging markets.
- However, emerging markets are supposed to be inefficient ... more so than developed markets.
- Active versus passive?
- ETFs are passive tools for active strategies. If they were for passive strategies only, we wouldn’t see the largest trading volume numbers.
### Why ETFs matter for emerging market exposure

**Figure 9: Top 20 ETFs worldwide by AUM, as at end Q1 2010**

<table>
<thead>
<tr>
<th>ETF</th>
<th>Ticker</th>
<th>AUM (US$ Mn)</th>
<th>ADV (‘000 Shares)</th>
<th>ADV (US$ Mn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>SPCR S&amp;P 500</td>
<td>SPY US</td>
<td>$76,098.2</td>
<td>169,558</td>
<td>$19,025.2</td>
</tr>
<tr>
<td>iShares MSCI EAFE Index Fund</td>
<td>EFA US</td>
<td>$35,804.8</td>
<td>15,828</td>
<td>$873.6</td>
</tr>
<tr>
<td>iShares MSCI Emerging Markets Index Fund</td>
<td>EEM US</td>
<td>$34,040.6</td>
<td>62,085</td>
<td>$2,587.6</td>
</tr>
<tr>
<td>Vanguard Emerging Markets</td>
<td>YWO US</td>
<td>$22,991.3</td>
<td>11,734</td>
<td>$482.4</td>
</tr>
<tr>
<td>iShares S&amp;P 500 Index Fund</td>
<td>IVV US</td>
<td>$22,859.2</td>
<td>3,524</td>
<td>$409.2</td>
</tr>
<tr>
<td>PowerShares QQQ Trust</td>
<td>QQQQ US</td>
<td>$21,020.6</td>
<td>70,597</td>
<td>$3,347.6</td>
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<tr>
<td>iShares Barclays TIPS Bond Fund</td>
<td>TIP US</td>
<td>$20,027.9</td>
<td>1,037</td>
<td>$107.7</td>
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<tr>
<td>Vanguard Total Stock Market ETF</td>
<td>VTI US</td>
<td>$14,475.7</td>
<td>2,006</td>
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<td>iShares Russell 2000 Index Fund</td>
<td>MM US</td>
<td>$13,349.7</td>
<td>58,255</td>
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<td>iShares iBoxx 7 Investment Grade Corporate Bond Fund</td>
<td>LQD US</td>
<td>$12,316.4</td>
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<td>iShares CDN LargeCap 60 Index Fund</td>
<td>XLCN</td>
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<td>iShares Russell 1000 Growth Index Fund</td>
<td>IWF US</td>
<td>$11,457.1</td>
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<td>iShares Barclays Aggressive Bond Fund</td>
<td>AGQ US</td>
<td>$11,463.3</td>
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<td>iShares MSCI Brazil Index Fund</td>
<td>EWZ US</td>
<td>$10,882.8</td>
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<td>S&amp;P400 MidCap SPDR</td>
<td>MDY US</td>
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<td>SPCR DJ Industrial Average ETF</td>
<td>DIA US</td>
<td>$8,478.6</td>
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<td>$796.2</td>
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<td>iShares FTSE/Xinhua China 25 Index Fund</td>
<td>FXI US</td>
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<td>$976.6</td>
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<td>iShares Barclays 1-3 Year Treasury Bond Fund</td>
<td>SHY US</td>
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<td>IHH US</td>
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<td>$85.3</td>
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</table>

Source: Global ETF Research and Implementation Strategy Team, BlackRock, Bloomberg.
## Why ETFs matter for emerging market exposure

<table>
<thead>
<tr>
<th>Ticker</th>
<th>ETF Description</th>
<th>Inception</th>
<th>Noteworthy</th>
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<tr>
<td>EWH</td>
<td>iShares MSCI Hong Kong Index Fund</td>
<td>3/12/1996</td>
<td>First Country Specific (not an EM anymore)</td>
</tr>
<tr>
<td>EWW</td>
<td>iShares MSCI Mexico Index Fund</td>
<td>3/12/1996</td>
<td>First Country Specific</td>
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<td>EWM</td>
<td>iShares MSCI Malaysia Index Fund</td>
<td>3/12/1996</td>
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<td>EWZ</td>
<td>iShares MSCI Brazil Index Fund</td>
<td>7/10/2000</td>
<td>First Brazil ETF</td>
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<tr>
<td>ILF</td>
<td>iShares Latin America 40 Index Fund</td>
<td>10/25/2001</td>
<td>First multi-country EM ETF</td>
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<tr>
<td>EEM</td>
<td>iShares MSCI Emerging Index Fund</td>
<td>4/7/2003</td>
<td>First broad GEM ETF</td>
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<td>2/24/2010</td>
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ETF use for emerging market exposure

How to use ETF for asset allocations to emerging markets:

• Cash equitization (lazy portfolio or parking spot)
• Core holding (policy or strategic asset allocation)
• Satellite holding (tactical asset allocation or non-long term hold: directional view)
• Short component (for market neutral, 130/30, portable alpha, etc.)
• Cash management tool
• Transition management tool
• Liquidity valve for hedge fund/private equity managers
• Portfolio completion
• Easy asset mix rebalancing to lower trading costs versus trading ordinaries/ADRs
ETF issues: Risks

- Risks to consider include:
  - tracking error ... why/how it exists
  - liquidity. Premium/discount around NAV based on supply/demand factors ... why frontier market ETFs have not been popular
  - regulatory concerns ... Example: Brazil 2% IOF tax
  - execution issues when index constituents changed
  - overseas trading (the effect of time zones)

- Other issues to consider:
  - fees/expenses
  - replication versus sampling
  - rebalancing rules (a degree of active management)

- Education is key
May 6, 2010: The “Flash Crash”

iShares Russell 1000 Growth Index Fund (IWF). IWF briefly traded for a penny on May 6th.

Thursday Open: $51.42
Thursday Low: $0.01
Thursday Close: $50.11
May 6, 2010: The “Flash Crash”

Chart of the Day: ETF Liquidity is MultiAsset (Victor Lim)

- As we’ve highlighted in the past, ETF liquidity remained strong during the financial crisis – with many days seeing over $100bn in ETF trading.
- However this statistic masks the diverse mix of ETF’s that are popular these days.
- Today’s chart shows that liquidity remains high (above $50bn/day) and shared across the broad range of asset classes - from sector and country equities, commodities, bonds and currencies.
- ETF’s continue to be used by sophisticated investors as a diversification and exposure tool.

ETF Value Traded – by Asset Type

Source: Credit Suisse – Portfolio Strategy
May 6, 2010: The “Flash Crash”

It’s important to know what’s behind the scenes in an ETF

- The participants
  - Market maker – provider of supply (to investors) and demand (to ETF)
  - Authorized participant
  - Arbitrageur
- Participants will do what they can to protect themselves
  - Widening spreads in times of uncertainty
  - Stepping back and removing liquidity
- Circuit breakers for each ETF and stock?
- This is an issue that still needs a lot of research/analysis
February 2010 news on emerging market country flows: Brazil easily the largest buy

- Brazil, led by its 11 names added, easily the largest net country buy that quarter at $276MM of expected inflows
- The largest country net sells are Taiwan (-$115MM due in part to 6 deletions), followed by Korea (-$74MM)

Now consider how indexes will evolve and look in the future with the growth of China, India and Brazil among others!
Conclusion on ETFs

• There are many uses for ETFs … it’s a Swiss army knife.

• ETFs allow an investor to implement a variety of strategies and are especially popular for gaining emerging market exposure due to the inherent characteristics its structure provides.

• As the local and global regulatory landscape changes, choice matters. When derivatives and other means don’t work, ETFs should be considered. Their growth thus far is a testament to their utility in various asset classes.

• In time, as we have seen with the robust offerings for US and developed market exposure, the same level of choice we be soon available for emerging markets.
Emerging Global Advisors is a boutique, New York City based Emerging Markets Research and Asset Management firm.

Emerging Global Advisors is committed to providing cutting edge performance-based research. We believe a focused, hands-on research approach is the best solution to gain unique intelligence into less researched global markets.

Our asset management efforts are focused solely on creating Exchange Traded Funds (ETFs) which we believe are one of the best solutions to gain exposure to less liquid markets around the world.
Emerging Global Shares - ETF
Overview

Broad-based

- Composite Index has 75% BRIC exposure versus 41% for other emerging market Broad Markets indexes (as of 12/31/09)
- An emerging market “Pure Play”

Sector

- Diversify Country risk
- Diversify Currency risk

Thematic

- Urbanization
- Infrastructure

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Thank you

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