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ETFR

exchange-traded funds report

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What's Inside...

ETFR Databank

Shorts strong in 2000; the QQQ helped

By Philip Scipio

Despite the bruising the Nasdaq took last year, the market system broke records for volume and dollar value of shares traded. Total share volume jumped 62% to a record 442.7 billion in 2000, up from 272.6 billion shares in 1999, according to Nasdaq. The dollar value of shares traded on Nasdaq jumped 85% to a record $20.4 trillion in 2000 from $11.0 trillion the prior year.

With the Nasdaq itself breaking records it comes as no surprise that the exchange-traded fund based on the Nasdaq 100 Index, often called the QQQ, grew by leaps and bounds last year. Just as there were savvy investors to take heavy interest in the bellwether tech firms of the Nasdaq 100 during its rise, there was no shortage of investors willing to short tech 7▶

S&P vs Vanguard appears close to an end

By Michael Ocrant

The McGraw-Hill Companies and the Vanguard Group are in the last stretch of a legal battle that will either allow or bar the listing of a new set of exchange-traded funds the mutual fund company is calling VIPERS, after both sides recently submitted final arguments outlining their positions in United States District Court for the Southern District of New York.

The arguments were submitted in close conjunction with the Securities and Exchange Commission's approval of VIPERS in December, an approval that was granted despite strong protests from McGraw-Hill, which had unsuccessfully sought a hearing on the issue before the regulator.

The closely watched case is the result of a lawsuit filed by McGraw-Hill on behalf of its Standard and Poor's division against Vanguard Index Trust and the Vanguard Group, which is seeking to list a series of ETF products based on the S&P 500 Index and other S&P indices. McGraw-Hill contends that these aren't allowed under its licensing agreement with the company without permission being granted to do so.

ETF industry participants are widely interested in the outcome of the case because of Vanguard's prominence in the index-based mutual fund arena, where it has staked its claim to become the second largest mutual fund company in the world, with about $575 billion under management.

Indeed, Vanguard's 500 Portfolio alone oversees about $100 billion in assets. Industry observers have speculated that the firm's brand name will go a long way in attracting new assets to the ETF marketplace because it is so closely associated with index mutual funds with which both retail brokers and their customers are highly familiar.

No new contract

In their arguments submitted to the court, both sides basically reiterated the positions they have long stood by in previous hearings and filings, most of which hinge on what each side contends is the proper and precise interpretations of the licensing agreement between them that was first drafted in 1985 and revised in 1988.

According to McGraw-Hill's final argument, the agreement(s) allow Vanguard to use S&P 500 data and trademark "in a very specific fashion, namely, in connection with the operation and management of a particular open-end investment company—Vanguard Index Trust," the company's index fund arm that oversees about $225 billion.

"Open-end investment company," according to McGraw-Hill, "was then, and is now, commonly understood to mean a mutual fund that itself issues and redeems shares at prices 8▶

Nuveen and Barclays race to offer first fixed income ETF

By Philip Scipio

Nuveen Investments and Barclays are vying with one another to be the first to offer an ETF bond product in the US. Barclays Canada rolled out a version of a bond ETF last year, but that product was not based on an index and was geared almost exclusively toward retail investors.

> "They appear to be a quick way to put cash into the bond market"

The blueprint for the two firms' US bond ETFs more closely follows the mold of the existing ETF products in that both are index funds and both are intended for an institutional client base as well as a retail client base. But unlike Barclays Canada, which actually began trading its funds last year, Nuveen and Barclays US have only filed for exemptive relief with the Securities and Exchange Commission.

While there is no way to gauge exactly how long it will take either set of fixed income ETF products to clear SEC review, those familiar with the process have suggested that it could last as long as a year. Both Nuveen and Barclays are hoping the products will be ready for launch much sooner, though neither would speculate on when.

Nuveen's bond ETFs, to be known as Fixed Income Trust Receipts, will be based on the Ryan Treasury Indexes of one-year, two-year, five-year and 10-year Treasury issues and 20-year Treasury STRIPs. Each fund will track a single bond.

The first draft of the proposal has already been reviewed by the SEC and returned with questions, according to Gary Gastineau, managing director of ETF product development at Nuveen. The firm is currently awaiting a second round of questions from the SEC.

"These new ETFs will make buying and selling Treasury securities as convenient as buying and selling stocks," says Gastineau. "They will benefit both retail and institutional investors."

The Barclays version

Barclays filed documents with the SEC during the first week of January seeking approval to launch five ETFs based on Lehman Brothers bond indices. Once approved by the agency, the five products—iShares 1–3 Year Treasury Index Fund, 7–10 Year Treasury Index Fund, 20+ Year Treasury Index Fund, Treasury Index Fund and Government/Credit Bond Index Fund—will join Barclays' stable of iShare-branded ETFs.

Each of the new funds will seek to provide investment results that correspond generally to the price and yield performance of its underlying index, using "passive" indexing investment strategies. Each new fund will utilize a "representative sampling" strategy to attempt to track its underlying index.

The new iShare funds will provide investors with a low-cost market basket fixed-income product that can be traded throughout the day at prices that reflect minute-by-minute market conditions rather than end-of-day prices. In addition, they will give investors an opportunity to diversify their portfolios by purchasing fixed-income securities at a low cost and with significantly lower transaction costs than if they had purchased individual bonds.

Barclays also sees the new ETFs providing investors a more tax-efficient investment vehicle than most traditional mutual funds or closed-end funds with similar investment objectives.

The Ryan indices reflect the risk and return characteristics of on-the-run Treasuries, says Gastineau. He says that OTR rates are appropriate benchmarks for US dollar-denominated debt because they are often used as base yields against which many debt instruments are evaluated.

The one-year, two-year, five-year and 10-year indices are constructed by replacing older OTR securities with the new OTR securities at the time of the Treasury auction. The 20-year STRIPs index is based on holding a single Treasury STRIP and rolling the position from the shorter STRIP to a longer STRIP to maintain a target duration position.

A question of appeal

Although both Barclays and Nuveen agree that fixed income ETFs will hold immediate appeal for retail investors, the question remains whether these products will attract institutional investors.

Gastineau says they will, though the focus will not be on the upper echelon of institutional investors, many of whom have their own trading desks.

With these funds, institutional equity investors will be able to quickly add fixed income exposure to their portfolios during times of market volatility, he says. Financial advisors will be able to conveniently tailor a Treasury portfolio to an investor's income needs and risk profile with a much lower minimum investment than required by straight Treasuries.

"They appear to be a quick way to put cash into the bond market," says James Kelly, president of Addison Capital Management. "I'd be interested in looking at fixed income ETFs once they were ready, particularly the products intermediate range one to two year and seven to 10 year funds.

"But I want to understand the composition of the underlying portfolio. What kind of yield is involved, and what protection exists for that yield? I want to understand the underlying expenses changed to provide the ETF."

Other details regarding the products remain under wraps as both firms enter a quiet period dictated by the regulatory process. But not everyone is convinced of the value these products offer.

"We prefer to buy municipals or Treasury bonds for our high-net-worth clients," says Robert Levitt, principal of Levitt Capital Management.

"We're using fixed income as a diversifier," he says. "Buying an index, you're getting an aggregate that can include corporate bonds and mortgage bonds from the various sectors," instead of higher quality bonds.

Euronext offers more of Europe for less

By Elise Coroneos

Euronext, Europe's first and only multi-country exchange, has begun trading the first of what is touted to be at least a dozen exchange-traded funds. Euronext, created by the merger of the Paris, Amsterdam and Brussels exchanges, started trading the Dow Jones Euro Stoxx 50 and the Dow Jones Stoxx 50 indices on January 15, and the Master Share CAC40 fund tracking the Paris CAC40 Index on January 22.

> "In Europe, it is the exact right time to launch these products"

To facilitate trading, Euronext on January 9 launched a platform called NextTrack dedicated to Trackers, as ETFs are known at Euronext. According to Marianne Demarchi, the head of Euronext's ETF segment in its cash products division, NextTrack will help increasingly interested European investors identify Trackers more easily.

"When we launched, there was a lot of interest from the press and investors," she says. "We have had many, many requests for information."

After a week of trading, the Dow Jones Euro Stoxx 50 and the Dow Jones Stoxx 50 saw about €27.0 million ($25.4 million) all together, roughly four times that traded on the Swiss Exchange for the same time period. On the day of its launch, Master Share CAC40 fund traded €31.0 million ($29.1 million).

"I feel that the market is really ready in Europe, and it is the exact right time to launch these products," says Demarchi. "Our aim at Euronext is to offer a really wide range of Trackers from the beginning, and not to wait too long."

Already on the launch pad for 2001, and due out in the first quarter, are an ETF that will track Amsterdam's AEX index, and pan-European sector and regional products, also in Amsterdam, that will be launched through the iShare brand. "We aim to have at least a dozen Trackers this year as a minimum," says Demarchi.

The Amsterdam Exchange, Brussels Exchange and Paris Bourse currently calculate 145 indices, of which 14 were created especially for derivatives trading, with the remaining created for benchmarking purposes. Demarchi says that in listing ETFs to be traded on NextTrack's trading platform, "one goal is to widen the range using Euronext indices."

It is possible that future ETFs based on Euronext indices may include the Euronext 100 index made up of the 100 largest officially listed securities in the Euronext stock market, or the Next 150 index, an index representing the 150 next largest companies that are not represented in the Euronext 100 index.

Better access for issuers

Euronext's single trading platform goes part of the way toward addressing the challenges faced by those seeking to list ETFs in Europe. Instead of approaching each country's regulatory authority separately for permission to be listed on their exchange, Euronext provides a single point of entry with streamlined regulatory and licensing procedures.

Companies wanting to list an ETF on Euronext simply choose one of the three entry points (Amsterdam, Brussels or Paris) as their home market and jurisdiction. From this gateway, listed products gain access to trade on the three exchanges, and simultaneously bypass the multiple language barriers that can often create time inefficiencies when trying to get a product to market.

Listing a Tracker on Euronext's NextTrack requires a single admission document that is harmonized among the three countries. "You just have to send an admission document to the market in either Paris, Amsterdam or Brussels," says Demarchi.

"You need to provide information for the listing that will give transparency for the Tracker. Also, on an ongoing basis, you need to provide a net asset value, and based on this net asset value we will calculate and disseminate an intraday net asset value."

Like other Euronext equity products, Trackers are traded through a central order book. Liquidity is guaranteed by at least two market makers per fund.

From a regulatory point of view, market participants are subject to the supervision of the regulator of the country in which they are granted their main license. The Euronext entry point chosen by the market participant determines the jurisdiction governing the membership agreement reached between the market participant and Euronext.

The jurisdiction under which the listing agreement is established (Belgian, Dutch or French) is relevant for reporting by Euronext's market surveillance department to regulators with regard to irregularities in trading in the securities issued by a company (in particular in the event of suspected insider trading, front running or market manipulation).

At present, trackers admitted to NextTrack in Paris are traded on the "Premier Marché" through the electronic trading system NSC-VE. Trackers admitted to NextTrack in Amsterdam are traded in the "Special Product Segment" through the electronic trading system TSA. In the second half of the year, they will be trade on a new single platform to be shared by the Amsterdam, Brussels and Paris markets.

Investor education

The prominence given to explaining ETFs on Euronext's Web site suggests that the company is serious about educating the European public about this relatively new form of investing.

"I think it is our role, as well as the issuers', to help promote and educate investors about these products," says Demarchi. Euronext's strategy includes an advertising campaign, road shows targeted to the professional community and conferences for retail investors.

"We really see Euronext as filling a gap by offering investors and users what they need to trade these rather new products in Europe."

The back office: An upfront look at the creation process

By Marsha Zapson

This is the second article of a two-part series examining that frequently overlooked component of exchange-traded funds: the back office. Last month, *ETFR* presented the players; this month, we take a close look at the ETF creation/redemption process.

> “DTCC breaks the CTF down into all its constituent pieces”

In summary, four banks in the US provide custodial and fund accounting services for ETFs. State Street Bank, with about $6.2 trillion under custody, services 20 domestic and two international ETFs: the Spider, Diamonds, Sector Spiders, nine StreetTracks, the Hong Kong Tracker and the Dow Jones 40, a Canadian product.

Bank of New York, with $6.9 trillion under custody, services the Nasdaq 100 Trust QQQ, the S&P 400 MidCap Spider, the 14 Merrill Lynch Holders and two European ETFs that track the Stoxx and Euro Stoxx 50.

Investors Bank & Trust, with about $330 billion under custody, services all of Barclays Global Investors' iShares, minus the country baskets. The country baskets, formerly known as the WEBS, has PFPC as its administrator and Chase Manhattan Bank as its custodian.

The service provider role

ETFR describes the creation/redemption process through the eyes of Investors Bank. As such, it assumes that the ETFs wending their way through the flow chart on page 5 are any one of the approximately 40 iShares that the bank services. The entire process described below—based on extensive interviews with Steven Gallant, client services director for ETFs at Boston-based Investors Bank—is similar in its essentials to that of the other service providers and their ETFs.

Each day when trading ends, Investors Bank steps into its role as service provider for its mutual funds and ETF accounts (some $6 billion out of its total assets under custody).

ETFR follows the creation/redemption process for an ETF from the primary market perspective. In this scenario, Investors Bank is the administrator, custodian, and transfer, accounting and securities lending agent for each ETF—which again is any one of Barclays iShares. The following discussion is based on the flow chart.

Because an ETF's net asset value is calculated at the end of the trading day (similar to a mutual fund), Investors Bank is doing a significant amount of the servicing work during that very tight window between 4 pm and 6 pm every afternoon. This is perhaps the most critical time in the creation/redemption process (but by no means the only time the bank is doing ETF-specific work), and arguably the time when the bank's automated system is under greatest stress.

Investors Bank spent nearly a year enhancing its core custody and accounting systems in order to handle the influx from the first wave of the iShares launch into its system. The bank built in many operational redundancies as a sort of insurance plan.

If any part of the system should go down, it will automatically switch over to the next hardware platform or software component. This design ensures that, from a technological standpoint, the creation/redemption process flows smoothly during that critical 4 pm to 6 pm window every day.

Step 1: Calculating NAV. Beginning with Investors Bank's role as fund accountant (lower left rectangle), the bank calculates the NAV of an ETF similarly to that of any other mutual fund. The NAV is based on the value of an ETF's underlying stocks at the close of trading day, or T. It's calculated daily regardless of whether there are creates or redeems.

Simultaneous with the calculation of NAV, Investors Bank computes the cash component, which includes any accrued dividends, interest on those dividends and accrued revenue from stock lending, as well as any cash actually held in the fund. It also includes any capital gains (which are theoretically nonexistant in the ETF structure), less losses on the portfolio basket that have not been reinvested since the last distribution, less any custody and transfer charges.

At this point, Investors Bank also projects tomorrow's cash component by estimating tomorrow's accruals, which may, for example, be affected by any potential corporate actions.

The NAV plus the actual cash component plus tomorrow's projected cash component make up the cash composition file. Once the CCF file is created, it goes to the fund sponsor (in this example, Barclays). The fund sponsor adds to the CCF file the basket of stocks that will be used for tomorrow's trades—which means that it determines the composition and weightings of the basket or the individual ETF.

"Looking at the creation process at T, we calculate the actual cash component after 4 pm using a basket that the sponsor created the previous night," says Gallant. "We then use today's market value, which we've calculated, and then compute the projected cash component."

Step 2: Accessing information. The resulting PCF file is sent every night to the Depository Trust Clearing Corp, which is a member of the Federal Reserve System. The DTCC is similar to a warehouse in which authorized participants—broker-dealers, market makers, large investors and institutions—access information and view the PCF. It's also where trades settle on T+3.

At the market's opening, the PCF and all its component parts become transparent and available for all to see, says Gallant. On T, any authorized participant will be able to read (note the arrow traveling from the AP to the DTCC called PCF read) the PCF for any ETF, and download the information. The PCF includes the basket composition and the cash component, which details the actual and the projected cash components.

The AP is now equipped to create or redeem an ETF. Armed with the knowledge contained within the PCF, the authorized participant now knows which securities, as well as the cash component, are required for delivery to DTCC on settlement day, or T+3. APs deliver and receive securities through DTCC for domestic ETFs.

Step 3: Creating an order. After reading the PCF and accessing the fund's information, the AP does a creation order request and sends it to the distributor, which in this case is SEI Investment Distribution Co. ETFs that trade on a listed exchange are created at their NAV in block-size creation units of 50,000. Each AP enters into an agreement with the distributor to deposit the actual securities into the applicable fund on T+3.

The distributor accepts all create orders from all APs, accumulating them throughout the day. It tallies the creates for all the various ETFs, and sends out a file identifying the APs and their total orders. The bulk of the orders arrive late in the afternoon, just before close. The distributor basically authenticates that the AP is just that, an authorized participant, says Gallant.

"Among other things," he says, "they're really making certain that the orders they receive from APs are in good order, accurate and so on. They put the information into a file and forward it to Investors Bank as the transfer agent. We get the orders in our transfer agency at 4 pm on T."

Once the confirmed orders hit Investor Bank's transfer agency, the transfer agent sends the creation trade file to DTCC and simultaneously sends it to the custodian, which in this case is Investors Bank.

So far, this whole process has occurred during T. Time is now inching into the early morning hours of T+1. After Investors Bank sends the CTF to DTCC, DTCC bursts the file. This means that DTCC breaks the CTF down into all its constituent pieces, or the number of securities that are going to move into and out of the fund's accounts, and returns it to fund accounting, says Gallant. At this point, only information is being exchanged; the actual securities will not be received until T+3.

Step 4: Settlement. As mentioned earlier, DTCC will have the basket of securities as well as the cash component for any trades that are going to settle on T+3. However, it should be kept in mind, that on T, T's basket (which was actually cut last night, or T-1) is used. The estimated cash component (also calculated on T-1) is added to that basket to be replaced, on T, by the actual cash component.

DTCC is now matching up the create orders received from the transfer agent and sending that match to Investors Bank in the trade detail file. If, for example, the S&P iShare is composed of only 490 trades (based on the PCF created by BGI the previous night), DTCC will be sending those 490 trades plus the cash difference.

On T+3, or settlement date, DTCC facilitates the movement of the trades composing the ETF to the AP as well as to Investors Bank. DTCC moves the underlying securities and cash component out of the AP's account (which are held by the transfer agent at this point) into the fund accounting system; the fund is settled, the books are balanced, and everything is even at the end of the day.

Exchange-Traded Fund: Creation order flow

Source: Investors Bank & Trust

Phantom tracking error

By Elise Coroneos

Logic says that by design, the performance of exchange-traded funds should closely follow the performance of their underlying indices. While most analysts agree that ETFs products should generally mirror their underlying indices, the quest to reduce sources of tracking error continues.

> “It is really a data proliferation issue”

The American Stock Exchange is currently addressing the tracking error that results from the different US market closing times for securities and ETFs. According to Cliff Weber, senior vice president of product development at the Amex, this issue goes back to the concern raised by Barclays Global Advisors with its filing for exemptive relief for its iShares fund products. “They first raised the premium discount issue about exchange-traded funds, which we are trying to address,” says Weber.

While the closing times for most securities and narrow-based (or sector) exchange-traded funds is 4 pm, broad-based exchange-traded funds trade until 4:15 pm. These extra 15 minutes of trading facilitate arbitrage opportunities between futures and the exchange-traded funds. Index futures trade until 4:15 pm.

At present, the closing net asset value disseminated to investors of exchange-traded funds is the 4:15 pm price. As a result, investors in broad-based exchange-traded funds can only compare the 4:15 pm net asset value of their exchange-traded fund with the net asset value of its underlying index, which is struck at 4 pm.

Weber says that the Amex has confirmed that it has engaged the services of a consulting firm to study the premium discount issue and better understand the factors that cause it. The study, he says, will result in the Amex concluding a better way to determine the end of day price for exchange-traded funds. “We are looking at a couple of different options to tackle the issue, but at this stage we are not exactly sure how it is going to be presented. Generally speaking, we are looking at providing better information so investors can follow the secondary market price versus the exchange-traded fund’s net asset value.”

So far, it is believed that only the American Stock Exchange has been innovative in addressing this issue affecting investors of exchange-traded funds.

Time and price discrepancy

Gus Fleites, principal and director of State Street Global Advisor’s exchange-traded funds, says that the current system whereby the 4 pm price for ETFs is not provided to investors means there is a perception that they do not accurately track their underlying index. “Any attempt that you make to calculate the share performance of the fund based on the 4:15 close against an index that is priced at 4 o’clock, it is going to create some noise,” says Fleites.

Diane Garnick, equity derivatives strategist at Merrill Lynch, says that although the extra trading time is important in order to give people the opportunity to hedge their futures positions, “we call it the 15 minutes of phantom tracking error.”

The primary reason it occurs is because some companies in the broad-based indices announce their earnings after the stock stops trading but before the exchange-traded fund stops trading, says Garnick. “An example is Microsoft who will announce their earnings at 4:05 pm. Given Microsoft’s weight in the S&P 500 and the Russell indices, whether they meet or beat expectations will have an impact on the futures and the exchange-traded fund market.”

According to Weber, such causal factors may not simply be a pricing discrepancy as popularly believed. “If a stock’s net asset value is calculated at 4 o’clock for a regular domestic equity index, but the last trade was at 10 o’clock in the morning, the cause of error might not really be a pricing discrepancy, but a timing discrepancy.”

Dual closing times

Fleites says that there is a way around the confusion. He believes that providing investors with the 4 pm net asset value of their ETFs is necessary to ensure that investors are able to measure its performance relative to the underlying index.

Fleites sees this as an important step toward establishing credibility among potential investors who want to monitor the accuracy with which the fund tracks the index. “The 4 pm price is more indicative of how people are looking at the products,” he says.

While determining the actual closing price of any stock is not exclusively an exchange-traded funds issue, it is more pronounced for ETFs because of the tracking considerations. Fleites believes that the answer extends beyond finding a better way of calculating the net asset value of exchange-traded funds. He believes that the exchanges will need to find a way to disseminate dual quotes to investors, that is, the price already available for 4:15 pm, with the addition of the 4 pm close.

“If there is a way to disseminate different prices I think it will serve the market well. The issue is convincing data providers to carry both prices. It is really a data proliferation issue,” says Fleites.

Garnick says that what is needed is a process of providing a 4 pm close for exchange-traded funds, so investors can mark their books.

She is a big supporter of the strides being made to address the issue. “As a result of the work at the Amex, if the index stops at 1500, and the exchange-traded fund stops at 1510, the Amex will provide the 4 pm close, which will allow investors to mark their books and records at the 4 o’clock close of 1500, thus avoiding that 15 minutes of phantom tracking error.”

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Shorts strong in 2000; the QQQ helped

stocks from Apple Computer and Amazon.com to eBay, Intel , Microsoft and WorldCom. And during what turned out to be Nasdaq's worst year ever, there was no shortage of people willing to short the entire index using the QQQ.

With about $23.6 billion assets at the end of 2000, the QQQ were second in size only to the S&P 500 SPDR with $25.5 billion in net assets. But no other ETF came close to the volume produced in the QQQ. The QQQ saw average daily trading volume of around 27.7 million shares a day, according to the American Stock Exchange. In contrast, the second most active ETF, the SPDR, moved about 7.7 million shares a day.

The number of shares traded on the Nasdaq stock market and in the QQQ surged in 2000 despite the lackluster performance of the Nasdaq composite index, which dropped 39.3% to close at 2470.5 at the end of 2000.

During every month of the year 2000, the short interest in the QQQ was at least twice that of the SPDR and more than 10 times the short interest in the Diamonds, which tracks the Dow Jones Industrial Average. For the year, the average monthly short interest in the QQQ was 44.8 million shares compared with about 17.6 million for the SPDR and 3.3 million shares for the Diamonds.

Popular with short-sellers

According to an Amex spokesman, the volatility and liquidity in the Nasdaq Index makes the QQQ a popular choice for short-sellers. In February when the short interest in the QQQ peaked at 66 million shares (three times the short interest in the SPDR and 22 times the short interest in the Diamonds), the average daily trading volume was more than 26 million. By the end of the year in November and December when the short interest was 50 million shares each month, trading volume spiked to an average of 43 million shares in November and 51 million share in December.

These staggering numbers may belie the profile of the investors using the QQQ to short the market. In addition to money managers and institutions using the QQQ as a hedge, rogue daytraders, often seen as the scourge of the market, and a more subtle breed of individual investors have taken to using the QQQ to short that Nasdaq with impunity.

"When you see those big numbers, 66 million shares, people think there is some hedge fund activity and that is not the case," says the manager of a short-only hedge fund. "Short interest in the QQQ has grown, but so has the open interest in the options for the QQQ and other products like it. There's also lot of arbitrage activity involved, but I wouldn't say it's a bunch of hedge funds and money managers."

In fact, like many hedge fund managers, this manager says he does not use ETFs. "We don't use them at all, and we have a hard time believing that hedge fund investors would be willing to pay hedge fund managers for using them. There's no advantage to using them from an alpha standpoint. It's purely a market-timing vehicle."

He adds that if an investor is asking a manager to be market neutral or long biased, the funds don't add much value other than to be a trading vehicle. "If you are running 100% long and 100% short, I don't think any part of the short should be exchange-traded funds. Your investors aren't paying you to be invested in an index," he says.

He says that day traders are using the QQQ, some doing so because they are primarily a trading vehicle. "Individual investors have gotten so pummeled investing in individual securities that they've started playing with the QQQ."

John Golden, director of business development at Lieber & Weissman Securities LLC, a registered broker/dealer, agrees that individual investors have been increasingly drawn to the QQQ product, and more and more have begun to use it to short the Nasdaq.

"Daytraders, money managers, institutions—I don't think you can so easily say these things appeal to one group or another, but we have certainly seen a great deal of interest by individual investors in using the QQQ to short the Nasdaq," says Golden.

And unlike individual stocks, investors don't have to wait for an uptick to unload a position. "The absence of the uptick rule when short selling exchange-traded funds has enticed all sorts of investors into trying to win profit from the Nasdaq's volatility," he says.

To use or not to use

While individual investors have undoubtedly begun to use QQQ, and to a lesser extent other ETFs to short indices and sectors, fund managers and institutions are the driving force, says a second short manager who admits using the QQQ as a hedge against individual stocks he's short.

"It's not something money managers, hedge funds in particular, are going to talk about using, but they use them," he says. "A lot of the tech guys in particular who saw their long positions savaged last year definitely began to short the QQQ as a hedge on their long positions."

But the first short manager counters: "If I were a hedge fund investor and I saw that the manager was using exchange-traded funds, I wouldn't be too happy about it." ✣

2000 Short Interest

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S&P vs Vanguard appears close to an end

determined by the fund's net asset value, at the end of each business day."

ETFs, which of course are traded like a stock throughout the day at prices that closely reflect NAV but may not exactly match it, are not covered under the agreement between the two companies, McGraw-Hill contends, and any attempt to launch the products is an unlawful use of S&P's intellectual property.

Further, McGraw-Hill maintains that the 1988 revision to the agreement pertained only to allowing Vanguard to use "500" in creating an index fund, in addition to S&P 500 data and its trademark to operate and manage the Vanguard Index Trust.

As part of that revised agreement, Vanguard agreed to pay S&P a maximum of $50,000 a year, a sum that included a $5,000 licensing fee that was the total annual payment made from 1985 to 1988 as part of the previous agreement, as well as a fee of one basis point of the average net asset value of the fund in excess of $1.2 billion, capped at $45,000 in perpetuity.

The contract calls for "no material changes" in the way the Vanguard fund operates without the prior approval of S&P, which McGraw-Hill claims would include the listing of ETFs.

Vanguard's contention that S&P and McGraw-Hill oppose the listing of VIPERS, among other reasons, to extract a more lucrative fee arrangement was dismissed in the court filings by the company as confusing the argument.

Also dismissed was an allusion by Vanguard in its court filing that McGraw-Hill might be seeking to shield its exclusive agreement with Barclays Global Investors for the listing of that firm's iShares ETFs, which are based on S&P indices, even though knowledgeable industry sources indicated that the licensing fees Barclays now pays S&P would be sharply reduced under its contract with the company if other entities are granted licenses to list ETFs.

McGraw-Hill, however, said in its court filings that it is not seeking to negotiate a new contract, only to shield its intellectual property, and that its product licensing agreement with Barclays and Vanguard was no different, for example, than a company with rights to a cartoon character licensing one company to use the character's image on a sweatshirt and another to use it on a lunchbox.

Scope of licensing agreement

For its part, Vanguard, in its filing for judgment, said the "sole question before the court is whether the licensing agreement . . . entitles Vanguard to use the S&P indices and trademarks in connection with VIPERS."

Vanguard contends that McGraw-Hill and S&P "never disputed that the agreement, as amended, permits Vanguard to use the S&P indices to select the composition of the index funds' portfolios in an effort to replicate, for the benefit of its existing classes of shares, the price and yield performance of the common stocks that comprise the benchmark indices," which the company argued would be no different than the goal of VIPERS.

"In short, the issuance of VIPERS will not result in any change in the manner in which the Fund [already] uses S&P's intellectual property," Vanguard said in its court filing.

Vanguard countered that S&P's contention that the original fund prospectus attached to the one-and-a-half-page 1985 agreement was meant as a way to restrain the manner in which the fund could be managed and operated, as well as to restrict the type of shares the fund could issue. It was instead done only to describe the use the fund was making of S&P's intellectual property, namely, the selection of stocks to replicate the performance of the index.

To claim that the 1988 agreement was only meant to supersede a portion of the 1985 contract and to specifically grant Vanguard the right to use "500" in its marketing of the fund ignores both that the later agreement was a 15-page document outlining the relationship in far greater detail, as well as Vanguard's creation of five new open-end S&P-based funds since 1988 that were approved with amendments to that agreement, according to Vanguard's court filing.

The use of S&P intellectual property to list VIPERS, Vanguard said, is not "far-reaching, indeterminate or unbounded," as McGraw-Hill has maintained, "but is broad enough to include VIPERS."

And while the Vanguard court filing failed to indicate whether the company would be willing to pay S&P a licensing fee to launch VIPERS, it noted that in private communications and in statements before the court by McGraw-Hill's legal team, there appeared to be no desire to grant a license for the products under any conditions.

In addition, Vanguard argues that the 1988 argument never refers to an "open-end mutual fund" or an "open-end investment company," which S&P claims defines the sole use of its name and data Vanguard was granted the right to use in developing its fund products—which seems to be the case based on a review of the agreement on file in the court record.

And, according to Vanguard, S&P's assertion that the 1988 agreement supersedes only part of the 1985 agreement is contradicted by a clause in the later agreement that indicates it "supersedes all previous agreements between the parties with respect to the subject matter, including, without limitation, a letter of agreement dated April 4, 1985."

McGraw-Hill's contention that the wording "with respect to the subject matter" in the far lengthier 1988 agreement alluded solely to allowing Vanguard's use of "500" in the development and marketing of its fund products "defies common sense," according to the court filing, which noted that the document covers many issues not even mentioned in the 1985 agreement.

Officials at both Vanguard, which is being represented by Wilkie Farr & Gallagher, and McGraw-Hill, whose legal firm is Weil, Gotshal & Manges, said they couldn't predict when the judge hearing the case might render an opinion or whether further hearings would be required.

BGI adds iShares

Barclays Global Investors will roll out 13 iShare-branded ETFs this year, raising the number of these offerings to more than 60. Included in the lineup is an iShare that will track the Lehman Brothers bond index, seven that will track Goldman Sachs indexes, and three that will track Frank Russell indices. These new iShares are before the Securities and Exchange Commission, and Barclays is currently in its quiet period and unable to comment on exact launch dates.

However, according to industry sources, Barclays is the first firm to sign a licensing agreement with Goldman to use its indices in an ETF product.

Barclays will also launch two products in February: iShares Nasdaq Biotechnology Index Fund and iShares Cohen & Steers REIT Fund.

According to Christine Hudacko, a spokeswoman for Barclays, the new Nasdaq biotch ETF that will track Nasdaq's biotech index, will cost 50 basis points, and will launch February 2. In a statement, Nasdaq said that it rebalanced its Biotechnology Index (IXBT) on January 23, and that the index has 76 stocks in it. Nasdaq also said that the rebalancing occurred in part to support the new iShare launch.

BGI's new REIT iShare is the first ETF to track real estate investment trusts. While there are several closed-end funds, mutual funds and hedge funds geared to real estate, there are no ETFs in this arena, said Hudacko. She said the ETF will comprise 30 REITS, and cost 35 basis points.

CBOE expected to list its first ETF option

The Chicago Board Options Exchange has internally approved what would be its first listed option for an exchange-traded fund and could launch the product before the end of January. The new ETF option would be based on Barclays Investor Group's S&P 100 iShares (ticker symbol OEF) that trade on the American Stock Exchange, CBOE sources said.

The remaining issue to be worked out before the launch of the option contract, is where to make room for it on the S&P 100 trading floor, sources said. Sources said allowing it to trade in the open outcry S&P 100 pit rather than allocating it to one of CBOE's designated primary market makers, which essentially function like specialists at the New York Stock Exchange and support large groups of stock and stock index options products to fill orders, was a compromise to avoid any delay in launching the product.

Market makers on the floor, sources explained, wanted the opportunity to trade the product in an open outcry environment. But, sources added, the remaining issue of where to physically make room for trading the product on the floor is expected to be resolved with little debate and should cause no delay in the launch.

Final approval for listing the products came in late January by CBOE's Index Floor Procedures Committee, which voted unanimously in favor of the proposal. The vote followed similarly unanimous votes by CBOE's board of directors, its S&P 100 Options Committee and its New Products Committee, sources said.

While Securities and Exchange Commission approval will be required to list OEF options because they will have strike price parameters that are somewhat different than for regular S&P 100 options, exchange sources said SEC approval is considered a formality that is expected to be granted quickly and almost immediately without any requirement for a hearing or public comment period.

New ETF derivatives have been widely anticipated by the industry, which sees extensive arbitrage and hedging possibilities using listed futures and options products based on the most popular underlying equity index benchmarks. The American Stock Exchange is the only other exchange to trade ETF options, which it has listed on Nasdaq 100 Index Tracking Stock (ticker symbol QQQ) and on iShares S&P MidCap 400 shares (ticker symbol IJH).

Giant Taiwan ETF possible

An ETF may be in the cards for Taiwan. The country's finance ministry has amassed an equity portfolio of local stocks worth US$5 billion via its National Stabilization Fund. The stocks were purchased last year to support Taiwan's falling equities markets, which had plunged 44% because of a weaker US Nasdaq and domestic political uncertainties.

Although the finance ministry is currently focused on stabilizing its equities markets, an advisory committee chaired by the deputy finance minister has been established to consider its options on disposing its shareholding. The committee has looked to Hong Kong's US$10 billion Tracker Fund Tracker Fund, Asia's first ETF, as a guide. Other alternatives are to sell stocks, possibly via an ETF or mutual fund, to offshore investors rather than domestic investors, or to sell Taiwan stocks via Global Depositary Receipts or American Depositary Receipts.

Vincent Duhamel, State Street Global Advisors's managing director for Asia, said that a Taiwan ETF similar to the Tracker fund could be a possibility. There are similarities between Taiwan and Hong Kong in terms of needing to sell down equity holdings, he said.

The Hong Kong government bought local stocks worth US$15 billion during the height of the Asian crisis in August 1998 to support its market. According to Hong Kong Monetary Authority figures, the portfolio rose by US$11 billion in value over 1999 as Hong Kong's equity markets recovered. The Tracker fund was created in November 1999, and enabled the government to dispose of US$4 billion worth of its shareholdings. Buyers of the ETF were mostly domestic retail investors. SSgA was the adviser to the deal.

On the move

STOXX Ltd has hired Kevin Pilarski to occupy the newly created position of regional director for the Americas. Pilarski will be responsible for licensing and marketing Dow Jones STOXX indexes to US investment management companies, financial services companies and exchanges throughout North and South America. He was formerly vice president of sales and relationship management at eSpeed, an electronic order matching system developed by Cantor Fitzgerald, and senior manager of institutional international marketing at the Chicago Board of Trade.

EXCHANGE-TRADED FUNDS
Week ending January 19 2001

Fund Name	Ticker	Volume	Shares (000)	Net assets ($ million)	Price	NAV	Spread	Return 1 Week	Return YTD	Return 1 Yr
Major market indices										
Nasdaq-100 Index Tracking Stock	QQQ	30 512 100	416 250	27 568.24	66.563	66.60	(0.06)	6.10	14.03	(31.02)
S&P 500 SPDR	SPY	6 221 175	195 675	26 320.24	134.781	135.05	(0.20)	2.11	2.74	(5.68)
DJIA Diamonds	DIA	1 158 100	23 801	2 521.72	106.719	106.86	(0.13)	1.31	(0.06)	(4.05)
iShares Dow Jones series										
iShares DJ US Basic Materials	IYM	4 325	250	8.80	35.125	35.21	(0.24)	(1.83)	(10.44)	
iShares DJ US Chemicals	IYD	2 000	400	15.51	38.531	38.77	(0.62)	(2.38)	(11.61)	
iShares DJ US Consumer Cyclical	IYC	8 150	350	20.72	59.250	59.19	0.10	(0.16)	6.40	
iShares DJ US Energy	IYE	66 450	650	32.44	49.984	49.91	0.15	(4.19)	(9.09)	
iShares DJ US Financial	IYF	30 825	250	20.84	83.563	83.38	0.22	(0.22)	(3.95)	
iShares DJ US Financial Services	IYG	8 600	250	24.27	97.250	97.09	0.16	(0.45)	(1.58)	
iShares DJ US Healthcare	IYH	29 750	900	57.05	63.375	63.39	(0.02)	(1.46)	(11.86)	
iShares DJ US Industrial	IYJ	1 225	400	22.54	56.625	56.35	0.49	1.85	0.22	
iShares DJ US Internet	IYV	26 900	750	25.45	34.156	33.91	0.73	8.22	10.52	
iShares DJ US Non-Consumer Cyclical	IYK	900	350	14.58	41.750	41.65	0.24	0.53	(3.89)	
iShares DJ US Real Estate	IYR	42 075	500	37.62	75.400	75.23	0.23	0.60	(0.72)	
iShares DJ US Technology	IYW	34 250	1 500	132.35	88.438	88.21	0.26	8.68	18.61	
iShares DJ US Telecommunications	IYZ	45 275	1 450	68.05	47.000	46.93	0.15	0.33	21.09	
iShares DJ US Total Market	IYY	7 750	850	53.07	62.516	62.43	0.14	1.91	1.60	
iShares DJ US Utilities	IDU	7 775	300	22.91	76.297	76.37	(0.10)	1.12	(14.06)	
iShares MSCI series										
iShares MSCI-Australia	EWA	10 825	5 600	55.16	9.875	9.85	0.25	1.93	3.95	(7.29)
iShares MSCI-Austria	EWO	7 650	1 400	10.93	7.938	7.82	1.51	1.60	4.96	(3.96)
iShares MSCI-Belgium	EWK	6 750	880	11.23	12.687	12.78	(0.73)	(3.80)	(0.49)	(9.88)
iShares MSCI-Brazil	EWZ	18 025	950	17.55	18.625	18.47	0.84	4.56	12.88	
iShares MSCI-Canada	EWC	10 800	1 300	17.78	13.75	13.67	0.59	6.28	2.80	8.77
iShares MSCI-EMU	EZU	12 250	800	58.30	74.625	74.01	0.83	1.27	1.88	
iShares MSCI-France	EWQ	33 450	3 401	82.20	24.312	24.21	0.42	(1.27)	(1.52)	(2.61)
iShares MSCI-Germany	EWG	65 450	8 401	167.43	20.062	19.96	0.51	0.94	2.88	(15.13)
iShares MSCI-Hong Kong	EWH	67 200	6 001	73.45	12.25	12.25	0.00	4.81	6.52	(2.41)
iShares MSCI-Italy	EWI	51 450	2 400	54.50	22.875	22.74	0.59	(0.54)	1.10	2.15
iShares MSCI-Japan	EWJ	1 145 775	52 201	576.30	11	11.03	(0.27)	4.76	(0.57)	(23.97)
iShares MSCI-Malaysia	EWM	32 425	17 550	90.56	5.375	5.16	4.17	7.50	6.16	(30.93)
iShares MSCI-Mexico	EWW	61 150	2 400	34.61	14.375	14.46	(0.59)	3.60	7.98	(15.29)
iShares MSCI-Netherlands	EWN	5 525	1 651	37.33	22.75	22.63	0.53	(1.62)	0.27	(5.05)
iShares MSCI-Singapore	EWS	25 725	9 900	64.25	6.5	6.49	0.15	(0.96)	0.00	(20.99)
iShares MSCI-South Korea	EWY	49 350	1 350	20.39	15.25	15.11	0.93	5.17	24.49	
iShares MSCI-Spain	EWP	55 650	1 500	37.77	25.375	25.2	0.69	(1.22)	10.62	(1.44)
iShares MSCI-Sweden	EWD	38 800	1 125	22.07	19.5	19.64	(0.71)	2.63	9.09	(21.07)
iShares MSCI-Switzerland	EWL	9 175	3 001	48.77	16.375	16.29	0.52	0.00	(2.61)	6.71
iShares MSCI-Taiwan	EWT	41 100	6 950	88.75	13.75	12.78	7.59	15.18	30.17	
iShares MSCI-UK.	EWU	50 025	9 001	157.25	17.5	17.53	(0.17)	(0.36)	(0.71)	(9.39)
iShares Russell series										
iShares Russell 1000	IWB	16 425	3 400	241.57	71.37	71.06	0.44	2.03	1.67	
iShares Russell 1000 Value	IWD	86 925	2 800	163.10	58.266	58.25	0.03	(0.51)	(2.92)	
iShares Russell 1000 Growth	IWF	36 250	2 300	158.26	69.063	68.81	0.37	4.05	6.87	
iShares Russell 2000	IWM	301 250	4 800	466.80	97.25	97.24	0.01	0.52	1.57	
iShares Russell 2000 Value	IWN	57 425	2 100	241.65	115.25	115.06	0.17	(0.38)	(0.33)	
iShares Russell 2000 Growth	IWO	242 475	450	29.77	66.25	66.16	0.14	2.09	3.21	
iShares Russell 3000	IWV	29 200	4 300	316.87	73.844	73.69	0.21	1.59	1.92	
iShares Russell 3000 Value	IWW	850	1 650	122.08	74.016	73.98	0.05	(0.48)	(3.40)	
iShares Russell 3000 Growth	IWZ	5 250	500	27.25	54.547	54.5	0.09	3.65	5.34	
iShares S&P series										
iShares S&P 500	IVV	65 500	17 550	2 359.60	134.380	134.44	(0.04)	1.70	2.30	
iShares S&P 100 Index Fund	OEF	9 200	2 650	187.01						
iShares S&P Global 100 Index Fund	IOO	3 160	1 600	114.10						
iShares S&P Europe 350 Index	IEV	39 775	1 650	122.07	76.250	74.22	2.74	(0.39)	(0.57)	

(continued over) 12▶

Fund Name	Ticker	Volume	Shares (000)	Net assets ($ million)	Price	NAV	Spread	Return 1 Week	Return YTD	Return 1 Yr
iShares S&P series *(continued)*										
iShares S&P MidCap 400	IJH	67 125	2 100	211.41	100.840	100.67	0.17	(0.71)	(2.36)	
iShares S&P MidCap 400/Barra Growth	IJK	37 200	1 650	194.45	119.200	117.85	1.15	(0.37)	(3.78)	
iShares S&P MidCap 400/Barra Value	IJJ	13 725	2 100	179.53	85.609	85.48	0.15	(0.13)	0.13	
iShares S&P SmallCap 600	IJR	64 375	1 550	169.60	109.130	109.42	(0.27)	(0.16)	0.96	
iShares S&P SmallCap 600/Barra Gwth	IJT	18 925	750	56.70	75.875	75.60	0.36	(0.98)	(3.23)	
iShares S&P SmallCap 600/BarraValue	IJS	31 000	1 550	123.63	79.766	79.77	(0.01)	0.73	3.59	
iShares S&P Toronto SE 60	IKC	1 025	150	8.33	55.125	55.43	(0.55)	3.46	6.01	
iShares S&P 500/Barra Growth	IVW	28 950	2 100	146.75	70.000	69.87	0.19	3.42	2.56	
iShares S&P 500/Barra Value	IVE	51 175	4 800	310.66	64.750	64.72	0.05	0.75	2.17	
SPDRs										
S&P 400 MidCap SPDR	MDY	658 150	45 073	4 169.70	93.250	93.49	(0.26)	0.07	(1.19)	13.32
SPDR Basic Industries	XLB	37 925	4 150	81.34	20.156	20.13	0.13	2.22	(5.91)	(15.35)
SPDR Energy	XLE	63 950	8 150	249.15	30.750	30.64	0.36	(2.43)	(7.35)	7.34
SPDR Financial	XLF	453 325	24 951	705.36	28.391	28.40	(0.03)	0.44	(3.76)	28.86
SPDR Industrial	XLI	13 125	2 100	65.06	31.359	31.25	0.35	1.47	0.35	11.93
SPDR Technology	XLK	541 800	36 600	1 394.09	38.070	38.09	(0.05)	8.68	21.58	(29.01)
SPDR Consumer Staples	XLP	129 350	7 450	191.91	26.016	26.06	(0.17)	1.03	(8.92)	12.86
SPDR Utilities	XLU	15 450	2 550	79.64	31.344	31.27	0.24	0.40	(5.56)	16.65
SPDR Consumer Services	XLV	23 800	2 650	77.64	29.875	29.78	0.32	1.48	9.63	(6.26)
SPDR Cyclical/Transportation	XLY	30 975	3 500	89.92	26.688	26.65	0.14	(0.58)	4.27	(6.78)
streetTRACKS (State Street Global Advisors)										
DJ Global Titans	DGT	4 050	400	31.74	80.188	79.64	0.69	3.34	4.18	
DJ US Large Cap Growth	DSG	1 075	200	16.42	83.250	83.11	0.17	2.27	3.58	
DJ US Large Cap Value	DSV	350	200	22.99	116.813	116.40	0.35	0.87	(0.80)	
DJ US Small Cap Growth	ELG	1 050	400	31.52	79.438	78.74	0.89	5.04	8.63	
DJ US Small Cap Value	ELV	850	400	53.09	133.625	133.89	(0.20	0.92	(2.14)	
Fortune series										
FORTUNE e-50	FEF	1 075	1 000	60.63	59.391	59.80	(0.68	5.38	19.38	
FORTUNE 500	FFF	5 600	250	23.35	94.000	93.77	0.25	2.17	1.71	
Morgan Stanley series										
streetTRACKS MS Internet	MII	4 200	250	8.16	32.063	32.59	-1.62	2.81	15.02	
streetTRACKS MS High Tech 35	MTK	36 975	900	73.12	81.430	81.23	0.25	9.12	21.09	
International Exchange-Traded Funds										
iShares iFTSE 100	ISF	Data not available at press time								
iShares iFTSE TMT	ITMT	Data not available at press time								
DJ STOXX 50 LDRS	SX5P	Data not available at press time								
DJ Euro STOXX 50 LDRS	SX5E	Data not available at press time								

Volume shows average daily volume for the week ending January 19 2001 (4 trading days for US-listed shares); **Shares** shows the number of outstanding shares; **Net assets** for AMEX-traded issues (Data source:Bloomberg) are calculated using the "Underlying Trading Value" or "IOPV." method, based on the outstanding shares at the prior day's close and, as such, are approximations; **Price** shows the closing price on Friday January 19 2001. **Sources** Volume statistics: AMEX, DeutscheBorse; Shares: AMEX, DeutscheBorse; Net assets AMEX/Bloomberg, DeutscheBorse; Price quotations Weisenberg/Thomson Financial, MAR research and other sources; NAVs: Weisenberg/Thomson Financial, DeutscheBorse;; Performance information: Weisenberg/ Thomson Financial, MAR research and other sources.

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EXCHANGE -TRADED FUNDS REPORT

Managed Account Reports, LLC
220 Fifth Ave., 19th Floor
New York, NY 10001-7781
United States of America
Tel: (212) 213-6202
Fax: (212) 213-1870
http://www.marhedge.com

President
Greg Newton
email gnewton@marhedge.com

Editorial
email edit@marhedge.com
Editor
Michael Ocrant
Managing Editor
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Associate Editors
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Marsha Zapson

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Editorial Assistants
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Tracy Taylor
Production Manager
Karyn Fry

Conferences
email conf@marhedge.com
Vice President/Conferences
Lora Ballato
Conference Coordinator
Jennifer Newman
Conference Officer
Jeannie Lee
Subscriptions/Marketing
email subs@marhedge.com
Marketing Manager
Gina Dzurenda

European Operations
International Business Manager
David Setters
Tel: +44 (207) 827-9977
Fax: +44 (207) 827-5236
Publication Consultants
Leon and Joy Rose
11120 Woodelves Way
Columbia, MD 21044
Tel: (410) 730-5359
Fax: (410) 730-3873
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$545 US-Canada
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