ETPs Amidst the Continuing Global Financial Recovery: 2011 Recap and Shifting Dynamics in 2012

2011 had no shortage of unique events that helped to create volatile market returns. These included unrest in the Middle East, the earthquake and subsequent tsunami in Japan, inflationary pressures in the emerging markets, the US credit downgrade and continued concerns of sovereign risk in Europe, to name a few. Place these against a backdrop of historically low interest rates and continued high unemployment around the world, as well as a global economy still feeling the effects of the credit crisis and what would one have? You might expect a precarious market environment; particularly within the global exchange traded product (ETP) market as these vehicles track countless asset classes and markets around the world. However, as evidenced by continuing levels of trading and substantial net new assets into ETPs around the globe, investors are still participating in the investment marketplace.

EXECUTIVE SUMMARY

For the past three years since the global financial crisis in 2008, challenging market conditions and unprecedented volatility have caused a significant shift in investors' appetite for risk. This has ultimately led to a stronger desire for liquidity. During this time, ETPs, which include exchange traded funds (ETFs), exchange traded currency (ETCs), exchange traded commodities (similarly abbreviated ETCs) and exchange traded notes (ETNs), have allowed investors to continue investing in the markets through a fund structure that provides increased transparency in the form of daily holdings, intraday price and performance and greater liquidity as compared to alternative investment vehicles. Since State Street Global Advisors (SSgA) introduced the world's first ETF in 1993, ETF providers have responded by expanding product lines to encompass a wider range of asset classes, including fixed income, emerging market equities and bonds, commodities among others. This paper provides a recap on the eventful year in the ETP industry as well as covers topics that divulge a turning point in the future direction of the market:

- Implications of global ETP turnover dynamics
- Assessing global asset class growth trends for 2011
- Major shifts in investing amidst the continuing global recovery
- The continuing global debate of physical and synthetic ETFs
- Upcoming trends for 2012

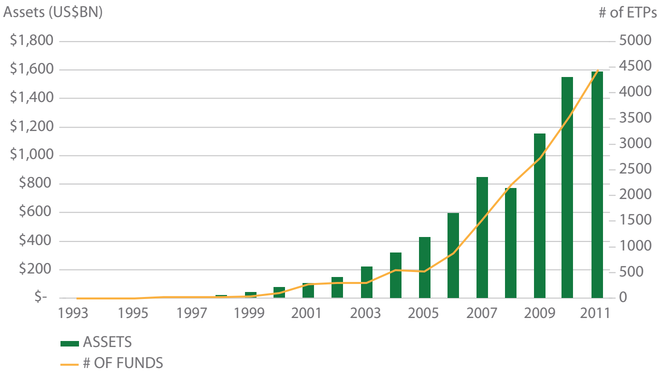
RECAP OF THE CURRENT GLOBAL ETP MARKETPLACE

ETPs offer an easy, cost-efficient way for investors to incorporate various asset classes, investment styles, industry sectors and even commodities to their portfolios. Because most ETPs are passively managed, they generally have low management fees and operating expenses. Like individual stocks, ETPs give investors the flexibility to buy and sell on the major stock exchanges throughout the day, at the market price. However, it's important to keep in mind that frequent ETP trading, which typically occurs through a broker, can significantly increase brokerage commissions, potentially washing away any savings from low fees or costs.

Despite negative market returns during the full year of 2011, investors continued to look to ETPs as a way to take directional views and implement investment strategies, as evidenced by an increase of over US$168bn in net new cash flows into ETPs. At the same time, negative price movements and exchange rate fluctuations resulted in an approximate decrease of US$118bn in the value of assets held by ETPs.

The result is that as at end Q4 2011, total ETP assets under management had increased by US$50bn from their level at the end of 2010 (see Figure 1 on next page). This was further supported their growing popularity with both investors (as demonstrated by the US$168bn of inflows) and providers (as shown by the rise in the number of ETFs – see Figure 1). Comparatively, global mutual funds saw total outflows summing to over US$235bn and experienced negative market movements of US$551bn, bringing the total decline in assets to US$786bn.

FIGURE 1: GLOBAL ETP ASSETS UNDER MANAGEMENT

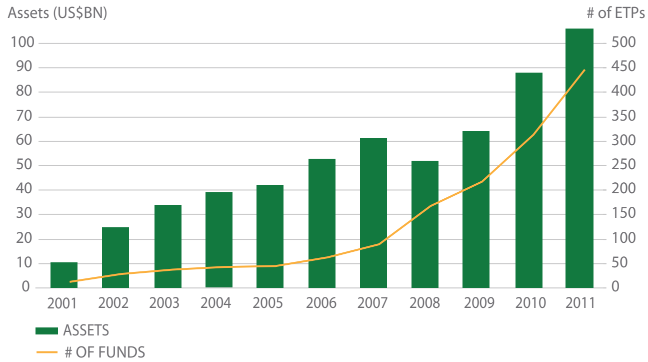


Source: SPDR ETF Strategy & Consulting Group, as of 31 December 2011.

In total, at the end of December 2011, the global ETP industry was represented by 4,458 ETPs and had assets under management of US$1.59tn. These products were offered by 189 providers on 54 exchanges around the world. Comparatively, at the end of 2010, there were 3,667 ETPs and assets of US$1.54tn; a 21.6% increase in number of ETPs and a 3.2% increase in assets. While ETPs are increasingly popular globally, the landscape remains skewed in favor of one market: the United States. The US accounts for 71% of ETP assets under management, as shown in Figure 2 below. However it should be noted that ETP growth in Asia Pacific for 2011 was six and a half times higher than that of the global growth rate. ETP assets in the region totaled US$105.8 billion in assets, representing approximately 7% of global ETP AUM.

However, while other markets are smaller and are likely to remain so, some are seeing rapid growth. Notably, Asia has seen a significant increase in assets held by ETPs within the region during 2011, as net new inflows largely offset negative investment performance (see Figure 3 to the right).

FIGURE 3: ASIA ETP ASSETS UNDER MANAGEMENT



Source: SPDR ETF Strategy & Consulting Group, as of 31 December 2011.

IMPLICATIONS OF GLOBAL ETP TURNOVER DYNAMICS

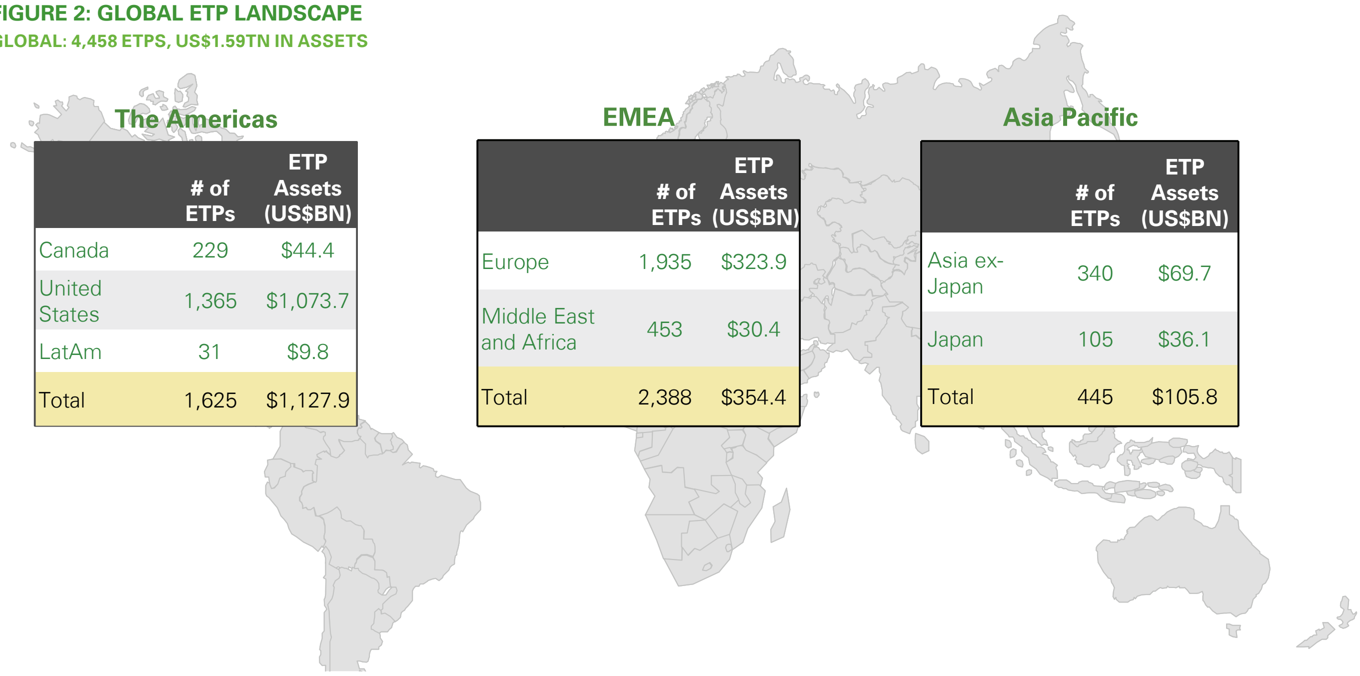
ETP turnover is one of the few factors that determine the liquidity of the ETP market. Liquidity is of high importance to most institutional investors, who can transact in any market they wish and will choose execution venues on the basis of transaction costs rather than location.

The dominance of the US in ETP assets partly reflects the greater development of the US ETP industry and the adoption of ETPs by the large North American institutional investor base. However, ETP turnover statistics illustrate another reason why the US exchanges maintain their lead.

US stock exchanges represent roughly 87% of total global ETP turnover, as shown in Figure 4 on the next page. This is an even greater share than the US's 71% of global ETP assets under management.

FIGURE 2: GLOBAL ETP LANDSCAPE

GLOBAL: 4,458 ETPS, US$1.59TN IN ASSETS



The Americas

	# of ETPs	ETP Assets (US$BN)
Canada	229	$44.4
United States	1,365	$1,073.7
LatAm	31	$9.8
Total	1,625	$1,127.9

EMEA

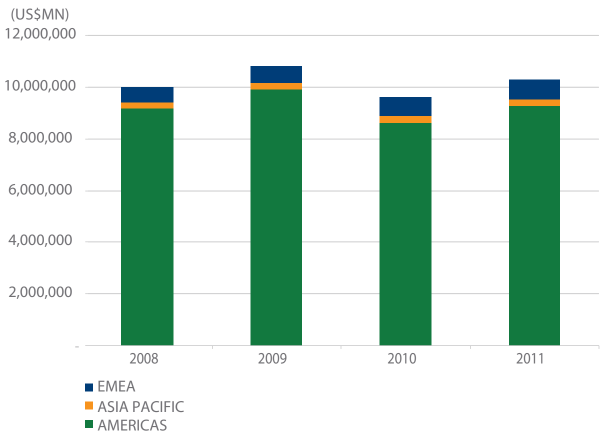
	# of ETPs	ETP Assets (US$BN)
Europe	1,935	$323.9
Middle East and Africa	453	$30.4
Total	2,388	$354.4

Asia Pacific

	# of ETPs	ETP Assets (US$BN)
Asia ex-Japan	340	$69.7
Japan	105	$36.1
Total	445	$105.8

Source: SPDR ETF Strategy & Consulting Group, as of 31 December 2011.

FIGURE 4: GLOBAL ETF TURNOVER BY REGION (ABSOLUTE)



Source: SSgA and World Federation of Exchanges, as of 31 December 2011.

This liquidity advantage reinforces the dominance of the US markets, making it harder for other regions to attract greater institutional trading and increase their share of global turnover. Figure 5 illustrates that Europe and Asia Pacific are managing to grow their share of ETP turnover. In 2011, the EMEA and Asia Pacific regions have increased turnover from the previous year by 32% and 27% respectively, while ETP turnover in the US increased by 5%. While the trend increases are large, the absolute volumes remain relatively small.

In this respect, the US is undoubtedly helped by the high concentration of trading activity on NYSE and NASDAQ. This also indicates that retail investors, supported by a robust financial intermediary channel, are relatively more active in the ETP space, as institutional investors tend to bulk trades to reduce transaction costs. Comparatively, Europe and Asia Pacific are more fragmented and are unable to create the same large pool of liquidity on any single exchange (see Figure 5 below).

FIGURE 5: TOP TEN GLOBAL EXCHANGES BY ETP TURNOVER

NO.	EXCHANGE	TURNOVER (US$MN)	NO. OF TRADES (000)
1	NYSE EURONEXT (US)	4,496,538	220,745
2	NASDAQ OMX	4,308,802	240,956
3	LONDON SE GROUP	313,755	5,115
4	DEUTSCHE BORSE	306,853	2,466
5	NYSE EURONEXT (EUROPE)	198,247	2,648
6	SIX SWISS EXCHANGE	117,165	983
7	TMX GROUP	115,926	8,670
8	KOREA EXCHANGE	108,915	30,508
9	MEXICAN EXCHANGE	90,239	547
10	STOCK EXCHANGE OF HONG KONG	70,076	2,513

Source: SSgA and World Federation of Exchanges, as of 31 December 2011.

ETP turnover and trade activity also divulge a difference in how investors in each region use ETPs. Within Asia, there is a preference for employing them for tactical purposes or transitions, consistent with a generally shorter-term investment culture than in the US and Europe. We can see some evidence of this in terms of the high number of trades relative to the amount of assets turned over in most Asian markets (see Figure 6 below).

FIGURE 6: TOP TEN ASIAN EXCHANGES BY ETP TURNOVER

NO.	EXCHANGE	TURNOVER (US$MN)	NO. OF TRADES (000)
1	KOREA EXCHANGE	108,915	30,508
2	STOCK EXCHANGE OF HONG KONG	70,076	2,513
3	SHANGHAI SE	41,837	4,363
4	TOKYO SE GROUP	34,054	--
5	OSAKA SE	24,615	--
6	SHENZHEN SE	23,479	2,403
7	TAIWAN SE CORP	12,277	1,571
8	SINGAPORE EXCHANGE	7,942	374
9	AUSTRALIA SE	7,764	247
10	NATIONAL STOCK EXCHANGE INDIA	3,481	4,137

Source: SSgA and World Federation of Exchanges, as of 31 December 2011.

This reflects the significance of retail investors in the local ETP market. Moving forward, we predict an increase in retail trading activity outside markets like the US and Korea, where this channel has already permeated the ETF space. In particular, regulatory changes from commission based to fee for service within the financial planner and advisor space in Australia, and elsewhere in the Asia Pacific region, will support the use of ETPs as cost effective vehicles with the investing public. Currently, Korea demonstrates this clearly, with an average size per trade of just US$3,570. Its presence within the top 10 exchanges for ETP turnover seems to be driven by rising retail interest in ETPs.

Korea has been one of the fastest-developing ETP markets in Asia over the last few years: there were 106 listed ETPs at the end of December 2011,[1] up from just 12 five years ago.[2] It's now the eighth most active exchange in the world for ETP turnover and the first in Asia.[1]

Turnover has increased by more than 1,400% during that time,[3] mostly due to retail investor enthusiasm for two products from Samsung Asset Management.[4] These were a leveraged ETF and an inverse ETF, both based on the KOSPI benchmark. During the market volatility seen in 2011, Korean investors made extensive use of these products to trade swings in the markets. The ETPs were being traded with additional leverage through the use of margin loans from retail stock brokers, before the government stepped in to restrict credit-fuelled trading.[5]

Events such as this demonstrate that mere growth in assets and activity are not sufficient. Institutional investors will continue to be concerned about the maturity and the stability of the ETP market and the assurance that liquidity will be available for large trades when required. Thus the US exchanges are likely to continue dominating global ETP activity for the foreseeable future.

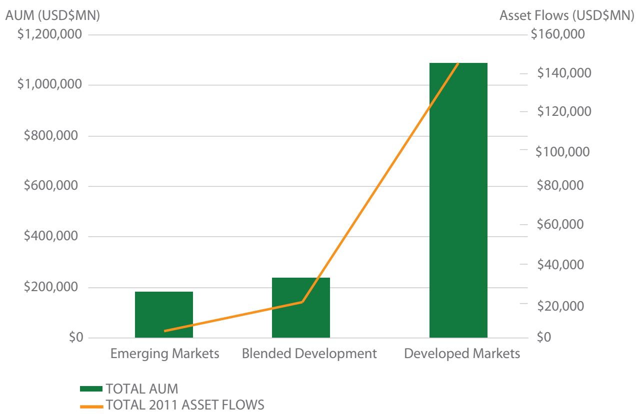
It was especially notable that in the aftermath of the earthquake in Japan in March, US-domiciled ETFs were the main beneficiaries of the resulting rise in trading. Volumes in Japan-related 2011 ETFs hit an all-time high, but Japanese providers were disappointed to see the bulk of inflows go into US-traded products[6]. Excellent liquidity in the US outweighed other potential disadvantages such as tax treatment and tracking error.

ASSESSING GLOBAL ASSET CLASS GROWTH TRENDS FOR 2011

Several trends have been evident in global ETP inflows during 2011. Some were a continuation of themes that seen for the last few years, while others marked a significant reversal.

Most notably, international flows favored developed markets, which saw sizeable net inflows of US$145bn, across all asset classes, including fixed income, equities, currency, alternatives and commodities, at the expense of emerging markets for the first three quarters of the year (see Figure 7 below). During the last quarter of 2011, inflows into emerging markets fixed income offset outflows from its equity class, which brought the overall asset class minimal growth. This trend reflected ongoing concerns about inflationary pressures in emerging markets, particularly in the first half of 2011, coupled with a better than expected outlook for developed markets. For most of 2011, global investors moved toward a more risk averse position due to a growingly unsettled market environment that saw many investors selling off high beta markets like emerging markets to traditionally safer assets in the developed space.

FIGURE 7: GLOBAL ETP AUM OF ALL ASSET CLASSES VS. ETP ASSET FLOWS

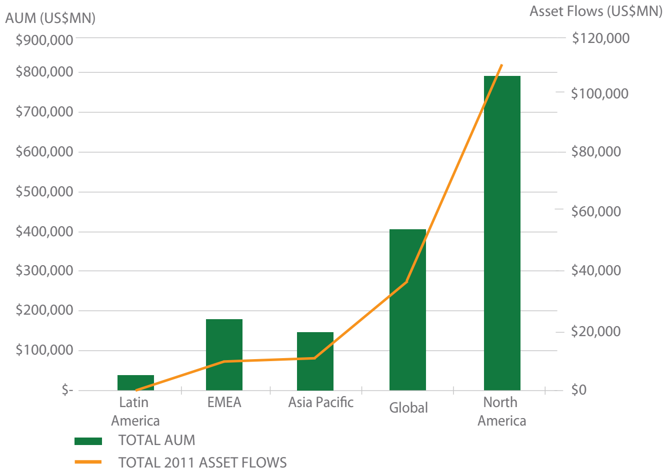


Source: SSgA and Markit, as of 31 December 2011.

Also consistent with the 'flight to safety', the United States – the traditional safe haven for global investors – saw the largest inflows both in absolute terms and relative to assets under management (see Figure 8 below).

This was also affected by the recent US debt downgrade and growing support from the Fed which caused some investors to trade on potential growth from attractive valuations.

FIGURE 8: GLOBAL ETP AUM VS. ETP ASSET FLOWS

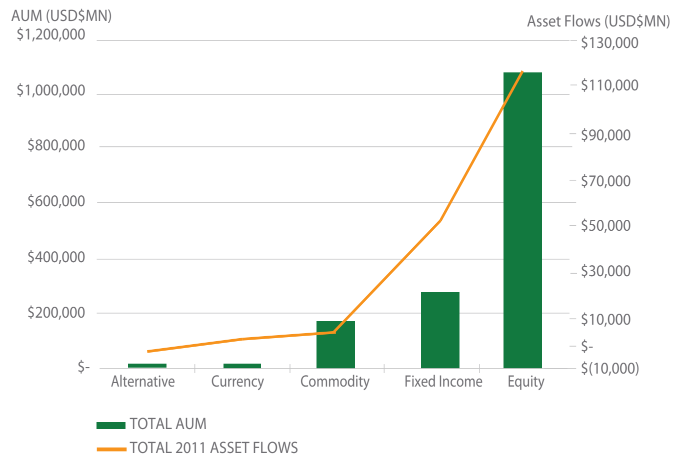


Source: SSgA and Markit, as of 31 December 2011.

At the end of 2011, the Equity asset class was by far the largest in terms of assets under management and attracted the strongest interest with inflows of US$115bn (see Figure 9). Fixed income also performed well with net inflows of US$50bn for the year. Notably, the fixed income asset class grew at a faster rate than equities, at 18% as compared to 10% respectively.

Demand for currency ETPs also saw the asset class grow approximately 30% of its assets under management, albeit from a much lower base. The asset class now stands with total assets of US$7.8bn. Commodity ETPs fluctuated throughout the year as many global equity and commodity markets fell during the course of 2011, however precious metal, and gold ETPs in particular, posted positive returns as investors sought refuge in that historic safe haven. Despite a negative performance in the fourth quarter of 2011, gold prices rose for the year 2011 by 10%[7]. In a period of economic uncertainty and increased volatility across most assets, gold continued to provide investors with a consistent source of diversification, risk management and wealth preservation. Total net inflows into the commodity ETP category at the end of 2011 totaled just over US$4.0bn.

FIGURE 9: GLOBAL ETP AUM ACROSS ASSET CLASSES VS. ETP ASSET FLOWS

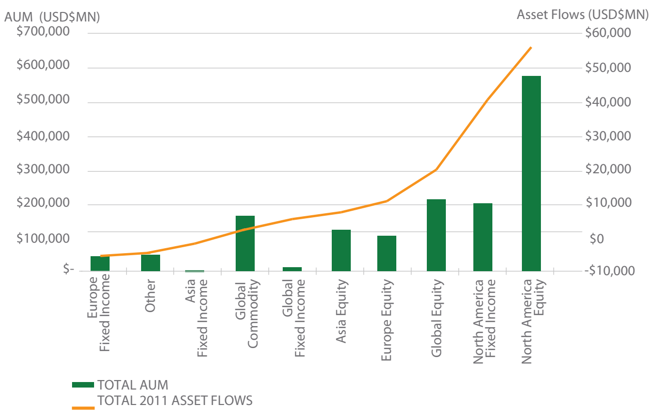


Source: SSgA and Markit, as of 31 December 2011.

A more detailed breakdown of asset class shows that North America equity was the most popular category; comprising 38% of total inflows (see Figures 10). Despite macro-economic challenges in 2011, not only did the US capture the majority of new ETP assets, but the flows into this category outpaced those in 2010. During 2011, the SPDR® S&P 500 ETF accumulated over US$10bn in new assets with other ETFs tracking high-dividend stocks, US market-cap segments and US sectors trailing behind.

At a close second, North America fixed income-focused funds made up 27% of total net inflows. As evidenced by weak or negative net flows into other fixed income classes, this was driven less by income-seeking and more by a flight into the security of US Treasuries during a period of market unrest. The decision by ratings agency Standard & Poor's to downgrade the US government's credit rating by one notch in early August has clearly had little effect on ETP investors' perception of the attractiveness of US debt.

FIGURE 10: ETP AUM ACROSS MARKET ASSET CLASSES VS. ETP ASSET FLOWS



Source: SSgA and Markit, as of 31 December 2011.

Global equity, Europe and Asia equity were also in demand; with these three regional equity categories collectively accounting for around 28% of net inflows (see Figure 11 below). While not in the top 5, the Global fixed income category posted a notable growth of 117% from its end-2010 assets under management, indicating a significant increase of interest to fixed income by investors around the world.

FIGURE 11: ETP CATEGORIES WITH HIGHEST INFLOWS

ETP CATEGORY	2011 NET FLOWS (US$MN)	% OF INFLOWS	% GROWTH
NORTH AMERICA EQUITY	$66,123	37.7%	12.9%
NORTH AMERICA FIXED INCOME	$47,691	27.2%	30.7%
GLOBAL EQUITY	$24,877	14.2%	12.9%
EUROPE EQUITY	$14,178	8.1%	14.9%
ASIA EQUITY	$10,502	6.0%	9.1%
GLOBAL FIXED INCOME	$14,414	4.6%	117.0%

Source: SSgA and Markit, as of 31 December 2011.

The weakest performing asset classes were European fixed income and Alternatives both of which saw moderate flows of -US$4bn, -US$3bn respectively (see Figure 12 below). All of these reflected global investors withdrawing from what were perceived to be riskier assets.

FIGURE 12: ETP CATEGORIES WITH HIGHEST OUTFLOWS

ETP CATEGORY	2011 NET FLOWS (US$MN)	% OF OUTFLOWS	% GROWTH
EUROPE FIXED INCOME	-4,184	56.4%	-8.2%
OTHER (ALTERNATIVES, CURRENCY, ETC)	-$3,228	43.6%	-5.5%

Source: SSgA and Markit, as of 31 December 2011.

MAJOR SHIFTS IN INVESTING AMIDST THE CONTINUING GLOBAL RECOVERY

While the first half of 2011 has presented investors with a host of significant market events and diverging trends, some investment themes have managed to stay consistent.

INCOME GENERATION

One multi-year trend that has continued into 2011 is the increased investment in ETPs that provide exposure to high dividend paying stocks. With government bond interest rates near historic lows and cash rates virtually at zero, investors have been starved for income in their portfolios. Investors have embraced the notion of "getting paid while they wait," rather than counting on capital appreciation. Dividend-oriented ETPs offer the potential for capturing much of the upside of traditional equities while providing higher yields. Historically, dividend income has contributed approximately one third of total equity returns to the S&P 500® Index. This percentage has historically been even greater in the international markets.

INFLATION PROTECTED SOLUTIONS: REAL ASSETS, COMMODITIES AND GOLD

Global prices for commodities and energy have been rising and the second round of quantitative easing (with proposals for a third round on its way) in developed economies has pumped over US$700bn into the economy on top of the US$1.7tn spent between late-2008 through 2011. As the world economy recovers, it could lead to heightened demand, especially from countries such as China and India. While supply is adequate for now, concerns still exist if asset preference shifts.

In response to all these factors, investors have been looking for strategies that can potentially deliver positive returns during rising inflation conditions since inflation erodes the purchasing power of consumers. Considered as non-traditional by investors, real assets are tangible physical things. But the real asset strategies used by certain suitable investors may take a broader approach, investing in bonds that are inflation-linked and in stocks of companies involved in commodities or natural resources, among others. Inflation protected securities like TIPS and Linkers are considered real assets because the value of these securities is linked to indices that measure the prices of food, energy and other consumer goods.

One of the most popular commodity investments of 2011 has been gold. As an investment, gold offers investors an attractive opportunity to diversify their portfolios—potentially reducing overall portfolio risk. Its measured appreciation and lack of correlation highlighted the unique role gold plays as a consistent vehicle for diversification, risk management and wealth preservation. The momentum of the gold spot price, as it reached a record high of US$1920.30 in September 2011, encouraged continued expansion in this asset class.

Since the first gold ETF was launched in 2004, gold ETPs have fully established themselves as an integral vehicle for accessing the gold market. As with any asset class, investors turn to gold for both tactical and strategic investment reasons. The tactical case has been driven by the positive price outlook associated with strong demand and tight supply for gold. The strategic case is driven by the investment diversification benefits of gold. Numerous institutions have been attracted by the investment attributes of gold — as a diversifier, as a safe haven during volatile times and as a hedge against inflation and dollar weakness. Global hedge funds, asset managers, broker/dealers, pension funds and endowments have all turned to gold as exemplified by their holdings in gold ETFs. The continued growth in this asset class may continue to be driven by the uncertainties in the global market, rising inflation and the search for a valued asset.

FIGURE 13: TOP GOLD-BACKED ETFS BY SIZE*

FUND	VOLUME (TONNES)	VALUE (US$MN)	% OF TOTAL	EXCHANGE**	REGION
SPDR GOLD SHARES (GLD)	1,208.2	58,481	56.1%	NYSE	North America
ZKB GOLD ETF	196.0	9,489	9.1%	SIX Swiss SE	Europe
ISHARES GOLD TRUST	144.3	6,983	6.7%	NYSE	North America
ETFS PHYSICAL GOLD	131.5	6,367	6.1%	London SE	Europe
GOLD BULLION SECURITIES – UK	115.3	5,583	5.4%	London SE	Europe
JULIUS BAER PHYSICAL GOLD	95.4	4,618	4.4%	SIX Swiss SE	Europe
XETRA-GOLD	49.0	2,371	2.3%	Deutsche Boerse	Europe
NEWGOLD	48.1	2,328	2.2%	Joannesburg SE	Africa
CS II GOLD ETF	42.4	2,051	2.0%	SIX Swiss SE	Europe
ETFS PHYSICAL SWISS GOLD SHARES	28.6	1,383	1.3%	NYSE	North America
UBS INDEX SOLUTIONS - GOLD ETF	25.0	1,209	1.2%	SIX Swiss SE	Europe
SOURCE GOLD ETC	24.6	1,190	1.1%	London SE	Europe
DB GOLD ETC	23.6	1,143	1.1%	Deutsche Boerse	Europe
GOLD BULLION SECURITIES - AUSTRALIA	14.7	714	0.7%	Australian SE	Asia-Pacific
ETFS PHYSICAL SWISS GOLD SHARES	6.2	298	0.3%	London SE	Europe
GOLDIST	1.4	70	0.1%	Istanbul SE	Middle East
RBS PHYSICAL GOLD	0.8	40	0.0%	Deutsche Boerse	Europe
DUBAI GOLD SECURITIES	0.2	7	0.0%	Nasdaq Dubai	Middle East
TOTAL	2,155.3	104,325	100.0%		

* The only fully gold-backed gold ETFs are included. Tonnage as of 30 June 2011. When data is unavailable, holdings have been calculated using reported AUM numbers.

** This column contains the primary exchange of where the ETF is listed. "SE" stands for stock exchange.

Source: Respective ETF/ETC providers, Bloomberg, LBMA, World Gold Council.

BROADENING PORTFOLIOS WITH INTERNATIONAL EXPOSURE

Around the world, most investors exhibit a significant home country bias in their portfolios. According to the 2010 World Wealth Report, high net worth investors in North America, Europe and Asia Pacific held between 59% and 76% of their portfolios in their local regions. North American investors demonstrated the most home bias, holding only 24% of assets outside North America. Similar data can be found from an analysis by Cerulli Associates of mutual fund and separate account wrap programs at brokerage firms. In the second quarter of 2010, they found that only 15-16% of those accounts were invested in international equities.

We expect to see ETP investors continue to expand allocations to markets outside their home country. One critique of international diversification has been the increase in correlations among US, European, Asian and emerging market equities. However, untapped opportunities such as small cap and sector-based equities remain in various regions. It is important to note that while correlations across global markets have increased, market performances across the world vary significantly. For example, year-to-date performances at the end of the third quarter, the US was up 2.1% as measured by the S&P 500, and International Developed markets were down 11.7% as measured by the Global Dow Index, and Emerging Markets were down 20.7% as indicated by the S&P Emerging BMI Index.

ACTIVELY MANAGED ETPS

Traditionally, ETPs have been viewed as a way to invest in passively managed strategies. However, the ETP structure is also capable of holding actively managed portfolios, thereby combining the transparency, liquidity and ease of dealing with the possibility of obtaining above-market returns due to manager skill.

At present, the number of actively managed ETPs is small. In the United States, which accounts for the vast majority of such products, actively traded ETPs hold around US$5bn in assets, according to Morningstar.[8] The majority of that US$5bn was in fixed income strategies, with over half concentrated in three funds.

This may be explained by the typical requirement that an active strategy exhibits a solid 3-year track record before US investment professionals will invest significant amounts. In addition, there are concerns that regular disclosure of these products' portfolios will put them at disadvantage, since hedge funds and other investors could identify and trade ahead of transactions by the ETP.

However, the industry should be able to educate investors that actively managed ETPs should be compared with traditionally managed mutual funds on cost, rather than with passive funds; on this basis, they compare very well. Meanwhile, many providers are deliberating the question of how to shield these products from 'front-running', with potential measures including less regular disclosure of portfolio holdings.

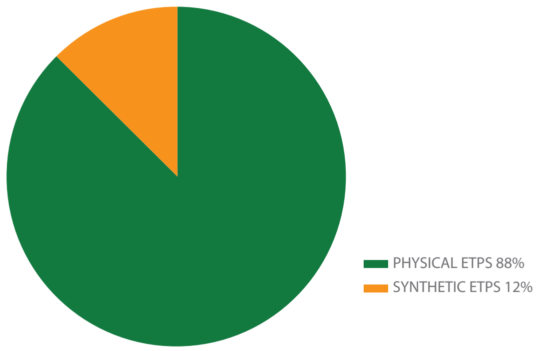
A number of major fund management groups are now launching actively managed ETPs. With investors increasingly convinced by the low costs and liquidity of ETPs for passive strategies, they are likely to begin embracing ETPs for active strategies as appropriate products appear in the market.

THE CURRENT PHYSICAL AND SYNTHETIC ETP LANDSCAPE AND FUTURE TRENDS

Serious concerns from global regulators, including the Financial Stability Board (FSB), Bank of International Settlements (BIS), the Reserve Bank of Australia (RBA), the International Monetary Fund (IMF) and the Hong Kong Securities and Futures Commission (SFC) regarding the use of derivatives for synthetic ETPs pervaded the global ETP market during 2011. Synthetic ETPs have allowed for greater diversity in product creation as this structure provides a low-cost solution to gaining access to asset classes that are not accessible through the physical replication model. Additionally synthetic ETPs may provide closer tracking to the underlying benchmark. However investors should understand the potential added risks to this tracking method.

Much of the recent concern centers on the complexity and added risks that synthetic ETPs take on relative to the physically-backed ETP structure. Currently, the majority of ETPs are physically-backed (see Figure 14 below). However the use of synthetic strategies has risen over the last five years; in Europe – where synthetic ETFs are most widely used – synthetic ETF assets under management are up approximately three-fold over five years, while physical ETF assets grew at around half that rate[9].

FIGURE 14: GLOBAL ETPS BY PRODUCT STRUCTURE



Source: SSgA and Markit, as of 31 December 2011.

While physical ETPs involves the manager purchasing all or a representative sample of the securities in the same proportion as the underlying index, synthetic ETPs are in most cases implemented through the purchase of total return swaps. The synthetic ETP provider enters into an agreement with one or more investment banks or counterparties in which the counterparty agrees to deliver the return of the underlying index, typically minus a spread, in exchange for the performance of a pool of securities that is held in the name of ETP.

Should the counterparty default, this collateral pool, or assets held, provides recourse for investors in the ETP. To minimise the risks, some synthetic providers over-collateralize the swap and/or use multiple swap counterparties. Rules on this matter may vary by jurisdiction.

A synthetic ETP should track the underlying index closely, but may also incur added hedging costs which may result in tracking error. In general, this type of ETP does not physically hold the index's component shares and may further lend the collateral onwards, increasing the leverage of the underlying assets.

SPDR
State Street Global Advisors

The synthetic fund structure has been criticised for introducing potential opacity, complexity and credit risk to ETP products and some believe may offer systemic risks if misused.

These issues are at the root of regulators' concerns and are reflected in recent changes to ETF regulations in some jurisdictions. The most notable of these was the Hong Kong SFC's decision to strengthen collateral requirements on ETPs based in the territory[10].

Hong Kong-domiciled synthetic ETPs are predominantly used to provide foreign investors with access to the China A share market. Owing to the restrictions imposed by the Qualified Foreign Institutional Investor scheme (QFII) and associated foreign exchange quota system, it is impractical for an ETF to hold A shares directly. The ETFs instead invest in derivatives called China A-Share Access Products (CAAPs) that are issued by an institution that has a QFII quota.

Under the previous rules for synthetic ETPs in Hong Kong, the ETP was only required to hold collateral from counterparties to CAAPs or other similar swaps when the net exposure to that counterparty exceeded 10%. Since this 10% limit applied per counterparty and many A-Share ETFs had multiple counterparties, the total uncollateralized exposure could exceed 10% by a substantial amount. Some ETPs had less than 30% of their gross exposure collateralized[11].

The new regulations represent a significant strengthening of the rules. Hong Kong-domiciled synthetic ETPs are now required to have 100% of their gross exposure collateralized plus an additional buffer of collateral as a safety measure. The face value of equities supplied as collateral must exceed 120% of the exposure they are collateralizing. This is expected to significantly increase the costs of such ETPs.

Whether these types of measures and the associated publicity surrounding synthetic ETPs will diminish their attractiveness remains to be seen. In some instances a synthetic structure may offer the only practical exchange traded vehicle that can provide efficient exposure to a specific asset class. However, it may be noteworthy that recent trends in the European market may have shown physical ETFs gaining at the expense of synthetic products.

European physical ETF assets under management are roughly flat since the beginning of the year, with net inflows offsetting investment performance. Conversely, synthetic ETFs have shown a decline in assets under management as net outflows compounded with negative market performance[12].

While this may require the industry to adapt, regulators are right to take appropriate measures to ensure the safety of ETPs. Going forward, it is in the interest of ETP providers that investors understand the characteristics of the products they are investing in and make choices accordingly. In order to achieve this objective, it is incumbent on all providers to be as open and transparent about their products as possible.

CONCLUSION

2011 has been a volatile time for investors and uncertainty over many issues remains. There is a growing consensus of slower economic growth for 2012.

However, the ETP industry has performed well in 2011, drawing net new assets of more than US$168bn by the end of December 2011. This reflects the ongoing realization by investors of how ETPs can improve the execution of their investment strategies.

In addition to their low fees, ETPs can offer high liquidity and ease of trading allied to a transparent and reliable framework. Such traits are especially in demand during uneven market conditions.

Looking ahead to 2012, one may reasonably anticipate the following for the ETP industry:

1. The search for diversification may continue, as investors try to add investments with low or negative correlations to stock and bond investing, which typically can be found in commodities or other alternatives. ETPs that track the global equity and fixed income markets may continue to be areas of future growth.
2. Investors may continue to seek income-oriented investments, whether it is with dividend-oriented ETPs or fixed income ETPs with higher yields, such as high yield bonds, convertible bonds or preferred stocks.
3. There may be a greater emphasis on inflation protected and lower duration bonds, as investors become increasingly wary of increased inflationary pressures and potential rate hikes both in the US and around the world in the years ahead.
4. With a recent increase in active ETP filings and after relatively slow growth to date, actively managed ETPs may begin to gain traction.
5. The use of synthetic products will remain a matter of significant debate among investors and regulators.
6. ETP assets and activity will continue to grow strongly and increase market share on many non-US exchanges, including in Asia. Considerations of liquidity may mean that many global institutional investors will continue to direct a large share of trading towards US exchanges.
7. Introductions to new asset classes and niche markets will continue to increase globally as countries continue paving the way for new ways to access the market. For example, in 2011 Australia's regulation now allows for the country to introduce its first fixed income ETF.

ABOUT SPDR® ETFS

Offered by State Street Global Advisors ("SSGA"), SPDR ETFs are a family of exchange traded funds that provide investors with the flexibility to select investments that are precisely aligned to their investment strategy. Recognized as the industry pioneer, State Street Global Advisors created the first ETF in 1993 – SPDR S&P 500®[13] which is currently the world's largest ETF.[14] SSgA introduced ETFs in Asia Pacific in 1999 when it launched the Tracker Fund of Hong Kong.[13] Since then, SSgA has introduced Singapore's first ETF, the SPDR Straits Times Index ETF.[13] Currently, State Street Global Advisors manages approximately US$274 billion of ETF assets worldwide.[15]

For comprehensive information on our ETFs, visit us at globalspdrs.com.

STATE STREET GLOBAL ADVISORS ASIA LIMITED
68/F, Two International Finance Centre
8 Finance Street, Central, Hong Kong
+852 2103 0100

STATE STREET GLOBAL ADVISORS SINGAPORE LIMITED
COMPANY REGISTRATION NO.: 200002719D
168 Robinson Road, #33-01 Capital Tower
Singapore 068912
+65 6826 7500

1 Deutsche Bank Asia Pacific ETF Weekly Review 5th October 2011, page 5, figure 6
2 Samsung Asset Management Overview of Korean ETF Market, page 8
3 Deutsche Bank Asia Pacific ETF Weekly Review 5th October 2011, page 19, figure 40
4 Deutsche Bank Asia Pacific ETF Weekly Review 5th October 2011, page 22, figure 48
5 Asian Investor "Korea Welcomes Cooling Move After ETF Trading Triples" 30th August 2011, at http://www.asianinvestor.net/News/268449,korea-welcomes-cooling-move-after-etf-trading-triples.aspx and in accompanying pdf
6 Asian Investor "Japan ETF Managers Intent On Recapturing Trading Flows" 14th September 2011 at http://www.asianinvestor.net/News/271751,japan-etf-managers-intent-on-recapturing-trading-flows.aspx and in accompanying pdf
7 London Bullion Market Association (LBMA), as of 30 September 2011.
8 Morningstar "Active ETFs: A State Of The Union" 15th September 2011 at http:// news.morningstar.com/articlenet/article.aspx?id=394478 (and http://finance.yahoo.com/news/Active-ETFs-A-State-Union-ms-615849178.html?x=0 for anyone without at Morningstar login)
9 BlackRock ETF Landscape Industry Highlights End Q3 2011, page 37 (note this refers to ETFs rather than ETPs and excludes certain products, predominantly commodities – hence wording of paragraph to say ETF rather than ETP)
10 Hong Kong SFC "Enhanced investor protection for domestic synthetic ETFs" 29th August 2011 at http://www.sfc.hk/sfcPressRelease/EN/sfcOpenDocServlet?docno=11PR101
11 BlackRock announcement 29th August 2011 at http://hk.ishares.com/content/stream.jsp?url=/content/hk/en/newsroom/notices/docs/iShares-Asia-Trust-Announcement-29Aug11.pdf
12 Deutsche Bank European ETF Market Monthly Monitor 30th September 2011, page 19 figure 38 and page 20 figure 40
13 The ETFs mentioned herein are offered in limited jurisdictions only and may not be available for certain investors.
14 Bloomberg, as of 31 December 2011.
15 As of 31 December 2011. This AUM includes the assets of the SPDR Gold Trust (approx. US$63 billion as of 31 December, 2011), for which State Street Global Markets, LLC, an affiliate of State Street Global Advisors serves as the marketing agent.