
THE ETF REPORT COMPENDIUM

July 2010

Featured Companies

iShares S&P/Citi International Treasury Bond (IGOV)
iShares Russell 2000 Index Fund (IWM)
iShares MSCI Emerging Markets Index (EEM)
PowerShares DB Agriculture (DBA)



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Murray's Musings

Product Lifecycle: Volatility and ETF Construction

The Russell 2000 rate of return since December 31, 1986 is 7.8% per annum. That nearly 25-year rate of return is interesting, because the iShares Russell 2000 Index ETF (IWM) has a rate of return of 4.31% since its inception on May 22, 2000. The table below lists the rate of return in the calendar years from 2001 to 2009 of the iShares Russell 2000 Index (IWM) alongside the NAV-based rate of return and the market total returns of the Nuveen New York Performance Plus Muni (NNP) closed-end fund that buys New York tax-exempt bonds. The pre-tax annualized rate of return for the Russell 2000 ETF is 4.22%. The annualized NAV-based rate of return for the Nuveen New York Performance Plus is 6.1%. Clearly, the Nuveen fund is more tax-efficient, so if one were to tax-adjust these numbers, the gap would be yet greater.

Over the same time period, the market-based rate of return of the Nuveen fund is 6.61%, which more or less approximates its NAV-based return. Making some crude heuristic allowance for the taxes that might have been paid if one owned the Russell 2000 ETF from 2001 through 2009, it doesn't require a great stretch of the imagination to say that the tax-free bonds offered, on an after-tax basis, double the rate of return of the iShares Russell 2000 ETF.

	<u>iShares Russell 2000 (IWM)</u>	<u>Nuveen New York Performance Plus Muni (NNP)</u>	
	Market Total Returns (%)	NAV-Based Total Returns (%)	Market Total Returns (%)
12/31/2001	1.78	5.03	10.13
12/31/2002	(20.37)	14.41	14.88
12/31/2003	47.58	7.62	15.15
12/31/2004	18.05	6.25	(0.34)
12/30/2005	4.46	4.37	11.17
12/29/2006	18.27	5.33	6.27
12/31/2007	(1.76)	2.03	(7.09)
12/31/2008	(34.15)	(10.80)	(22.48)
12/31/2009	28.51	23.98	43.97
Cumulative	45.04	70.44	77.86
Annualized	4.22	6.10	6.61

Source: Bloomberg

Even the Nuveen New York Performance Plus has a certain amount of uncomfortable variability attached to its rate of return, as evidenced by the numbers for the years 2007 and 2008. Nevertheless, the variability is distinctly less than that of the iShares Russell 2000 ETF. If one takes variability in market price as a measure of risk, one might

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rhetorically ask—because no answer will be offered here—what rate of return on the iShares Russell 2000 ETF would be required to make it an acceptable rate of return relative to the Nuveen fund.

The modern approach to volatility control is to take inherently volatile securities like those in the Russell 2000, and blend them with other inherently volatile securities. The object is to find instrumentalities that vary relative to each other to dampen the volatility by the proper admixture of those securities. That approach clearly didn't work out very well in 2008.

The table below lists a variety of other ETFs that had negative rates of return, including the iShares Dow Jones Select Dividend Index Fund (DVY), a dividend-related ETF of scale.

2008 Total Returns for Selected ETFs (%)	
iShares S&P 500 Index Fund (IVV)	(36.94)
iShares Russell 2000 Index Fund (IWM)	(33.66)
iShares S&P GSCI(R) Commodity-Indexed Trust (GSG)	(47.47)
iShares iBoxx \$ High Yield Corporate Bond (HYG)	(23.89)
iShares iBoxx \$ Investment Grade Corporate Bond Fund (LQD)	(0.34)
iShares JPMorgan USD Emerging Markets Bond Fund (EMB)	(11.81)
iShares MSCI Emerging Markets Index Fund (EEM)	(50.01)
iShares MSCI EAFE Index Fund (EFA)	(43.14)
iShares Dow Jones Select Dividend Index Fund (DVY)	(32.99)

Source: iShares website

One could have escaped those negative returns in Treasuries. Below is another table that lists three Treasury ETFs with different maturity ranges. These ETFs offered great rates of return but, given the low level of rates at the current time, it's hard to imagine that the returns experienced in 2008 could be replicated. There's a fair amount of risk in owning them if rates should one day rise, and most people believe that they will.

2008 Treasury Bond ETF Returns and Distribution Yield

	Returns (%)	Distribution Yield (%)
iShares Barclays 7-10 Year Treasury Bond Fund (IEF)	18.02	3.17
iShares Barclays 10-20 Year Treasury Bond Fund (TLH)	20.08	3.30
iShares Barclays 20+ Year Treasury Bond Fund (TLT)	33.77	3.75

Source: iShares website

One may ask what the sources of variability are and whether or not it is possible to control variability using ETFs. Interest rates are one source of variability and, when they rise, all financial assets are worth less. One way to reduce the variability, in principle, would be to sell those securities short and accept the negative carry. If rates were to rise, that strategy might presumably offset some of the variability that one would otherwise experience. It's

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easier just to sell short the U.S. Treasury bonds of the appropriate maturity, rather than short the ETFs themselves but, in principle, one could do that as well.

Credit spreads affected the 2008 experience dramatically. Another way to reduce the variability would be to look for a bond fund holding bonds with deteriorating credits. That approach might have helped if it had been employed in 2008. However, if one accepts the thesis that many nations are on the precipice of eroding the market's perception of their creditworthiness, the S&P/Citigroup International Treasury Bond Fund (IGOV) looks interesting. I'll discuss this topic more in the *Featured Companies* section.

This Treasury Bond ETF has large exposures to many of the nations that are said to have deteriorating credits. For example, the fund has a weight of 4.69% in Greece, 4.93% in Spain, 9.39% in Italy, and 24.25% in Japan. The distribution yield on this fund is 1.12%, and the weighted average maturity is 8.45 years. There are other examples in this fund of presumably deteriorating credits, but there aren't very many ETFs with those characteristics. Also, it's not entirely clear that the credit worthiness of those nations will actually be called into question in the way people suggest. There will be more on that subject in the *Featured ETFs* section.

Another approach would be to look at the product lifecycle as another source of variability. How could one illustrate the ever-shortening product lifecycle? The equity holdings of Berkshire Hathaway offer an example. The table below lists that company's equity portfolio as it existed—in terms of names, not in terms of weights—on September 30, 1985.

Berkshire Hathaway Portfolio as of September 30, 1985

Burroughs
Capital Cities/ABC
City National
FirsTier
GEICO
Handy & Harman
National Service Industries
R.J. Reynolds
Washington Post
Wesco Financial

Source: Train, John. *The Midas Touch*. New York: Harper & Row, 1987. (page 174)

Burroughs Corporation was a computer company. Berkshire Hathaway might have done well on the trade but, at the end of the day, it was a trade, because the fundamental situation of Burroughs was ever-worsening, and that company is no longer a factor in the world of computers. Berkshire Hathaway held a position in Cap Cities/ABC, which eventually became part of Disney, a position that Berkshire Hathaway held for a while.

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Cap Cities/ABC was a fabulous company for some time but, at the moment, the fundamentals of network and cable television are deteriorating.

Berkshire Hathaway also owned National City Corporation, which was a California bank that was a successful long-term investment. National City has successfully grown the company by acquisition for some decades. There was a large position in GEICO, which ultimately was bought out by Berkshire Hathaway and became a wholly-owned subsidiary. There was a position in Handy & Harman, which was a silver producer and precious metals refiner that filed for bankruptcy in March of 2000. The portfolio also included National Service Industries, historically a conglomerate involved in many activities. The only element of that company that still exists is Acuity Brands, which is a company that makes lighting equipment. The other businesses were sold. Berkshire owned a small position in FirstTier Inc., a small Omaha bank. Also in the portfolio was a position in R.J. Reynolds, whose fundamentals have deteriorated over the years.

The *Washington Post*, was in the portfolio in 1985. I personally believe that it is a good company, and its best days might yet be ahead of it. Nevertheless, it's certainly true to say that its fundamentals have deteriorated over the years, not only in the newspaper business, but also in network television and the magazine business, including *Newsweek*. Wesco Financial, which became a truly successful investment over the years, was also on the list holdings and it has appreciated more than tenfold. The two best investments in that group of companies are clearly Wesco Financial and GEICO. What is the common denominator of those two companies? It is that the business that each engages in today is not radically different from the business as it existed in 1985. Coincidentally, those two investments happen to have the longest product lifecycle.

Industry Thoughts

Product Lifecycle: Variability in ETF Returns

To illustrate the importance of product lifecycle, I'll use the U.S. consumer goods sector and the Dow Jones U.S. Consumer Goods Sector Index Fund (IYK). The table below shows the ten largest companies in this ETF. The largest weight is Procter & Gamble at 14.92%, and the second-largest is Coca-Cola at 9.29%.¹ This fund is a good example of one of the issues relating to ETF construction. The business and return dynamics of Coca-Cola are not radically different from the return dynamics of Procter & Gamble. If, for whatever reason, misfortune should befall Procter & Gamble, it happens to be nearly 15% of the portfolio.

iShares Dow Jones US Consumer Goods Sector (IYK)

Procter & Gamble	14.92%
Coca Cola	9.29%
Pepsico	8.41%
Philip Morris International	7.72%
Kraft	3.88%
Altria	3.69%
Colgate-Palmolive	3.38%
Ford	3.27%
Monsanto	2.50%
Kimberly Clark	2.14%

Source: iShares website

The table below lists the ROEs and net profit margins over the last 10 years of Coca-Cola, Procter & Gamble and Kimberly Clark. I think that the readers will see that the metrics for these companies are not radically different from each other. Therefore, there's no advantage, from the point of view of structuring the ETF, of making Procter & Gamble a much larger position than Coca-Cola, or of assigning Kimberly-Clark the smallest weight among the top holdings.

¹ Weights are as of Friday, July 16, 2010.

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	<u>Coca Cola (KO)</u>		<u>Procter & Gamble (PG)</u>		<u>Kimberly Clark (KMB)</u>	
	ROE (%)	Net Profit Margin (%)	ROE (%)	Net Profit Margin (%)	ROE (%)	Net Profit Margin (%)
2000	23.4	12.5			31.2	13.9
2001	35.0	22.7	24.3	7.1	28.5	12.1
2002	33.7	20.3	31.8	10.5	28.8	12.3
2003	30.9	20.8	32.0	11.7	24.3	11.7
2004	30.4	22.3	35.6	11.7	26.7	11.7
2005	29.8	21.1	37.5	12.0	28.4	9.9
2006	30.0	21.1	13.8	12.5	24.6	9.0
2007	27.5	20.7	14.5	13.1	34.9	10.0
2008	28.4	18.2	16.2	14.0	43.8	8.7
2009	27.5	22.0	16.9	13.7	34.9	9.9

Source: Bloomberg

In an ETF sense, one way that the variability might be somewhat reduced for the sector funds would be to approach it from an equally-weighted standpoint. If the variability problem occurs in one of the small-weighted companies, it obviously would not be relevant for the ETF. However, if the problem happened in the largest weighted company, it would destroy the entire investment thesis of the ETF. It's hard to imagine one company in that sector being so much more outstanding than the others.

There is yet another way to approach the sources of variability, and that's from the point of view of product lifecycle. There are some interesting companies that qualify, in an SIC Code sense, for inclusion in the ETF that have much shorter product lifecycles than a company like Coca-Cola. Two obvious examples are Philip Morris International and Altria. Philip Morris International is 7.72% of the ETF. It is a cigarette company and, although tobacco liability is not treated with the same seriousness outside the U.S., other nations are making strenuous efforts to have their populations smoke less. It's always possible that there will be liability in the future. Altria is the second-largest of the shorter product lifecycle companies in this ETF. It has a weight of 3.69%. It has been a fine stock, but it does have this issue of variability.

The more variable companies in this ETF are listed below. The third-largest of this group is Ford Motor Company. Though it's a consumer durable, not a consumer staple, it qualifies to be in this sector, because its end user is the consumer. Had the ETF been organized around the question of consumer staples only, it wouldn't have consumer durables in it, so Ford wouldn't be included. Johnson Controls, which is not in the top ten holdings, has a 1.65% weight in the ETF. It makes automobile parts and other durable goods, so it is included for the same reason as Ford.

Nike makes sneakers, and one could argue that competition in the sneaker business makes it much more volatile than the likes of Coca-Cola and Procter & Gamble. In theory, it

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could be eliminated. Lorillard, another a tobacco company, is included. It is a recent spin-off of the Loews Corporation.

<u>Sources of Potential Volatility in IYK</u>	
	<u>Weight (%)</u>
Philip Morris	7.72
Altria	3.69
Ford	3.27
Johnson Controls	1.65
Nike	1.60
Lorillard	0.95
Total	18.88

Source: iShares website

When General Motors becomes publicly traded in due course, it will be a consumer products company, albeit a durable and, by the rules of ETF structure, it will have to be included in IYK. The inclusion of General Motors will cause the weight of automobiles in this ETF to be greater; therefore, one could say that the business risk element of the ETF will increase.

Since 2001, the Dow Jones U.S. Consumer Goods Sector Index Fund has a compound annual rate of return of 4.70% before taxes. Obviously, it would have a lower rate of return after taxes. Much of that return is due to the high dividends paid by these businesses. Although I didn't try to prove it, I believe it is true that exclusion of the more dangerous product lifecycle firms from the ETF would not only increase the rate of return, but would decrease the variability.

<u>Dow Jones U.S. Consumer Goods Sector Index (IYK)</u>	
	<u>ROR (%)</u>
2001	2.21
2002	(4.95)
2003	20.83
2004	11.39
2005	1.44
2006	14.32
2007	9.18
2008	(25.90)
2009	23.19

Source: iShares website

Facts & Figures

Product Lifecycle: Innovation and Competition

This section features more dates than data. It highlights the increasingly compressed time period following the successful introduction of a new product by a company before others introduce competing versions of it. In the past, there was a time lag—sometimes significant—between development of major innovations and when they became widely used by the public. For example, air conditioning was invented by Willis Carrier in 1902; however, it wasn't available in large measure until well after the Second World War. It took half a century before air conditioning became a viable consumer product, and it didn't really gain mass appeal in the United States until well into the 1970s.

As we all know, Orville and Wilbur Wright flew at Kitty Hawk in 1903. One might say that the First World War accelerated the development of the military aviation industry, but the product lifecycle of the airline industry didn't begin for the mass public until the 1950s. Commercial air travel existed in the 1930s, but it was a relative luxury. It took about half a century for air travel to develop into an industry.

In 1904, John Fleming invented the first vacuum tube that changed AC current to DC current. Lee De Forest further developed the vacuum tube, and by about 1907 he had built the first Audion, a precursor to radios. He used vacuum tubes that could magnify a weak electronic signal. However, it wasn't until the 1920s that radios were mass produced. Development of that invention took about 20 years.

Here are more examples. In 1908, a Belgian gentleman by the name of Leo Baekeland patented a substance that he called Bakelite, which was the first plastic ever manufactured. It wasn't until the 1960s that plastic became widely used. The first touch-tone telephone was introduced to the public in 1964. Dennis Gabor, a physicist, won the Nobel Prize for Physics in 1971 largely for his work in holography, but he had invented it in 1947. In 1948, George de Mestral invented Velcro using plant burrs as his model. It wasn't patented until 1955.

A significant amount of time elapsed between creation of the inventions cited above and when they were broadly available to the public. Today, that time is ever shortening, as evidenced by how soon high-definition televisions were available after Woo Pak, a Taiwanese-Chinese gentleman, produced the first one in a laboratory in 1991. From a product lifecycle point of view, the problem lies in how soon after an innovation is unveiled by its creator that a competitor can come to market with a new and improved product.

A good example is the fairly recent introduction of Kindle by Amazon. Three months ago Apple Computer released the iPad, its own version of that product. We know for certain that Hewlett-Packard is working on its version of a tablet, because it acquired Palm just for that purpose. We have no idea, nor does Hewlett-Packard, of what that device might look

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like but, in a year or possibly less, it will introduce a similar product to the market. It's unlikely to be the only entrant in that market to compete with Apple and Amazon.

The product lifecycle is getting ever shorter, and it is a source of variability in the structuring of portfolios. However, there is no quantitative way to screen for duration of a product lifecycle the way can screen, for example, a group of bonds and calculate their duration with absolute precision. Who can say with any degree of certainty what the product lifecycle for any company is? It's going to become a greater and greater problem in investing, and no one has a good solution for it. It has relevance in the structuring of ETFs inasmuch as, if one doesn't give thought to the issue of product lifecycle, one could inadvertently create an ETF that is not only variable, but could ultimately have a low rate of return.

How They Did It

Tales of the Greatest Investors of All Time

Cargill

Cargill is an agricultural conglomerate, and is one of the largest companies in the world. It has \$116 billion of revenue; therefore, if it were publicly traded, it would unquestionably be in the S&P. The company employs 160,000 people in 67 different countries, so it's a global conglomerate. It accounts for 25% of U.S. grain exports and 22% of U.S. domestic production of meat. Those figures are astonishing if one reflects on the different varieties of meat that are produced. The company is more or less two times the size of Archer Daniels Midland (ADM) in terms of revenue and assets, and ADM is itself a very large company. Cargill is unique among companies, because it attained its size without ever accessing the public markets for equity capital. It is one of the largest, if not the largest, of the private companies that never accessed the equity market.

Cargill trades in virtually every agricultural-industrial commodity you could possibly think of, and it trades in virtually every energy commodity. Not only does it trade in the various ingredients that are used to make pharmaceuticals, it has processing plants that make manufacture them, because so many are organically derived. It also has a major presence in agriculture.

W.W. Cargill founded the company in 1865 to store and trade grain. Those remained the activities of the company for a number of decades, until a gentleman by the name of John McMillan began working for the company in circa 1898. McMillan had the good fortune to marry the daughter of Sam Cargill, who was in charge of the company at the time. When Sam Cargill died in 1903, McMillan became head of the company. To this very day, descendants of the McMillans and the Cargills are major shareholders of Cargill.

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Historically, Cargill has always taken an aggressive, one might even say adversarial and confrontational, approach with its competitors, regulators and observers. The company's management has been willing to take certain risks at various points in time, and fortune has always smiled upon it. For example, in the years before the First World War, Cargill became excessively leveraged, which might have been a problem for the company had the First World War not occurred when it did. The war caused a disruption of agricultural production in Europe resulting in an enormous rise in grain prices in the U.S. For that reason, Cargill became much more profitable. Even after the war, it was supplying grain to the various devastated European countries. Those activities increased the company's volume by much more than it would have otherwise. In very few years, the company managed to pay off all its debt, and it paid in gold.

Moving forward to 1934, the circumstances behind Cargill's expulsion from the Chicago Board of Trade (CBOT) illustrate how confrontational the company can be. At that time, the company was probably the dominant grain trading company in the U.S., so for the CBOT, which is now part of the Chicago Mercantile Exchange, to deny them trading access shows the magnitude of the problem. After some court proceedings, the U.S. government ordered the CBOT to admit Cargill as a member. According to both the CBOT and the U.S. government, once Cargill became a member, it tried to corner the market on corn. It bought up much of the corn supplies in the U.S. in 1937 and 1938. The CBOT was not without recourse; it ordered Cargill to sell some of its corn inventory, and the United States government issued a similar order. However, Cargill resolutely refused to do so and, as a result, the CBOT suspended the company's membership in the exchange. Shortly thereafter, the Second World War broke out and, as during the First World War, there was again an increased demand for grains because there was so much destruction in Europe. At that time, Cargill was happy to sell its corn inventories. Nevertheless, it refused to rejoin the CBOT until about 1960.

In the 1990s, some members of the Cargill family objected to the company's policy of reinvesting the bulk of its profits in the growth of the company. They wanted higher dividends paid to the family. The non-objecting family members bought out the 17% ownership of those wishing for higher dividends. They paid in cash.

What is the secret of Cargill's success? I think we can point to three aspects of it. The first is that it is a unique example of a company with a high information quotient, because it trades in virtually every commodity imaginable. Any type of economic activity increase or decrease is very quickly reflected in the buying and selling of some type of raw material. Since Cargill does business with virtually every company, it gets to see that information first. Moreover, Cargill is one of the largest shipping brokers in the world. Even before one buys or sells a commodity, one has to arrange for its transportation; therefore, an early sign of economic activity is demand for shipping or changes in lease rates. Given its size, Cargill gets to see that, quite legally, before anyone else.

Another interesting point is that as a commodities trader and producer, Cargill has to maintain a lot of inventory. All businesses maintain inventory to meet their level of inventory demand; however, inventory absorbs capital. There's a cost for carrying any type

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of inventory, but agricultural commodities, especially grain, are unique, because grain is the most fungible of the commodities in terms of borrowing. In agricultural commodities, borrowing is done in the form of what's known as a warehouse receipt. Essentially, the lending bank accepts a warehouse receipt that gives it recourse to take over that amount of a given agricultural commodity stored in a certain warehouse in the case of default.

Since the commodity is priced on an exchange, the bank knows its value on a minute-to-minute basis. It has a certain comfort level, because it can always verify that the collateral is there. Therefore, from a banking standpoint, warehouse receipts are the most acceptable form of collateral; better, in fact, than real estate. As a result, Cargill has access to about the lowest-cost short-term lending one can possibly imagine, and on the best possible terms. The company can extract money from its inventory holdings by borrowing against them, something that a manufacturing company wouldn't readily be able to do.

Another aspect of Cargill has to do with government regulation. Governments frequently try to regulate the agricultural market, but it's very difficult to accomplish effectively. Nations like France and Italy routinely seek to protect their own corn producers with protective tariffs, because their producers are far less efficient than their American and Canadian counterparts. Many years ago, the French and Italian governments imposed protective tariffs on corn, which exist to this very day. A company like Cargill, in principle, should have lost some of its business in those European nations but, in fact, it never really did. Cargill merely realized that it could substitute tapioca as an animal feed relative to corn. Tapioca is made from the cooked, chopped root of the cassava plant. From the point of view of Cargill, the result was that it was using less of its corn from the U.S. and more of its cassava and tapioca from the Far East. Its business was largely unaffected, even given the major effort on the part of various European countries to control the agricultural market.

There is a French company called Louis Dreyfus that was founded in 1851, and is very similar to Cargill. It also exists in the private realm. Its scale of business operations and its modus operandi closely resemble those of Cargill. The common denominator of both companies, albeit under different managements, historical circumstances, regulations and customers, is the product lifecycle. Except for technological changes, the grain trading market itself is not radically different now than it was in the 19th century.

By the way, for anyone who doubts that assertion, I recommend two novels by Frank Norris: *The Pit* and *The Octopus: A California Story*. They were written in the 19th century about commodities trading, and they could have been written last month.

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Featured ETFs

iShares S&P/Citi International Treasury Bond Fund (IGOV)

This ETF, also mentioned in the *Musings* section, has a certain number of potentially problematic credits within it, including the four listed below, which absorb 43.07% of this ETF.

Japan	24.16%
Italy	9.33%
Spain	4.86%
Greece	<u>4.72%</u>
	43.07%

The countries on the list above do not represent the totality of the problematic credits, because all of the potentially problematic credits are present in this fund. It has a weighted average maturity of 8.37 years and a duration of 6.51 years, a weighted average bond price of \$104.57. The latter figure is very important because, problematic though these credits potentially are, and worried though equity investors are, the average bond in this portfolio trades well above par. The weighted average coupon is 3.77%, and the distribution yield is 1.12%, so the effective cost of carry of being short this fund is the distribution yield.

What's interesting about the fund is where the given bonds trade in relation to how they're viewed by the world. As is well known, on virtually any yield to maturity, Japanese paper yields much less than 1%. Greek government paper maturing in 2018 yields 10.55%, which is a relatively high yield for a sovereign credit, but not for one that is in danger of default. Ironically, Greek paper maturing in 2037 yields only 9% on a yield to maturity basis.

<u>Issuing Country</u>	<u>Maturity Date</u>	<u>Yield to Maturity (%)</u>
Greece	2018	10.55
Greece	2037	9.00
Spain	2024	4.85
Italy	2019	3.98
Irish	2020	5.53
Portugal	2037	5.92

Source: iShares website

Portugal is the first country noted in the acronym PIIGS, which is the well-known journalistic acronym for the group of nations in great danger of defaulting. The long-term Portuguese government bond yields more or less 200 basis points above the United States Treasury, which in itself is a possibly questionable credit. Therefore, for those worried about these countries defaulting, it seems like this ETF is a much better short.

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iShares Russell 2000 Index Fund (IWM)

According to its own fact sheet, this index has a P/E of 25.4x and a price-to-book ratio of 2.67 times. The rate of return on this ETF for the years from 2001 to 2009 was discussed in the *Musings* section, but here's another way of looking at it. There are 2,015 holdings in the Russell 2000, an odd number to say the least. A look at the ten largest holdings in that index offers a sample of the profitability dynamics of the companies. The most recent 12 months' return on equity is as high as 28.6% in the case of Rock-Tenn, and as low as negative 43.3% in the case of Nordson. The average return on equity for the most recent 12 months is 5.16%. The rate of return on equity among the top ten, on average, excluding all the negative returns on equity, is 13.31%.

iShares Russell 2000 Index Fund (IWM) Top Ten Holdings*

	Most Recent ROE (%)	Highest ROE Past 10 Years(%)
Salix Pharmaceuticals Ltd (SLXP)	(11.60)	11.30
Tibco Software Inc. (TIBX)	7.80	8.30
Jack Henry & Associates Inc. (JKHY)	16.50	18.40
Rock-Tenn Company (RKT)	28.60	28.60
MFA Financial Inc. (MFA)	12.40	15.10
Nordson Corp. (NDSN)	(43.30)	25.50
Parametric Technology Corp. (PMTIC)	4.10	24.20
FirstMerit Corp. (FMER)	7.70	16.00
Adtran Inc. (ADTN)	16.40	27.80
Proassurance Corp. (PRA)	13.00	13.40

Source: iShares website

*As of Friday, July 16, 2010

With over 2,000 companies in this index, if one viewed it as a company in and of itself (i.e., collapsed the income statements and the balance sheets of all 2,015 members into one), it's hard to imagine how it could, on an aggregate basis, produce a return on equity sufficiently high to justify a price-to-book-value ratio of 2.67 times and get an acceptable rate of return. In principle, if one buys a 10% return on equity at book value, one is earning 10% over time. If one pays over 2x book value, one would need a proportionally higher return on equity to earn a rate of return over time that would be sufficiently high, which is unlikely.

The table above has a column that lists the highest ROE of the past ten years of all the companies that were in the top ten on Friday, July 16, 2010. The highest ROE of any company is Rock-Tenn at 28.6%, which occurred last year. The least of the highest ROEs was 8.3% for Tibco Software. In order to have a rate of return on equity sufficiently high to justify the P/E and price-to-book-value ratios as they exist today, one would need to

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have all of the highest returns on equity achieved not only simultaneously, but also with regularity over the course of years, which is unlikely.

At least insofar as the value is concerned, it is possible to earn a high rate of return on the Russell 2000 even if the returns on equity are not commensurate with market expectations. The reason is because this ETF has a fairly high degree of price variability, which is not surprising given its structure. A possible strategy is as follows. As of July 16, 2010, the iShares Russell 2000 Index Fund trades at roughly \$61. One can buy the index and write the January 2011 \$61 call options at the money, so their expiration is roughly six months away. They trade at \$5.72 bid. Assuming a steady state environment in which the Russell 2000 Index paid no dividend return whatsoever and the price was not variable at all, one would earn 19.72% by collecting the premiums. Therefore, a buy-write on the ETF, is actually a better strategy than buying the fund itself. The variability that has been inadvertently injected into the structure of the index has a value if one accesses it through the options market.

iShares MSCI Emerging Markets Index (EEM)

The buy-write strategy described above would also work for this ETF. Here we can look at the emerging markets a little bit differently. The emerging market companies are, in principle, emerging; they are small companies growing to big status. The problem with the emerging markets index, as it exists, is that it is market capitalization-weighted, which means that the largest companies not only have the largest weights in the index, but they are themselves large companies.

The table below lists the revenues in the most recent 12 months for the 10 largest companies in this ETF. Of the ten largest holdings listed in the table below, Samsung has the largest revenue figure at \$173 billion. Gazprom has \$98.6 billion of revenue, and Banco Bradesco has \$36.1 billion of revenue. One has to go to a very low level, in terms of market capitalization, in the MSCI Index to find the small companies one might expect to find in the emerging market economies.

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MSCI Emerging Markets Index Fund Top Ten Holdings*

	Revenues (\$ in billions)
Samsung	\$173.0
Taiwan Semiconductor	\$9.8
China Mobile	\$56.2
Petroleo Brasileiro	\$104.9
Infosys	\$4.8
Banco Itau	\$44.2
Gasprom	\$98.6
HDFC Bank	\$4.1
Vale	\$28.6
<u>Banco Bradesco</u>	<u>\$36.1</u>

Source: iShares website

*As of July 16, 2010

By comparison, in its most recent 12 months, IBM had \$96 billion of revenues. Samsung's revenue is almost twice that size. Cisco, which is a large company in the U.S., had \$37.7 billion of revenue. JPMorgan, the largest of the U.S. banks, had \$64.4 billion of revenue. With Banco Bradesco's \$36.1 billion in revenue, it is already more than half the size of JPMorgan Chase. Therefore, one is not buying emerging companies. Instead, one is buying huge companies that dominate emerging nations, which is a very different situation.

Due to the political structures of these countries, and because their economies have rather cyclical characteristics associated with them, the variability of the companies in this ETF is rather large, and the variability measured in the price of the index is very large. Therefore, it is possible to access the rate of return implied by the variability by employing the buy-write strategy. On Friday, July 16, 2010, the MSCI Emerging Markets ETF closed at \$38.65. One could buy the ETF and write the at-the-money January 2011 \$39 calls at \$4.05 bid. Assuming that the index were unchanged in price (a ridiculous assumption), that one did nothing other than collect the premiums, and that there were no dividends paid on the ETF, one would have a so-called annual steady-state rate of return of 20.7%.

Interestingly, market participants take a very different approach regarding options trading on this ETF. There is enormous open interest outstanding on the options that are out-of-the-money, both on the call and put side. For example, the January 2011 \$48 calls, which are fairly decently out-of-the-money, trade at pennies (\$0.62 ask), and the open interest outstanding is 37,332 contracts. Over 3.7 million shares is a lot of open interest for an out-of-the-money call. Similarly, the January 2011 \$25 puts, which are quite far out-of-the-money, trade at \$0.75 ask and have open interest outstanding of 33,146 contracts, which is over 3.3 million shares.

Market participants expect the variability and are investing in straddles. A more interesting strategy would be to engage in the buy-write and collect the premium. In any event,

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whether one approaches the variability from the point of view of a straddle or a buy-write, the options seem to have much more value than buying the individual companies, at least for the most part.

PowerShares DB Agriculture (DBA)

This ETN is an example of the reverse of the previous two. It has holdings of all the important agricultural commodities. The table below displays the included commodities and their weights.

PowerShares DB Agriculture Fund*	
	Base Weight (%)
Cattle (Feeder Cattle)	4.17
Cocoa	11.11
Coffee	11.11
Corn	12.50
Cotton	2.78
Lean Hogs	8.33
Live Cattle	12.50
Soybeans	12.50
Sugar	12.50
Wheat	6.25
Wheat (Kansas)	6.25

Source: PowerShares website

*As of July 16, 2010

The next table shows the August average harvest price for corn going back to 1973. In that year, the price was \$2.95 a bushel, and it is currently \$4.07 a bushel. It's not inherently variable. Normally, when a price goes up, the agricultural producers put more land under acreage. Here are some selected prices for other commodities. The average August harvest price of soybeans in 1973 was \$8.24 a bushel, and today it is \$9.85 a bushel. That price increase probably didn't even keep pace with the inflation rate through 2010. The CBOT average price since 1973 was \$6.12 per bushel. The price for the year 1973 was \$8.42 a bushel, in 1980 it was \$7.65 a bushel, in 1983 it was \$8.50 a bushel and in 1988 it was \$8.52 a bushel.

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Average Annual Harvest Price per Bushel of Corn

Year	Price/Bushel	Year	Price/Bushel	Year	Price/Bushel
2007	\$3.31	1995	\$2.83	1983	\$3.53
2006	2.30	1994	2.19	1982	2.33
2005	2.15	1993	2.49	1981	3.11
2004	2.25	1992	2.19	1980	3.42
2003	2.20	1991	2.49	1979	2.82
2002	2.59	1990	2.51	1978	2.19
2001	2.17	1989	2.30	1977	1.89
2000	1.78	1988	2.89	1976	2.79
1999	2.14	1987	1.57	1975	3.12
1998	2.06	1986	1.61	1974	3.58
1997	2.63	1985	2.30	1973	2.97
1996	3.64	1984	2.97		

Source: USDA National Agricultural Statistics Service

The price of soybeans has demonstrated variability over the years, but it hasn't increased at the rate of inflation. For that reason, investors have been engaging in straddles on this index. For example, the January 2011 \$30 calls on the PowerShares DB Agriculture ETF are \$0.25 ask, and open interest is 12,508 contracts or over 12 million shares. This call is far out-of-the-money. One of the reasons that this is inherently a non-volatile index is not merely because the individual agricultural commodities are not very volatile, but because it has a plethora of agricultural commodities and they don't have the same cycle. They may be governed by the production cycle, weather, changes in government regulation or other constraints; therefore, it's not easy to get all the agricultural commodities appreciating mightily at the exact same moment.

However, if there were an economic disruption, as happened in 2008, the commodities do more or less exhibit very tight correlations. If one were looking for a trade with a very low cost of capital employed while waiting for an exogenous event to disrupt the market, a straddle might be the thing to do. If, however, there were an agricultural commodity shortage, it would logically follow that more land would be placed under cultivation. In that scenario, it's likely that more fertilizer would be used. Fertilizer is the common denominator with virtually all the agricultural products, and it's not easy to increase the fertilizer capacity. Therefore, if one believed that an agricultural shortage was imminent, a better trade might be to buy inherently volatile companies like Potash Corporation or Mosaic Corporation.

It turns out, ironically, that the Mosaic Corporation, one of the large fertilizer companies in the world, is roughly two-thirds owned by Cargill Corporation. Given everything that was just said about Cargill Corporation, its high information quotient, its large trading presence in all the various commodity markets and exchanges, it's hard to imagine how any individual following the commodity markets could get to the those markets before Cargill.

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Therefore, if one wants to best Cargill at its game, one only has recourse to pre-position oneself with an out-of-the-money straddle on an index like the PowerShares DB Agriculture ETF and wait for the disruption to occur. It's not inherently volatile, so the cost of the options is relatively low. It seems an act of arrogance to think that any individual trader could have better access to the market than Cargill, given that it owns a very big piece of the market and trades in it simultaneously.

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Money Manager Index

From Jan 1983 to June 2010

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Yr. End	Index	Annualized return	
															Yearly return	(since inception)
1983								1.00	0.81	0.76	0.87	0.75	1983	0.75	(60.5)%	(50.2)%
1984	0.75	0.71	0.70	0.66	0.67	0.67	0.61	0.83	0.79	0.76	0.67	0.65	1984	0.65	(13.5)%	(26.5)%
1985	0.92	0.93	0.99	0.95	1.20	1.30	1.32	1.38	1.28	1.50	1.86	2.02	1985	2.02	211.8%	33.7%
1986	2.46	2.78	2.47	2.31	2.36	2.33	2.03	2.23	1.98	2.37	2.34	2.34	1986	2.34	15.9%	28.2%
1987	3.21	3.27	3.16	2.55	2.37	2.30	2.39	2.47	2.22	1.56	1.44	1.52	1987	1.52	(35.0)%	9.9%
1988	1.80	1.87	1.78	1.79	1.69	1.94	1.92	1.96	2.01	1.97	1.95	2.07	1988	2.07	36.0%	14.3%
1989	2.42	2.37	2.54	2.63	2.64	2.64	2.93	3.12	3.07	3.05	3.23	3.26	1989	3.26	57.8%	20.2%
1990	3.12	3.15	3.53	3.06	3.47	3.45	3.30	2.70	2.68	2.40	2.52	3.02	1990	3.02	(7.3)%	16.1%
1991	3.08	3.49	3.70	3.68	3.71	3.61	3.86	4.05	4.07	4.69	4.47	5.72	1991	5.72	89.4%	23.0%
1992	5.76	5.61	5.30	5.12	4.98	4.99	5.93	6.06	6.19	6.56	7.25	7.36	1992	7.36	28.6%	23.6%
1993	8.06	8.04	8.20	7.94	8.15	8.57	9.05	10.00	9.99	9.31	8.97	8.90	1993	8.90	21.0%	23.4%
1994	9.52	8.73	8.05	7.85	7.81	7.53	7.66	8.31	8.15	8.52	7.88	7.95	1994	7.95	(10.6)%	19.9%
1995	7.74	8.38	8.72	8.77	9.20	9.35	9.93	10.78	11.22	10.53	10.89	10.40	1995	10.40	30.8%	20.8%
1996	11.12	11.50	11.33	11.62	11.86	12.53	11.91	12.36	13.32	14.03	14.42	15.02	1996	15.02	44.4%	22.4%
1997	16.04	16.81	15.32	17.27	18.42	20.29	22.28	21.39	25.31	24.95	24.95	25.50	1997	25.50	69.8%	25.2%
1998	25.67	29.00	29.89	30.60	28.90	30.44	27.67	21.33	21.74	25.16	27.27	25.41	1998	25.41	(0.4)%	23.3%
1999	26.00	23.71	23.92	26.77	28.94	29.74	28.78	26.74	25.89	27.73	28.54	30.55	1999	30.55	20.2%	23.2%
2000	31.07	31.19	36.01	35.60	35.20	40.32	43.58	45.75	45.62	48.69	44.05	49.84	2000	49.84	63.1%	25.2%
2001	50.23	46.41	44.27	46.96	48.90	49.98	50.67	49.70	46.47	44.81	48.04	51.91	2001	51.91	4.2%	23.9%
2002	53.62	53.74	55.11	52.52	52.83	50.48	42.58	44.92	41.54	42.66	45.78	43.17	2002	43.17	(16.8)%	21.4%
2003	42.72	41.18	42.36	45.98	49.02	50.71	53.47	53.97	53.46	56.12	55.83	58.49	2003	58.49	35.5%	22.1%
2004	64.38	65.08	64.63	61.68	60.86	62.30	58.71	64.08	65.73	68.86	73.53	78.16	2004	78.16	33.6%	22.6%
2005	76.46	77.94	74.06	72.83	77.02	80.25	83.59	83.07	86.03	89.19	96.58	97.35	2005	97.35	24.6%	22.7%
2006	107.62	111.44	110.75	111.88	101.89	100.61	100.62	104.98	114.61	116.64	113.78	118.05	2006	118.05	21.3%	22.6%
2007	125.73	123.77	122.62	127.58	133.57	134.68	126.61	124.07	133.57	148.09	135.13	135.56	2007	135.56	14.8%	22.3%
2008	127.53	115.76	115.94	121.58	130.51	115.68	119.94	120.55	109.69	72.70	62.95	67.91	2008	67.91	(49.9)%	18.1%
2009	57.51	51.76	65.63	79.49	85.67	90.79	99.97	101.69	107.32	107.36	110.94	115.01	2009	115.01	69.4%	19.7%
2010	106.84	110.32	118.13	114.91	100.179	88.170								88.17	(23.3)%	18.1%

Name	Amount Invested	Name	Amount Invested
Affiliated Manager	\$ 22,947	Pzena Investment Mgt	\$122,426
Alliance	\$ 7,633		
BlackRock	\$ 23,205		
Waddell & Reed	\$ 27,513		
Eaton Vance	\$ 2,641		
T. Rowe Price	\$ 2,423		
Franklin resources	\$ 908		
Legg Mason	\$ 1,000		
Federated Inv	\$ 26,381		

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International Money Manager Index

From Jan 1983 to June 2010

Year	31-Jan	28-Feb	31-Mar	30-Apr	31-May	30-Jun	31-Jul	31-Aug	30-Sep	31-Oct	30-Nov	31-Dec	Yr. End	Index	Annualized return	
															Yearly return	(since inception)
1986											1.00	1.02	1986	1.02	10.0%	10.0%
1987	1.25	1.37	1.48	1.48	1.37	1.33	1.39	1.40	1.33	0.81	0.76	0.73	1987	0.73	(27.7)%	(23.3)%
1988	0.75	0.92	1.02	0.95	0.80	0.89	0.88	0.82	0.86	0.88	0.89	0.93	1988	0.93	26.4%	(3.4)%
1989	1.03	1.02	1.06	1.17	1.19	1.18	1.25	1.16	1.17	1.20	1.21	1.28	1989	1.28	37.8%	8.1%
1990	1.24	1.24	1.18	1.19	1.22	1.24	1.26	1.26	1.23	1.24	1.25	1.33	1990	1.33	3.7%	7.0%
1991	1.34	1.52	1.56	1.58	1.57	1.47	1.52	1.64	1.81	1.89	1.94	1.92	1991	1.92	44.8%	13.5%
1992	2.01	1.93	1.88	2.14	2.19	2.13	2.08	1.99	1.95	1.77	1.76	1.96	1992	1.96	1.9%	11.5%
1993	1.98	2.03	2.20	2.39	2.42	2.45	2.54	3.05	3.01	3.07	3.01	3.30	1993	3.30	68.7%	18.1%
1994	3.72	3.39	3.17	3.04	2.99	2.89	3.01	3.14	3.13	3.19	3.15	3.15	1994	3.15	(4.7)%	15.1%
1995	3.07	3.12	3.28	3.41	3.56	3.59	3.87	3.76	3.76	3.77	3.70	3.73	1995	3.73	18.6%	15.4%
1996	3.76	3.85	3.70	3.79	3.96	3.90	3.75	3.96	4.16	4.47	4.90	4.86	1996	4.86	30.3%	16.8%
1997	5.11	5.37	4.99	4.96	5.43	5.94	6.57	6.32	7.45	7.24	6.80	7.19	1997	7.19	47.9%	19.3%
1998	7.12	8.05	8.78	9.25	8.95	8.74	8.91	6.67	6.08	7.01	7.51	7.71	1998	7.71	7.3%	18.3%
1999	7.99	8.21	8.68	9.07	8.71	8.61	8.63	8.43	8.47	8.79	9.80	10.79	1999	10.79	39.9%	19.8%
2000	11.23	12.27	13.95	13.50	13.73	15.39	15.85	16.82	17.07	16.31	14.43	16.76	2000	14.43	33.8%	20.7%
2001	17.42	15.88	13.46	15.14	15.84	15.15	14.21	13.61	10.77	11.43	13.90	14.12	2001	14.12	(2.2)%	19.1%
2002	14.74	13.78	15.09	15.11	16.38	14.14	12.92	12.10	11.23	11.06	11.33	10.50	2002	10.50	(25.6)%	15.7%
2003	10.18	9.52	9.69	10.62	12.17	13.04	13.98	15.38	16.67	17.88	18.16	18.07	2003	18.07	72.1%	18.4%
2004	20.00	22.41	29.98	35.46	26.68	30.80	25.37	25.20	23.67	23.34	27.56	31.48	2004	31.48	74.2%	20.9%
2005	32.19	32.57	31.88	27.79	27.36	29.05	30.38	31.49	33.39	32.24	32.95	37.18	2005	37.18	18.1%	20.8%
2006	41.01	40.97	43.69	46.45	42.39	41.58	40.60	43.32	43.55	43.70	44.58	49.38	2006	49.38	32.8%	21.3%
2007	50.95	51.18	53.59	56.09	58.16	56.37	53.90	48.65	50.96	57.03	48.21	45.75	2007	45.75	(7.3)%	19.8%
2008	38.71	39.71	38.59	40.18	39.25	35.10	34.59	33.33	26.09	18.72	14.50	15.79	2008	15.79	(65.5)%	13.3%
2009	14.62	13.24	14.96	19.63	22.82	23.73	26.14	27.05	28.41	28.53	28.69	29.83	2009	29.83	89.0%	15.8%
2010	28.50	27.58	29.90	29.58	25.53	24.72								24.72	(17.1)%	14.5%

Name	Amount Invested	Name	Amount Invested
IGM FINANCIAL INC	\$1,000	HENDERSON GROUP PLC	\$14,447
F&C ASSET MANAGEMENT PLC	\$1,203	RAB CAPITAL PLC	\$24,603
INVESCO PLC (PREVIOUSLY AMVESCO)	\$1,357	AZIMUT HOLDING SPA	\$21,908
SCHRODERS PLC	\$1,208	EVEREST FINANCIAL GROUP LIMITED	\$23,437
RATHBONE BROTHERS PLC	\$1,208	CHARLEMAGNE CAPITAL LTD	\$36,848
ABERDEEN ASSET MGMT PLC	\$1,208	PARTNERS GROUP-REG	\$36,848
CI FINANCIAL INCOME FUND	\$2,585	INVISTA REAL ESTATE INV MNGT	\$36,589
MAN GROUP PLC	\$2,862	ASHMORE GROUP PLC	\$36,688
AGF MANAGEMENT LTD-CL B	\$3,343	BLUEBAY ASSET MANAGEMENT/UNI	\$37,469
SPARX GROUP CO LTD	\$11,762		