EXCHANGE-TRADED FUNDS

A new generation of ETFs widens allocation horizons

Francois Millet, head of index-linked products sales at SGAM Alternative Investments, explains how after the recent explosion of exchange traded funds, the innovative 'structured ETFs' can address the need for security and performance while creating new asset allocation tools

Beyond the multiplication of new index exposures offered by managers of traditional exchanged-trade funds (ETFS), a new generation of ETFs has emerged over the past 12 months in Europe and in the US. They provide alternative asset allocation components to portfolio managers while also adding the flexibility and ease of use of traditional ETFs, and therefore facilitate reallocation.

This promising new generation of products comprises mainly structured ETFs, and attracts structured products into the ETF arena while lifting them to the full transparency standards of ETFs, and enhanced ETFs (ETFs based on enhanced indices) that rely on stock selection.

A variety of risk profiles and pay-offs are already available, including capital protection, leverage, reverse exposure and enhanced return profiles. No doubt they will expand and offer fund managers a number of new tools with which to implement their asset allocation choices in the near future.

Some of these products even provide a dimension of active management, whether it is based on a systematic process or on discretionary decisions. In all cases we are in the ETF universe for good, since the name of the game is transparency: the underlying portfolio must be known at all times, and an indicative NAV is made available to allow fair market pricing in a continuous way.

According to their structures, these ETFs can either be used to 'delegate' allocation to the ETF manager, or they can be selected directly as building blocks by the asset allocator doing its own combination of investments.

For example, the 'SGAM ETF Flexible' range provides equity index exposure with limited risk taking thanks to partial capital protection. This means that the ETF manager may combine perfect index investment with non-risky assets at some stage, in order to fulfil capital protection. As a result, the portfolio can be re-allocated daily between the index assets and the non-risky assets, which can be heavy to handle for full baskets of stocks comprising the index.

Additionally, an investment committee can alter parameters used to calculate the optimal index exposure, thus taking into account the market environment, for example a sharp rise in market volatility and valuation criteria. In such a case, it can prove to be a clever, time and cost-saving decision for the risk averse investor to delegate dynamic allocation to the ETF manager.

Moreover, sophisticated investors are able to combine structured ETFs having non-linear pay-offs with other assets that are imperfectly correlated, in order to create new risk diversification strategies.

However, a leveraged ETF can be used as a tool for cash extraction and in order to modulate one's risk profile. For example, in a diversified portfolio with a dynamic bias (60 per cent equity/40 per cent fixed income), the same risk profile can be achieved by investing 43 per cent in equity through a 200 per cent ETF and 57 per cent in fixed income. The risk exposure becomes 86 per cent equity and 57 per cent fixed income, i.e. it stays at 60/40 split. The extracted cash is re-invested in fixed income assets, thereby raising the fixed income floor of the strategy.

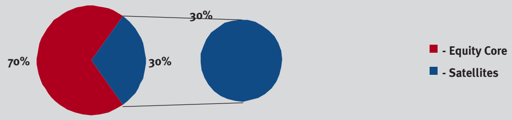
Enhanced ETFs can significantly increase the return of a core-satellite portfolio. The 'old-fashioned' mutual funds may not provide the transparency of ETFs, nor their attractive cost structure and the easy access to the performance of an index with only one transaction. Even so, they are especially useful in an alpha searching context where many investors want see their equity funds at least in-line with the performance of benchmark indices.

Core-satellite strategies can be a solution which generate alpha while preserving benefits of ETFs. While the core delivers the index performance at a moderate expense ratio, the satellites are investments that search for alpha. Diversification and de-correlation can be calibrated as needed to obtain the client's desired risk level. ETFs are already widely used as cores. But leveraged ETFs gain more and more attention as they allow unlocking of a part of the cash previously invested in an index core, in order to enhance the part allocated to alpha search. SGAM ETF Leveraged is based on equity securities holding, rather than derivatives. It can be used by institutional investors facing limitations in the use of futures, other derivatives or funds including such instruments, It is also intended for investors who want to acquire leverage on the index without taking on additional debt.

Figure one: applying structured ETFs to a managed portfolio

Invested amount	100
Portfolio allocation	
- Equity Core	70%
- Satellites	30%

		example
Core return	r_C	7%
Satellites return	r_S	9%
Leverage cost of finance (*)	r_L	3,5%
(*) Eonia + 0,50%		



Initial portfolio

Invested Amount	Underlying	Allocation %	Expected return	Example %
70	Index	70%	70 r_C	4.9%
30	Satellites	30%	30 r_S	2.7%
100		100%		7.6%

Portfolio using SGAM ETF Leveraged

Invested Amount	Underlying	Exposure	Allocation %	Expected return	Example %
54	ETF 200% CAC40	108	70%	108 r_C -54 r_L	5,7%
46	Satellites	46	30%	46 r_S	4,2%
100		154	100%		9,8%

(1) Example based on permanent 200 per cent exposure, both scenarios are compared before management fees

Source: SGAM AI

Let's look to a portfolio allocation of 70 per cent in an equity core and 30 per cent in a satellite. Rather than investing 70 per cent in an ETF tracking the index, we allocate 54 per cent to SGAM ETF Leveraged with a 200 per cent exposure to the index. This will instantly enhance the core performance from 4.9 per cent to 5.7 per cent.This allows us to increase the alpha searching satellite up to 46 per cent to re-establish the initial risk allocation of 70/30. As it is more strongly exposed to the satellite now; we will see its performance contribution increase from the initial 2.7 per cent to 4.2 per cent. In total we gain a performance of 9.8 per cent instead of 7.6 per cent.

Of course, this strategy needs careful risk management which could consist of rebalancing the core-satellite portfolio in case of downturn of the markets by switching to a simple ETF or to a protected ETF when we see the portfolio outside of a defined overall risk profile.

STRUCTURED ETFS IN EUROPE

Demand for structured investment products has picked up again in Europe, especially within the eurozone. And there seems to be no stopping the expansion of the European market for ETFs, which have become increasingly popular among individual investors and are now widely used by institutions, too.

Structured ETFs widens access to structured investments to as many investors as possible and on advantageous terms. ETFs are ideal for this purpose, due to their flexibility, transparency and low costs.

With products such as SGAM ETF Flexible, it is now possible to invest in an index with a single stock market order, while benefiting from capital protection equivalent to 80 per cent of the ETF price on the preceding 31 December.

SGAM ETF Leveraged offers exposure of up to 200 per cent to the eurozone stock market, the Nasdaq-100 or the CAC 40. It provides leverage with no maturity and avoids the use of derivatives. Professional investors will appreciate the opportunity to manage portfolios with a smaller capital commitment via a cash-market product in a straightforward investment fund, without having to use futures.

An initial review of the CAC 40 range since inception on 19 October 2005 shows that the two ETFs are market-responsive and complementary. SGAM ETF Flexible CAC 40 effectively replicated the performance of that index, while offering partial capital protection over the entire period. SGAM ETF Leveraged CAC 40 has yielded twice the CAC 40's return since inception. It quickly gained in popularity and is ranked seventh in transaction volume on Euronext/Nextrack Paris.

The performance curves for the two CAC 40 ETFs are illustrations of the value that structured ETFs can add to the conventional tracker fund market. Addressing both the need for security and the demand for performance, adapting to each investor profile, they create fresh prospects for the ETF market and new asset allocation tools.

CORPORATE STATEMENT

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SOCIETE GENERALE
Asset Management

Société Générale Asset Management, (SGAM), is the asset management subsidiary of the Société Générale Group. SGAM manages €334bn in the US, Continental Europe, the UK and Asia and employs 2,600 specialists worldwide. SGAM investment funds cover all asset classes: equity, fixed income, balanced and alternative investments strategies. The alternative investments activity is grouped in a wholly-owned subsidiary, SGAM Alternative Investments, a leading global specialist, which manages almost €54bn in structured products, private equity, hedge funds and real estate. All figures as at 30 June 2006.