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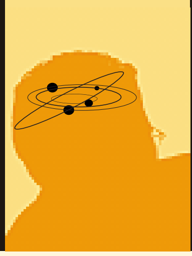
PWM
PROFESSIONAL WEALTH MANAGEMENT
SOLUTIONS FOR EUROPEAN DISTRIBUTORS



FIXED INCOME ETFs

REFRESHING EXCHANGE NEWS

Barclays Global Investors' iShares brings the benefits of the exchange-traded fund – diversified exposure to numerous companies through a cheap and efficient single trade – to the bond market

The first quarter of 2003 saw the launch of the first two fixed income exchange-traded funds (ETFs) for European investors. The first was the eb.rexx German government bond ETF, launched in February by Indexchange, and primarily targeted towards German retail investors. The second was the iBoxx Euro Corporate Bond ETF, launched in March by iShares, primarily targeted at institutional investors, but accessible to retail investors too. The arrival of fixed income ETFs in Europe follows on from the launch of similar products, by iShares, in the US last July.

ETFs allow investors to buy or sell an entire index, in one trade, through a single security. ETFs provide investors with exposure to market performance, as represented by the index. But does the advent of fixed income ETFs bring anything new to the investment landscape?

'Price discrimination is rife in the direct bond market, particularly with smaller trades. This contrasts sharply with trading on an exchange.'
Elizabeth Para, Barclays Global Investors

PRIVATE INVESTING

Private investors are able to gain fixed income exposure in their portfolios by trading government and corporate bonds directly, and they can also access more diversified, managed portfolios through open-ended funds, eg unit trusts, or closed-end funds, eg investment trusts. Fixed income ETFs, however, provide private investors with several benefits over and above what was available from the more traditional investment vehicles.

An allocation to corporate bonds within a portfolio can provide the investor with returns that have low correlation to equity markets, thus reducing the overall risk of the portfolio. Investment grade bond investments tend to be less volatile, or risky, than equity investments. And within the investment grade category, corporate bonds provide investors with higher income or yield than comparable government bonds. However, diversification is a major concern for any investor seeking exposure to corporate bonds. If a portfolio's entire bond allocation comprises just two or three bonds, a default on the part of one of those issuers can be a significant drag on performance. Adequate diversification

BENEFITS FOR PRIVATE INVESTORS

	Fixed income ETFs	Direct bond investment	Traditional open-ended fund	Closed-end fund
Diversification – easy to achieve?	√	x	√	√
Aims to track a market index?	√	x	x	x
Transparent pricing?	√	x	x	x
Trades close to fair value (NAV)?	√	n/a	√	x
Competitive fees?	√	n/a	varies	varies
Transparent holdings & risk exposure?	√	√	x	x
Intra-day trading?	√	√	x	x
Can be sold short?	√	√	x	x

Source: iShares

is difficult to achieve unless a portfolio is very large.

But creating a large portfolio is difficult for private investors because the bond markets are dominated by large institutional players trading on an over the counter basis. Price discrimination is rife in the direct bond market, particularly with smaller trades. This contrasts sharply with trading on an exchange. For this reason, most private investors seeking exposure to bond markets tend to favour funds.

ADVANTAGES

ETFs offer several advantages over traditional open and closed-end funds. The most obvious difference can be seen in the fees. Many fixed income ETFs were designed for use by large, institutional investors, and their fees are set accordingly, with total expense ratios as low as 0.20 per cent per annum for the iBoxx corporate bond ETF. As exchange-listed securities, these ETFs are as easily accessible to private investors as an equity is, in many European countries.

ETFs are index tracking strategies, which generally fully replicate the exact stocks or bonds which are held in a specified market index. As a result the fund holdings and risk exposures of an ETF are completely transparent to the investor. ETFs give investors the return on a specific market, such as the FTSE 100, or iBoxx Euro Liquid Corporates Index.

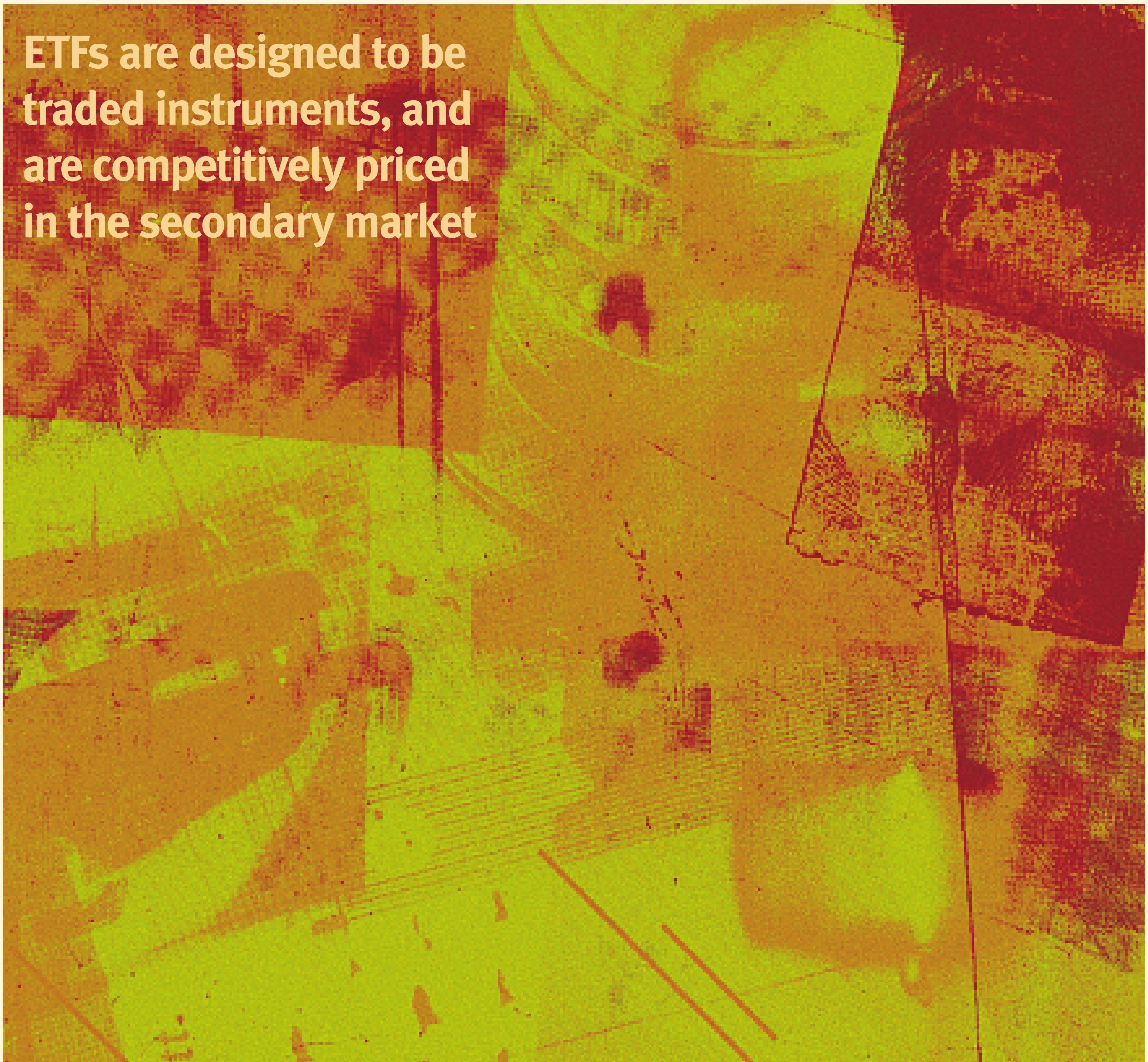
Investors in traditional actively managed funds, by contrast, have no control over what the fund invests in, or whether an investment style is consistently followed or not. Actively managed funds can underperform a market index and at times they cannot even provide the investor with the exposure to the market that they think they are getting.

A further advantage is that ETFs trade intra-day, and can be sold short, unlike traditional funds. This allows investors to take shorter term, or immediate exposure in a market, or to use ETFs to hedge against specific short-term event risks.

It is worth noting that ETFs are designed to be traded instruments, and are competitively priced in the secondary market.

INSTITUTIONAL

Institutional investors are beneficiaries of the same features specific to ETFs outlined above. They also have access to other investment instruments, like futures contracts, interest rate swaps and over-the-



ACCESS FOR INSTITUTIONAL INVESTORS

	Fixed income ETFs	Government bond futures	Basket-linked notes	Interest rate swaps
Exposure to the corporate bond market?	√	x	√	x
Competitively priced?	√	√	x	√
Objective selection of underlying bonds in portfolio?	√	√	x	n/a
Delivers coupon income?	√	x	√	√
DRAWBACKS				
Is a derivative or invests in derivatives?	x	√	√	√
Requires investor to roll contracts or note series?	x	√	√	x

Source: iShares

counter trade notes, whose returns are linked to a static basket of bonds (basket-linked notes).

But while futures contracts are extremely liquid and competitively priced, there are currently no futures contracts on credit markets in existence. Similarly, interest rate swaps are very liquid and competitively priced, but they do not give the investor exposure to the broader corporate bond market. As these are derivatives, many investors are not able to use futures or swaps within their portfolios. With futures contracts, the investor does not receive any coupon income, and each quarter must roll from one contract to the next, incurring transaction and administrative costs. In the case of interest rate swaps, documentation and ongoing operations surrounding the transaction can be onerous, and the investor is exposed to counterparty risk.

Basket linked notes, like ETFs, seek to give investors exposure to a diversified credit portfolio, through a tradeable product. These notes tend to be proprietary to a single bank, however. Thus they are not as competitively priced in the market as an ETF, which generally has multiple market makers. Once an investor buys a basket linked note, he or she is limited in the number of counterparties (often to just one) who will be willing to buy the note back at a later time.

Another drawback of the basket linked notes is, unlike the ETF, which simply replicates a specified, rules-based market index, like the S&P500, iBoxx, etc, selection of the underlying credits in a basket-linked note is not always transparent or rules-based.

The basket of bonds underlying a basket-linked note is static, whereas an ETF is dynamically managed to track a market index's returns over time. Therefore, the liquidity of the note, and the degree to which it's static portfolio is representative of the overall market and its characteristics, deteriorates as the note ages. To address this, the investor must roll from the old note series, into a new note series periodically, similar to a futures contract calendar roll, incurring transaction and administrative costs.

Furthermore, as was the case with interest rate swaps and futures, many notes are structured as derivatives, or gain their exposure to corporate bonds, not by investing directly in the bonds themselves, but rather by holding credit default swaps (CDS). Many investors are not able to use CDS-based notes because of the counter-party risk and basis risk between the cash bonds and CDSs.

ETFs are more attractive because they are not derivatives at all, but funds. Therefore they can be sold to many classes of investor from the most sophisticated to those more in need of regulatory protection.

SOLID START

Exchange-traded funds were first developed in the US equity market, but they bring obvious benefits to the fixed income arena. Fixed income ETFs are off to a solid start since their launch in the US in July 2002, and in Europe in the first quarter of 2003. They are being used by a wide range of investors, from private clients to institutional asset managers, to hedge funds. ETFs marry the transparency, competitive pricing and easy trading of the equity market with the market representation and objective stock selection of an index tracking strategy. Plus, they provide diversification through one investment. Their growing popularity with a broad fixed income investor base can be attributed to the fact that they do truly represent an innovation within the asset class.

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