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ETFs and ETNs With Little Volume But Big Returns, Part 2

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This year marked the beginning of a turning point for the industry as a whole; portfolio managers and investors alike are realizing that liquidity is not a requirement for success.

Part 1 of this series highlighted ETFs and ETNs that have generated eye-opening performance over time but likely suffer from lack of investor interest due to relatively low average daily trading volumes and embedded misconceptions among the investing public (on both retail and institutional levels). Since March, has the world of ETF investors scrapped misconceptions in regard to effectively trading large volumes in relatively thinly traded products? I'd say the answer is “no,” but strides are being made in the correct direction thanks to continual education about the ETF/ETN product structures from the ETF issuers and effective measures of executing large trades in lightly traded ETFs by ETF-centric trading firms.

As Matthew MacEachern, portfolio manager at Florida-based Emerald Allocation Strategies, puts it, “ETFs do not require a certain amount of trading volume or average volume to be liquid. Liquidity of the underlying securities in the ETF will determine its liquidity. The idea that "Volume Rules" is misguided and misinformed. The good news is that this misinformation can create market inefficiencies which can be capitalized on.”

Michael McClary, CIO of Valmark Advisers in Ohio, adds, “Execution is much deeper than just trading volume and spreads. ETFs have a complete second level of liquidity, made possible by the ability of ETFs to issue new shares on the fly.” He elaborates, “If they dug a little deeper, I feel that many investment managers would find that many of the trades that they feel are an issue are actually N.O.P., or normal operating procedure”

All of this being said, there are still “screening metrics” that appear from time to time in the ETF media or are simply part of an institution’s or an advisory firm’s “rules of thumb” that “require” that ETFs/ETNs trade

a) 100,000 shares on an average daily volume basis
b) Have a certain level of AUM within the fund, i.e. $100 million and
c) Have to adhere to a specific width between the published bid/ask quotes.

We at Street One Financial find that because there is such a bevy of ETF/ETN products in the universe (equity, fixed income, commodity, actively managed, currency, long/short, etc.), rules of thumb such as those above aren't consistent with reality and often limit the strategies available to the ultimate end user of the ETF/ETN. In essence, these “rules” address ETFs and ETNs as if they were individual small-cap stocks from a feasibility-of-trading standpoint and the practice of installing such screens is akin to investing with “blinders” on. And in a world of increasing ETF usage, limiting strategies due to embedded misconceptions regarding trading volume and liquidity simply handcuffs overall performance and competitive ability because, in order to keep pace with peers, one must often venture into new strategies as they become available or at least have the capacity to be nimble where necessary. Below we've listed tables of ETFs and ETNs (not including leveraged and inverse products) that have at least one year of live returns data, and that also trade, on average, less than 50,000 shares daily. Supposing that “low volume” ETFs are those that fall somewhere between 50,000 and 100,000 shares traded daily, please keep in mind that the line had to be drawn somewhere for this analysis and there are potentially dozens of other products with considerable performance that simply trade more than 50,000 shares daily on average. These products encompass the six major asset classes as defined by ETF Database of Equity (Domestic/International), Fixed Income, Commodity, Currency, Multi-Asset, and Real Estate. In all likelihood, most of these names are unfamiliar to ETF investors on both retail and institutional levels and are likely not utilized in many portfolios for what seems like a flawed and poor reason: lack of trading volume. This said, as investors become more educated on how to optimally trade ETFs/ETNs on both sides of the trade (buying and selling), especially those lacking heavy daily trading volume, portfolios will become more exposed to a wider array of strategies and ideally rein in better performance over time and bring additional diversification as well.

	Domestic Equity (Average Daily Volume < 100,000 Shares)			
Ranking	Symbol	Name	Average Volume (Shares)	YTD % Return
1	IIH	Internet Infrastructure HOLDR	68,934	53.26%
2	SPGH	UBS E-Tracs S&P Gold Hedged	1,146	48.70%
3	PXQ	PowerShares Dynamic Networking	67,116	45.53%
4	PEJ	PowerShares Dynamic Leisure & Entertainment	40,485	39.66%
5	FBT	First Trust Arca Biotech	61,733	37.29%
6	RFG	Rydex S&P 400 Midcap Pure Growth	77,083	36.08%
7	PNQI	PowerShares Nasdaq Internet	14,371	35.84%
8	PXI	PowerShares Dynamic Energy	31,340	33.88%
9	PXE	PowerShares Dynamic Energy Exploration & Prod.	27,905	33.47%
10	PWJ	PowerShares Dynamic Mid Cap Growth	32,177	32.46%

	International/Global Equity (Average Daily Volume < 100,000 Shares)			
Ranking	Symbol	Name	Average Volume (Shares)	YTD % Return
1	CU	First Trust ISE Global Copper	38,264	35.99%
2	BJK	Market Vectors Gaming	18,763	34.39%
3	EPOL	iShares MSCI Poland	71,857	33.19%
4	CNDA	IndexIQ Canada Small Cap	25,303	29.21%
5	PSAU	PowerShares Global Gold and Precious Metals	13,436	28.79%
6	AXMT	iShares MSCI ACWI ex-U.S. Materials	5,666	28.62%
7	LATM	Market Vectors LatAm Small Cap	19,687	28.21%
8	BRAQ	Global X Brazil Consumer	32,680	22.95%
9	MES	Market Vectors Gulf States	12,932	22.61%
10	TWON	IndexIQ Taiwan Small Cap	3,739	22.48%

	Fixed Income (Average Daily Volume <100,000 Shares)			
Ranking	Symbol	Name	Average Volume (Shares)	YTD % Return
1	UBD	Guggenheim U.S. Capital Markets	1,230	8.16%
2	STPP	iPath U.S. Treasury Steepener	10,222	6.70%
3	PSK	SPDR Wells Fargo Preferred Stock	28,921	6.31%
4	LTPZ	PIMCO 15+ Yr U.S. TIPS	51,661	6.00%
5	TLH	iShares Barclays 10-20 Yr Treasury	58,071	5.53%
6	VCIT	Vanguard Interm-Term Corporate Bond	65,304	5.36%
7	VGIT	Vanguard Inerm-Term Govt. Bond	6,400	4.84%
8	VGLT	Vanguard Long Term Govt. Bond	13,393	4.77%
9	PICB	PowerShares International Corporate Bond	15,284	4.72%
10	PLW	PowerShares 1-30 Laddered Treasury	32,744	4.18%

	Commodity (Average Daily Volume < 100,000 Shares)			
Ranking	Symbol	Name	Average Volume (Shares)	YTD % Return
1	BAL	iPath DJ-UBS Cotton Total Return	46,820	105.01%
2	DBS	PowerShares DB Silver	75,021	71.22%
3	USV	UBS E-Tracs CMCI Silver Total Return	2,233	70.20%
4	JJS	iPath DJ-UBS Softs Total Return	11,474	59.70%
5	JO	iPath DJ-UBS Coffee Total Return	22,090	56.82%
6	JJT	iPath DJ-UBS Tin Total Return	10,246	54.07%
7	CORN	Teucrium Corn	45,391	48.07%
8	JJP	iPath DJ-UBS Precious Metals Total Return	4,848	36.68%
9	JJA	iPath DJ-UBS Agriculture Total Return	31,175	32.93%
10	DBP	PowerShares DB Precious Metals	83,691	32.55%

	Currency (Average Daily Volume < 100,000 Shares)			
Ranking	Symbol	Name	Average Volume (Shares)	YTD % Return
1	SZR	WisdomTree Dreyfus South African Rand	7,078	14.68%
2	JYF	WisdomTree Dreyfus Japanese Yen	2,138	10.37%
3	JYN	iPath JPY/USD Exchange Rate	3,150	10.26%
4	INR	Market Vectors Indian Rupee/U.S. Dollar	2,667	5.57%
5	FXM	CurrencyShares Mexican Peso Trust	7,361	5.20%
6	AYT	Barclays GEMS Asia-8	2,949	5.14%
7	FXS	CurrencyShares Swedish Krona	7,865	4.41%
8	ICN	WisdomTree Dreyfus Indian Rupee	13,391	4.09%
9	BNZ	WisdomTree Dreyfus New Zealand	18,893	4.06%
10	JEM	Barclays GEMS Index	1,788	2.81%

	Multi-Asset (Average Daily Volume < 100,000 Shares)			
Ranking	Symbol	Name	Average Volume (Shares)	YTD % Return
1	AOA	iShares S&P Aggressive Allocation	10,997	13.75%
2	TZO	iShares S&P Target Date 2035	900	12.64%
3	TZV	iShares S&P Target Date 2040	3,450	12.32%
4	TZL	iShares S&P Target Date 2030	1,364	11.93%
5	TZI	iShares S&P Target Date 2025	1,728	11.40%
6	TZG	iShares S&P Target Date 2020	2,118	10.85%
7	TDV	TDX Independence 2040	3,598	10.53%
8	TDN	TDX Independence 2030	3,314	10.08%
9	TZE	iShares S&P Target Date 2015	1,351	9.92%
10	PAO	PowerShares Riverfront Tactical Balanced Growth	12,828	9.22%

	Real Estate (Average Daily Volume < 100,000 Shares)			
Ranking	Symbol	Name	Average Volume (Shares)	YTD % Return
1	RTL	iShares FTSE NAREIT Retail	8,450	26.59%
2	REZ	iShares FTSE NAREIT Residential	21,034	22.96%
3	FRI	First Trust S&P REIT	68,992	21.33%
4	IFNA	iShares FTSE EPRA/NAREIT North America	3,567	17.53%
5	FTY	iShares FTSE NAREIT Real Estate 50	25,093	17.10%
6	PSR	PowerShares Active U.S. Real Estate	5,989	16.89%
7	WREI	Guggenheim Wilshire U.S. REIT	3,248	14.90%
8	GRI	Cohen & Steers Global Realty	10,346	12.82%
9	FFR	First Trust FTSE EN Dev. Markets	16,198	12.75%
10	WPS	iShares S&P Developed Ex-U.S. Property	28,213	10.54%

Upon closer examination of these top performing ETFs/ETNs, we consulted with a number of industry pundits including representatives from prominent ETF issuers and buy-side portfolio managers, as well as Michael Johnston of ETF Database, a well-known and respected ETF informational website. Johnston had the following to offer in regards to our study: “The last several years have seen tremendous innovation on the product development front in the ETF industry. As a result, investors now have more options than ever before, including increasingly targeted products and access to increasingly complex asset classes and investment strategies. The industry remains very top-heavy, with a handful of funds accounting for the bulk of assets and trading volume. So advisers who follow rules of thumb and demand a minimum asset level or trading volume miss out on a huge chunk of the ETF universe, including a number of products that offer unique exposure or a compelling investment thesis. Although advisers and individual investors have learned quite a bit about ETFs over the last several years, there are still some misconceptions around the concept of liquidity. Slowly, investors are realizing that historical volume figures are of limited importance, and that the 'spontaneous liquidity' possible through the exchange-traded structure makes ETFs very different from stocks, at least from a trading perspective.”

Christian Wagner, CIO of Longview Capital Management based in Delaware and New Jersey, agrees, adding, “When it comes to ETPs [exchange-traded products], trading volume tells far from the entire story. Some of our greatest alpha drivers in 2010 have been achieved in low-volume ETNs like **iPath DJ Cotton ETN** (BAL), **iPath DJ Copper ETN** (JJC), and **iPath DJ Sugar ETN** (SGG). Trading volume and underlying liquidity are distinctly different attributes in these securities. Do the research. Volume scans alone will cause an investor to miss out on some very interesting opportunities. If you were basing a large part of your investment decision on volume you should discount the validity of Berkshire Hathaway A as a viable investment candidate.”

Michael Paciotti, the CIO of Pennsylvania-based Integrated Capital Management, addresses these topics as well. Paciotti stated, “There are many elements to liquidity. While the knee-jerk reaction is to evaluate liquidity based on trading volume, this is actually misleading. We’ve seen several high-volume ETFs trade at substantial premiums or discounts from NAV [net asset value] while we’ve been able to move rather large dollars into thinly traded ETFs within a penny or two of NAV. It’s really the liquidity of the underlying notional investment that is the driver to liquidity in an ETF. ETFs tracking high-yield credit or micro-cap stocks will tend to trade at a larger premium or discount from NAV than ETFs tracking Treasuries or large-cap equities. It’s the arbitrage mechanism that is inherent in the creation and redemption process that keeps spreads narrow, independent of volume. That is not to say that volume is irrelevant, it is just less relevant when trading ETFs than it is when trading individual securities.”

John Hoffman, external institutional portfolio consultant at the ETF issuer Invesco PowerShares, which is well-known for its fundamental indexing strategies in conjunction with Research Affiliates (RAFI) as well as successful funds such as **PowerShares Water Resources** (PHO), **PowerShares QQQ Trust** (QQQQ), and the PowerShares DB family of commodity and currency ETFs, had the following to say about where we currently stand in regards to these matters:

> The growth in the ETF product, in terms of the number of products listed, has enabled investors the ability to attain very precise exposures. However, many investors begin their research based on the trading volume of the ETF and screen out the lowest volume products. Trading volume simply reflects how popular an ETF is in the market place and thus may not be the most appropriate metric to begin your selection process with. If you were in the market for a high performance sports car, you would not begin your selection process by isolating the best selling vehicles. Instead you would screen on metrics that align with your requirements such as horse power or how fast the car can go from zero to 60.
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> In the case of the ETF, investors need to begin their research by looking under the hood of the ETF. An ETF's performance is not based on how popular the ETF is in the market place, but rather it is based on how the securities in the portfolio perform. Similar to how you would select a car, begin your ETF research by looking at the engine, which in the case of the ETF is the index and the securities that comprise the ETF. Look at how they are weighted, how many securities there are in the portfolio, how they are selected, and when do they change. For example, one retail ETF may be highly concentrated in the largest retail stocks, while another retail ETF may provide exposure to small- or mid-cap retailers.

Sara Grillo, principal at New York-based Diamond Oak Capital Advisors, took our study a few steps further and presents her own list of prototypical “low volume ETFs” with considerable year-to-date performance. She notes **Vanguard FTSE All World Ex-US Small Cap** (VSS) up 21.35%, **First Trust Value Line Dividend** (FVD) up 13%, **PowerShares Global Agriculture** (PAGG) advancing 13.99%, **First Trust Chindia** (FNI) up 15.89%, **PowerShares Emerging Infrastructure** (PXR) gaining 21.87%, **Elements MLCX Grains Total Return ETN** (GRU) up 20.84%, **Elements MLCX Biofuels** (FUE), which has rallied 31.06% this year, and finally **iShares DJ US Utilities** (IDU), which is up only 3.4% year to date, but also boasts a 3.75% yield.

(Disclosure: Clients of Diamond Oak hold IDU and VSS. Grillo holds VSS.)

Grillo adds, “Many ETFs which trade with smaller ADV are what we would consider sector funds which focus on a sector of the market. Typically they would be used to accent a particular feature of a portfolio rather than comprise a large part of it. For example, IDU may trade at an average of 40,000 or 50,000 shares per day, but because it is a utility-focused fund, it would never be a core holding anyway. Its best use would be as a “satellite” position comprising 2% to 5% of the total portfolio. Advisers may use a thinly traded ETF such as IDU sparingly for yield enhancement.”

Another ETF issuer, well-known for its dividend- and earnings-weighted strategies as well as its successful line of internationally focused and currency-based ETFs, is WisdomTree. David Abner, director of Institutional ETF Sales and Trading and also the author of *The ETF Handbook*, offered the following perspectives on how he sees the evolution in trading ETFs, particularly low-volume ones, panning out.

> People are starting to move down the curve and when looking at the details, people are moving beyond the top 30 funds (in terms of AUM size) as far as adding them to their portfolios. They are embracing the broader universe of funds, with less average daily volume, that may give them an opportunity to add alpha to their portfolios. Others, who have not learned that trading volume is not an effective screen, are unfortunately missing out.

Another interesting dynamic that Street One has noted is the phenomenon of asset inflows to **Vanguard Emerging Markets** (VWO) from **iShares Emerging Markets** (EEM) in 2010 largely due to investors becoming more comfortable with the liquidity and trading aspects of VWO, as well as its favorable live head-to-head performance. This phenomenon seems to have actually helped one of WisdomTree's products, **WisdomTree Emerging Markets High Yielding Equity** (DEM), because it has produced performance that has trumped both EEM and VWO (DEM up 17.85% in the trailing one-year period versus EEM up 12.80% and VWO up 15.50% during the same period). Thus, just as investors have become more comfortable trading VWO even though it has less trading volume than EEM, they have likewise embraced DEM after learning how to trade it more efficiently, and they have realized the benefits of an alpha-generating strategy in their portfolios.

In speaking to Richard Kang, CIO of Emerging Global Shares, an ETF issuer focused on emerging-markets ETFs with notable funds including **Small Cap India** (SCIN), **Brazil Infrastructure** (BRXX), **China Infrastructure** (CHXX), and **Emerging Markets Consumer** (ECON), we learned that the issuer is generally very conscious of the underlying liquidity in the indexes that they base ETF products on during the product-creation stages. Specifically, Kang noted that Emerging Global Shares realizes that if it creates an international sector-based ETF that owns strictly emerging-markets equities, they may consciously screen out certain names in those sectors or markets because they don't want to run the risk of the bottom half of an index having underlying liquidity problems. Kang noted, for example, that a certain ETF may have only 30 underlying names in its index as opposed to say 100 because issuers don't want to include equities that themselves may have specific liquidity problems, and it provides some level of assurance that the equities that make up the index are large-cap if not mega-cap names.

Adam Patti, CEO of IndexIQ, an ETF issuer known in the industry for its "Rules Based Alpha" philosophy, which "combines the benefits of traditional index investing with the alpha potential sought by active managers," also had some points to offer:

> One of the key themes we hear out in the field speaking with advisers centers on ETF "liquidity." Given a lack of proper education early in the development of the ETF market, many advisers are still under the impression that their ability to efficiently buy or sell a given ETF depends on the trading volume of that ETF. As we explain to advisers every day, this is absolutely false. I understand why advisers may believe this, particularly given the bloggers and other pundits in the market railing against "illiquid" ETFs.
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> ETFs are not individual stocks. The liquidity of an ETF is 100% based on the liquidity of its underlying holdings. If the portfolio components of any ETF are liquid, then the ETF is by definition easily tradable, both on the buy and sell side. If the index upon which the ETF is based is of high quality and has appropriate liquidity screens then an adviser will never have a problem.

> Given that ETFs are not individual stocks, there are certain things advisers should be aware of; for instance, always set limit orders when buying ETFs, regardless of its trading volume. Additionally, when buying big blocks of any ETF it is often more efficient to work directly with an Authorized Participant or other liquidity provider. This is because, unlike individual stocks, ETFs can be created on the demand of an adviser, meaning that new shares of the ETF will be constructed and provided directly to the adviser typically at or close to the NAV. This process works exactly the same when advisers are selling blocks of shares.
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> Given the widespread misunderstanding regarding the trading of ETFs, many advisers actually view buying the less “liquid” ETFs as a competitive advantage. This is because many of the newer or more sophisticated ETFs that have come to market are still trading at relatively low volumes yet are often of higher quality from an investment perspective than some of the older and more “liquid” issues. Understanding how ETFs trade and not getting scared off from buying some of these newer ETFs can offer an adviser’s clients access to exposures that provide a better constructed portfolio, perhaps better than other advisers who stick with the more plain vanilla, older ETFs in the marketplace. ...
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> My message is simple, pick the best product to serve the needs of your clients, don’t worry about trading volume -- it is irrelevant.

At Street One Financial, being involved in the ETF trade-execution space as a liquidity provider for end users such as institutions, RIAs, and broker/dealers, we believe that 2010 marks the beginning of a turning point for the industry as a whole, mainly attributable to ongoing education by the ETF issuers, trading firms, and informed investment managers who have been successfully building portfolios of ETFs/ETNs in some cases for more than a decade. Also, it generally only takes a successful trade or two in a “low-volume” ETF for one to dispel embedded myths and misconceptions, and open up new horizons of opportunity within one’s portfolio.

This coming year, 2011, comes to us with a multitude of newly launched products and dozens more on the shelf awaiting their launches, with many of these funds more esoteric in their investment strategy than the next. That said, removing the “blinders” when it comes down to screening potential products for inclusion in investment portfolios will be more crucial going forward in order to objectively evaluate the landscape. Portfolio managers and investors alike need to be open-minded in the ever-expanding universe of ETFs/ETNs, and more importantly understand how to execute their ETF/ETN orders effectively. In doing so, they can avoid missing or intentionally avoiding funds like some of 2010’s winners that I've cited in this report, and can instead add alpha to their portfolios and transform their practices through more efficient and effective trade execution.

No positions in stocks mentioned.