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MarketWatch at Wed 29th Jun 3:22pm AEST

Markets Closed Markets Open

ETF regulation avoids another derivative disaster

- Andrew Main
- From: [The Australian](#)
- June 27, 2011 12:00AM

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THERE'S a lot to be said for being a late adopter of new trends, to judge by how exchange traded funds are being viewed in this country.

We're basically looking at the Mark II model, the one with the bugs ironed out, at a time when ETFs only represent 4 per cent of the capitalisation of our sharemarket. The catch, which car manufacturers know so well, is that the stories about the Mark I version of anything occasionally catching fire or blowing up are still echoing around the industry, even though Mark II buyers, our local investors, should be in for a much easier run now with ETFs.

Exchange traded funds or ETFs arose in the 1990s in the US as a simple way for investors to diversify their risk.

In their basic form they are just a tradable index fund, designed to replicate the performance of a spread of stocks without the retail (or institutional) investor having to go to the trouble or expense of buying the full portfolio.

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They took off like a bushfire, partly because of their diversification and partly because of their low cost compared with managed funds, which are more active stock pickers but have a much higher cost structure.

But you can get too much of a good thing. They grew so big in the US that in the Flash Crash of May 6 last year they represented over 60 per cent of the trades that ended up being cancelled. That was all about automatically generated sell orders looking in vain for a buyer.

The rush to innovation in the US also meant they moved away from the plain-vanilla funds that mostly make up the market in Australia, and got into leverage -- inverted funds running double shorts and the like.

That's all very well if the risks and purpose are fully disclosed but the trend created quite a lot of "synthetic ETFs" that made up for a lack of liquidity in certain stocks by including a swap deal with an investment bank to establish the supposed collateral against which the ETFs were issued. All the deal had to do was make the fund perform like the stocks it supposedly represented, which was an open invitation to quantitative analysts and derivative specialists to show off how clever they were.

That got ETFs a bad name in the US because a spade ceased to be a spade and you didn't really know what sort of collateral was actually backing your product.

This is starting to remind us of CDOs and the rapacious "financial engineering" culture that caused all the grief in the global financial crisis. Instead of considering the likely needs of investors, investment banking product specialists were lured by pushy quantitative specialists into sharing the revenue stream from new products aimed more at enriching the issuers than actually offering prosperity to the buyers.

The Economist this week reports that since in some countries the collateral does not have to be related to the stated aim of the ETF, mismatches occur.

It says the International Financial Stability Board found that the collateral pledged to one emerging markets fund largely comprised Japanese shares and US bonds, neither of which had anything to do with the product supposedly being offered.

The Economist also notes that investment banks have an incentive to establish synthetic ETFs and their relation, exchange traded notes or ETNs, as a cheap way of financing their assets. Fortunately the exotics never got as far as the CDO market did, for instance, before the calls for tighter controls and greater transparency got very loud. That takes us to now, the moment in the saga where Australia has started to take ETFs seriously. In 2005, there were around 9900 investors in ETFs in Australia, most of them running self-managed super funds, and now there are reportedly more than 50,000 of them.

That compares with about 41,000 trading the much more highly leveraged CFDs (contracts for difference) and 13,500 trading unlisted equity funds, according to a presentation made last week in Sydney by Investment Trends.

At a recent seminar for institutional investors promoting ETFs, ASX executive Richard Murphy sounded a similar warning by telling issuers not to "tip in some CDO that you couldn't sell" as collateral for a new product. He also drew a major distinction with US practice by saying that the regulators here have limited the synthetic element of any ETF listed here to a maximum of 10 per cent of the collateral.

One index specialist, the people who devise the indices against which new ETFs benchmark themselves, said in Sydney last week that "you would be amazed to find out how much constructive work ASIC has done in this area" despite having no barrow to push for our regulator.

"They've done a really good job going through the way these things are put together, making sure they are going to be what they say they are," he added.

It's probably a bit early to predict that everyone in Australia who buys into an ETF is going to have a seamless run, but this may just be one of those newish financial products where the regulations have been in place before there's been a mass retail take-up. That's the reverse of what usually happens, where ASIC and corporate cops try to plug the dam of financial folly after the cracks have started to appear. A mix of good management and good luck.

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REPORTS from London suggest that the tide is turning for tin after weeks of slumping prices for the metal.

Matthew Stevens

["Cousins is wrong to condemn business for seeking debate across an agenda broader than the carbon tax"](#)

GEOFF Cousins' assault on big business would be laughable but for the fact Australia is so burdened with critical national disconcert and challenge.

Bryan Frith

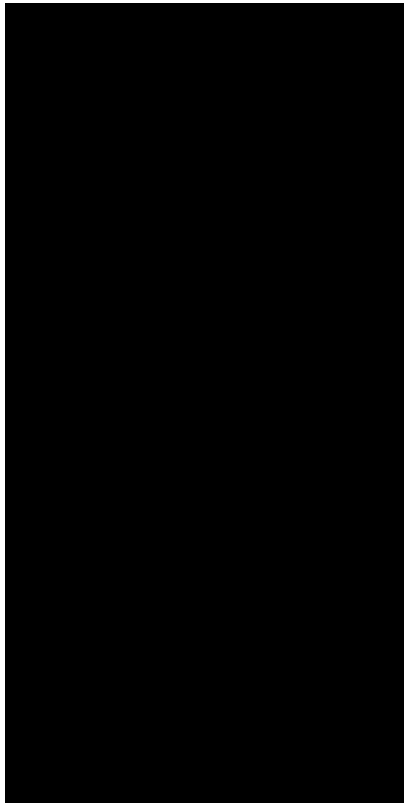
["Directors cannot simply rely only on management or advisers, but must bring their own minds to bear on issues"](#)

JUSTICE John Middleton's decision in favour of ASIC in the Centro case does not so much raise the bar for directors as remind us where it has sat.

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ASX 200 Top Gainers & Losers

Company Name	PriceChange		%Change
Sigma Pharmaceuticals ...	0.38	+0.01	UP +2.73%
SP AusNet	0.91	+0.02	UP +2.24%
Mesoblast Ltd	8.89	+0.17	UP +1.94%
DuluxGroup Limited ...	2.77	+0.04	UP +1.46%
TPG Telecom	1.69	+0.02	UP +1.19%
Gloucester Coal...	8.70	-1.20	Down-12.13%
Gunns Limited	0.39	-0.05	Down-10.35%
Whitehaven Coal	5.78	-0.65	Down-10.11%
Karoon Gas Australia ...	6.05	-0.66	Down-9.84%
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