

one Point of View

Business Characteristic ETFs: Completing the Core

Research compiled by Michael Venuto, CIO and David Dziekanski, Portfolio Manager

At Toroso, we believe the historical returns of mainstream indexing may not be what investors should expect to receive in the future. In the past decade the indexing business has moved from a benchmarking business to an investable universe or an asset gathering business thanks, in large part, to the growth of the ETF industry. (For more detailed information on this development, please review Toroso's November 2013 Commentary: [ETFs: The Business of Indexation.](#))

In technical terms, market cap weighted indexes became float-adjusted market cap indexes. Companies with high levels of inside ownership receive decreased weightings in most of the major index companies. Additionally, many securities are excluded from mainstream indexes due to a number of counter intuitive indexing rules. This issue was highlighted this year with the largest IPO in history; Alibaba Group Holding Limited (NYSE: BABA). Many investors were surprised to learn that geographic rules within most popular emerging market indexes forced the exclusion of this highly sought after new issue.

Are Active ETFs the Answer?

The next logical step is to look to active management to provide access to the securities orphaned by most indexes and the excess returns they may provide. Today we are seeing a constant flow of headlines about active ETFs and significant recent rulings by the SEC regarding the active ETF structure. Toroso believes this obscures the real opportunity. Active ETF management, in our opinion, faces a substantial hurdle which will not be solved through an ETF structure. The success of an Active ETF hinges on two factors that are difficult to achieve simultaneously, since one begets the other: trading volume and performance.

Instead of trying to fit active management into an ETF format that is dependent on trading volume as a key viability statistic, we feel that the real story lies with the ETFs in the business characteristic space. This approach provides access to those characteristics that active managers target in a passive, more transparent format. We have identified 22 such ETFs listed in the Appendix.

Business characteristic ETFs are designed to provide passive access to investment strategies used by hedge fund managers and billionaires. Some focus on corporate actions, share repurchase programs, spinoffs, insider sentiment and product life cycles just to name a few. We think these ETFs allow passive investors access to the characteristics active managers seek out in a low cost, transparent and tax efficient

manner. In other words, we believe these ETFs are the link between active and passive management.

The goal of this commentary is to show where investors can get access to such sought after securities in their ETF portfolios by identifying Business Characteristic ETFs that will provide simple access to a specific theme.

Examining the Overlap

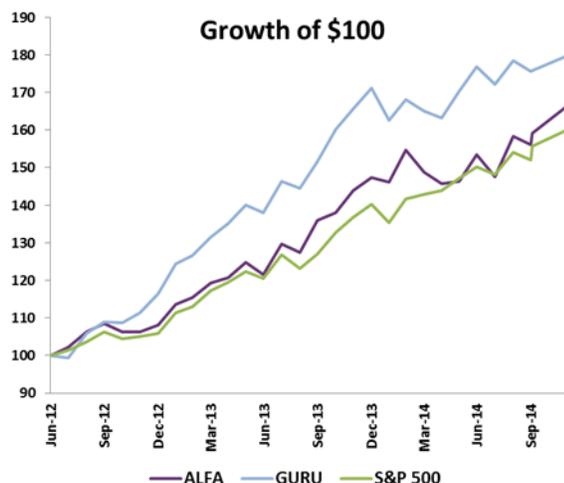
We define "overlap" as the percentage of the ETF that is contained or represented by an ETF to which it is being compared. The chart below compares the percentage overlap for a selection of US-only Business Characteristic ETFs to the SPDR S&P 500 ETF (Ticker: SPY), which replicates one of the most popular indexes and is the ETF with the longest track record. In addition, we compare those Business Characteristic ETFs to the Vanguard Total Stock Market ETF (Ticker: VTI) to demonstrate the amount of overlap that these Business Characteristic ETFs have compared to another broad based ETF.

ETF	Ticker	% of Overlap to SPY	% of Overlap to VTI
Guggenheim Spin-Off ETF	CSD	1	1
The Forensic Accounting ETF	FLAG	46	42
First Trust US IPO Index Fund	FPX	3	4
Global X Guru™ Index ETF	GURU	11	9
Global X Guru™ Small Cap Index ETF	GURX	0	0
Direxion iBillionaire Index ETF	IBLN	13	9
Renaissance IPO ETF	IPO	0	1
Direxion All Cap Insider Sentiment Shares	KNOW	9	6
Morningstar Wide Moat ETF	MOAT	10	7
Guggenheim Insider Sentiment ETF	NFO	7	7
PowerShares NYSE Century Portfolio	NYCC	25	26
PowerShares BuyBack Achievers Portfolio	PKW	9	9
Stock Split Index Fund	TOFR	6	4
SPDR S&P 500 ETF	SPY	100	81
Vanguard Total Stock Market ETF	VTI	81	100

The overlap chart above shows just how different these ETFs are compared to broad based US equity market ETFs such as SPY and VTI. These ETFs can provide access to the securities and themes that active managers will often pay a premium to purchase.

Domestic Business Characteristic ETFs

1. **ETFs Based on the Actions of Others.** GURU, GURX, ALFA, IBLN all seek to provide exposure to the conviction holdings of hedge funds or billionaires. This is a common practice in the active management world that has helped to generate alpha for many fund managers. Each of these take different approaches to execution, most are equal weighted and focus on equities of all capitalizations, but with a large cap bias. GURX from Global X Funds is an exception and dedicated to small caps. AlphaClone Alternative Alpha ETF (Ticker: ALFA) is unique in that it has a built-in hedging mechanism against the S&P 500, which is triggered by moving averages, and the portfolio is weighted based on hedge fund conviction. The commonality has been excess returns as evidenced by ALFA and GURU, which have the longest history:



2. **ETFs Based on the Actions of Insiders.** The Direxion All Cap Insider Sentiment Shares (Ticker: KNOW) and the Guggenheim Insider Sentiment ETF (Ticker: NFO) come from two different ETF sponsors and use the same index provider, Sabrient Systems, LLC. Amazingly, these two funds with seemingly similar mandates and a common index provider only have 19% holdings overlap. This is why the evaluation of these ETFs and their underlying indexes is so important. Again, the commonality is performance but the true story is tax efficiency. KNOW for example has 920% turnover according to Morningstar; and in 2013 the fund was up 33% with no capital gains distribution.
3. **ETFs Based on the Actions of the Companies.** Many of the other Business Characteristics ETFs focus on the actions of the companies themselves, rather than hedge fund managers or insiders. The biggest success story is the PowerShares BuyBack Achievers Portfolio (Ticker: PKW), which now has over \$2.5 billion in assets. The AdvisorShares TrimTabs Float Shrink ETF (Ticker: TTFS) has a

similar mandate and performance but substantially less assets, which is likely to be a result of its active, rather than passive, ETF structure. Other interesting ETFs in this sub-category of “company actions” include the Guggenheim Spin-Off ETF (Ticker: CSD) and USCF Stock Split Index Fund (Ticker: TOFR). Also, there are two ETFs that focus on US IPOs, the First Trust US IPO Index Fund (Ticker: FPX) and a newcomer without much performance data, the **Renaissance IPO ETF (Ticker: IPO)**; surprisingly these two ETFs only have 18% holdings overlap.

Global and International Business Characteristic ETFs

There are only five Business Characteristic ETFs that focus on global or international companies. The PowerShares International BuyBack Achievers™ Portfolio (Ticker: IPKW) is the international version of PKW and looks for international companies that are buying back shares. Global X Guru™ International Index ETF (Ticker: GURI) is the international version of GURU from Global X Funds, which focuses on conviction hedge fund holdings in international stocks, or ADRs. **Renaissance International IPO ETF (Ticker: IPOS)** was recently launched and provides access to international IPOs. These are relatively new ETFs and only time will tell if they will be as successful as their US versions. The most interesting global ETF in our opinion is from EG Shares and focuses on the geography of revenue. The EGShares Blue Chip ETF (Ticker: BCHP) follows an index of 30 global blue chip companies that derive meaningful revenue from the emerging markets. In the active management world this is often referred to as emerging market linked equities.

Business Characteristic ETFs in the Fixed Income Space

The fixed income world has only one ETF currently in this space, the Fallen Angel High Yield Bond ETF (Ticker: ANGL) from Market Vectors. The index focuses on the debt of companies that had much higher credit ratings in the past. Again this has proven to produce returns superior to traditional fixed income indexes and ETFs. ANGL has outperformed both SPDR® Barclays High Yield Bond ETF (Ticker: JNK) and iShares iBoxx \$ High Yield Corporate Bond ETF (Ticker: HYG) by over 500 basis points since inception in April of 2012. Toroso sees many opportunities for growth and expansion of business characteristic indexes in the fixed income space.

Completing the Core

From time to time, Toroso uses Business Characteristic ETFs to complete and enhance many of the core holdings of our clients. We have found that we can get exposure to under-owned, opportunistic securities through careful analysis of Business Characteristic ETFs. By pairing traditional market cap index based ETFs with ETFs tied to business characteristic indexes we may be able to build portfolios that behave like a portfolio of actively managed funds at a lower overall cost.

In the last 25 years ETFs have risen to prominence due to their low costs, ease of trade, transparency and tax efficiency. Our excitement about the business characteristic category is not a discredit to the original concept. But it does allow savvy investment managers the opportunity to outperform traditional index-based strategies in two possible ways:

1. Overuse of traditional market-weighted index strategies may reduce their effectiveness in helping an investor reach their investment return goals.

2. By identifying “alpha” seeking, concentrated ETFs that follow many of the techniques employed by active managers in a passive ETF format.

Therefore, we believe that the solution to mainstream index exclusion and diminishing returns does not begin with the active ETF structure debate. Toroso believes many solutions already exist in the business characteristic based ETF category; the true challenge is the proper use of these ETFs.

Appendix

Business Characteristic ETPs	Ticker	Inception Date	Geography	Asset Class	Characteristic	Structure	Weighting
AdvisorShares TrimTabs Float Shrink ETF	TTFS	10/4/2011	US	Equity	Float Shrink	Active ETF	Equal
AlphaClone Alternative Alpha ETF	ALFA	5/31/2012	US	Equity	Hedge Fund Conviction	Hedged ETF	Tiered
Direxion All Cap Insider Sentiment Shares	KNOW	12/8/2011	US	Equity	Insider Conviction	ETF	Tiered
Direxion iBillionaire Index ETF	IBLN	8/1/2014	US	Equity	Billionaire Conviction	ETF	Equal
EGShares Blue Chip ETF	BCHP	4/23/2014	Global	Equity	EM Revenue	ETF	Equal
ELEMENTS SM Linked to the Morningstar [®] Wide Moat Focus SM Total Return Index	WMW	10/17/2007	US	Equity	Wide Moat	ETN	Equal
First Trust US IPO Index Fund	FPX	4/12/2006	US	Equity	IPO	ETF	Capitalization
Forensic Accounting ETF (The)	FLAG	1/30/2013	US	Equity	Forensic Accounting	ETF	Tiered
Global X Guru [™] International Index ETF	GURI	3/10/2014	International	Equity	Hedge Fund Conviction	ETF	Equal
Global X Guru [™] Index ETF	GURU	6/4/2012	US	Equity	Hedge Fund Conviction	ETF	Equal
Global X Guru [™] Small Cap Index ETF	GURX	3/10/2014	US	Equity	Hedge Fund Conviction	ETF	Equal
Global X SuperDividend [™] ETF	SDIV	6/8/2011	Global	Equity	Pure Yield	ETF	Equal
Guggenheim Insider Sentiment ETF	NFO	9/21/2006	US	Equity	Insider Conviction	ETF	Equal
Guggenheim Spin-Off ETF	CSD	12/15/2006	US	Equity	Spin Offs	ETF	Capitalization
Market Vectors [®] Fallen Angel High Yield Bond ETF	ANGL	4/10/2012	US	Bonds	Newly Distressed	ETF	Capitalization
Market Vectors [®] Morningstar Wide Moat ETF	MOAT	4/24/2012	US	Equity	Wide Moat	ETF	Equal
PowerShares BuyBack Achievers Portfolio	PKW	12/20/2006	US	Equity	Share Repurchase	ETF	Capitalization
PowerShares International BuyBack Achievers [™] Portfolio	IPKW	2/24/2014	International	Equity	Share Repurchase	ETF	Capitalization
PowerShares NYSE Century Portfolio	NYCC	1/13/2014	US	Equity	100 Years Public	ETF	Equal
Renaissance International IPO ETF	IPOS	10/6/2014	International	Equity	IPO	ETF	Capitalization
Renaissance IPO ETF	IPO	10/16/2013	US	Equity	IPO	ETF	Capitalization
Stock Split Index Fund (The)	TOFR	9/15/2014	US	Equity	Stock Split	ETF	Equal

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