

Insights

from Dow Jones Indexes

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Industry Perspective

ETF Ratings Firm Moves Ahead with Industry

Midway through an interview, Mel Herman stops and, a smile on his face, apologizes for talking so fast and so fervently. His zeal for the subject has gotten the best of him.

"ETFs are my passion," he explains.

Spend a little time with Mel, the President of Marco Polo XTF, the exchange traded fund (ETF) rating agency, and you will agree. At a time of market turbulence and general disruption, the ETF market is one of the few sectors that has seen growth, and that is enough to get anyone excited; not to mention someone who had to stare down many financial professionals who thought that ETFs would disappear in a sustained bear market.

"I believe that ETFs are the most innovative financial product in at least the past two decades," says the Wall Street veteran. "While the markets are taking a beating, ETFs have seen net inflows while mutual funds are redeeming client assets at a record pace. In fact, there was a 20% increase in assets from 2007 to 2008; from \$150 billion to \$186 billion. It's remarkable and we see the trend continuing into 2009."

Mel goes on to say that it is actually market volatility itself that is causing the ETFs' rise in popularity. The funds are publicly traded on exchanges and not open-end, like most mutual funds. Their underlying basis is usually an index that follows a certain market, sector, industry or geographic area (or combination of these). The

Mel Herman

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reason investors love ETFs is that they grant exposure to a particular group of equities (or other securities) without as much of the risk.

"We have seen an interesting trend emerging, and it has accelerated in the past few months. There are institutions, endowments, investors of all stripes who are selling off their individual stock holdings and reinvesting into ETFs that cover those very stocks. In fact, Harvard University's endowment did this recently. They divested themselves of equity positions and bought into ETFs. This gives them full coverage for their portfolios with less of the risk. It's a win-win for Harvard – or for any investors."

Setting themselves apart

XTF has a unique role in industry: it provides ratings of ETFs for the many (and growing number of) investors who are looking to put their money into these funds. What separates them from other agencies is the way they conduct ratings; something that is a point of pride for Mel.

“We have a quantitative, rules-based, completely transparent ETF ratings process that is completely one-of-a-kind in the financial services industry,” he explains. “We don’t give investment advice. We don’t manage money. We’re not sponsors or issuers. XTF only does ratings. With this massive influx of money into ETFs, investors need to be able to do their research; to know which is right for them. We rate every ETF based on 14 different data points, including seven for structural integrity, like concentration risk and bid-ask ratio. The other seven are based on investment metrics, which is performance. Then we give an overall rating. It helps investors sort through the hundreds of alternatives out there. That’s why they turn to us.”

Mel has seen XTF’s workload increase as the market for ETFs goes up. He thinks that it’s not just the fact that money is flowing into the ETF market. He credits his firm’s independence and integrity, which clients find refreshing, especially in today’s environment. He thinks that it’s also the company’s accuracy and attention to detail that helps them to stand out.

XTF starts coverage of a security (compiling data) once it starts trading. After six months on the market, the firm will give it a rating. Clients can get ratings on not just equities, but also fixed income (including governments), currencies, commodities, real estate and multi-asset products. And they are assured that the research is unbiased and very usable.

“Trial by fire”

“The reason we have confidence in ETFs — even in tough market conditions — is because we are witnessing them not just survive, but also to thrive. There were some who saw them as a fad, just a short time ago. This is their trial by fire and they’re emerging even stronger.” Mel enthusiastically points out that his company’s attention to detail and its employees’ many years of experience in trading and market-making helped them to occupy their strong position in the market. “We provide structural integrity ratings for 99% of the market cap of the U.S. ETF market. We also provide overall ratings, which includes structural and performance, for 97% of the market cap of this market here in the U.S. Our reach has depth and breadth that our clients value.”

XTF’s cheerleader-in-chief takes great satisfaction in the fact that his Web site (www.xtf.com) allows for easy navigation and exceptionally

detailed information for its users. It is a comprehensive and sophisticated research tool for not just ETFs, but their underlying constituents as well.

For example, if you were interested in researching the oil and gas sector in the U.S., you might come across the iShares Dow Jones Energy Sector ETF (IYE) which is based on the Dow Jones U.S. Energy Index. You could find its 92 components and see that Exxon Mobil (XON) has a large percentage of its capitalization. You can then click on XON to see that it is listed in dozens of other ETFs, including those in which it has less exposure (or more, depending on your faith in the oil giant). The information is unbiased and XTF clients have come to see the quality (and quantity) of data as unsurpassed in the industry.

A look ahead

What are XTF’s next steps? The company is expanding coverage outside the U.S., where in fact, the majority of ETFs are traded. Agreements are being completed for even more widespread exposure in the coming months in Japan, Europe, Asia and other markets. And they are looking at strategic cooperation agreements with the top names in financial markets, including Dow Jones Indexes.

“We look at Dow Jones as one of the leading index providers on the Street today. No question.” Mel goes on to say that XTF wanted to work with the firm due to its renown and reputation in the indexing world. “I mean, the Dow Jones name is a door opener, no doubt about it. When we were presented with this opportunity, we jumped at it. Take a look at the different types of products they come up with; the innovation, creativity and especially the meticulousness they put into everything they make. In bull markets, in bear markets, ‘Dow Jones’ means something.”

Mel understands that there were many names with whom his firm could have cooperated. But he says that he did not need a market research firm to tell him that Dow Jones was right for him. He covers ETFs inside and out, he says, and sees not just the number of them that are based on Dow Jones indexes, but also the caliber of companies with which they partner. With once-venerable Wall Street “names” falling from grace (and in many instances, into oblivion), he likes the idea of collaborating with a firm he considers a market leader.

Mel Herman believes in ETFs and his company. He sees great things for the industry, his firm and its planned alliance with Dow Jones Indexes. He has proved the naysayers wrong more than once. Spend some time with him and it is very easy to walk away convinced that he is really onto something.

Just ask him.