Asset View

Whitepaper

ETFs
Growing popularity

An Alternative Approach to Commodities Investing

A smart approach to Japanese equity exposure

ETF

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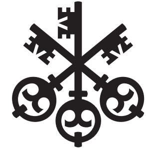

UBS Asset Management offers a comprehensive range of active and passive investment styles and capabilities, across both traditional and alternative asset classes. We take a connected approach to find the answers to our clients' investment challenges. Our global capabilities include equity, fixed income, currency, hedge funds, real estate, infrastructure and private equity investment capabilities that can also be combined into customized solutions and multi asset strategies. Complementing our investment offering, our fund services business provides professional white labeling services including fund set-up, accounting and reporting for traditional and alternative funds.

Invested assets totaled GBP 562 billion as of 30 June 2017. We are a leading fund house in Europe, the third largest international asset manager in Asia, the largest mutual fund manager in Switzerland[1] and one of the largest fund of hedge funds and real estate investment managers in the world.

We have around 3,600 employees located in 23 countries. Our main offices are in Chicago, Frankfurt, Hartford, Hong Kong, London, New York, Singapore, Sydney, Tokyo and Zurich.

Source: Morningstar/Swiss Fund Data FundFlows March 2017.

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WisdomTree launched its first ETFs in the United States in June 2006 and in Europe in October 2014. A smart beta innovator, WisdomTree pioneered the concepts of fundamentally weighted indexes and active ETFs—and is currently an industry leader in both categories. WisdomTree strategies span asset classes and countries globally.

In Europe, WisdomTree offers UCITS ETFs and ETPs, under the Boost brand. The UCITS ETFs focus on Dividend Growth, Equity Income, Small Cap, Currency Hedged strategies and Enhanced Broad Commodities while the Boost ETPs include short & leverage exchange traded commodities and other exchange traded products across asset classes.

INTRODUCTION

ETFs Whitepaper

Growing popularity

An Exchange Traded Fund ("ETF") is a passive fund which tracks an index, rather than an active investment, and seeks to outperform a given index through frequent buying and selling of individual investments.

> "Institutional investors' investment in exchange-traded funds is growing"

The benefits of ETFs, including lowering overall investment costs, diversification, improving accessibility of asset classes and global markets, liquidity, holdings transparency, and low investment minimums have led to their adoption and acceptance by an increasing number of investors.

As a result ETFs (including Exchange Traded Products) have seen a boom over the last ten years, so much so that the global AUM of exchange traded products (all asset classes) is now over $4tn, which compares to around $800bn in 2008.

And this growth isn't coming just from the retail sector. Institutional investors' investment in exchange-traded funds is growing, as more asset managers are offering ETFs into their capabilities and investors are reviewing their allocation between active and indexed investment approaches.

The following Whitepaper provides views from two asset managers, UBS Asset Management ("UBS") and WisdomTree Europe Ltd ("WisdomTree").

UBS provide their thoughts on investing in Commodities whilst WisdomTree focus on how you can get exposure to Japanese Equities using ETFs.

Written by Sean Thompson
Managing Director
CAMRADATA

Variety

Exchange Traded Funds, from equities to commodities. UBS ETF.

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An Alternative Approach to Commodities Investing

Investing in commodities is not as straightforward as with most other asset classes. Accessing commodities poses a number of challenges, most notable is contending with how best to participate in movements in underlying spot prices via the use of futures contracts.

UCITS eligibility rules dictate that direct investment in physical commodities is not permitted. Neither is investing directly in commodities futures. Thus, the only way to access these under UCITS guidelines is via investing in a wrapper (such as an ETF) which tracks a Commodities index through the use of derivatives such as swaps. The index itself will be made up of a basket of commodities futures which are selected, weighted, rolled and traded according to a specific methodology as defined by the index provider. Further, UCITS rules make a clear distinction between a genuine ETF - and an ETC tracking a single commodity which is typically a debt security issued by an investment bank and thus has considerably less investor protection than a UCITS ETF.

Broad commodities indices can have quite varied characteristics and these features can have a major impact on investment returns. Accordingly, when investing in a commodities ETF, it's very important for investors to look carefully at the underlying component weightings and the methodologies being employed. Simply, all broad commodities indices are not created equal.

Index weights of commodities indices

A surprising feature of broad commodities indices is the varied weightings – particularly as regards Energy. For example: As of end-August 2017, Energy makes up 59.2% of the S&P GSCI index, 33.7% in the UBS Bloomberg CMCI index and 28.7% in the Bloomberg Commodities index. As one can imagine, this can cause quite divergent sets of performance between these indices and passive products tracking them.

These differences come as a result of index providers' methodologies. If they are using only worldwide production for the basis of the weightings, this would tend to produce heavier weights towards the Energy sector. However, if Consumption, Economic Weights (e.g. CPI) and Liquidity factors are also used, this can produce a rather different and arguably a more balanced exposure to broad commodities.

> "The impact of negative roll yield can create a sizeable divergence between the performance of commodity spot prices vs that delivered by ongoing rolling of commodities futures contracts"

Negative roll yield

Investment returns delivered by a commodities index are primarily made up of price movements of the underlying commodities it holds, as well as the 'roll returns' resulting from the ongoing requirement of having to roll the futures contracts to keep the ongoing exposure to each of the respective underlying commodities. The latter is in fact a considerably more important contributing factor to performance than many investors may appreciate.

The very nature of the index gaining exposure to these commodities via futures markets means that a major feature of the performance of that index will be dictated by how the rolling of these futures contracts is managed. To maintain exposure to a specific commodity such as copper for example, there is an ongoing process of selling the front month copper futures contract before it expires and replacing it with the next available contract so as to continue to keep that exposure. If the later dated contract being bought has a higher price (for simplicity, let's say e.g. $6,700/tonne) than the one which is about to expire (e.g. $6,500/tonne), this produces 'negative roll yield'. When the later dated contracts along the commodities futures curve are more expensive than the front of the curve, this is known as 'contango'. Clearly, a persistent contango-shaped curve can become quite expensive for investors. Selling low and buying high was never a successful investment technique after all.

'Backwardation' is the opposite, where the price of the later-dated contract is lower than the current contract which needs to be sold. This scenario would produce 'positive roll yield'. Generally, across a wide range of commodities, there will be a far larger number of individual commodities in contango than in backwardation.

When we talk about a curve being in contango or backwardation, it's important to understand that in practice, the shape of these curves is not simply linear.

Backwardated curves typically reflect a situation where there is a supply shortage or some sort of negative shock to supply which has caused the shorter-dated part of the futures curve to be pushed up higher relative to the longer-dated part. The futures curve is not a prediction of where commodity prices will be in the future, but rather what an investor is willing to pay today for delivery of those contracts in future.

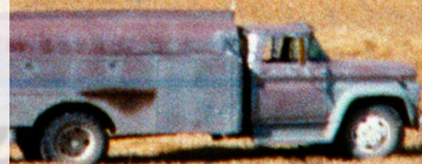
The fundamental issue at hand is that many first generation commodities indices have a number of shortcomings. They are only participating in the rolling process in the 'congested' front month part of the curve (with everyone selling their expiring contract and trying to buy the next available contract within the same specific roll period - and there are few market participants on the other side). This exacerbates the contango situation.

This has led to index providers looking at new methodologies to gain access to commodities via the use of futures. This can include:

- Deferred rolling: Similar to standard first-generation, but rolling contracts with longer-dated maturities
- Optimised rolling: Where the index provider actively seeks contracts that will improve the roll yield by incurring less congestion-related costs.
- Constant Maturity: A rules based approach which trades smaller amounts on a frequent basis and thus maintains a consistent contract maturity. In addition to reducing negative roll yield, the market impact is considerably lower.

UBS Bloomberg CMCI Composite broad commodities index

The UBS Bloomberg CMCI Composite Index ('CMCI') is a second generation commodities index which uses a 'constant maturity' (the CM in CMCI) concept which has proved to deliver better performance than traditional 1st generation broad commodity indices (such as the S&P GSCI and the Bloomberg Commodities ('BCOM' mentioned earlier) yet with lower levels of volatility. The CMCI constant maturity concept means that small amounts of each of the various commodities are being rolled continually – thus, avoiding the 'congestion' associated with rolling futures contracts at predetermined days each month or quarter. The CMCI represents a modern investment benchmark tracking 26 commodities which reflects more accurately the real nature of commodity markets.



The CMCI methodology is distinct from first generation indices in that the underlying futures contracts are bought across the various commodities at five different points in the various curves (3m, 6m 12m, 2yr and 3yr). This allows for more balanced participation in the curve. It also means more access to the parts of the curve which are in backwardation, not just in contango. As highlighted previously, futures rolling in a market in contango would get very expensive and will generate more negative roll yield.

Ultimately, what matters is that this methodology has delivered superior results. Since inception in 2007, the CMCI Commodities index has healthily outperformed first generation indices and done so with lower levels of volatility. Even against other 2nd-generation indices such as the DBLCI, JPMCI, MLCX and CS CI, the CMCI has delivered better risk-adjusted returns[1].

Conclusion

For investors who are looking to access the broad commodities market via a UCITS ETF wrapper, it's important to look carefully at the underlying constituent weighting makeup of the index which is being tracked. However, it is equally important to consider how the underlying index manages the way the commodities futures contracts are accessed. The impact of negative roll yield can create a sizeable divergence between the performance of commodity spot prices vs. that delivered by ongoing rolling of commodities futures contracts. The second generation UBS Bloomberg CMCI Composite Commodities index and the UBS CMCI UCITS ETF which tracks it can help investors access a balanced broad UCITS commodities portfolio in a more efficient manor than ETFs tracking more traditional broad commodities indices. More recently, UBS Asset Management launched a broad commodities ETF which uses the Bloomberg Commodities commodity weights index coupled with the CMCI rolling methodology which is particularly useful for investors who might have the BCOM as their benchmark and do not have risk budgets which allow for different underlying benchmarks such as the CMCI. The UBS CMCI Composite UCITS ETF is currently the largest broad commodities ETF in Europe with assets in excess of USD 1.1bn (31/08/2017).

1 Past performance is not a guide to the future

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A smart approach to Japanese equity exposure

Japanese equities retain a position of significant importance for many investors with the second largest country weight in the MSCI World benchmark index after US equities.

The weight of close to 9% as of the end of August 2017, combined with the relatively unique attributes of the economy and equity market means that investors look at Japan as a specific allocation relative to other regions and countries. This also means that there is no shortage of ETFs that track the many indices that cover the Japanese equity market. The challenge for investors is to consider whether pure market capitalisation indices offer the best solution for accessing a market that has some unique characteristics and macro-economic factors.

Abenomics and structural reforms are a key feature

For many years investors, have shied away from Japanese equities based on long-run structural weakness in the economy, deflationary pressures, weak GDP growth and a lacklustre approach to corporate governance. The election of Shinzo Abe at the end of 2012 created a new dynamic of monetary easing, fiscal stimulus and structural reforms. Abenomics has been at the heart of the investment these for Japanese equities and we examine how this can be best accessed from the perspective of a smart beta approach to the equity market.

Structural reform has been one of the key pillars to change, aided by dramatic shifts in monetary policy to negative rates and targeting a zero percent yield for 10 year government bonds. Investors were initially keen to focus the opportunities created by Abenomics, particularly driven by the weakness of the Yen. The most recent April-June 2017 GDP report suggests that the Japanese economy has entered into a sweet spot, with growth accelerating and broadening into all components of domestic demand. While the 4% annualised GDP growth rate marks peak slingshot acceleration, the details of the report fully verify our thesis that Japan has entered a self-sustaining domestic demand-led up-cycle.

Positive trends in employment, wages and capital expenditure

Various key aspects of the economy have continued to respond to structural reform and change. Wage and income dynamics have turned positive with the absolute level of workers' compensation rising by 2.6% in April-June pushing absolute compensation to levels last seen in 1998/1999. More importantly this up-trend is structural as opposed to cyclical. At the same time, Japan's demographic dynamics is forcing a structural shift from part-time to full-time employment and steady upward pressure on wages and incomes. While for the past two decades, excess employment put downward pressure on wages and forced headwinds against consumption, Japan's labour shortages are now becoming reliable tailwinds for domestic demand.
The structural improvement in employment quality—full-time employment has been accelerating steadily over the past 18 months, creates a strong foundation for rising household formation and, importantly, rising household sector leverage. The recent GDP report confirms continued strength in residential investment, up 6%, for the sixth consecutive positive growth quarter. Again, we stress that Japan's housing up-cycle is not merely cyclical, but structural, a direct consequence of the demographic dynamics where household formation is now rising.

Private sector capital expenditure also registered its eight-consecutive growth quarter. Meanwhile, the combination of record-low interest rates and record-high corporate cash balances suggests an on-going ability to raise investment. Given low interest rates and a rising rate of return on invested capital suggests it increasingly pays to invest. In our view, Japan's business investment cycle has further to run and the visibility of the capital expenditure cycle suggests it is poised to become a key leading indicator of the underlying strength of the economy. All of which suggest that Japan's capital goods sector is poised for both domestic- and export-led growth.

There is an important positive knock-on effect for Japan's financials in general, particularly the banking sector which should be poised for improved earnings on the back of rising demand for loans. As corporate demand for productive capital rises, so should demand for financial capital. The bullish capital expenditure intentions imply a likely re-leveraging.

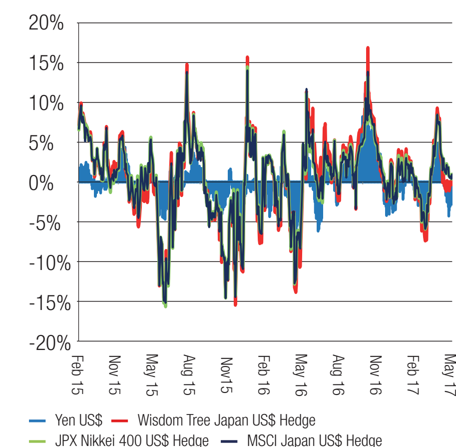
Low valuations, strong earnings growth and a weaker Yen

Overall, we expect this year to be one of a positive reversal of earnings momentum predicated on a pickup in top-line sales growth and a weaker currency capable of delivering substantial earnings growth. The broad equity market, as represented by TOPIX, is trading at the lower end of its valuation range in terms of both historic and prospective PEs.

At the heart of the Japanese equity story is the performance of the Yen. In early Q4 2016, having languished at levels close to Y100 v US$, the rapid appreciation of the US$ in a post-election environment saw the exchange rate weaken rapidly to over Y118. As the strength of the US$ has unwound over the course of the year the Yen has dipped below Y110 and has recently trended lower to around Y113.

The main impact of the weaker Yen, which is a core part of the Bank of Japan's policy aims, is to reinvigorate inflation through higher import prices, helping to stimulate demand but additionally to boost exporters and overseas sales and profits. Whilst domestic recovery is a long-term aim, the weaker Yen can have a more meaningful and direct impact on export oriented companies. This has been quick to reveal itself in the outperformance of the export-tilted WisdomTree Japan Equity Index compared to other Japanese equity benchmarks such as MSCI Japan and the JPX NIkkei 400, all measured with a US$ hedge.

Over time it is also evident that the WisdomTree index is typically more sensitive to movements in the exchange rate. The chart of rolling one month returns highlights how WisdomTree's focus on exporters provides for outperformance as the Yen weakens.



A unique index to capture the Japanese investment theme

WisdomTree's unique export-oriented index for dividend paying stocks, requires companies to have more than 20% of revenue from overseas providing a differentiated sector and company composition. This methodology tends to produce an index that has substantial deviations in sector weights compared to benchmarks such as MSCI Japan. These sector over and underweights can deliver significant contributions to performance.

The current largest overweight sector is Consumer Discretionary with a weight close to 25%, a 4.1% overweight, although this has only had a modest impact on performance. Industrials, where the WisdomTree Index is overweight by almost 2.5% has delivered 30% of the outperformance of the past six months. Two areas where the index is substantially underweight are the domestically oriented Telecommunications Services and Real Estate sectors. On a combined basis the WisdomTree index is around 10% points underweight relative to MSCI Japan, and this has delivered 2.4% of outperformance accounting for almost 44% of the alpha generated over the past six months. The WisdomTree Japan Equity Index has also outperformed the JPX Nikkei 400 Index, which has a focus on quality factors such as return on equity and operating profits, as well as corporate governance measures.

Owning Japan based on factors such as the weakening Yen, which is key to the performance of the economy, suggests that investors should consider the WisdomTree Japan Equity Index due to its focus on export oriented stocks. The WisdomTree Japan Equity UCITS ETF tracks this index and is available in a number of currency hedged share classes reflecting the fact that whilst Japanese equities may be attractive, total returns can easily be eroded by a weakening Yen.

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The value of your investment could go down as well as up and past performance is not a guide to future performance

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Peter Beaumont, Finance Director, Cornish Mutual

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Fixed Income SRI
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Emerging Market Small Cap Equities
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Multi Sector Fixed Income
Active UK Government Fixed Income

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