THE WALL STREET JOURNAL.
MONDAY, JANUARY 7, 2013

EXCHANGE-TRADED FUNDS

What ETF Managers Do

These funds are typically easier to run than most mutual funds, but they require a kind of precision

By Ari I. Weinberg

They make it look so easy—partly because it is.

At 30 years of age, Hao-Hung (Peter) Liao leads a handful of portfolio managers at Van Eck Global who oversee some $24 billion in investor assets around the world. Mr. Liao's rapid ascent—and the parallel success of his tiny team in handling its outsize mission—owe a great deal to the unique traits of the investments in which the team specializes: exchange-traded funds.

Peter Liao

"It's pretty simple, really," Mr. Liao says in the headquarters of New York-based Van Eck Global, the sponsor of Market Vectors ETFs. Mr. Liao never has to pick a stock, and executes trades only under certain circumstances. The primary mission for him and his colleagues is to keep their funds' holdings, and the value of those holdings, precisely in line with the indexes they track.

Such ETFs are easier to manage than index-tracking mutual funds. A single person or small team can oversee a long list of ETFs, as Mr. Liao and his team do. Indeed, 87% of Van Eck's ETF assets are in the 38 funds run by Mr. Liao and his staff of three portfolio managers and analysts.

Less Trading

ETF managers generally don't buy and sell the underlying securities to meet investor orders, unlike index and actively managed funds. This keeps commissions, expenses and taxes down.

Instead, market makers and brokers facilitate ETF trades. For an ETF to work, it requires "authorized participants"—institutions that typically receive ETF shares in exchange for purchasing and handing over a basket of the underlying securities, which are held by a third party for safekeeping. Similarly, authorized participants usually receive a basket of the underlying securities when they redeem their ETF shares. But in general, it is buying and selling by authorized participants, market makers and other traders and investors that helps smooth the market in ETF shares—selling ETF shares when their price is at a premium to that of the underlying stocks, and buying them back if there's a discount.

Mr. Liao and his team have to stay current on market rules and activity in many countries. In Brazil, India and Indonesia, for example, when a change in an index occurs or there is demand for new ETF shares, the team can be required to buy or sell the local stocks involved on behalf of the authorized participant. One day recently, Mr. Liao was busy placing share purchase orders with a few brokers in India as part of creating $4.6 million in new shares of the Market Vectors India Small Cap ETF.

A Day in the Life of an ETF Manager

Here's a representative day for managers of an exchange-traded fund. Tasks and timing can vary with asset types and among firms.

8:00-9:00 A.M.	■ Check on overnight fulfillment of overseas orders ■ For thinly-traded bond markets, understand the price and volume of securities for sale
10-2 P.M.	■ Trade based on cash orders for ETF shares, which tend to settle during the trading day
OVER THE COURSE OF THE DAY	■ Monitor reports of the day's creations/redemptions ■ Track corporate actions like mergers and spin-offs that could affect index composition ■ Analyze and develop a plan for announced index rebalancing or reconstitution ■ Buy or sell securities in open markets to manage cash from interest and dividends
3-4 P.M.	■ On the day of an index rebalance for U.S. stocks, a flurry of trading up to the close
4-6 P.M.	■ Fund's net asset value (NAV) is struck as prices settle ■ Evaluate daily NAV tracking vs. benchmark ■ Publish basket for tomorrow's in-kind transactions ■ Place trades with international brokers

Time to Think

Far more trading is required around the end of each calendar quarter since that is typically when there are lots of changes in the composition of the stock indexes and other benchmarks that the ETFs track. "Both positive and negative tracking difference are bad," says Mr. Liao, who on days with less action might be found at his desk evaluating what effects pending dividends or mergers might have on companies in his funds, or exploring ideas for new ETFs.

Mr. Liao left his native Taiwan as a teenager to attend high school in the U.S. and graduated from New York University in 2004 with a joint major in math and economics.

After college, Mr. Liao joined Van Eck Global as an assistant to company principal Jan F. van Eck, and after little more than a year he became a manager for the company's first foray into ETFs: the now $9.2 billion Market Vectors Gold Miners ETF, often referred to by its ticker symbol, GDX.

"Peter had shown an ability to quickly analyze complicated commodity futures indexes," says Mr. van Eck. "The ETF job requires a high degree of precision."

Mr. Weinberg is a writer in New York.

(over please)

ETF Managers Don't Buy and Sell Securities. Usually.

Here are cases in which they must trade like other fund chiefs

There's a myth about exchange-trade funds that all of their underlying securities walk in and out of the fund through tax-efficient "in kind" transfers: exchanging securities for shares of the fund and vice versa.

But that's not exactly true, particularly when dealing with securities markets in the developing world and certain assets or derivatives that can't be transferred.

Here are a few cases where these paragons of passive management become active buyers or sellers of securities:

◆ **INTERNATIONAL MARKETS:** Many emerging markets place restrictions on flows of securities that prevent the passing of shares from one owner to another without a purchase and sale. Hence, managers of ETFs in these markets buy the required securities themselves.

◆ **FIXED-INCOME SECURITIES:** An ETF manager is more likely to buy assets in thinly traded parts of the bond market, such as municipals and high-yield corporates, which tend not to be used frequently for in-kind transactions. The managers also take in cash to make purchases in parts of the bond market, such as mortgage-backed securities, where trading is primarily in contracts tied to future delivery of a certain pool or type of mortgage.

◆ **PAYOUTS:** Most ETFs almost immediately use the interest and dividends they receive from their holdings to make additional purchases of the underlying securities.

◆ **REBALANCING AND RECONSTITUTION:** When an index changes, transactions with an ETF's authorized participants help filter some securities in and out of the funds, but ETFs must do most of the required buying and selling of securities themselves.

Events that can trigger index changes for bond funds include debt downgrades and debt maturation. For stock funds, think corporate mergers and periodic scans for stocks that meet specified criteria.

—Ari I. Weinberg