



# Alternative Equity Investments

## Rev 1.0c

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### Introduction

The equity (stock) market is typically seen as a place to invest in ownership shares of public companies. However, equity products are no longer limited to single domestic companies. For example, American Depository Receipts (ADRs) have given investors the opportunity to invest in foreign companies while avoiding regulatory issues sometimes involved with investing abroad. Meanwhile, exchange-traded funds (ETFs) provide a proxy for fractional ownership in domestic and foreign company's shares, participation in bond issues, and even commodities.

### ADRs – American Depository Receipts

ADRs are dollar-denominated certificates that represent ownership in the shares of a non-U.S. company. To facilitate settlement and regulatory issues, the certificates are traded rather than the underlying shares. A broker can purchase shares of a foreign company, place them in their vaults for safekeeping, and issue ADRs that represents those shares in the vaults. An ADR can be cancelled by an investor and exchanged for the underlying shares at any time. There are 4 types of ADR programs which have different U.S. regulatory requirements. For example, level 3 ADRs must release their financial statements in accordance to GAAP whereas level 1 ADRs need not do so. The ADR program level provides a signal to the market concerning the required level of compliance.

### ETFs – Exchange Traded Funds

Exchange Traded Funds (ETFs) are investment vehicles that provide investors a cost effective way to invest in a basket<sup>1</sup> of securities. An ETF is setup as a fund or trust that holds a portfolio of securities that is designed to track the returns of a specific index, sector, or commodity. This is typically done by holding the actual securities of what the ETF plans to track. The ETF is then divided into shares that are more manageable for investors to purchase. For example, purchasing 1 share of QQQQ (Nasdaq 100 Trust Series 1) is designed to be similar to investing a total of \$38.20 (QQQQ share price) divided amongst the 100 largest NASDAQ stocks (weights dependant on the Nasdaq 100 index weightings). It is important to understand that when buying an ETF, you are not actually buying the shares of the

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<sup>1</sup> Almost all ETFs represent baskets of stocks. However, newer ETFs like the Gold ETF only has 1 underlying instrument.

underlying index. You are simply purchasing a fraction of a fund/trust that holds shares in the companies in the index.

Although all ETFs have similar tracking objectives, there are minor differences in the way they are setup. The 3 possible structures are:

**Open-end index fund**

This structure takes dividends received from the shares held by the trust on their receipt-date and reinvests them in more shares until the fund's next quarterly dividend date. This structure is permitted to loan securities to dealers for short-selling, and use derivatives. iShares and iUnits use this structure.

**Unit investment trust**

This structure cannot reinvest dividends and simply holds them and pays them out at the next quarterly dividend date. Diamonds, Spiders, and Qubes all use this format.

**Grantor trust**

This last structure is significantly different than the first two. It directly distributes dividends to shareholders as soon as the underlying stocks pay them<sup>2</sup> and also allows investors to retain their voting rights. HOLDRs are setup as a Grantor trust.

The major difference with Mutual funds is that ETFs are traded on a stock exchange. The benefits of being exchange-listed are liquidity and costs. ETFs do not have the extensive marketing network that is prevalent in most mutual funds, therefore their overhead costs (measured as the Management Expense Ratio) are lower. Costs for brokerage commissions on ETFs versus front-load, end-load, or no-load mutual funds also differ depending on your broker. ETFs can be bought or sold anytime the exchange is open. In contrast, mutual funds are typically restricted to buying at the NAV on daily close. Lastly, most ETFs offer large institutions the ability to redeem blocks of ETFs for their underlying security baskets. Mutual funds do not have these provisions.

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<sup>2</sup> This means that if your HOLDR has 5 dividend paying stocks that pay quarterly, you could potentially be receiving 20 dividends a year from the HOLDR.

A description of some of the more popular tradable securities that track indices follows:

**DIAMONDS** track the Dow Jones Industrial Average (BridgeStation symbol is **US;DIA**)

Shares of Diamonds represent ownership in the *Diamonds, Trust Series 1*, a unit trust that has been setup to hold a portfolio of equity securities that comprise the Dow Jones Industrial Average. The Dow Jones Industrial Average is an equally-weighted basket of 30 “blue chip” U.S. stocks. The performance of the Diamonds, before expenses, should closely match the yield and returns of the DJIA. Diamonds are distributed by *ALPS Distributors Inc.*

**Spiders** tracks the S&P 500 Index (BridgeStation symbol is **US;SPY**)

Spiders are the S&P 500 Depository Receipts. They are unit trusts that act as a proxy of the S&P 500 index. The S&P 500 index is a market value-weighted index of the largest 500 companies listed in the United States. Although there are a handful of funds that also track the S&P 500, the Spider is the only one with options. Spiders are very liquid.

**Qubes** track the Nasdaq 100 Index (BridgeStation symbol is **US;QQQQ**)

The Qubes are the Nasdaq 100 Trust Series 1. They were originally traded primarily through the American Stock Exchange (AMEX) under the symbol QQQ. Recently trading has moved to the NASDAQ under the symbol QQQQ. Qubes are comprised of 100 of the largest and most diversified companies listed on the NASDAQ exchange.

### **iShares, Vipers, and iUnits**

iShares and Vipers are funds that are run by Barclays Global Investors and Vanguard Funds respectively. The two types of funds are setup in a similar manner except for some tax differences. The management fee on Vipers is less than the fee on iShares, but both are extremely low when compared to mutual funds (0.43% for iShares and 0.22% for Viper). Vipers typically track MSCI indices whereas iShares focus on S&P/Barra/Russell indices. iUnits are the Canadian equivalent to the American brand iShares. iUnits are also run by Barclays Global Investors.

### Street Tracks

These funds are similar to the family of funds that are offered by Barclays and Vanguard. The main thing to note about Street Tracks is that they have recently introduced a Gold ETF<sup>3</sup> that tracks the price of 1/10 oz of gold. If gold is trading at \$450.00 per oz, the ETF will be priced around \$45.00. This appears to be just the beginning of a trend to make more sophisticated investment choices available to the retail investor.

### HOLDRS – Merrill Lynch

HOLDRS<sup>4</sup> are significantly different from most ETFs in that they are not UITs. HOLDRS are setup to represent an investor's ownership in many companies, while packaging the investments in a single security. Purchasing a HOLDR is similar to purchasing a basket of stocks that are bundled together. The main advantage of HOLDRS is that they retain individual investor's voting rights and claims on dividends. Each HOLDR round-lot (100 shares) represents an investment in a basket of shares. What is unique about HOLDRS is that you can convert a round-lot into their underlying basket (for a fee). This is particularly useful because you can defer taxable gains and realize taxable losses by converting your units into the underlying and selling them accordingly.

### Links to ETF/ADR Resources

<http://moneycentral.msn.com/content/common/P118061.asp>

<http://www.adr.com>

<http://www.iunits.com>

<http://finance.yahoo.com/etf/browser/mkt>

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<sup>3</sup> <http://streettracksgoldshares.com>

<sup>4</sup> <http://www.holders.com/holders/main/index.asp?Action=FAQ>