

## Insights into Evaluating Exchange Traded Funds (ETFs)

The impact ETFs have had in reshaping the way investors build and manage portfolios is a testament to the appeal of their core benefits, which include diversification, lower fees and expenses, liquidity and transparency. As the industry expands, institutions, investment professionals and retail investors have demanded a greater variety of ETFs to meet a broader range of objectives and risk tolerances. ETF providers have responded by expanding product lines to encompass a wider range of asset classes, including fixed income, emerging market equities and bonds, commodities among others.

However, the proliferation of ETFs is clearly responsible for some confusion among investors and industry observers, as it has made the ETF screening process more challenging. Knowing what you own is an important investment principle regardless of whether you are buying a security, mutual fund, or ETF. To this end, investors should understand that not all ETFs are created equally. Variables such as product structure, benchmark selection, costs, liquidity, and the manager's track record and risk management processes should be carefully considered before investing in an ETF.

The rapid increase in the number of ETFs across the globe in recent years has made the task of navigating the landscape progressively more onerous. Consider the fact that there were 648 product launches in 2010 alone helping to bring the number of industry offerings to over 2,600 with assets of US\$1.6 trillion worldwide today.<sup>1</sup> This growth has been fuelled by products that offer exposure to more diverse asset classes, including fixed income, emerging market equities and bonds, currencies, commodities and other alternatively weighted and strategic indices. These ETFs also offer various ways to access this exposure, as determined by product structure and selected benchmark.

These developments have made the task of evaluating ETFs more complex, as products that appear similar at first glance may be quite different upon closer inspection. The increased scrutiny of ETFs is evidence of the industry's greatest opportunity and challenge – promoting a better understanding of the structures and safeguards that span a rapidly growing industry. An evaluation of an ETF's underlying index is no longer sufficient, as optimised structures via swaps and derivatives have brought complexity and opacity to the ETF industry. The concerns echoed in recent reports by regulators underscore the need for all ETF providers to work toward ensuring that all investors fully understand the structure of their products. This paper provides a brief framework for evaluating ETFs globally by providing insight into the following issues:

- I. Product structure: physical ETFs vs. synthetic ETFs
- II. Index composition: Weighting methodologies
- III. Securities lending: Purpose and process
- IV. Total costs: Liquidity, role of the bid/offer spread and premium/discount to NAV
- V. Tracking error: What the fund NAV and total return of the index indicate
- VI. ETF provider: How to evaluate

### I. PRODUCT STRUCTURE

There are several different investment techniques used by ETFs around the world. The three most common are: full replication through the purchase of physical securities; optimisation-based tracking through the purchase of physical securities; and synthetic replication through the implementation of total return swaps or other derivatives.<sup>2</sup>

#### PURE ETFS (PHYSICAL HOLDINGS)

##### Full Replication

- The full replication approach using physical securities involves the manager purchasing all securities in the same weight as the underlying index. Over time, the manager then tracks changes in the index and manages cash flow from dividends. This strategy may therefore likely provide very close tracking with the underlying index. All assets are held in a custody account in the name of the shareholders of the fund.

### Optimisation (or Representative Sampling)

- The optimisation-based approach, or representative sampling, involves the manager using a sampling or 'optimisation' process to create a portfolio of physical securities that closely resembles that of the underlying index. The rationale for doing this is to control trading costs and promote liquidity, but such a structure might introduce a higher level of tracking error since it only covers a selection of the underlying benchmark. This could potentially miss some movements of the market of securities that are not included in the portfolio. All assets are held in a custody account in the name of the shareholders of the fund.

To date, all State Street Global Advisors' (SSgA) SPDR® ETFs across the globe are supported by the physical replication model using either full or optimised replication and have an established track record spanning nearly two decades.<sup>3</sup> During this period of time, which encompasses several prominent market disruptions, SPDR ETFs efficiently handled significant inflows and outflows and consistently delivered index-tracking performance.<sup>3</sup> The skill and experience of the asset manager are key factors to providing a fund with low tracking error to its index.

### Synthetic ETFs

- The synthetic replication method is in the majority implemented through the purchase of total return swaps (there are fund structures in Hong Kong using notes to obtain index performance) where the provider enters into an agreement with one or more investment banks or counterparties.<sup>3</sup> The counterparty agrees to deliver the return of the underlying index, typically minus a spread, in exchange for the performance of a pool of securities that is held in the name of ETF. Should the counterparty default, this collateral pool, or assets held, provides safety for

investors in the ETF. To minimise the risks, some synthetic providers over-collateralise the swap and/or use multiple swap counterparties but rules vary by jurisdiction. A synthetic ETF should track the underlying index closely, but may also incur added hedging costs which may result in tracking error. In general, this type of ETF does not physically hold the index's component shares and may further lend the collateral onwards, increasing the leverage of the underlying assets. The synthetic fund structure has been criticised for introducing opacity, complexity and credit risk to ETF products and offer potential systemic risks if misused. Figure 1 outlines the important differences between physical and synthetic ETFs while Figure 2 provides an overview on the key risks of investing in synthetic products that investors should consider.

**FIGURE 1: CHARACTERISTICS OF PHYSICAL VS. SYNTHETIC ETFS**

FEATURES	ETFs HOLDING PHYSICALS	SYNTHETIC ETFs
EXCHANGE TRADED	Yes	Yes
COUNTERPARTY RISK	No	Yes
TYPICALLY INVESTS IN SECURITIES INCLUDED IN THE UNDERLYING BENCHMARK	Yes	No
SIGNIFICANT USE OF DERIVATIVES, SWAPS AND/OR FUTURES ON WHICH ETF PERFORMANCE IS SUBSTANTIALLY DEPENDENT TO ACHIEVE RETURNS	No	Yes
TRANSPARENCY IN UNDERLYING HOLDINGS IN FORM OF DAILY PORTFOLIO HOLDINGS	Yes	Depends on provider practice
MAY NEED TO MAINTAIN UNSUSTAINABLE SUBSIDIES TO COUNTER PERFORMANCE IN FORM OF DAILY PORTFOLIO HOLDINGS	No	Yes

Source: State Street Global Advisors, as of 31 May 2011.

Note: This is a general description of the ETF product landscape. Individual products may vary by local jurisdictions and provider policies.

**FIGURE 2: KEY RISKS INHERENT TO THE SYNTHETIC FUND STRUCTURE THAT INVESTORS SHOULD UNDERSTAND AND CONSIDER**

<p><b>Counterparty Risk</b></p> <p>Since synthetic ETFs do not generally hold the actual physical securities of the fund's underlying benchmark, the returns are achieved via derivative contracts (e.g. futures, options, swaps, notes) with investment banks or other such firms. Investors should understand the implications of the contract, the level of counterparty risk and the ratings of underlying derivative providers.</p>	<p><b>Contract Terms</b></p> <p>Derivative contracts are usually either collateralised, (backed by assets to support the performance of the fund) or uncollateralised (swap contract only, payment dependent on the creditworthiness of the counterparty). Investors should understand the level and quality of collateralised contract (full vs. partial), whether there are other assets held by the fund and the quality of the assets.</p>
<p><b>Ownership Rights</b></p> <p>In a collateralised derivative contract, the counterparty nets profits and losses before actual settlement of the contract. Investors need to be aware of whether the physical assets for settlement are actually held, whether these assets are further pledged to other contracts, loans, etc and how that affects their ownership to these assets. This is known as re-hypothecation of funds.</p>	<p><b>Operational Provisions</b></p> <p>Some synthetic fund managers are vertically structured and provide multiple services as one entity (e.g. acting as derivative counterparty, fund manager and market maker). Investors need to understand the process in which the firm manages fund governance as well as the increased risks involved in investing in underlying operations that have potentially minimised objectivity and checks/balances.</p>

Source: State Street Global Advisors, as of 31 May 2011.

Note: This is a general description of the ETF product landscape. Individual products may vary by local jurisdictions and provider policies.

SPDR ETFs do not presently offer any synthetic ETFs, but recognise that this structure may offer benefits to investors who are comfortable with the risk-return profile of these products - particularly as it relates to gaining access to asset classes that are not accessible through the physical replication model.

While there are benefits and risks to each approach SSgA does not believe that, in general, ETFs pose a unique

systemic risk. However it is true that increased disclosure, greater transparency and improved investor education are vital to helping investors decide which financial products are most appropriate for their investment needs. Figure 3 outlines the differences between exchange traded products (ETPs), including ETNs and ETCs, and unlisted derivatives, outlining the features and benefits for each product structure.

**FIGURE 3: UNDERSTANDING HOW THE UNDERLYING STRUCTURE OF VARYING EXCHANGE TRADED AND UNLISTED PRODUCTS AFFECT ITS FEATURES AND BENEFITS**

	STRUCTURED FUNDS					STRUCTURED PRODUCTS	
	ETFs			EXCHANGE TRADED COMMODITIES (ETCS)		EXCHANGE TRADED NOTES (ETNS) AND CURRENCY ETFS (ETCS)	UNLISTED RETAIL DERIVATIVES
	FULL REPLICATION	REPRESENTATIVE SAMPLING	SYNTHETIC REPLICATION	COMMODITY TRUSTS	FUTURES BASED COMMODITY ETCS		
DESCRIPTION	All of the index's securities are purchased in their respective weights	A subset of physical securities that closely resembles the index	Represent a derivative contract with a bank or other counterparty	Physical commodities held by most Trusts	Track commodity indices of futures contracts on physical commodities	Provide returns indexed to various market benchmarks	Standardised contract to deliver leveraged returns of shares (spread betting, contracts for difference (CFDs), covered warrants)
OWNERSHIP	Shares represent fractional ownership of assets held	Shares represent fractional ownership of assets held	A derivatives contract that represents the contractual right plus collateral or other assets to provide returns of the underlying index	Shares represent fractional ownership of assets held	Asset backed bonds, fully collateralised	Senior, unsecured, unsubordinated debt, issued by an underlying bank	Uncollateralised bank risk
REGULATORY STRUCTURE	Open Ended Fund under Investment Company Act of 1940, UCITS Structure or other local regulated structure			Generally a trust structure (e.g. Grantor Trusts under Securities Act of 1933)	Generally Open Ended Commodity Funds under Securities Exchange Act of 1934 or offshore legal structure	Generally debt obligations registered under the Securities Act of 1933 or offshore legal structure	OTC Derivatives
BENEFITS	Closely tracks the return of the index  Transparent  Clarity of ownership	Reduces operating cost and capital necessary from not owning every security in the index  Transparent  Clarity of ownership	Provide lower cost of operation  May offer access to assets that cannot be fully replicated	Typically backed by physical commodity in the name of the Trust  Avoids the risk and cost of holding physical commodities for the investor	ETCs track commodities - not commodity companies - and enable investors to gain exposure to commodities without trading futures or taking physical delivery  Wide product choice	Offer easy access to hard-to-reach assets such as currencies and countries that impose limits on foreign investment	Allows investor to speculate on rising or falling shares  Avoids stamp duty  Provides increased leverage (greater exposure to the potential upside and downside than with buying and holding a share)
LIMITATIONS	Can have higher costs due to trading costs  Not all asset classes can be covered	Securities may fail to track the index resulting in tracking error  Not all asset classes can be covered	Risk of re-hypothecation of collateralised assets  Credit risk  Counterparty risk  Reduced transparency (uncertainty of holdings)	Normally cannot directly redeem shares for underlying bullion or precious metals	Typical high tracking error to spot price due to contango and backwardation related to futures, leading to losses from rolling futures contracts in contangoed markets and gains in backwardated markets	Not secured debt; there is no principal protection  ETNs do not pay interest and the issuer is subject to default risk  Credit rating risk	Retail derivatives are mostly unregulated  The use of derivatives results in credit risk  100% counterparty risk  Reduced transparency

Source: State Street Global Advisors, as of 31 May 2011.

Note: This is a general description of the ETF product landscape. Individual products may vary by local jurisdictions and provider policies.

## II. INDEX METHODOLOGY

Investors should be sure the securities that comprise the benchmark match the exposure they seek. There may be several indices that cover the same market segment, for example one might track only a small segment of the market while the other may provide broader exposure and therefore hold a greater number of securities. This can result in differences in exposure and will almost certainly result in variations in performance between seemingly identical indices.

It is important to consider not only what the index is comprised of, but the methodology behind its construction. Historically, indices have used market capitalisation weighting, meaning that the constituent's weight in the index is determined by their respective market capitalisation. More recently, proprietary indices have emerged using an assortment of different weighting techniques. Fundamentally-weighted indices that weight respective companies based on characteristics such as dividends, revenue or earnings have also been introduced.

### WHY DOES THE INDEX WEIGHTING MATTER?

An index's weighting methodology can lead to inconsistencies in performance and risk/return characteristics among seemingly similar indices. These inconsistencies may be driven in part by the sector weights that define each product. For example, financial companies are generally among the highest paying dividend components of an index. As a result dividend weighted indices tend to overweight financials, which is then reflected in the ETFs that are benchmarked to these indices. This type of ETF focuses on providing high dividends and historically has done so; however these differences in sector weights are important when considering performance from an attribution standpoint as well as for planning for a balanced portfolio.

Another consideration to be mindful of when evaluating an index is the breakdown between growth and value securities. An index or ETF that is fundamentally weighted by dividends may have an inherent bias toward value companies that pay a

higher dividend. As a result, the performance between a fundamentally-weighted index and a market capitalisation weighted index tracking the same market segment could vary during a time when growth and value stock performance has deviated.

The same logic used to derive differences in growth, value and sector exposure can be used to help explain why an index's market capitalisation distribution may vary depending on how the index is constructed. For example, in 2008 small cap stocks across the globe were crippled, only to rebound sharply in 2009 as credit and global equity markets stabilised. In markets where the small cap segment is outperforming, it can be expected that an equally weighted index and corresponding ETF may display parallel movements. However, in years when small cap names are out of favor, an index or ETF with a large cap tilt will better withstand downward pressure.

This is not to say that any one index or weighting methodology is superior to another, but it is critical that investors ensure that the exposure a given index provides aligns with the exposure they seek and the views they are trying to express. Figure 4 provides a number of mainstream index methodologies but in fact new ways of benchmarking, such as risk weighted and GDP weighted, have forayed into the marketplace.

**FIGURE 4: UNDERSTANDING HOW INDEX METHODOLOGIES AFFECT FUND EXPOSURE**

MARKET CAPITALISATION	Stocks are weighted by their representative market capitalisation
PRICE WEIGHTED	Stocks are weighted by their respective price per share
FUNDAMENTALLY WEIGHTED	Respective companies weighted by fundamental characteristics or factors such as dividends, revenue or earnings
EQUAL-WEIGHTED	All component stocks receive the same weighting

Source: State Street Global Advisors, as of 31 May 2011.

### III. SECURITIES LENDING

Securities lending plays a major role in the efficient functioning of the securities markets worldwide. It can be an important and significant business practice whereby securities are temporarily transferred by one party (the lender) to another (the borrower). Most “physical” ETFs, such as SPDR ETFs in some regions, engage in securities lending programs, typically using a lending agent to lend a portion of securities in the ETF portfolio to brokers, dealers, and other financial institutions. Securities lending within the SSgA family of SPDR ETFs (where applicable<sup>4</sup>) directly benefits shareholders, as the income it generates reduces fund expenses and improves index tracking after expenses.

Security lending programs are not new nor are they unique to ETFs. They are in fact a common practice for many traditional commingled and mutual fund offerings.<sup>3</sup> Important measures are taken to ensure the safety of these programs associated with SPDR ETFs. For instance, SPDR ETFs participate in an indemnified securities lending program, which means that State Street Bank & Trust, the securities lending agent for SPDR ETFs will indemnify the ETFs in the event of a borrower default. In addition, the operational procedures for share creation and redemption are designed to protect the interest of the fund’s shareholders by contractually requiring the fund’s Authorised Participants (i.e., approved institutional trader or market maker known as an “AP”) to represent that shares being tendered for redemption are settled shares in the possession of the AP or the client they represent. As such, a SPDR ETF is not directly impacted by the amount of lending in the secondary market (“short interest”) and cannot be redeemed for more than its actual shares outstanding.

Though they are widely available in many countries securities lending programs are still in their early stages in much of the Asia Pacific region, where SPDR ETFs do not currently engage in this practice. Details and risks of securities lending programs are disclosed in qualifying SPDR ETF Prospectuses/Product Disclosure Statements.

### IV. TOTAL COSTS

The expense ratio is not the only cost associated with ETFs. Commissions and transaction costs apply when buying ETF shares on the secondary market. ETF shares trade throughout the day like any other stock on major exchanges. As a result, any commissions would be absorbed by the investor purchasing or selling shares.

The fund’s expense ratio and expected commission payments are costs that can be accurately forecast and, in some countries, are capped. However, as the next few paragraphs indicate, there are a number of less transparent costs that may arise from ETF transactions.

#### BID/OFFER SPREAD AND LIQUIDITY

The nature of ETFs can lead to implicit costs of investing. The primary implicit costs are trading costs and tracking error. Aside from commissions, the most obvious trading cost is the bid/offer spread. While some ETFs trade at spreads within a few basis points, other thinly traded ETFs may widen out. ETF bid/offer spreads are readily available through a variety of third party data sources or exchange websites. Since ETFs are open ended vehicles in which new shares can be created and old shares redeemed, it is also important to look at the underlying liquidity of an ETF’s constituents when evaluating

execution cost. It is from these underlying securities that ETFs derive much of their natural liquidity. ETF sponsors should have an accessible capital markets team to help institutional investors navigate through the intricacies of trading their ETFs.

#### PREMIUM/DISCOUNT TO NAV

An ETF’s premium or discount is another element that should be considered in a thorough evaluation. The market price for an ETF reflects market supply and demand for an underlying product while the Intraday Indicative Value (IIV) or Intraday Optimised Portfolio Value (IOPV) is a signal of the underlying value of the securities in the fund. The creation/redemption mechanism is responsible for keeping the market price of the fund in line with the IOPV. For example, if an ETF’s market price was trading at a significant premium to the indicative value, an arbitrage opportunity may exist for the Authorised Participant (AP). The AP might be enticed to create more shares and capitalise on the difference. The existence of more shares in the market should cause the market price to come back into formation with the IOPV. However, in markets where pricing of the underlying securities in an ETF are dislocated, or illiquidity limits an AP’s ability to hedge their position, it can be expected that the ETF’s market price may drift further from the IOPV.

## V. TRACKING ERROR

Tracking error is another important indicator of a fund's overall quality. Investors using ETFs are looking for cost effective beta exposure to a desired market segment. Excessive tracking error can negate this fundamental purpose of ETF investing. Tracking error has many definitions, although the simplest is defined as the difference between a fund's NAV performance and the total return of the underlying index. It is important to note that it is the fund's NAV performance that should be considered, as opposed to the market price performance of the ETF. An investor's cost basis for a share purchase is driven by supply and demand and cannot be used as an accurate assessment of how well a fund tracks its index. Depending on an investor's time horizon, tracking error can be measured daily, monthly, quarterly or annually. For example, an investor actively trading ETFs would be more concerned with how an ETF tracks on a daily basis, whereas a long-term investor might only monitor a fund's tracking on a yearly basis. In either case, funds with tighter tracking should have a competitive advantage.

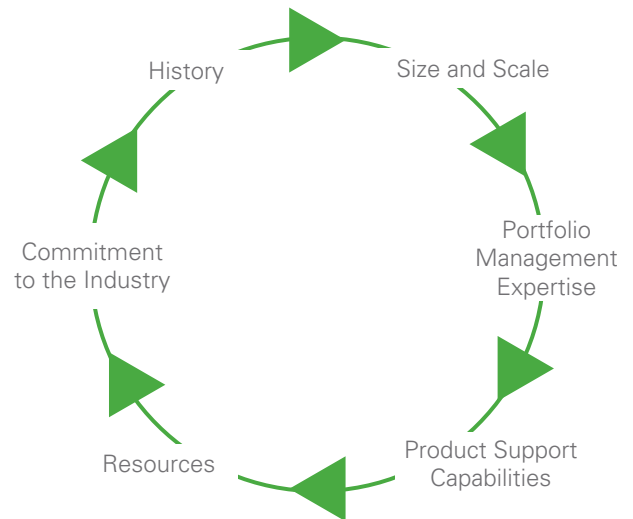
ETFs that are fully replicated, such as some SPDR ETFs, can tend to exhibit low tracking error. However, ETF expansion has been propelled by growth in products offering access to more non-traditional markets that tend to exhibit greater market inefficiencies. ETFs that invest in these markets or asset classes may have a greater likelihood of exhibiting wider tracking error regardless of being invested in physical securities or in derivative contracts. In order to efficiently optimise a fund, the fund provider's portfolio management history and skill play an important role as will any investment bank's ability to provide synthetic exposure with low hedging costs. In general, an investment manager with a history of indexing strategies and the foundations in place to support ETF growth should have success transferring those skills to ETF management.

## VI. THE ETF PROVIDER

With over 100 ETF sponsors globally, the evaluation of the provider is a necessary part of the process. There are a variety of characteristics to look for in an ETF provider:

- Company history
- Size and scale
- Commitment to the ETF industry
- Resources and distribution
- Portfolio management expertise
- Product support capabilities

**FIGURE 5: CHARACTERISTICS OF AN ETF PROVIDER**



A company with significant size and scale will more often have the product management capabilities already in place to support the development, management and distribution of an ETF. Sound product development, skillful portfolio management and widespread distribution capabilities provide a strong foundation for a successful ETF provider.

Sophisticated index portfolio management expertise has become increasingly important, as more ETFs are introduced that track indices which are more difficult to replicate. Replicating the risk/return characteristics of an index with thousands of issues takes extraordinary portfolio management skill, particularly in some of the more opaque and illiquid markets.

As the product landscape expands and products become more complex, so too can the investor's due diligence responsibilities. To accommodate the investor, progressive ETF sponsors have dedicated resources to respond to client inquiries and requests for analyses. These resources can be helpful to the investor not only in helping to decipher the difference between similar ETFs, but also by offering a point of contact for potential questions that may arise.



## CONCLUSION

As the industry expands, institutions, investment professionals, and retail investors have demanded and received a greater variety of ETFs to meet a broader range of objectives and risk tolerances. However, along with this evolution comes the growing complexity of ETF analysis, as ETFs that appear to represent the same market segment can sometimes look markedly different beneath the veil in terms of index methodology and product construction.

Ultimately, investors need to look beyond just the exposure of the underlying index when evaluating an ETF. Assessing critical factors such as tracking method, index methodology and overall cost are important in order to best determine whether the ETF fits the desired risk/return profile and investment objective of the investor. And perhaps most important is considering an ETF provider with a strong indexing history, deep portfolio management expertise and dedicated client service and support to help investors evaluate their options.

## ABOUT SPDR® ETFs

Offered by State Street Global Advisors, SPDR ETFs are a family of ETFs that provide investors with the flexibility to select investments that are precisely aligned to their investment strategy. Recognised as an industry pioneer, State Street Global Advisors created the first ever ETF in 1993 - the SPDR S&P 500®, which is currently the world's largest ETF.<sup>5</sup> In 2001, SSgA introduced ETFs in Australia when it launched the SPDR S&P/ASX 200 Fund and the SPDR S&P/ASX 50 Fund. Currently, State Street Global Advisors manages approximately US\$260 billion of ETF assets worldwide.<sup>6</sup>

**For more information about our ETFs or how to invest, please call +612 9240 7600 or email [info@spdrs.com.au](mailto:info@spdrs.com.au).**

<sup>1</sup> Bloomberg, as at 31 March 2011.

<sup>2</sup> Schoenfeld, Steven. *Active Index Investing*. (New York: Wiley Press, 2004).

<sup>3</sup> State Street Global Advisors, as of 31 May 2011.

<sup>4</sup> Current lending policies for SPDR ETFs: Lending allowed in European UCITS funds and U.S. 1940 Act funds. SPDR ETFs do not engage in securities lending practices in Asia (Australia, Japan, Hong Kong and Singapore).

<sup>5</sup> Bloomberg, as of 31 March 2011.

<sup>6</sup> As of 31 March 2011. This AUM includes the assets of the SPDR Gold Trust (approx. US\$56 billion as of 31 March 2010), for which State Street Global Markets, LLC, an affiliate of State Street Global Advisors serves as the marketing agent.

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ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETFs net asset value. Brokerage commissions and ETF expenses will reduce returns.

These investments may have difficulty in liquidating an investment position without taking a significant discount from current market value, which can be a significant problem with certain lightly traded securities. Diversification does not ensure a profit or guarantee against loss.

Passive management and the creation/redemption process can help minimise capital gains distributions. Frequent trading of ETFs could significantly increase commissions and other costs such that they may offset any savings from low fees or costs.

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