



## SPDR S&P/ASX 200 Fund

**(ASX Ticker Code: STW)**

Product Recommendation: Overweight

### Investment objectives

The SPDR S&P/ASX 200 fund seeks to closely match, before fees and expenses, the returns of the S&P/ASX 200 accumulation index, assuming full re-investment. It is listed on the ASX market (ticker code: STW), and can be bought and sold just like an ordinary share.

It is designed to provide cost effective, transparent, and highly diversified exposure to the Australian equity market. As detailed more fully below, ETFs offer the diversification benefits of a managed fund, the flexibility and liquidity of a listed stock, and the simplicity, transparency, low cost, and tax efficiency of a low turnover indexed fund.

### Who is it suitable for?

As a liquid listed investment, the SPDR S&P/ASX200 fund is a convenient vehicle for short-term traders. For long-term investors, it can also offer passive low-cost exposure to the Australian market. If desired, warrants and options over the fund are also available, enabling investors to leverage up or hedge investment exposure in certain periods - without needing to vary underlying fund holdings, and potentially trigger tax consequences.

Further details on such strategies are provided below.

### Management expense ratio

The management fee is 0.286% pa.

### Risk and Long-Run Expected Returns

Reflecting the strength and resilience of the Australian economy in recent decades, the Australian market has been one of the best performing global markets - and with relatively low volatility.

### Investment Performance - \$A terms, 1995-2009

	CAGR*	Std. Deviation
S&P/ASX 200	10.2%	13.0%
US S&P 500	7.0%	19.9%
MSCI Emerging markets	6.5%	24.5%
World MSCI Index	4.3%	16.6%

\*Compound annualised gross return

## Market Performance - \$A terms

Log Index Dec-95 = 100



With low technology exposure, the Australian market fared relatively well during the global dotcom crash earlier this decade. With its major mining exposure, it then managed to ride the global commodities boom in recent years. Our strong banking sector also allowed financial stocks to avoid the worst of the recent global financial crisis.

Indeed, the Australian economy grew by 0.6% in the June quarter, and despite the global financial crisis, only experienced one quarter of negative economic growth over the past year. According to Federal Treasury's mid-year economic and fiscal outlook, the economy is expected to grow at a below-trend 1.5% this financial year, with growth picking up close to trend at 2.75% in 2010-11. The rate of unemployment is expected to rise moderately further over the coming year to 6.75%, before edging down again.

Reflecting the economy's gradual economic recovery, the Reserve Bank of Australia has already begun lifting official interest rates from near-50 year lows of 3%. Official interest rates were increased to 3.5% over October and November, and interest rates should rise to at least 4.5% by mid-2010. Even at this level, however, interest rates would remain fairly low by historic standards.

Australia is a soundly managed economy, with a well-functioning financial sector and a mining sector well-positioned to benefit from the ongoing growth in emerging markets - particularly China. Another factor in Australia's favour is its relatively strong population growth by the standards of most developed economies.

Australia's generous dividend imputation system has also encouraged maintenance of a relatively high market dividend yield of around 4%.

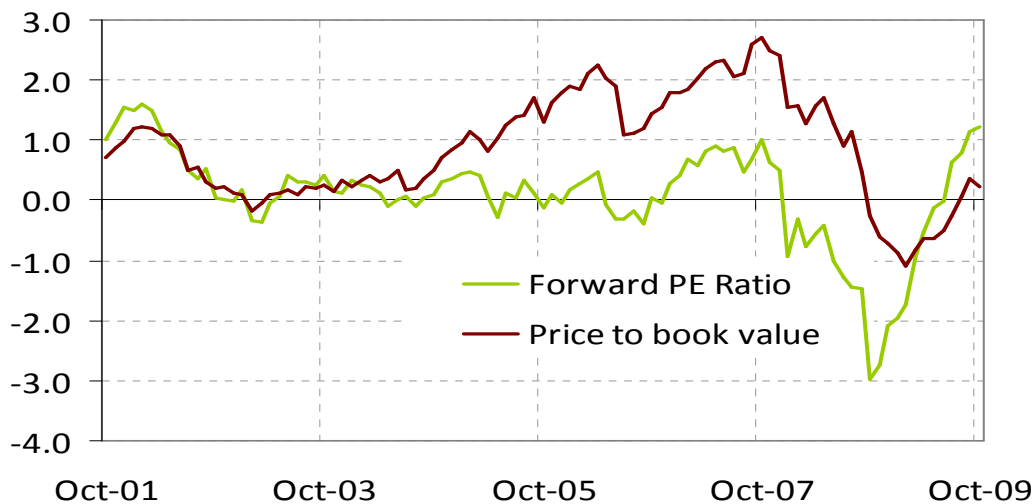
Investors should expect long-run returns from the S&P/ASX 200 of around 9.5% pa - including real earnings growth in line with the economy's growth of 3%, plus 2.5% inflation, and a 4% dividend yield.

### Current Valuations & Market Outlook

The SPDR S&P/ASX200 fund is one of PennyWise Investment's current top picks within the ETF space.

Despite the strong bounce back in the S&P/ASX 200 index since March, PennyWise Investment valuations suggest by end-October the market was close to fair value - with a projected nominal return over the coming year just under 10%.

#### Valuations - std deviations from long-run average



The S&P/ASX 200 price-to-book value is close to its long-run average. The 12-month forward price to earnings ratio at end-October was 16.4, compared with a long-run average of 14. This PE premium, however, exists at close to the bottom of the earnings cycle. After a fall in earnings of 21.4% in 2008-09, consensus estimates from Thomson Reuters suggest earnings will dip a further 1.6% this financial year, before rebounding a solid 21% in 2010-11 and 15.8% in 2011-12.

Another way to value the market over a more medium-term basis is to compare prices to the trend growth in corporate earnings – PennyWise Investment's price to trend earnings or "PTE" ratio. According to our estimates, the "PTE ratio" was 12.7 at end-October, compared with projected long-run average of 16.3 – implying an under valuation of around 22%.

Assuming trend real earnings growth of 3%, the current dividend yield of 4.2%, and a rise in the PTE ratio to 16.3 over 5-years, would imply compound annualised real returns over the next 5-yearsof 12%. This is higher than the long-run expected real return of 7%.

### Australian Market: Price to Trend Earnings Ratio

times trend earnings

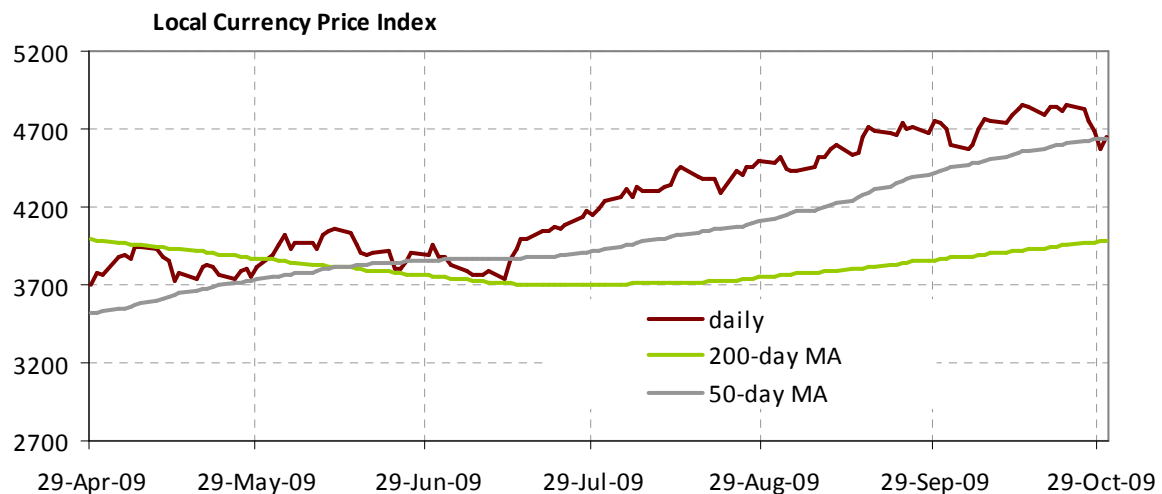


From a technical view point, the market continues to reflect this positive fundamental backdrop.

As at end October, the S&P/ASX 200 index was comfortably above its 200-day moving average – one of PennyWise Investment's key indicators of medium term trend. In the short-run, however, the market rally did appear a little over extended, with prices an unusually high 2 standard deviations above the 200-day moving average. Along with softness in international markets, that saw the index pull back in the final week of the month, touching below its 50-day moving average.

While a period of consolidation is probably required after the strong market rally since early March this year, we believe the market is still in the early stages of a cyclical upswing.

### Short-Run Performance



## How to USE ETFs - Passive and Active Strategies

ETFs are flexible enough to be used by any type of trader or investor.

Long-term investors can use broad market ETFs – like the SPDR S&P/ASX200 fund - as a cheap and effective component of their **core** portfolio, as it provides instant diversification at a fraction of the cost of most actively managed funds. Investors can then concentrate on seeking out higher risk/return “**satellite**” investments to spice up their portfolios should they desire. Satellites could include individual listed company stocks, or other more specialised ETFs – such as covering emerging markets, or global industry sectors.

Another convenient method for long-term investors is “**dollar cost averaging**”, whereby investors set up a pre-set schedule to invest fixed dollar amounts in ETFs at regular intervals i.e. \$1000 every 3 months.

The advantage of this fixed dollar method is that, over time, investors will be buying more ETFs when prices are low (i.e. during market downturns), and less during market peaks – effectively timing entry into the market over the economic cycle and enhancing returns. The downside to dollar cost averaging through ETFs is that brokerage commissions may be relatively high for small investments – so investors should consider making fewer but larger regular investment so as to reduce brokerage costs.

Investors also have the option of hedging their ETF exposures over time – or leveraging up returns – though **options or warrants**. There are a number of call warrants available over the SPDR S&P/ASX200 fund, for example, which allows a convenient means of adding leverage to their investments – with the chance of higher returns in strongly rising markets, through at the risk of greater negative returns if markets turn down.

With a call warrant, for example, investors pay a fee – or up front partial payment – in exchange for the right to make the full purchase of SPDR S&P/ASX200 units at an agreed upon “strike” price sometime in the future. The warrant issuer effectively provides a loan for the outstanding balance, which can be terminated should the option to buy not be taken up.

If market prices rise above the strike price, investors can take up their rights to purchase the shares, or sell their call warrant at a profit. By contrast, if the share price falls, investors do not need to take up their purchase rights and the most they can lose is the initial cost of purchasing the call warrants – effectively a “stop loss” to limit their downside. Their loss would be further reduced if they sold the call warrants before they expired worthless.

Trading warrants provided no dividends and offer higher leverage, and would suit more short-term or speculative traders in the SPDR S&P/ASX200 fund. Instalment warrants by contrast, offer full dividend rights – and can be either a “rolling” warrant, where dividends are paid back to the investors, or “self-funding” warrants where dividends are automatically used to pay down the loan balance on the warrant.

As well as warrants, call and put options are also available over the SPDR S&P/ASX200 fund, enabling investor to speculate on short-term market price moves, hedge exposures, and enhance long-run returns. Investors who think the market may rise (fall) over the short-term, have the option of buying call (or put) options over the SPDR S&P/ASX200 fund.

Call options – like call warrants – provide the right to buy shares at an agreed “strike” price sometime in the future, and their value rises in line with market prices. Put options provide the right to sell shares at an agreed price sometime in the future, and their value rises as market prices fall.

In times of high market volatility, for example, investors have the ability to buy put options which would gain in value if market prices fell – effectively “**hedging**” one’s exposure to the market without needing to sell their underlying investments and trigger capital gains tax.

Another option for long-term investors is the “**covered call**” strategy – where an investor gains an extra premium by selling call options against their underlying SPDR S&P/ASX200 units. Effectively the investor sells the right to other investors to buy their units if market prices rise above a certain level.

The covered call strategy essentially entails sacrificing some potential upside in share prices, in exchange for the certain return from premiums on call options sold – it is a particularly effective strategy in periods where market prices are rising relatively slowly.

### About State Street Global Advisors

State Street Global Advisors is one of the largest ETF providers in the world.

State Street Global Advisors were the first to launch ETFs, when their SPDR (Standard & Poor's Depository Receipt) products listed on the US market almost 20 years ago. US ETF assets have jumped from \$US1 billion in 1995 to \$US630 billion, due to strong interest from retail investors.

SPDRs were first launched in Australia in 2001, and while they remain relatively under utilised by US standards, their popularity is growing rapidly. Indeed, the value of Australian ETF investment funds has grown from \$48 million in June 1998 to around \$3 billion by 26 October 2009.

The SPDR S&P/ASX 200 remains the largest Australian listed ETF, with \$2.06 billion in funds by 26 October 2009.

### PennyWise Investment

PennyWise Investment is Australia’s first and only specialist investment advisor on exchange traded funds. Our monthly investment report reviews both the fundamental and technical outlook for the S&P/ASX200 index and other international markets – such as emerging markets - which have associated ETFs trading on the local market. We also provide ETF-based model portfolios for self managed super funds and financial planners.

More detailed research on a range of local and international ETFs is available at [www.pennywiseinvestment.com.au](http://www.pennywiseinvestment.com.au)

### Investment Background: More on Exchange Traded Funds (ETFs)

Exchange traded funds (ETFs) are listed indexed investment funds that passively track the performance of selected equity, bond or commodity indices such as the S&P/ASX 200, America's S&P 500, or even emerging markets.

ETFs have a number of advantages. For starters, one ETF alone – such as the SPDR S&P/ASX 200 fund, offers the immediate diversification benefits of a managed fund. Investors get exposure to the whole market in one transaction, without having to juggle investments in many different stocks.

ETFs also offer the flexibility and liquidity of a listed stock. Investors can gain access to all or part of their ETF investments relatively easily by simply selling them back to the market. And unlike some listed investment companies, active market makers ensure they do not trade at substantial discounts or premium to their net tangible assets.

ETFs also offer the simplicity, transparency, low cost, and tax efficiency of a low turnover indexed fund. Finding an active fund manager that consistently beats the market is not easy. A recent survey by Standard and Poor's, for example, found that 75% of actively managed Australian equity funds failed to beat the S&P/ASX200 benchmark over the previous 5-years.

Accordingly, if you or your clients do not have the time or inclination to seek out consistently good active fund managers, ETFs provide a cost-effective ready alternative.

And unlike some managed funds – such as hedge funds - index based ETFs have transparent investment strategies – there is no "black box". Investors know exactly what they are buying – a broad exposure to the stocks that make up a major equity index.

Like traditional indexed funds, moreover, ETFs usually have much lower turnover than many actively managed funds - and so create less capital gains tax liability for investors within a current financial year. ETFs are also uniquely structured so that redemptions do not create tax liabilities for remaining investors through the sale of underlying securities.

A recent survey by Investment Trends indicated the number of Australian ETF investors almost doubled from 10,000 in November 2006 to 19,000 at the end of last year. In addition, survey responses indicated that 33,000 people are considering investing in ETFs.