

Fixed Income ETFs

Bonds Get to Work

Since their emergence in 2002, fixed income Exchange Traded Funds (“ETFs”) have helped break down many of the barriers to bond investing for investors of all stripe. It’s no surprise, then, that bond ETFs have been steadily gaining momentum in the marketplace. While they still don’t get anywhere near as much attention as equity ETFs (in no small part due to their 10-year head start) growth in the absolute numbers and assets of fixed income ETFs has been impressive. At the end of third quarter 2009, TrimTabs Investment Research reports that assets invested in the fixed income piece of the ETF market stood at around \$91 billion, a 59% increase from a year earlier.

And with 75 million or so baby boomers set to retire over the next several years, we think it’s reasonable to expect that the demand for income—and the demand for sensible fixed income investments—will continue to expand.

Bond ETFs represent a particularly timely investment in the face of a particularly difficult global economic environment. Before the 2008 recession hit, investors were generally incorporating just one broad-based bond fund into their portfolio. Nowadays, these same folks, many of whom suffered steep losses, are not only looking for more diversification among investments, they’re being a lot more selective in terms of who manages those investments.

In the meantime, there’s occurred a major development in the fixed income ETF space: the launch of actively-managed product. Indeed, in March of 2008, when relatively few were watching, the firm formerly known as Bear Stearns listed its “Current Yield Fund” on the American Stock Exchange. Both the firm, the fund, and the exchange have since disappeared, but the benefits of the idea most certainly have not. With the launch of actively-managed ETFs, the ETF no longer has to be synonymous with passive investing.

The actively-managed bond ETF is an exciting addition to the investment marketplace, offering a welcome choice to investors looking for the kind of liquidity and ease of trading to which equity traders have long been accustomed. For years, the bond investor desiring a commingled vehicle has had only two choices: relatively expensive, actively-managed mutual funds, or lower-cost, passively-managed index mutual funds. The actively-managed bond ETF offers a powerful alternative to both.

Coming of Age

Just like their passively-managed counterparts, actively-managed bond ETFs provide diversification with one trade, the ability to use stop loss and limit orders, marginability, tax efficiency, and a relatively low minimum investment. And that’s because fixed income ETFs—unlike most bonds themselves—trade on the New York Stock Exchange or NASDAQ. That feature makes bond ETFs, both passive- and actively-managed, unique in the world of fixed income. The kind of price transparency that comes with exchange listing simply didn’t exist in fixed income world until ETFs came along.

In the seven years since the first passively-managed bond ETF hit the marketplace, sponsors have been steadily rolling out funds designed to offer investors an opportunity to achieve broad or targeted bond market exposure through specific sectors like government, corporate, or mortgage-backed, maturity range, or other attributes like credit quality. Today’s array of bond ETFs are straightforward, easy to interpret, and fills specific investment needs expediently. Among the ways fixed income is being packaged these days are:

- *Treasury ETFs* in a range of maturities
- *Corporate bond ETFs* from investment-grade funds to junk bonds
- *TIP ETFs* (Treasury inflation-protected securities) for an inflation hedge
- *Total bond market ETFs* for broad fixed income exposure
- *Municipal bond ETFs* for tax-free income in a range of maturities

Taken together, these bond ETF offerings provide a kind of precise, liquid¹, and low-cost² exposure to the fixed income market that opens the door for investors and portfolio managers to implement strategies never thought possible with individual bonds, not least of which asset-allocation and sector-rotation plans. The huge inflows last year into ETFs tracking inflation-protected bonds and corporate debt clearly reflected the fact that investors were increasingly using bond ETFs to manage the fixed income side of their portfolios.

¹ETFs are considered to have continuous liquidity because they allow for an individual to trade throughout the day. ²Ordinary brokerage fees apply.

The surge in popularity has prompted sponsors to create new varieties of fixed income ETFs, including everything from convertible-bond funds to high-yield municipal-bond funds. ETFs provide investors with a way to enter fixed income categories like high-yield or sovereign debt markets that only large institutions could access before. Along with liquidity, diversity, and low cost, ETFs offer a way to diversify a portfolio.

These sorts of benefits have helped bond ETFs swell to about \$90 billion in assets in 2009 from \$55 billion at the end of 2008. Last winter, when the spread between investment-grade corporate bond risk premiums reached five percentage points over Treasuries with comparable maturities, the door was opened across the board for fixed income ETFs. As recently as January 2007, there were six bond ETFs. Since then, 63 new bond ETFs have been launched, and that number is only expected to grow.

This growing array of fixed income ETFs adds a new layer of complexity, of course, since investors still have to make a choice of duration, sector, and yield curve exposures for their bond allocation. Actively-managed broad market bond ETFs, with professional oversight and risk management within a single investment, go a long way toward simplifying the choice.

Tax-Free Bonds: Big Changes In The Marketplace

On a relative basis, nowhere has the pace of change been faster than the usually staid tax-free bond market. In fact, the municipal industry might be catching an early glimpse into what “new normal” looks like.

With over 50,000 issues and an estimated value of over \$2.7 trillion, the municipal bond* market has long provided investors, typically those individuals or corporate entities in high marginal tax brackets with income exempt from federal and state or local taxes. But even as the amount of municipal debt has expanded at a steady pace, the composition of who owns them has transformed at a quicker one, in no small part due to the passage in February 2009 of the American Recovery and Reinvestment Act. That legislation created the Build America Bonds program, which enables municipalities to forego the traditional tax exemption on their debt and instead issue taxable debt and receive a federal subsidy equal to 35% of the interest costs. Many issuers have found it is cheaper to borrow money in the taxable market with the federal subsidy than in the tax-exempt market without it.

Known as “BABs”, these bonds enable municipalities to float debt that is more attractive to new investors, specifically those who are already tax-advantaged and would otherwise have no reason to bid for tax-exempt bonds. The result has been an eruption of BAB sales into the taxable market.—and the emergence of foreign investors as major buyers of new municipal bonds.

At the same time, a new investment vehicle has been encroaching on this market that was once a market dominated by households: Municipal bond ETFs. No ETF devoted to municipal bonds even existed in mid-2007 and now there are more than 20. And according to the Federal Reserve, their assets have nearly tripled in the last year.

Until the introduction of the muni-ETF a little more than two years ago, there were three primary ways to gain exposure to municipal bonds: purchasing individual bonds, investing in actively-managed municipal bond funds, or hiring a professional bond manager to manage a separate account. All three approaches work, of course, but each has observable drawbacks.

Individual municipal bonds, for example, trade in a notoriously opaque over-the-counter negotiated market, where price transparency and liquidity are difficult for the average investor. And it's entirely challenging for all but the largest investor to purchase enough bonds to achieve real diversification within the asset class, leaving portfolios exposed to changing interest rates, municipality-specific events, poor market sentiment and more.

For their part, actively-managed muni-bond mutual funds typically take a “total return” approach to their investment strategy, meaning the fund manager attempts to provide a level of tax-free income while actively trading the securities to capture any capital appreciation. In some cases, this strategy results in a capital gains tax. Beyond that, actively-managed mutual funds also charge relatively high expenses that erode the after-tax benefits of a total-return oriented fund.

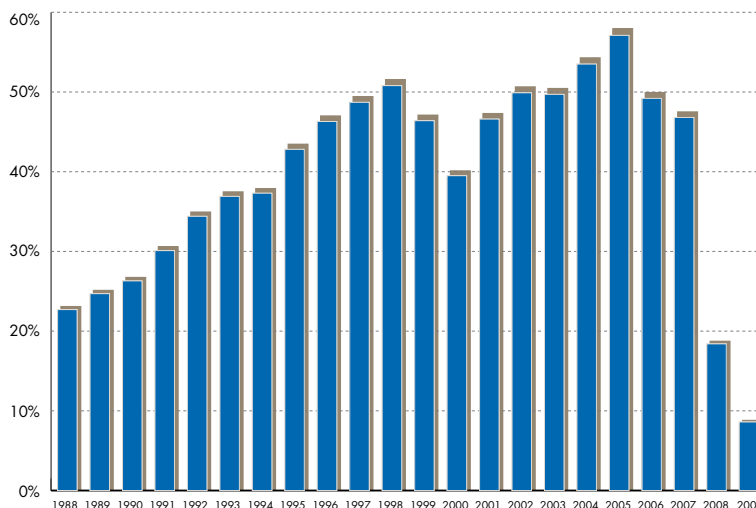
Separately managed bond accounts, meanwhile, offer the advantage of customization and tax sheltering, but access to successful money managers is typically out of reach for investors with less than \$250,000 to allocate to fixed income. Beyond that, the need to manage an individual's unique cash needs (deposits or withdrawals) can have a negative impact on an account's performance.

No surprise, then, that advisers and investors were clamoring for municipal bond ETFs as a way to provide the benefits of tax-free bonds without the burdens of traditional ownership. And the match was virtually made in tax-exempt heaven. In just the first three quarters of 2009, exchange-traded funds—among all different types of investors and groups—added the most municipal bond assets to the category, increasing some 28% to \$5.1 billion. In total, municipal bond funds are one of the fastest growing segments in the exchange-traded fund industry with the addition of more than 20 funds in the past two years.

Indeed, with offerings now ranging from general municipal funds like the iShares S&P National Alternative Minimum Tax (AMT) Free Municipal Bond to the PowerShares Build America Bond, which invests in niche municipal bonds backed by stimulus cash, the benefits of tax-free bonds are becoming increasingly available to wide range of investors.

For the issuers of the bonds themselves, however, the current environment is far less pleasing. Not only is a difficult economy stressing the revenues of cities, counties, and state governments around the nation, the financial sturdiness of leading bond insurers like AMBAC Financial Group, Inc. and MBIA Inc. is in question. The result has been a significant migration toward lower quality in the municipal marketplace over the past few years. This migration represents an acute challenge to the passive investing approach.

Municipal Bond Insurance Market Share % Insured out of Total New Issue Volume



*Data as of 1988 – December 2009.
Source: Bond Buyer Yearbook/Thomson Financial*

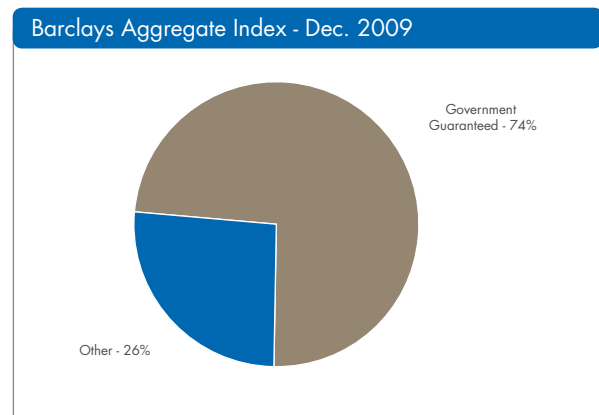
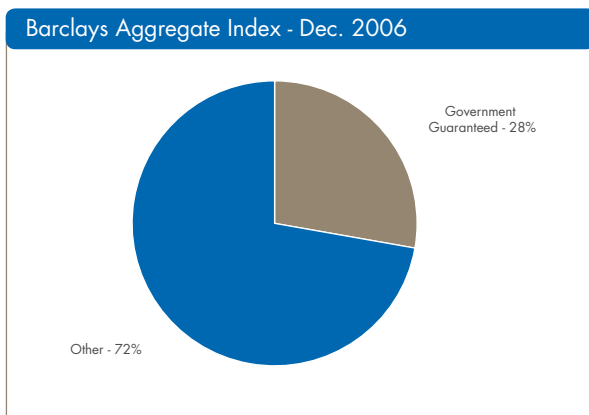
According to McDonnell Investment Management, around 70% of the municipal bond market was AAA-rated when ETFs were introduced in 2007, and nearly 50% of new issues were insured. Today, fewer than 31% of tax-exempt bonds carry the highest rating, and less than 10% of new issues are insured. In this environment, a passive manager, who by definition pays little attention to credit momentum or the ability of any government entity to make good on its promise to repay, is left to 'ride the quality lower' in an effort to replicate an index. An active manager, on the other hand, can analyze each municipality's ability to meet debt payments, collect taxes, and use federal stimulus funds, and be more discriminate on which securities, states, and sectors he or she invests in.

The current reality is that for all the investment merits of municipal bonds, the municipalities that issue them are feeling a fair degree of economic stress. Actively-managed muni-ETFs, then, appear to be a timely and untapped market for innovative firms with a solid track record in credit research and bond management. Recent announcements by PIMCO and Grail Advisors regarding the launch of actively-managed product may well portend the future of the muni-bond ETF marketplace.

Taxable Bonds: Big Changes In The Indexes

Despite the category's obvious asset gathering success, passive management of taxable bond ETFs is also coming under pressure. Like the municipal market, passive investors without the ability to use research and judgment to mitigate risk and anticipate negative credit events, are challenged by tough market environments. And active managers, again because they are able to conduct their own due diligence, are better placed to access and exploit market opportunities. But unlike the municipal market, these opportunities lie in taxable bonds' migration toward higher credit quality.

Indeed, taxable bond indexes have exhibited the opposite trend of their tax-free counterparts as the influence of government bond purchases and the explicit and implicit guarantees have combined to lower yields and bond yield spreads over Treasuries.



Source: Barclays Capital. Government Guaranteed: In 2006, only included Treasuries and GNMAs. In 2009, also includes FNMA and FHLMC, which are now in government conservatorship. Other: In 2006, included Agency Debt and MBS, CMBS, ABS and Credit. In 2009, only includes CMBS, ABS and Credit.

Since July 2007, McDonnell's data shows yield premiums on the Barclays U.S. Agency index narrowed from a high of 180 basis points to a mere 30 basis points in December 2009 in response to the federal government taking conservatorship of Fannie Mae and Freddie Mac. While a typical passively-managed bond ETF has benefited by the narrowing of the spread, the fund is forced to continue holding the lower yielding security given its stated objective of replicating the index composition and returns. An active manager can be more discriminate in choosing higher yielding securities, overweighting higher yielding sectors, or positioning the portfolio along the yield curve to take advantage of its steepness.

Beyond that, passive management leads to 'predictable' sales, regardless of a security's market condition. Specifically, when a company's credit rating is downgraded such that it can no longer be a constituent of the index, passive managers have no choice but to become a seller. Market participants are aware of this reality, and affected bonds almost always suffer an exaggerated fall in price on downgrade announcements, often recovering later. While the biggest and largest SEC-designated "Nationally Recognized Statistical Rating Organizations" have been thoroughly discredited over the last couple of years, passive managers still have to rely on these rating agencies whether they buy, hold, or sell.

Active managers, on the other hand, can rely on their own internal research to assess buy, hold, and sell decisions and tend to use rating agencies as a minor component of their security selection process. While a passive manager may be forced to sell at the worst possible price, an active manager can rely on in-depth credit analysis to time a transaction.

And, very importantly these days, active management risk is not necessarily correlated to interest rate risk. Most bond managers long ago realized that market timing or interest rate timing is extremely difficult, and therefore maintain a portfolio's duration close to the benchmark. The absolute risk of active and passive managers then, at least in terms of volatility, is extremely similar. Said another way, the appointment of a passive manager is not a way of reducing risk. In fact, active managers might be better placed to avoid or mitigate default risk, which is significantly heightened in times of economic difficulty, and therefore reduce the total risk of the portfolio. The bottom line is skilled active managers can capitalize more efficiently on the bond market's inefficiencies and represent the potential for higher risk-adjusted returns.

Appealing to Individuals and Institutions

Whether they're passive- or actively managed, the ability to efficiently trade fixed income ETFs intraday is a particular benefit to individual investors who have graduated from individual bonds or bonds through mutual fund products. Like institutions, individuals have grown comfortable transacting on the basis of market prices immediately visible to them. And they enjoy the ability to adjust portfolio holdings in the presence of volatility, which may affect price differences between the time of the investment decision and the market close, when most fund products accept inflows and outflows. More flexible to trade and more tax-efficient than traditional mutual funds, ETFs are well suited for both long- and short-term holdings in any investor portfolios.

For institutional investors and portfolio managers, meanwhile, bond ETFs have a number of specific uses, including:

- *"Bondetizing" cash.* A term coined by the fixed income managers at McDonnell, "bondetizing" refers to putting idle portfolio cash to work in a product tied to the fund's benchmark or to an appropriate sector. This could be a temporary investment that minimizes cash drag or benchmark risk while the investor waits for a particular purchase.
- *Managing cash flows.* Investment managers who see regular inflows and outflows of cash can use ETFs for their liquidity and their ability to represent a "slice" of a portfolio. Investing or raising cash by moving in or out of individual positions can leave a fund with tracking risk to the benchmark.
- *Diversifying credit exposure.* Investing in shares tied to an index provides diversified exposure and reduces risk in the event of specific issue news. Typically, the volatility or risk associated with an index or basket is lower than the volatility or risk of an individual index component. *Diversification does not eliminate risk.*
- *Filling gaps or taking active views on sectors.* ETFs tied to a credit or maturity may be used to fill gaps in a portfolio on a tactical basis. Such strategies could be used to reduce an over- or underweighting relative to a benchmark.
- *Shorting or hedging index exposure.* Managers who have a negative view on a market segment or specific sector may want to establish a short position to capitalize on that view. ETFs can also be sold short against long holdings as a hedge against a decline in the market or specific sector.

Overall, the trading costs from the market impact of selling an ETF could be lower than the cost of liquidating a large holding in a specific name as a result of the greater liquidity and lower volatility of the diversified ETF product.

Off the Shelf

Given that fixed income ETFs have broken down so many of the barriers and added so many benefits to bond investing for investors, it's no surprise that bond ETFs have been steadily gaining momentum with sponsors.

Among the list of fund companies expanding their bond ETF offerings is PIMCO, the largest bond-fund manager, moved into the fixed income ETF market this year with a short-term Treasury index fund and several Treasury Inflation-Protected Securities (TIPS) index funds. iShares, the largest provider of bond ETFs and the first company to offer them, has 25 bond ETFs. State Street Global Advisors, the second-largest bond ETF provider, counts 18 bond ETFs among its roster of funds. Grail Advisors, meanwhile, has announced plans to combine the benefits of the ETF structure with a number of actively-managed strategies from veteran fixed income management teams.

Interestingly, all of this transparency has hastened the demise of a Wall Street moneymaker since bonds financed the expansion of railroads into the American West 140 years ago: the retail bond salesman. Indeed, with visibility comes tighter bid-ask spreads, and with that the Street's oldest profession has lost its advantage. As one trader was heard to say: "Instead of letting a little bit of transparency in there, they just opened the windows completely and all the shades and everything, and it was complete sunshine."

But changing from a completely dark market to a transparent one makes it more efficient, which makes it better for all players in the long run. To that end, the equity desks at many of the larger brokerage firms are latching on to bond ETFs. Though they represent fixed income, bond ETFs are executed just like stocks and traders are building out the necessary infrastructures to run “baskets” of fixed income product, stacked and racked by sector, by security, and by yield curve. All of this means an increasingly efficient bond market where active managers should be able to add value through a disciplined security selection process.

A New Bond World

The bond ETF landscape is changing quickly and innovative products are being introduced continuously. While this trend is exciting and likely to continue, it does pose a challenge for today’s financial advisors. In a 2008 survey by State Street Global Advisors and Knowledge@Wharton, nearly 70% of advisors cited “unknown, untested indexes” and “the overwhelming number of choices” as the greatest disadvantages of ETF investing. Planners are already seeing baby boomers searching for income combining high yield with long maturity as they look to transition their retirement assets into income-generating investments. For these advisors, electing an ETF that is the “best fit” for an investor’s portfolio will take time, expertise, and professional analysis.

In the meantime, if the trends in the broader ETF marketplace are any indication, growth in actively-managed ETFs will likely increase. To date only a few actively-managed bond ETFs have been launched, including the PowerShares Active Low-Duration and PIMCO’s Intermediate Municipal Bond Strategy Fund, but there are several more on the way, including the Grail McDonnell Intermediate Municipal Bond ETF and the Grail McDonnell Core Taxable Bond ETF.

Bond ETFs are a welcomed alternative to individual bonds and traditional fixed income mutual funds, and the menu of offerings is expanding dramatically. In the end, the individual investor could be the real beneficiary of this latest financial innovation.

Disclosure

** Source: The Municipal Securities Rulemaking Board 2008 Fact Book.*

Shares are not individually redeemable. Investors buy and sell shares on a secondary market. Only market makers or "authorized participants" may trade directly with the Funds, typically in blocks of 50,000 shares. For more information about taxes, consult your tax attorney or accountant for advice.

There are risks involved with investing including possible loss of principal. The ETFs are actively managed and the Shares may trade above or below their net asset value. The trading price of shares may deviate significantly from net asset value during periods of market volatility. Shares are not FDIC insured, may lose value, and will have no bank guarantee.

Investors in any bond fund are subject to fluctuations in price due to issuer and credit quality, rising interest rates, inflation and call risks associated with the underlying bonds owned by the fund.

Performance data quoted represents past performance. Past performance is no guarantee of future results.

An investor should consider investment objectives, risks, charges and expenses carefully before investing. The Prospectus contains this and other information. For more complete information about the Grail McDonnell ETFs or to obtain a Prospectus, call 415-677-5870 or visit www.grailadvisors.com. Please read the Prospectus carefully before investing.

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For more complete information about the PowerShares QQQ and PowerShares BLDRS or to obtain a Prospectus, call 800-983-0903 or visit www.invescopowershares.com. Please read the Prospectus carefully before investing.

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Definitions

AAA Bond Rating: the highest rating that can be given.

Correlation: a statistical measure of how two securities move in relation to each other.

Volatility: the relative rate at which the price of a security moves up and down.