



Richard Bernstein, Chief Executive
and Chief Investment Officer

Richard Bernstein Advisors

Richard Bernstein Advisors LLC (RBA) is an independent investment adviser focusing on longer-term investment strategies that combine top-down, macroeconomic analysis and quantitatively-driven portfolio construction. We strive to be the leading provider of innovative investment solutions for investors, and our competitive edge is our research-driven macro style of investing.

Our top-down macro approach differentiates our firm from the more common, traditional bottom-up approach of most asset managers. Our extensive array of macro indicators allows us to construct portfolios for clients that are innovative, risk-controlled, and focused on overall portfolio construction instead of individual stock selection.

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SPECIAL COMMENTARY:

Embrace, Don't Fear, Illiquid Asset ETFs

It seems ironic that Wall Street today loves the words “innovation” and “disruptor”, but fears innovation and disruptive technologies within their own industry. The flow statistics certainly show that investors have generally embraced the use of Exchange Traded Funds (ETFs)¹, but there remains considerable fear mongering regarding ETFs and, more specifically, ETFs based on illiquid² assets. We don't believe such fears are justified. They might reflect a misunderstanding of ETF trading or perhaps are defensive tactics associated with the new competition of a disruptive technology.

The empirical evidence, as opposed to supposition about “what if” situations, has not confirmed the often cited criticisms of ETFs holding illiquid securities. Recent and significant examples demonstrate that ETFs based on illiquid assets not only withstood a volatility storm, but their trading became more liquid and efficient both on an absolute basis and relative to that of the illiquid underlying securities.

The empirical data does raise important questions about the illiquidity premiums that investors currently pay to managers who invest in illiquid asset classes. ETFs now offer liquid access to illiquid securities, which means that managers of illiquid assets will need to better justify fees and conditions related to clients' access to funds. **Investors no longer have to tolerate lock-ups and gates, which restrict investors' access to their own funds, to get exposure to illiquid asset classes.**

There are, of course, a select group of managers who produce so much “alpha” that investors are well-compensated for the lack of access to their money. However, with the advent of ETFs in illiquid asset classes that offer both asset class returns and daily liquidity, a long-term multi-manager investment strategy should progressively focus on ETF selection and ETF allocation rather than on selecting among the majority of managers of illiquid securities who restrict investor liquidity while generally producing minimal or no alpha.

There are two aspects to ETF trading:

- 1) Creation/Redemption process**
- 2) Trading existing ETF Shares**

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Understanding ETF Trading

ETF trading has two aspects: the creation and redemption of an ETF's shares outstanding and the trading of those ETF shares. Most concerns about ETFs of illiquid securities seem to concentrate on the former and ignore the latter.

The creation and redemption of ETF shares is based on a basket of the ETF's underlying assets. For example, shares of an ETF based on a stock index would be created or redeemed based on the constituents of the index. Shares of some ETFs are created or redeemed based on a representative sample of the underlying index because full replication is impossible. That is generally the case when the underlying stocks or bonds are relatively illiquid.

Shares can be created or redeemed when the net asset value of an ETF diverges significantly enough from an ETF's price to justify the increase or decrease in the number of shares and when the underlying security prices have not yet adjusted. When the trading value of an ETF is too high relative to the net asset value, more shares will tend to be created to push the trading value down to the net asset value. When the trading value of the ETF is too low relative to the net asset value, then shares will tend to be redeemed to increase the trading value.

The second piece to ETF trading is the actual trading of the existing ETF shares. ETF shares trade on exchanges with price discovery based on bid/ask spreads and market making as do other listed securities. It is critical to understand ETFs trade independently of the trading of the underlying securities. For example, shares in global equity ETFs listed in the United States trade during US trading hours while non-US markets are closed because of time zone differences.

ETFs can sell at significant premiums or discounts to net asset value if the creation/redemption process and market trading aren't efficient. However, there are many investments that can sell at premiums or discounts and some, such as closed-end funds, can do so for long periods of time.

Some critics of ETFs of illiquid securities might not fully understand ETFs' two trading considerations. They often comment on the potential inability to create and redeem shares if an illiquid market had a disruption. However, they ignore the fact that the ETF, which trades in a listed and much more liquid market, can trade independently of the underlying assets. This is a fundamental aspect of ETFs. ETFs' trading represents the trading in baskets of securities already held and does not represent the trading in the actual underlying market.

An ETF investor can exit the investment regardless of whether the underlying market is active. It makes no difference whether an ETF is based on stocks in countries in which markets are closed for time difference or holiday or whether an ETF is based on illiquid assets in a market that has stopped functioning because of panic or fundamental problems. As with any market listed investment, there is no guarantee of selling price, but an ETF based on illiquid assets is more likely to provide immediate liquidity relative to that offered in the underlying illiquid assets' primary market.

Virtually all financial assets are more liquid than the underlying asset that they represent

A well-respected money manager was quoted in The Wall Street Journal on July 21 as saying, “No investment vehicle should promise more liquidity than is afforded by its underlying assets.” This statement seems to ignore that virtually all financial assets are more liquid than the underlying asset that they represent. An investor can transact more easily in the equity of a company than they can in the underlying assets on the balance sheet. Commodity futures are more liquid than the underlying commodities (I don’t want to physically sell live cattle or pork bellies, do you?). REITs are more liquid investments than the underlying real estate. A fear that ETFs might be more liquid than their underlying assets seems to ignore the long list of financial assets that are more liquid than their underlying assets.

There are recent examples of significant market disruptions that demonstrate the importance of both parts of ETF trading. In these instances, ETFs continued to trade despite total or partial market closure. A prolonged closure of a market clearly represents an extreme case of asset illiquidity.

Chinese equities

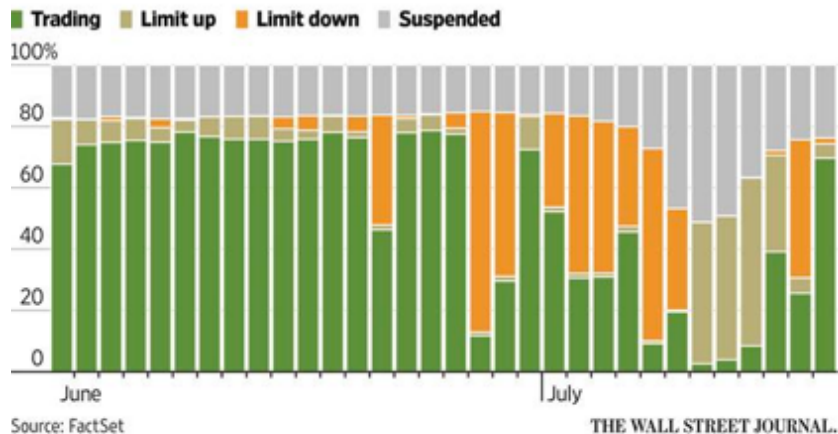
Chinese equities have experienced considerable volatility during 2015. Chart 2 shows the CSI 300 index over the past five years, and its extreme volatility over the past year or so. Chinese authorities have tried to curtail the recent bear market by adding liquidity, preventing new issues from coming to market which might add to the over-supply of shares, and by halting trading in many securities. The Wall Street Journal on July 21 commented that only about 3% of Chinese listed companies in mid-July could trade normally because of suspended trading or trading limits (See Chart 1). One cannot find a more illiquid market than one that basically doesn’t trade!

CHART 1:

Suspended Animation

The effect of trading suspensions over the past month in China was magnified when many of the shares still trading hit daily limits.

Breakdown of stocks listed in Shanghai and Shenzhen



ETF liquidity soared as the underlying market became increasingly illiquid.

Chart 3 shows that the discontinuity of trading in many of the underlying issues did not hurt the liquidity of the Deutsche X-trackers Chinese A-Shares ETF (ticker: ASHR)³. In fact, the bottom panel of Chart 3 demonstrates that the value traded of the ETF soared as the underlying market became increasingly illiquid. The liquidity of the ETF increased as the turmoil in the Chinese stock market increased and as the underlying securities became less liquid.

Chart 4 demonstrates that the relationship between the ETF's value and the net asset value (NAV)⁴ of the underlying securities becomes more suspect as the underlying securities stop trading. This might be a problem for short-term traders, and these disparities reflect both emotion and the total inability (because of closed markets and regulation) to arbitrage the differences between the two.

We view the disparities as being relatively normal. Two things to consider when examining the spread between the ETF price and the NAV:

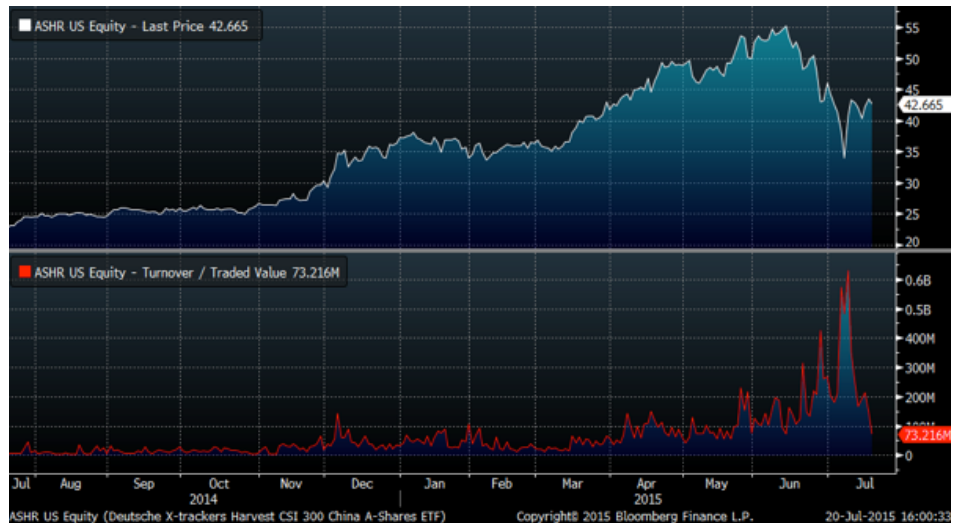
- 1) The wider disparity between the ETF price and the NAV occurred largely because the underlying securities were not pricing. When this happens, pricing models rather than market quotes are sometimes used to estimate NAV. However, this is exactly our point. The ETF continued trading despite that the underlying market stopped trading.
- 2) Longer-term investors should probably not worry about short-term disparities between an ETF's price and the underlying NAV because the two tend to roughly equate over time. Even traditional stocks' prices differ from the underlying NAV, but stocks' prices and NAVs tend to converge. Value investors typically attempt to take advantage of such stock mispricing by going long stocks whose prices understate NAV and by shorting those whose prices overstate NAV. The point being that it is not unusual to see such disparities in financial markets.

CHART 2: CSI 300 index (price)



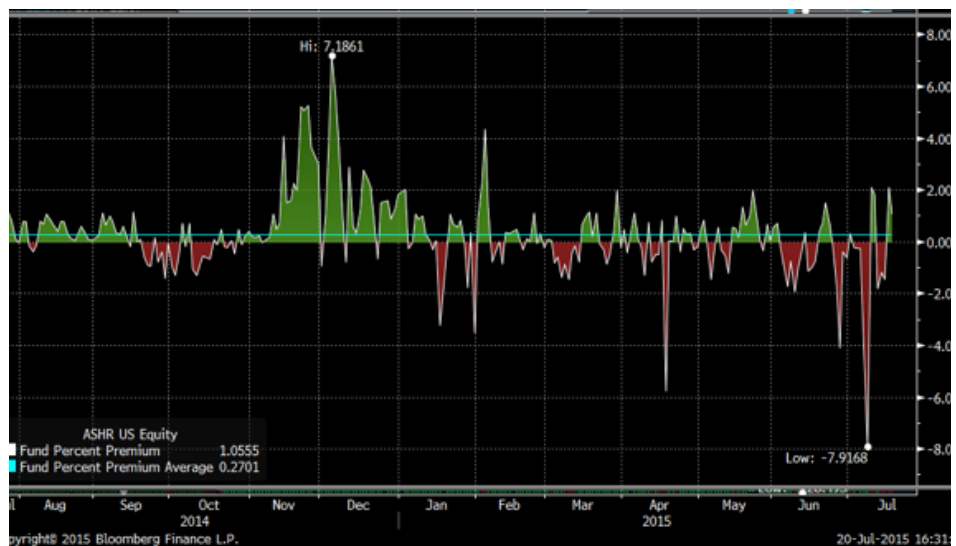
ETF volume rose as the underlying market became increasingly illiquid

CHART 3: Chinese A-Shares ETF (ASHR)



The relationship between an ETF's value and the net asset value (NAV) of the underlying securities becomes more suspect as the underlying securities stop trading

CHART 4: NAV of premium/discount of ASHR



Greek Equities

Greece's debt problems and the resulting financial market uncertainty caused the Greek stock market to close as of June 26. Similar to the China example above, the Global X FTSE Greece 20 ETF (GREK) traded with increased, not decreased, liquidity despite that the underlying market became totally illiquid -- it has been closed for an extended period of time! (See Chart 5)

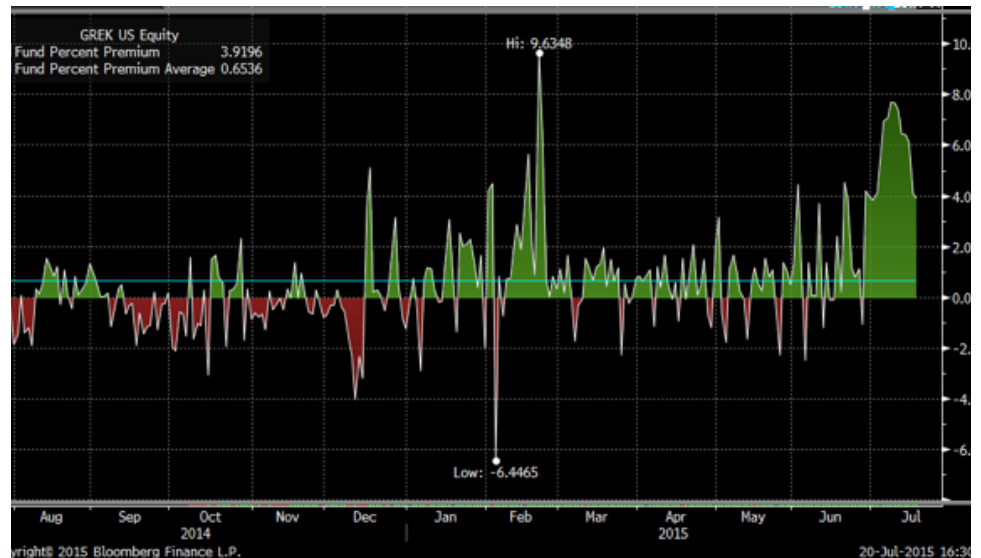
Chart 6 points out that the disparity increased between the ETF and the underlying NAV. Again, our thesis is not that the markets will efficiently value the underlying securities when an underlying market closes. Rather, it is that the fears associated with ETFs of illiquid securities seem unfounded. In such instances when a market became extremely illiquid (i.e., the market closed or trading was halted in the underlying securities), the liquidity of the associated ETF increased, and investors could more easily exit the asset class via trading the ETF than by trading the underlying securities.

CHART 5: Greece 200 ETF (GREK)

The Global X FTSE Greece 20 ETF (GREK) traded with increased, not decreased, liquidity despite that the underlying market closed



CHART 6: NAV of premium/discount of GREK

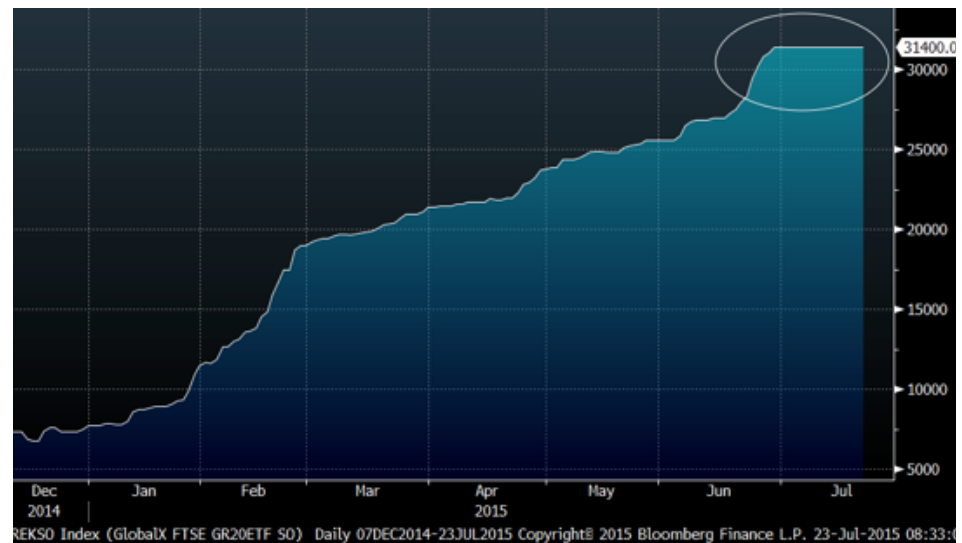


Some have suggested that illiquid asset ETFs' Achilles heel is the creation and redemption process. They argue that in a crisis there could be so many redemptions in such a short period of time that the underlying illiquid market will not be able to fulfill the sell orders and redemption will be impossible.

The example of Greece seems to argue that this fear is also unfounded. Chart 7 shows the shares outstanding of GREK. The shares outstanding represent the creation/redemption process. Because the Greek stock market completely closed, the creation and redemption process stopped. No ETF shares could be created or redeemed (note that shares outstanding are unchanged for the month of July 2015).

Despite the abrupt stop to the creation/redemption process for GREK because of the closure of the underlying market, the ETF itself continued to trade and did so with tight bid/ask spreads and increased dollar-valued traded. The fear mongers have suggested that a scenario in which the underlying market can't trade should result in a failure of the ETF construct. However, the abrupt ceasing of the create/redeem process for GREK seemed to support, not detract from, the robustness of the ETF structure.

CHART 7: Shares outstanding of GREK



The ETF continued to trade well despite the complete stoppage of the creation/redemption process

ETFs as “liquidity benchmarks”

ETF naysayers’ assumptions seem to be wrong. ETFs holding securities that have become totally illiquid have so far experienced more liquidity, not less, during market disruptions, and investors have been more able, not less able, to execute trades in those ETFs. In the examples of China and Greece, the underlying assets became totally illiquid. The market closed or trading was halted, and one could not transact in the underlying securities at any price. Yet, in both cases, liquidity of the related ETFs increased.

ETFs holding illiquid assets may serve another purpose. Managers of illiquid securities have historically been paid a premium for managing illiquid portfolios. It seems as though those premium fees are now obsolete. ETFs now serve as viable “liquidity benchmarks” to which managers of illiquid assets must now compare themselves. Managers should be able to charge a liquidity premium fee only if they can buy or liquidate assets in their portfolios faster and more efficiently than an investor could enter or exit an asset class via an ETF.

ETFs of illiquid securities provide investors with access to illiquid markets’ index returns with no lockup or gates and provide serious competition for the average manager of illiquid assets. To reiterate, there are a select group of managers whose performance alpha is so large that it more than compensates investors for a lack of access to

their own money. However, it is impossible that all managers can provide such large alphas to justify lockups and gates. To paraphrase Garrison Keillor, are all asset managers above average?

Asset allocation remains more important than manager selection

It has long been our view that asset allocation ultimately drives the majority of investment returns. Investing with a good manager in the wrong asset class is likely to underperform a bad manager in a good asset class. It is the asset class and not the individual manager that generally drives the majority of a portfolio's returns. The continued broadening of ETF offerings gives investors the opportunity to access asset classes that previously were off limits, and to typically do so with daily liquidity.

RBA's role as asset allocators of clients' funds has been enriched by these new ETFs, and we fully embrace them in our tactical portfolios.

1. Investopedia defines Exchange Traded Funds (ETFs) as marketable securities that track an index, commodity, bonds, or basket of securities. ETFs trade like a common stock on an exchange.
2. The AICPA defines illiquid as, "Not readily convertible into cash, such as a stock, bond, or commodity that is not actively traded, and would be difficult to sell in a current sale."
3. RBA currently does not own any of the ETFs specifically mentioned in this report.
4. The AICPA defines Net Asset Value (NAV) as the excess of the fair value of securities owned, cash, receivables, and other assets over liabilities of the investment company.

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RBA Investment Process:

- Quantitative indicators and macro-economic analysis are used to establish views on major secular and cyclical trends in the market.
- Investment themes focus on disparities between fundamentals and sentiment.
- Market mis-pricings are identified relative to changes in the global economy, geopolitics and corporate profits.

About Richard Bernstein Advisors

Richard Bernstein Advisors LLC is an independent investment adviser. RBA partners with several firms including Eaton Vance Corporation and First Trust Portfolios LP, and currently has \$3.4 billion collectively under management and advisement as of June 30, 2015. RBA acts as sub advisor for the Eaton Vance Richard Bernstein Equity Strategy Fund, the Eaton Vance Richard Bernstein All Asset Strategy Fund and the Eaton Vance Richard Bernstein Market Opportunities Strategy Fund and also offers income and unique theme oriented unit trusts through First Trust. RBA is also the index provider for the First Trust RBA American Industrial Renaissance® ETF and the First Trust RBA Quality Income ETF. Additionally, RBA runs ETF asset allocation SMA portfolios at UBS, Merrill Lynch, Morgan Stanley Smith Barney and on select RIA platforms. RBA's investment insights as well as further information about the firm and products can be found at www.RBAdvisors.com.

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