Mobius Sees Emerging Markets Growth: “I think we are bouncing along the bottom.”

Mark Mobius, Ph.D., executive chairman of Templeton Asset Management, Ltd., manages over $50 billion in open and closed-end funds for the Franklin Templeton Group. The first closed-end fund focusing on emerging markets investments was the Templeton Emerging Markets Fund.

Dr. Mobius has spent much of his 40 years working in Asia and since 1987 has directed the Templeton research team that manages dozens of emerging markets portfolios in 15 offices worldwide. Mark earned his master’s degrees and doctorates in fine arts, psychology, political science and economics from Boston University and the Massachusetts Institute of Technology.


Dr. Mobius directly manages the last three of these funds.

CEFA is considering investing in TRF because of its exposure to Russia. Dr. Mobius invests at least 80% of TRF’s assets in investments tied economically to Russia or east European countries. It is a volatile fund so timing is important.

We interviewed via phone Dr. Mobius on September 2, 2011 in Hong Kong:

SL: Hello again, Mark. It has been over 20 years since we first met in Chicago at a closed-end fund conference. You have always been bullish about the emerging markets. We had planned to give you a question outline but didn’t get to it.

Mobius: No problem. I like the spontaneity because it is more fun that way.

SL: Good! This is fun for us as well. This interview is a highlight of my year as we learn so much from you that benefits our readers. We have one thing in common; we both enjoy our work so much that we never think about retiring. Our active lifestyles keep us well.

Our readers would like to know just how many funds you are managing.

Mobius: We manage about $50 billion now, and it breaks down this way. In all, we manage 60 funds and portfolios. Of those, four are closed-end funds. Three are for the U.S. market, and one is listed in the U.K. (Templeton Investment Markets Trust, LSE:TEM). The balance consists of open-end funds, private client accounts, institutional funds and strategic equity funds.

SL: Are you writing any new books? Mobius: Yes, I have done a series of books on various aspects of the financial markets. I have finished books on mutual funds, foreign exchanges and just finished one on bond investing.

SL: Where have you been traveling lately? Mobius: I just returned from Russia last night after going down the Volga River to the Caspian Sea, looking at oil rigs. We traveled by boat and went by helicopter to a rig.
offshore. We are still very positive on Russia.

SL: Russia has been my focus lately. I just read a new book about Russia’s progress since communism went away 20 years ago. I will tell you about it later.

Are you still as bullish on the emerging markets as you were last year, despite the worldwide concerns about a slowdown and the highly volatile stock markets?

Mobius: The so-called world “slowdown” has not impacted the emerging markets because these countries are still growing at incredible rates. A slowdown really depends on where you are standing. It puzzles me why so many people are alarmed about what is just a part of the economic cycle.

SL: The emerging markets have tumbled many times since September 2011. This may be a sign that even the fast growing economies are being dragged into the economic malaise.

However, despite this carnage, The Wall Street Journal reports that many investors remain optimistic about the medium and longer term prospects for many emerging markets economies. Has heavy selling taken place in Asia, Latin America and Russia?

Mobius: Yes, it happens in other markets as well but to a lesser degree. Investors will react because they need some liquidity in order to do what they do.

The important point is that investors around the world react to this incredible volatility and seek liquidity wherever it may be found. Then you get a higher correlation between what is happening in the U.S. and the world. The correlation coefficient then goes up quickly.

SL: How does that work in volatile markets?

Mobius: The correlation is the degree in which markets move together, and it is very much with us in times of crisis such as the sub-prime crisis, where everything moved globally. Half of the fund managers around the world are in indexes. With ETFs, it is even more powerful because they try to follow an index to the highest degree.

Everything globally moves because you have these high frequency traders who are in every market. They are everywhere, and of course, as the indexes move so do half the fund managers around the world.

SL: How can you track the correlation?

Mobius: You calculate two times the U.S. data on a daily basis against data in the emerging markets index to the degree in which the movements are the same as a percentage change. Then you have a correlation coefficient of one. If there is absolutely no correlation, the coefficient is zero. If these markets move in an opposite direction, then the correlation is minus one. If one side goes up, the other goes down.

However, the correlation doesn’t happen so much now because the emerging markets are so tied together. In the frontier markets, there is a lower correlation than with the rest of the markets. Franklin Templeton is now the largest investor in these markets with over a billion dollars.

It is interesting to see how these markets react, but once you get past the initial shock of the system, the correlations fall away as the markets begin to take on a life of their own. I think that this is very important to remember.

When I look at emerging markets, they are in an incredible boom, especially in Asia. They are growing three times faster than the developed countries, and there is still growth in Latin America, Africa and in other parts of the world. A slowdown of 8% to 7% still provides an incredible growth rate.

The key lies in three variables:
1. The debt-to-GDP ratios of these countries are much lower than those of the developed countries.
2. The emerging countries are growing very fast, three times faster than the developed countries.
3. Foreign reserves in emerging countries are at new highs. In China, it is about $3 trillion, Russia and Saudi Arabia have over $400 billion and about 10 other countries have over $200 billion. This is very important because people are waking up to find out that maybe these countries are going to be more stable than the developed countries, as there is a combination of high growth and high foreign exchange reserves as well as low debt levels. This provides a stable investment climate that attracts investors once they get over what is happening in the U.S. and Europe. There will be slowdowns and market declines along the way.

[Editor’s Note: There are more signs of a slowdown in the world’s economies. It is increasingly clear that the U.S. could share in this slowdown.

The Financial Times reports: “The global recovery is in danger of skidding off course with growth slowing sharply amid financial turbulence and policy paralysis.” They wrote that “the slide back towards stagnation is much more prevalent in the advanced world compared with emerging economies.”

The Wall Street Journal adds that many Wall Street strategists, having spent much of the year making ever-higher predictions for Standard & Poor’s stock index, are now cutting their forecasts. The Journal admits that predicting the direction of the stock market is more art than science, although these predictions are watched closely by
advisors and money managers. Some argue that stocks have fallen too far and remain convinced that the economy will sidestep Europe’s debt crisis and fears of a global recession. CEFA is in that camp.

SL: In the last few weeks, while traders were dumping large cap stocks, CEFA was buying depressed funds. We were able to benefit our clients with closed-end funds with deep discounts.

Sir John Templeton said: “Buy low – at the point of maximum pessimism.” He wrote: “It is extremely difficult to go against the crowd, to buy when everyone else is selling, when things look darkest. But, if we buy with the crowd, we will achieve the same results as everyone else.” He also wisely pointed out: “When almost everyone is pessimistic at the same time, a further market collapse is a rare event.”

What bothers me most is negative consumer sentiment. Many small investors must have been saying to their spouses “maybe we ought to sell everything”, and many of them did sell at the worst possible time. However, cash levels are still high at mutual funds, which will come back into the markets. The question is when.

Unfortunately, many investors have been dumping their portfolios and jumping into gold. While smaller investors are losing money, high-speed traders have made enough money to purchase yachts!

Mobius: That’s right. This kind of high volatility puts a lot of pressure on people, but investors should not worry about a 20% decline because fundamentals are still very good, especially in the emerging markets.

With approximately 1,300 exchange-traded funds, we have the phenomenon of “no-news” resulting in an incredibly automatic trading atmosphere.

A lot of money is being managed by computers, where if the computer notices a blip, it goes wild. There is so much intense selling pressure in large cap stocks that it sucks all the oxygen out of the markets, and stocks plunge precipitously.

This high frequency trading is done on an automatic basis and is making dramatic market moves. That is why I tell people to not worry about it. Nowadays, a 20% decline is done in two days, so it is no longer a big deal. We have to be ready to tolerate this kind of volatility. When equities move, the indexes move, creating a snowball effect. I know that it puts a lot of people on edge, but the fact of the matter is the fundamentals are still very good.

SL: You have helped us understand what is really going on.

Mobius: In the U.S., the huge ETFs are following indexes. As soon as something moves, they have to move. It is a snowball effect.

[Editor’s Note: The New York Times Magazine on September 25 had a major article on this, focusing specifically on how hedge funds are suspect. The Dodd-Frank law will require medium and large size hedge funds to register with the SEC. Our only concern is that there have been delays in implementing this law, as a result of ferocious lobbying by the hedge funds and their allies.]

SL: Where is the money going?

Mobius: The money is going into bond funds. Franklin Templeton has done well because we have many good bond funds that allow people to move from equities into bonds, with the exception of the emerging markets which are still seeing net cash inflows. This is unlike what happened during the subprime crisis when we saw net outflows. I think people are beginning to wake up to the reality that in times of crisis, sometimes there are great opportunities, rather than great disasters.

SL: That is a classic sign of a bottom, isn’t it?

Mobius: Yes, but most people are missing two things. First, they don’t diversify globally. They make a big mistake by only diversifying within their own country.

Second, the emerging markets represent 34% of the world’s total market capitalization, but most investors only place about 8% of their portfolios in them. Obviously, something is wrong because they should be getting more exposure to the emerging markets. It is important to invest in fast growing regions of the world.

SL: Fortunately, it appears now that the stock markets have stabilized, at least for the moment. We all hope that investors will realize the stock markets are deeply oversold and the fundamentals, as you point out, are better than what many think they are. In the last few weeks, we were buying. Were you buying as well?

Mobius: Yes.

SL: It is too bad that many investors react to headline news and think the world will be ending just because of the activities of these high frequency traders. Rather, they should be taking advantage of all the bargains available.

There is no recession on the horizon, but consumers will not start buying again until hope emerges. The U.S. “corporate sector is stronger, and our population is growing, not shrinking”.

This scenario fits into the Templeton philosophy “to buy when everyone else is selling, when things look the darkest”. We are bullish on these markets and hope that 2011 and 2012 will bring even more upside surprises.

We are also always watching for deeper discounts on closed-end funds. We were lucky recently when one of our Templeton high-yielding emerging markets bond funds that had been trading at a substantial premium for over a year, suddenly dropped so we were able to pick it up at a near 10% discount. The amazing thing was the fund shot back up to a premium the next day so many of our clients made profits in a matter of hours. Haven’t the mutual fund redemptions continued to be high?

Mobius: Yes, that’s true.

SL: At CEFA, we have five portfolios that invest some of their cash in the emerging markets. Our International Equity portfolio, our best long-term performer, holds 73% in regional and country funds and has a balance in global bond funds and global real estate funds. The other portfolios have lower percentages in the emerging markets.

There may be growth in the emerging markets in what is called the “contagion” effect. In other words, if Europe has a bad day because of potential Greece default, Spain and Ireland will go under, and then the U.S. markets will drop. Everyone then waits for the Asian markets to open so the cycle of fear continues. Have you been following any of this?

Mobius: [Laughs] I constantly see TV programs which are so focused on the short-term and constantly worrying about
what is happening here and there. What amazes me is that in Europe they seem to connect the currency to the debt situation. I don’t see any connection.

They say, “We may leave the euro.” This would be a shame because it has nothing to do with the currency. When the European banks buy Greek bonds, Greece will get out of the problem by being able to earn tourist dollars. The euro is a good currency, and we believe that they will pull themselves out.

For the U.S., quantitative easing will return, but the big question is how will the markets react? The U.S. stock market went up 82% as a result of the Federal Reserve’s quantitative easing during the first quarter of 2011 (“QE1”) and 32% with QE2. I don’t know what the reaction will be, but these money operations do help stock markets because it pours money into markets that is looking for a home.

Is consumer confidence really in trouble? If so, that is not a good development. If you look at the price of gold, you realize that the demand for it is growing as the central banks are buying rather than selling gold.

We are, therefore, in a situation where people are really shaken as a result of the U.S. downgrade by Standard & Poor’s and the return on U.S. Treasuries. Many do not know that Standard & Poor’s was not the only agency that did it. The reality is that other smaller rating agencies downgraded the U.S. as well. I think it fair because the Congress has not gotten its act together.

SL: We have some good news about Russia. President Medvedev recently visited the Silicon Valley in California to learn about their high tech industry. Are you aware of that?

Mobius: Yes, Russia is full of very intelligent scientists so it won’t be difficult for them to move on that development. It’s only been recently that they’ve gotten their act together.

SL: With all of the mining and oil drilling going on throughout Russia, how much attention do you think the Russians are paying to preserving the environment?

Mobius: They are paying much more attention to it now.

SL: I hope so, but we are skeptical because it is something our oil-thirsty world doesn’t have much of a record of doing. We note the environmental degradation in the Canadian tar oil sands, Chinese coal mines and Siberian oil wells and ask if it will ever improve?

Mobius: I hope so as they are realizing that this is important. However, the price of oil will continue to be the critical factor in Russia’s macroeconomic outlook.

An economist at a leading bank said that energy prices generate 40% of Russian GDP and warns that dependence on oil “is the most important risk factor for Russia”. The government’s own forecasts suggest that the budget will balance in 2012 only if average oil prices for the year clock in at $125/barrel. If inflation doesn’t slow, the government may expand its use of price caps for some food staples and other products, and use other administrative measures detrimental to businesses and investors to cap price growth.

SL: With U.S. crude oil prices near $85, they have a long way to go to balance their budget.

Do you think that the U.S. will be able to pass the free trade agreements with South Korea, Panama, Columbia and other nations?

Mobius: The U.S. is really far behind the rest of the world. The president of Caterpillar recently emphasized that fact. He said it is a crime they are not passing trade agreements with some of our best trading partners, while the Chinese are busy signing agreements. We are losing marketshare in many countries.

[Editor’s Note: As we were going to press, free trade agreements with Korea, Columbia and Panama were just passed by Congress.]

SL: Does Libya have a significant amount of oil to globally affect oil prices?

Mobius: No, not really. It is only about 2% of the oil markets. Libyan crude is the “sweet” or light crude that is much desired by Italian refineries. There are some concerns, but it is not a big deal in my view. The reality is demand for fuel from oil, coal or natural gas is growing at a rapid pace globally and will continue to grow.

[Editor’s Note: Libya has announced that they are starting to produce oil again but at low levels.]

SL: We have some concerns about Russia’s heavy dependence on oil and its lack of a diversified economy.

There is also some evidence that we are running out of oil, despite many new finds. Higher oil prices will benefit the development of renewable energy. From more efficient cars and advances in batteries to shale gas and wind power, all of these developments have provided reasons for greater confidence in our energy resiliency. (Source: The Wall Street Journal)

Have you read The Return: Russia’s Journey from Gorbachev to Medvedev, just published by noted scholar Daniel Treisman of UCLA? It is the first comprehensive history of post-communist Russia and describes Russia’s re-emergence as a pivotal nation in world affairs.

Mobius: I would like to read it as I think that many people are too negative on Russia and are not following what’s going there. I’ll log into Amazon and order the book while we are talking.

SL: My, you are quick. It is a revealing and important book. We learned that there still are alcohol problems in Russia as well as smoking problems. Russia is losing much of its population, as many as 700,000 people a year, because of low birth rates and emigration.

Professor Treisman presents a comprehensive portrait of a strong and independent country that is returning to the international community on its own terms. However, he also says that the countries around Russia, the former Soviet states, are far worse off than Russia is now.

There is some good news. The September 2011 issue of The Atlantic has an article about a new development in Russia, calling it the “Next Russian Revolution”. It is taking place in the town of Skolkovo outside of Moscow, where they are building a high-tech center. If all goes well, it will house 15,000 scientists and entrepreneurs by 2015.

The government plans to spend some $6.6 billion on this new city. It will be the centerpiece of the Kremlin’s plans to turn
Russia into a major technological power. What do you think of that?

**Mobius:** I have heard something of it.

**SL:** Skolkovo is only part of an idea to create a “modern and luxurious mini-city” that can serve as an incubator for technology entrepreneurs. They are relaxing restrictions on visas and imports, and creating tax breaks. The new city will sit outside the purview of Russia’s normal government bureaucracy with its vast capacity for graft, red tape and delay.

Skolkovo is an effort to bring together in a single place all of the elements that are essential for commercially viable innovation. To that end, the community will include the Skolkovo Institute of Science and Technology, which has partnered with MIT, your alma mater. The project represents Russia’s latest effort to grapple with one of the recurring, central questions of its history – how to keep pace with the world’s leading countries.

Professor Treisman also writes that under Russia’s tundra lie enormous reserves of oil and gas, gold, diamonds, nickel and iron ore. “Many scholars see such natural abundance as a paradoxical burden. In spite of this development, strong growth in Russia still remains hostage to commodity prices, while rising inflation and government spending threaten the foundations of Russia’s economic renaissance.”

“Governments that can rely on income from the sale of mineral resources,” he writes, “have no need to develop the complex institutions of conflict management and political exchange that are the hallmarks of modernity. Instead of bargaining with the public over taxation, rulers can simply buy citizen’s acquiescence – or buy enough machine guns and mercenaries to keep them in check.”

The U.S.-based private equity firm, Siguler Guff & Company, which has over $8.5 billion in assets under management, will be investing billions in the new city. We find all of this very exciting as it will bring Russia into the 21st century.

Russian President Dmitry Medvedev recently invited a group of U.S. venture capitalists and entrepreneurs to visit this high tech hub, which is located in Moscow’s woody suburbs, in an effort to convince them of plans to spur economic modernization and reduce its dependence on oil and gas by giving birth to a local “Silicon Valley”.

Siguler Guff will immediately be pumping $250 million into digital infrastructure and IT services for Skolkovo. Currently there are talks with a number of companies in the U.S., Asia and Europe. Some names include Cisco and Nokia. We will be following this exciting development.

**SL:** We have thought all along that Putin would succeed Medvedev. We have read Russian history, and there cetainly is a big improvement from the dark days of communism.

**Mobius:** I sympathize with their efforts to get things right.

**SL:** In the 20 years since they got their freedom, Professor Treisman points out that the Russians are highly literate, unlike others in many other emerging countries.

I have recently learned from a Russian friend, Anatoly Mikutin, who closely follows developments on Russian television, that they have commenced another program to give large amounts of money to young couples to have babies. They hope this program will also encourage those who left the country to return home.

I have also looked into living conditions. I found that the poverty rate has dropped from an incredible 40% in 1999 to 14% in 2010, compared to a rising rate of 15% in the U.S.

We want to know what is really important for investors to understand before we invest in Russia. The population has been dropping 700,000 each year but has now stabilized with new incentives from the government.

What about consumer growth there?

**Mobius:** It is good that you mention that because in our private equity operations, we have made quite a lot of money on consumer stocks in Russia. We brought one consumer-goods company to market. It is now controlled by a leading multinational company and has been an incredible success. The company has 30 industrial sites in 16 cities, from Vladivostok to Kiev. Their sales are running in the billions of dollars a year. So, consumerism in Russia is growing at a very fast pace.

**SL:** That is good to hear. How closely do you follow the work of Transparency International (“TI”), which leads the fight against corruption worldwide. I now support it because of the good work that they do. They lead the fight against corruption. Do you think TI has made progress?

**Mobius:** Oh, yes. TI has definitely made a big impact around the world because people can look and see “where are we” in the ratings.

**SL:** The most transparent countries rated by TI are Denmark, New Zealand, Singapore, Finland and Sweden, while the worst are Somalia, Myanmar, Afghanistan and Iraq. The U.S. rates 22, and Russia needs to do better at 154 out of a total of 178 countries. The group studies how prevalent bribery is in each country.

**Mobius:** There is also an indicator called the “ease of doing business index” which describes the business situation in these countries and what’s happening on the ground in terms of corruption. This is one example of what is happening now as information is getting out.

[Editor’s Note: The “ease of doing business index”, created by the World Bank, is based on a study of laws and regulations, with the input and verification by more than 8,000 government officials, lawyers, business consultants, accountants]
and other professionals in 183 economies. Higher rankings indicate better, usually simpler regulations for businesses and stronger protections for property rights. The countries with the highest rankings are Singapore, Hong Kong, New Zealand, United Kingdom and the United States. The lowest are Guinea, Eritrea, Burundi, Central African Republic and Chad.

SL: Has there been any improvement in accounting standards since we last talked?

Mobius: Oh, yes. There is one case in India where a billion dollars was missing from one of the major software firms.

SL: Hopefully this will improve. What about the recent non-violent protests in India?

Mobius: The protests are very critical. The middle class in India is now growing and rising up. The young people are really letting the Indian Congress know that “enough is enough”. They are fed up with this option and want something done about it. There is a lot of support for that, and I think it is a good development.

This is only part of the significant things that are happening around the world. We are in a situation where, with the cell phone, iPads and iPhones, news travels at the speed of light, and people can get together and organize themselves easier and faster than ever before. These events create incredible political changes.

SL: Does this go beyond what TI uses for their ratings?

Mobius: Oh, yes, most definitely. That is why we spend a lot of time visiting companies to be sure that we understand what is happening. We question them on what we see in the numbers and that sort of thing. More and more countries are adopting the high International Financial Reporting Standards (“IFRS”), formerly known as the International Accounting Standards (“IAS”).

[Editor’s Note: IAS accounting standards are principle-based standards, interpretations and framework. They were adopted by the IAS Board between 1973 and 2001.]

Mobius: More and more countries are adopting the IFRS standards. I don’t like the “accrual” system of accounting and the “mark-to-market” changes that have been made recently because they create incredible volatility in the numbers.

SL: How is it changing? Does it go away from the standards or towards them?

Mobius: Unfortunately towards them.

SL: I am not an accountant, but how does that affect the lack of transparency in accounting?

Mobius: That is the problem. In a mark-to-market situation, it leaves a lot of leeway for management and auditors to pick the numbers. There is a debate taking place right now on this in Europe, where they say, “My bonds are worth such and such value,” but in a thinly traded market, the bonds may stay at 50% of their value.

SL: How would you look at a small bank in Sri Lanka?

Mobius: They would definitely follow the international standards because of the regulatory agencies. When a company is going to be evicted, they usually insist on at least three, four or five years of audited financial statements done by an outside accounting firm. Of course, it varies. Some of the Chinese companies did not use proper accounting but were able to be included. They tried to get around the restrictions that apply in their own markets or here in Hong Kong.

SL: We will continue to follow this important subject and are very interested in your new investments in the frontier markets that you write about on your blog (mobiusblog.com). We are now raising some cash for the possibility of investing in your Templeton Frontier Markets Fund (NYSE:TFMAX), which appears to be unique and has great potential.

[Editor’s Note: This Fund started trading on October 14, 2008, has assets of approximately $295 million and a net expense ratio of 2.18%. Mark manages this Fund and is quite positive on Africa, which he sees as a new emerging market.]

If you buy a small company in Nigeria, does that make it a frontier market stock?

Mobius: Some of the companies we visit are owned by a conglomerate, say, Unilever. It would be Unilever local and would definitely be a frontier stock.

SL: In your book, Passports to Profits, you listed 84 investment rules. Rule No. 1 was: “Your best protection is diversification.” We firmly believe in that and do everything we can to diversify our portfolios to reduce investment risks.

Mobius: Many Americans think that it is too risky to invest in the emerging markets. We think that NOT to invest in the emerging markets is risky.

Mobius: Fundamentally frontier markets like Vietnam, Nigeria, Ukraine and other countries are moving pretty fast to adopt these standards, but they have a ways to go. Most of the companies are small so they can’t afford to get the accounting firms in there. It is very spotty. I would say that some countries are incredible and the companies are very good, but some are not adopting the standards or are not applying them properly.

SL: We see that your September 7 blog indicates that Bangladesh is “an important frontier market” and that you see potential growth in that country. You also wrote earlier about the debt, the Eurozone and the U.S. being affected by investor confidence...
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levels like we have discussed in this interview.

You also mentioned that you are watching Romania, Russia and Poland, which must mean that you are paying close attention to your Templeton Russia and East European Fund.

How many subscribers do you have reading the Mobius blogs?

SL: Thanks so much for your time, Mark. As always, we have enjoyed talking to you and will telephone you again in the spring.

Disclosure: Clients of Closed-End Fund Advisors and family members of George Cole Scott own shares of GIM, TEI, EMF, and TRF.

Exchange-Traded Duds: ETFs Are Striking Out

The exchange-traded fund (“ETF”) concept was born in 1993, with the introduction of SPDR which contained a portfolio of stocks designed to replicate the performance of the S&P 500 Index. Since then, ETFs have attracted more than $1.3 trillion worldwide and are still growing.

Impressive growth has been a defining characteristic of the ETF industry, much to the concern of its predecessor, the closed-end fund industry, by far the oldest funds.

Nobody likes to see someone or something die before its time. But, in the case of ETFs, a surprising number of weak funds may be holding on and refusing to shut down this year – to the detriment of investors. We explain why.

To be fair, many of the new ETF and exchange-traded notes (“ETN”) ideas that have popped up in recent years have been tremendous successes. CEFA uses a few of them in its business but is careful to research their size and liquidity before purchasing.

The U.S. securities regulators have been looking into whether some turbo-charged ETFs amplified the topsy-turvy swings in the August 2011 stock markets. We feel that we can’t emphasize enough the “threats” that ETFs can pose to unsophisticated investors.

The September-October CFA Magazine cover story reports: “ETFs promise cheap diversification and liquidity, but many investors do not realize that there are “perhaps unintended consequences for systemic risk. ETFs have colonized pretty much every available niche in the investment world – frequently at the expense of traditional vehicles such as mutual, [closed-end] and hedge funds.”

Mobius: I think it is about 5,000 now. I am quite surprised at the number of people who look at it. We try to keep it updated, but it depends on what else is happening.

SL: I think if you would post on your blog what you just explained to us about the big traders creating so much volatility, it would help to calm a lot of investors.

Mobius: Yes, a very good point.

They continue: “The land grab has apparently just begun, which means it’s time to start thinking about unintended consequences. One of history’s clearest lessons is that when financial innovation really gets going, it tends to race ahead of regulators, who only catch up after an idea has revealed its dark side in some painful, sometimes systemic fashion. And, while ETFs haven’t reached the rarefied heights of, say, mortgage-backed securities, they are raising a few red flags.”

[Editor’s Note: CFA Magazine, published by the CFA Institute, is a professional publication which offers global financial reporting to its members worldwide.]

It will be interesting to see if the regulators can really do anything to slow the volatility that still plagues the global stock markets.

ETFs have surged in popularity, even among sophisticated money managers who, according to Morningstar, generate 35%-40% of all exchange trading. ETFs are also used by high frequency traders who buy and sell them at a rapid clip, making money on small moves.

SEC officials are zeroing in on “leveraged” ETFs which amplify investor bets but also substantially raise risks. These funds often use derivatives such as option contracts, which typically offer double or even triple the return on an index.

According to recent data from Morningstar, almost half of the 1,300 ETFs in the market have less than $50 million in assets – the minimum for an ETF firm to typically turn a profit – and that was before the August 2011 market turmoil. Yet, only a handful have been shuttered so far, compared to at least 50-a-year for the past three years, prompting analysts to suggest that some funds are sticking around when they should close down.

Ron Roland, a Texas money manager who compiles an ETF-death-watch list on www.InvestWithAnEdge.com, Roland estimates that more than 150 funds are on life support, not generating enough gains or interest to justify their continued existence. He says that the pros who created these products are “in denial”.

A lot of what is happening, critics say, is the by-product of managers launching ETFs almost weekly to try to jump on what’s been a booming bandwagon. To their credit, some funds do close.

A spokesman for Invesco PowerShares Capital Management, an ETF company in Wheaton, Ill., says the firm recently closed two ETFs after reviewing several factors, including “investor interest”.

J. Garrett Stevens, chief executive of FaithShares in Oklahoma City, says the firm liquidated all five of its Christian-oriented ETFs this year because they “didn’t have the brand recognition” to attract enough assets.

ETFs, like mutual funds, have to constantly promote themselves for new shareholders, although at a considerably lower cost. Analysts say a lot of other funds should consider the same path. When ETFs close, investors generally aren’t hurt because they are given time to cash out. If they do hold on until the end, investors will get back the cash value of the shares on their final trading day.

Even if ETFs don’t close, investors might get the best prices on these thinly-traded products. In the worst case scenario, there may be no bidders.
In our opinion, we are convinced that total return investing through closed-end funds is still a very compelling way to consistently generate high returns over the long term as well as modest cash returns by taking advantage of weakness in volatile markets worldwide. The average fund has been paying an annualized 7.3% distribution and is priced at an -4% average discount.

Both portfolio managers are cautious and stick to CEFA’s philosophy as we are always looking for opportunities to add to our clients’ portfolios where the prices are so low that we can longer resist the temptation to buy.

We have 630 closed–end funds from which to choose, so we rarely use mutual funds and ETFs except in cases where there are no alternative choices.