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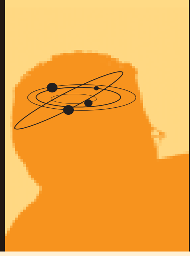
SOLUTIONS FOR EUROPEAN DISTRIBUTORS



EXCHANGE-TRADED FUNDS

LATE OFF THE BLOCKS IN EUROPE, BUT GAINING GROUND

The market for ETFs on this side of the Atlantic may only have got going three years ago, but in 2003 it is on track to double in size yet again

Exchange-traded funds (ETFs) have been one of the fastest growing areas in the European asset management industry in recent times. While these products have been available in the US for several years, their introduction in Europe only started in 2000.

Since ETFs became available in Europe, assets under management in this new and innovative investment vehicle have risen to over $16bn (€14bn). (See Chart 1.)

Despite prolonged stock market declines between 2000 and 2002, ETF assets – almost exclusively invested in equities – have doubled in each of these years. The largest funds in terms of assets are those concentrated on either the DJ Euro Stoxx 50 or local indices (FTSE100, DAX, SMI and CAC40), together accounting for approximately 60 per cent of the European ETF industry. The ETF market is on track to again double in size in 2003 and, as a result, is receiving even greater levels of interest from European investors.

At one level, the early stage growth pattern of European ETFs mirrors the development of their US counterparts. First launched in 1993, the American ETF market expanded rapidly and now stands at around $120bn (€103bn). In another respect, the relatively large number of different funds available in Europe (around 120) directly results from a fragmented market place.

The ETF market is similar in many ways to the traditional European mutual fund market, where large numbers of products are needed to provide locally tailored solutions, as funds cannot always be distributed on a pan-European basis.

‘It is little surprise that some of the smaller sector ETFs have already gone to the wall’
Markus Hübscher, Credit Suisse Asset Management

FUNDAMENTAL FOCUS

The big disappointment of the launching spree that took place over the last three years has been sector ETFs. These products were expected to grow dramatically, the only uncertainty being whether global or regional sectors were the game to play. It is now clear that neither of the two have, to date, proved a success, nor is it any surprise that some of the smaller sector ETFs have already gone to the wall. Their failure is largely due to the severe equity bear market that has seen investors return to a focus on fundamentals, avoiding “theme” and “idea” based investments. With a stock market recovery now underway, it is expected that this trend will begin to be reversed, and remaining sector ETFs will be able to gather more assets.

HOW THEY WORK

Exchange-traded funds are, as the name implies, funds that are traded on a stock exchange. ETFs consist of two different markets: a primary market for subscription and redemption of shares, and a secondary market at the

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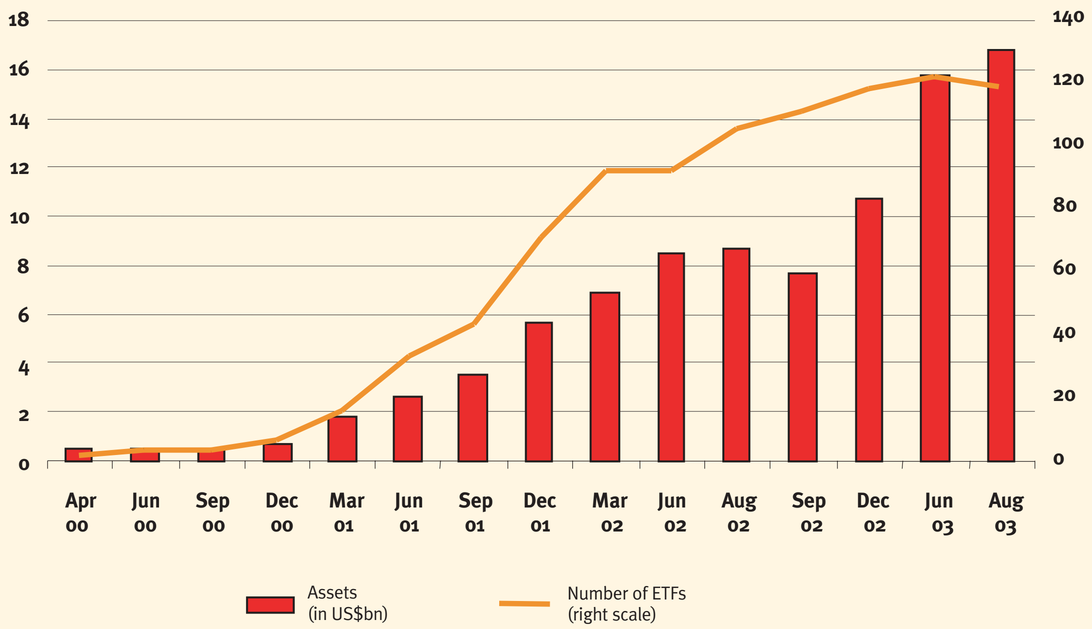
Significant growth record of exchange-traded funds in Europe



Source: Morgan Stanley

exchange, where they are traded (see Chart 2).

In the primary market, market specialists create and redeem shares in the ETF at its net asset value (NAV) on a daily basis. This is done in large blocks of shares, typically in excess of €1m, which represents a creation or redemption basket. These new shares, once created, can then be traded in the secondary market.

In the secondary market, ETFs are bought and sold in exactly the same way as equities. This is a key difference between ETFs and mutual funds as investors do not subscribe or redeem units with the fund management company, rather they execute buy and sell orders through a stockbroker dealing directly with stock exchange market makers.

Due to the fact that an ETF is linked to an index, market makers can easily provide continuous pricing because its intra-day NAV moves in line with the respective index. This unique feature allows market makers, arbitrageurs and other market participants to trade the ETF close to its intra-day NAV, as any discount or premium is likely to be rapidly closed by investors for a risk-free profit.

Some commentators have also expressed concerns about the liquidity of these new vehicles. However, this subject is very often misunderstood, as an ETF's actual liquidity is a function of the marketability of the underlying securities held in the fund (and therefore of the index).

Investors can easily go to a market maker and fix the price of the ETF off-exchange (ie intra-day NAV plus spread and commission).

The best of ETFs

Here are three key benefits of exchange-traded funds:

- **They capture the flexibility of equities (intra-day trading and pricing on a regulated exchange) with the diversification and efficiency of a fund.**
- **They are a simple, cost effective way to gain exposure to an asset class in a single trade.**
- **They provide a core building block for an investment portfolio as part of an asset allocation strategy.**

TARGETS

There are a number of different investors that currently trade ETFs. These include private client stockbrokers managing discretionary portfolios, fund of fund providers, and professional investors for specific strategies such as structured products and cash equitisation.

The future development of the industry over the near term will be characterised by further new product launches, together with consolidation amongst existing ETFs that have achieved critical mass.

New product development is currently focusing on fixed income ETFs, which are expected to prove attractive to investors for the following reasons:

- Government bond ETFs with a specified term structure allow the investor to remain within a maturity window without constant portfolio rebalancing;

- Corporate bond ETFs enable investors to obtain exposure to a diversified, investment grade credit portfolio.

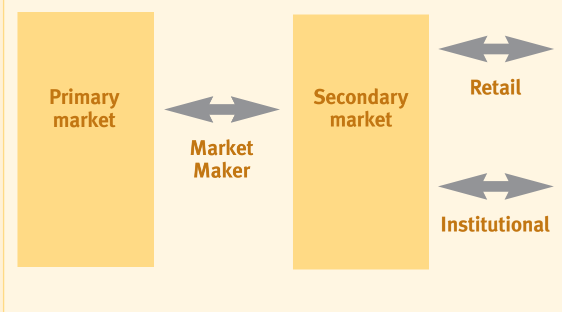
DEVELOPMENTS

One of the key developments over the medium to longer term will be the increased cross-border listing of ETF products. Some progress has been made in this area, but more is necessary, as this remains a cumbersome process in many European jurisdictions, largely due to a fragmented market place that is characterised by different regulatory regimes and stock exchanges.

Cross listing is important in Europe, because securities bought in the domestic market are usually cheaper (through lower commission) than securities bought abroad.

Once this process starts to gather pace, a consolidation amongst ETF providers is anticipated as a more homogeneous market structure takes shape across Europe.

2 How exchange-traded funds operate



In summary, the European ETF market has expanded rapidly over the past three years. Whilst development in certain areas went too far, ETFs remain one of the most interesting financial innovations of recent years and, going forward, they are expected to continue to grow significantly.

Markus Hübscher, managing director, head of quantitative portfolios, Credit Suisse Asset Management

CORPORATE STATEMENT

Credit Suisse Asset Management (CSAM) is one of the world's largest asset managers and one of the few with a truly global platform. CSAM has 2021 employees in 22 offices across three regions worldwide, clients in more than 50 countries and total assets under management of $312.1bn as at 30 June 2003. We offer a full range of financial investment products and services to institutional, retail and private clients.

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