ETF Focus

The Claymore the Merrier

By Lawrence Carrel
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THE ETF MACHINE shifted into high gear with the debut of 21 exchange-traded funds last week. That set a record for weekly launches, eclipsing the mark of 20 hit during the week ended June 16. There are now 303 ETFs trading in the U.S. Among the three firms offering the latest funds was Claymore Securities, a privately held issuer of financial products that's a newcomer to the U.S. ETF market.

After building a $14 billion asset base in closed-end funds, unit investment trusts and other managed portfolios, the Lisle, Ill., firm has now turned to ETFs. While its Canadian division had already launched ETFs up north, the five issued Thursday on the American Stock Exchange are Claymore's first domestic ETFs.

The new offerings are based on novel investment approaches. The most intriguing, in our view, is the **Claymore/Sabrient Insider ETF** (NFO[1]) that's tied to an index from Sabrient Systems, an independent equity research firm in Santa Barbara, Calif. Comprised of 100 equally weighted stocks, the Sabrient Insider Sentiment Index looks at five quantitative factors related to the accumulation trends of company insiders including open-market purchases. The index also weighs revisions to analysts' earnings estimates.

"We are looking at both insider buying and analysts upping their guidance," says Scott Martindale, Sabrient's managing director. "Those are the two major themes."

Legal insider buying encompasses stock purchases by executives, board members and large shareholders. Since insiders should know more about a company's operations than anyone else, it's considered a bullish signal when they start accumulating their own shares. (Insider selling is less telling since sales are often made to diversify holdings or meet specific financial needs.) Insiders are required by law to report trades almost immediately, so stocks often experience a quick pop right after insider purchases are made public.

The Claymore/Sabrient Insider ETF works on the theory that insider buying is a bullish signal, but don't expect it to pick up shares the day transactions are announced. The ETF rebalances its holdings quarterly. As such, those immediate gains likely won't be included in returns, but Claymore believes the long-term benefits of insider ownership will.

"We're looking to exploit the opportunity within the marketplace where insiders believe in long-term prospects for the company," says David Cohen, Claymore's managing director of product development. "The individual portions of the market that invest on insider trading can conceivably have a very short-term impact on the price. But it's very difficult to hold a stock price at an inflated level for any extended period of time based on speculation [alone]."

According to Sabrient, the creator of the insider index, back-testing shows its index would've posted an average annual return of 17.85% over the past 10 years. Compare that to the 7.33% return of the benchmark Russell 3000 index, and it appears the insider ETF might have a formula for market-beating returns that doesn't rely solely on day-of pops tied to insider buying. The insider index currently holds 33 large-capitalization stocks (market value above $5 billion), 49 midcap stocks (between $1 billion and $5 billion) and 18 small-cap stocks (less than $1 billion).

The insider index limits its quarterly turnover to just 25% of the portfolio. In addition, there can be no more than 20 stocks, or 20% of the ETF, from any one sector or industry. Within a sector, no more than 10 stocks can come from any one group, which ensures diversity of holdings.

Another new offering that we like is the **Claymore/Sabrient Stealth ETF** (STH[2]), which looks for promising stocks that are flying under Wall Street's radar. The portfolio holds 150 companies that are expected to benefit from the academically observed "neglected stock effect." Holdings are rebalanced every quarter. The neglected stock effect implies that companies not followed by analysts trade at depressed prices, yet produce superior returns relative to better-known securities. Ideally, an index contender should have no Wall Street coverage, but a stock with up to two analysts following it may be considered for inclusion.

Sabrient analyzes cash flow yields, return ratios, earnings changes and valuations to find stocks with robust growth characteristics and the potential to outperform small-cap indexes. With little or no analyst data available, these metrics are all backward-looking. And because most companies with little coverage are tiny, small stocks make up most of the Stealth portfolio. Sabrient back-tested the Stealth index for the 10 years through September. The firm says the index produced an annual average return of 20.3% vs. 9.4% in the Russell 2000, the key small-cap benchmark. One word of caution: Small stocks have outperformed large stocks over the past four years, and many market observers think small-cap dominance has run its course for now.

Of the three remaining ETFs from Claymore, two are based on indexes from Zacks Investment Research in Chicago. The **Claymore/Zacks Yield Hog** (CVY[3]), created for investors looking for a high income stream, seeks to offer more yield than any current dividend-based ETF. Common stock comprises 50% of the ETF. Of the other 50%, Claymore says this is the first fund to invest in preferred stocks, master limited partnerships, unincorporated energy companies and closed-end funds. It holds up to 150 securities.

"The Yield Hog index is the first I'm aware of, that has closed-end funds as a choice of securities in the underlying index," says Ron DeLegge, editor of ETFguide.com, a web site focused on ETFs. "In other words it would be the first ETF that is a fund of funds."

The **Claymore/Zacks Sector Rotation ETF** (XRO[4]) holds between six and 13 sectors at a time, based on value and growth metrics. The sectors are rotated quarterly based on a macroeconomic model. The remaining offering, **Claymore/BNY BRIC ETF** (EEB[5]), is the first U.S. EFT to focus solely on the economies of Brazil, Russia, India and China. It tracks an index created by the Bank of New York. Expense fees for all five of the new ETFs are capped at 0.6%.