

ETFs Fact or Fiction: ETFs with Higher Short Interest Have Higher Risk

ETFs have been growing in popularity due to the many benefits and trading options they offer investors. However, some commentators have raised concerns about ETFs and their common use as shorting vehicles. Specifically, they have stated that the unique share creation and redemption process employed by ETFs could put them at risk of default if a high volume of redemption requests for the 'phantom shares' generated by multiple short sales exceeded the actual supply of 'real' shares. This assertion demonstrates a misunderstanding of how ETF trades are executed and settled.

Short selling involves someone selling a security that they do not own with a view to repurchase it later at a lower price. This allows investors to implement a negative opinion on companies that they feel are overpriced.¹ ETFs are commonly used by investors to express both a long (positive) and short (negative) view on a broad asset class, sector or country. Short interest is measured in terms of the number of shares held short, which can also be expressed as a dollar amount (shares times share price) or percentage of total outstanding shares. Based on the precise nature of their exposure, sector and industry ETFs tend to be among the ETF categories most often used for short selling. For example, the retail stocks in the SPDR® S&P® Retail ETF's (XRT) underlying index are constituents of the consumer staples and consumer discretionary sectors. While neither sector is among the largest in terms of ETF assets, from an ETF category perspective, both are among the largest in terms of short interest as a percentage of assets (see Figure 1).

FIGURE 1: SHORT INTEREST AS A PERCENTAGE OF ASSETS

CATEGORY	ASSETS (\$ MIL)	SHORT INTEREST (\$ MIL)	SHORT INTEREST (%)*
SIZE - SMALL CAP	25,504.39	15,590.87	61.13
SECTOR - FINANCIALS	9,019.48	4,010.36	44.46
SECTOR - CONSUMER STAPLES	8,286.32	3,416.59	41.23
SECTOR - INDUSTRIALS	4,210.28	1,609.27	38.22
SECTOR - ENERGY	14,472.90	5,372.92	37.12
SIZE - LARGE CAP	178,357.92	62,795.83	35.21
SECTOR - CONSUMER DISCRETIONARY	4,439.13	1,288.17	29.02
SECTOR - HEALTH CARE	8,727.09	1,754.34	20.10
CURRENCY	6,268.73	1,172.21	18.70
SECTOR - MATERIAL	14,834.68	2,113.86	14.25

Source: Bloomberg, L.P., SSgA, as of 12/31/2011.

*Short interest represents the number of shares reported as held short as a percentage of total shares outstanding.

The twenty largest ETFs by the percentage of shares short represent a wide range of ETF categories (see Figure 2). Many represent popular, broad-based indexes, such as the Russell 2000®. Others represent narrow slices of the market, such as retail, real estate or regional banking.

As shown in Figure 2, there are several ETFs indicating more than 100% in short interest. Some might interpret that to mean that the number of shares owned by investors exceeds the shares issued and that some shares are therefore unsupported by underlying assets. This is definitely NOT the case, as all ETF shares are fully backed by underlying assets.

FIGURE 2: 20 LARGEST US ETFs BY SHORT INTEREST (%)

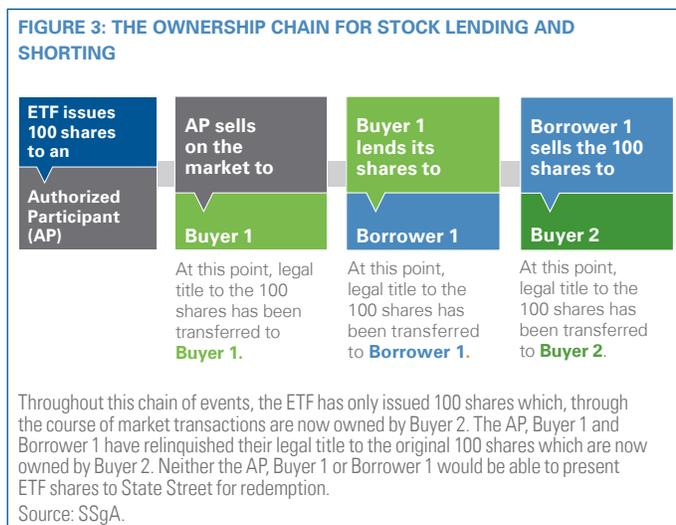
ETF NAME	TICKER	ASSETS (\$ MIL)	CATEGORY	SHORT INTEREST (%)*
SPDR S&P RETAIL	XRT	614.84	Sector - Consumer Staples	450.01
POWERSHARES AEROSPACE AND DEFENSE	PPA	53.69	Sector - Industrials	250.08
SPDR S&P OIL & GAS EXPLORATION & PRODUCTION	XOP	777.18	Sector - Energy	247.56
CURRENCYSHARES EURO	FXE	277.18	Currency	239.45
PROSHARES VIX SHORT-TERM FUTURES ETF	VIXY	28.40	Specialty-Domestic	173.69
SPDR S&P REGIONAL BANKING**	KRE	721.38	Sector - Financials	170.76
RYDEX S&P EQUAL WEIGHT HEALTHCARE	RYH	46.51	Sector - Health Care	153.12
DIREXION DAILY GOLD MINERS BEAR 2X SHARES	DUST	6.39	Inverse/Leveraged	150.59
SPDR S&P CAPITAL MARKETS	KCE	22.36	Sector - Financials	146.69
ISHARES PHILX SOX SEMICONDUCTOR SECTOR INDEX	SOXX	177.84	Sector - Technology	143.24
ISHARES RUSSELL 2000	IWM	14,071.50	Size - Small Cap	108.50
UNITED STATES OIL	USO	1,135.68	Commodity	101.74
DIREXION DAILY 7-10 YEAR TREASURY BULL 3X SHARES	TYD	3.89	Inverse/Leveraged	84.60
SPDR S&P SEMICONDUCTOR	XSD	33.24	Sector - Technology	74.13
POWERSHARES 1-30 LADDERED TREASURY	PLW	162.35	Fixed Income	73.06
MATERIALS SELECT SECTOR SPDR	XLB	1,635.59	Sector - Material	65.29
DIREXION DAILY REAL ESTATE BEAR 3X SHARES	DRV	26.58	Inverse/Leveraged	63.76
DIREXION DAILY BASIC MATERIALS BEAR 3X SHARES	MATS	3.42	Inverse/Leveraged	60.52
DIREXION DAILY AGRIBUSINESS BEAR 3X SHARES	COWS	3.15	Inverse/Leveraged	60.01
ISHARES DOW JONES US REAL ESTATE	IYR	3,294.98	Sector - REIT	56.92

Source: Bloomberg, L.P., SSgA, as of 12/31/2011.

*Short interest represents the number of shares reported as held short as a percentage of total shares outstanding.

**Prior to October 24, 2011, the SPDR S&P Regional Banking ETF was known as the SPDR KBW Regional Banking ETF and the SPDR S&P Capital Markets ETF was known as the SPDR KBW Capital Markets ETF.

Figure 3 provides a simplified view of the ownership chain for stock lending and shorting, which helps to clarify who has rightful possession of ETF shares.



For example, if Buyer 1 lends 100 shares of XYZ ETF to Borrower 1, who then immediately sells them short to Buyer 2, ownership of these shares could temporarily appear on the account records of all three investors, creating the illusion that 300 shares actually existed. Industry commentators have incorrectly assumed that if all three parties tried to redeem these shares, the ETF would be redeeming 200 more shares than actually existed.

This assumption has led to the misunderstanding of how ETFs are traded and, in particular, shorted. While shares sold short may temporarily appear on the ledgers of multiple buyers and borrowers, there is only one actual 'owner' of ETF shares. Final ownership is only determined by the trade that settles the assigned shares. Most ETF sponsors, including State Street, require Authorized Participants or their clients to demonstrate proof of ownership of ETF shares before they can be redeemed. In this illustration, only Buyer 2 would be able to redeem these shares, since this investor was the final 'purchaser.'

For nearly two decades, ETFs have grown to become an extremely popular choice for investors seeking a cost effective option for executing both short- and long-term investment strategies under a wide variety of market conditions. While there have been some misconceptions about the use of ETFs for shorting purposes, investors should remember that in most developed financial markets, ETFs are strictly regulated to help ensure liquidity, manage risk and operate with a high degree of transparency and fiduciary oversight. Investors can trade ETFs with confidence knowing that they are subject to the same regulations that govern other pooled investment funds. Understanding their unique characteristics is an important step toward determining whether ETFs can be an appropriate choice for your portfolio and the role they may play in helping you achieve your own investment objectives.

INDEX DEFINITIONS

RUSSELL 2000® INDEX

The Russell 2000 Index measures the performance of the small-cap segment of the US equity universe. The Russell 2000 is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

ABOUT SPDR® ETFs

SPDR ETFs are a comprehensive fund family of over 100 ETFs, spanning an array of international and domestic asset classes. Offered by State Street Global Advisors, SPDR ETFs provide investors with the flexibility to select investments that are precisely aligned to their investment strategy. Recognized as the industry pioneer, State Street created the first ETF in 1993 (SPDR S&P 500® – Ticker SPY). Since then, we've sustained our place as an industry innovator through the introduction of many ground-breaking products, including first-to-market launches with gold, international real estate, international fixed income and sector ETFs.

For information about our ETF family, visit www.spdrs.com

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¹ For more information on short selling, please visit <http://www.sec.gov/spotlight/keyregshoissues.htm>. The use of short selling entails a high degree of risk, may increase potential losses and is not suitable for all investors. Please assess your financial circumstances and risk tolerance prior to short selling.

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ETFs trade like stocks, fluctuate in market value and may trade at prices above or below the ETFs' net asset value. Brokerage commissions and ETF expenses will reduce returns.

While the shares of ETFs are tradable on secondary markets, they may not readily trade in all market conditions and may trade at significant discounts in periods of market stress.

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