THE INNOVATORS

WHO TO STA… ETF

Andrew Chanin's HACK attracted $1.4 billion in its first eight months. Time to hire that first employee!

BY ANTHONY EFFINGER

PHOTOGRAPHS BY **SASHA MASLOV**

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It's not hard to enter this market. But be warned: For every rocket, like the cybersecurity phenomenon HACK, there are a whole lot of zombies.

STARTING AN EXCHANGE-TRADED FUND IS A LITTLE LIKE LAUNCHING A ROCKET.

There are lots of different contractors and regulations. There are plenty of crashes.

Andrew Chanin, the 30-year-old founder of New York–based PureFunds, watched two of his first three ETFs fail before reaching Earth orbit. They liquidated because they couldn't gather enough assets to cover expenses. A third fund barely made it aloft; it still has just $3.9 million in assets.

Chanin kept at it. In November, he launched the PureFunds ISE Cyber Security ETF (Symbol: HACK). By July, HACK had attracted $1.4 billion—one of the fastest ascents in ETF history.

It got lift from a well-timed computer breach. Just 12 days after HACK started trading, news broke that malefactors had looted the computer network at Sony Pictures Entertainment, taking terabytes of data, including Social Security numbers, salary figures, and e-mails that exposed the film studio's leaders as the petty backbiters everyone imagines Hollywood big shots to be. Relentless coverage made computer security look like a crucial and immediate concern. And its ticker symbol advertised HACK as the way to play it.

PureFunds had, and still has, just one employee: Chanin, who looks like Ferris Bueller in a suit. He was competing against the biggest ETF companies around: BlackRock, Vanguard, and State Street. But Chanin was first to market with a computer-security ETF, and he had a perfect, memorable ticker symbol in an industry that is full of them: CURE (a health-care fund), FAN (wind energy), CROP (agribusiness), IPO (recent non-U.S. IPOs), and TAN (solar).

There are 6,500 ETFs in the world, with $3 trillion of assets under management. A new one rolls out, on average, every business day. The industry is surging, for a variety of reasons. Investors are dumping mutual funds for ETFs, which have a reputation for lower fees (though mutual funds are catching up, and some Vanguard funds are cheaper). Even better, ETFs can be bought and sold like equities during the trading day, and they have tax advantages because ETF shares are created and redeemed in kind and thus almost never produce capital gains for shareholders.

Like the cheapest mutual funds, almost all ETFs are driven by indexes. With such scant fees, it's hard to pay human managers, and, thanks to index evangelists like John C. Bogle, the founder of Vanguard, many people think managers aren't worth the money.

But Bogle has never rolled out indexes like these. Take GURU—the Global X Guru Index ETF. It tracks the Solactive Guru Index built by Solactive AG, in Frankfurt. The gurus in this case are hedge fund managers, the alpha dogs who move billions in and out of stocks based on their wits and, sometimes, their whims.

A group at Solactive called the Index Committee compiles a list of hedge funds from various sources (including this magazine, according to Solactive documents) and then eliminates those managing less than $500 million, making that the guru cutoff. Also, the largest holding must be at least 4.8 percent of the fund, and the manager can't change more than 50 percent of the portfolio in a quarter. Then Solactive takes the top holding from each of those funds and puts them in an index.

But is it really an index, or is it an ever-changing list of stocks held by hedge fund managers, most of whom are active managers, Bogle's sworn enemy? Solactive CEO Steffen Scheuble says it is an index, because the methodology is strict.

In the worst cases, the index alchemists are preying on Bogle-headed investors who think indexes are always safe and cheap, says Chris Abbruzzese, chief investment officer at Rain Capital Management, which oversees $250 million in Portland, Oregon. "Just because something tracks an index doesn't mean that the index doesn't have its own tortured logic," Abbruzzese says.

Gary Gordon, president of Pacific Park Financial in Ladera Ranch, California, is more charitable. He says the biggest problem with ETFs is liquidity. Some of the small ones trade so infrequently that they are hard to sell if you own them.

That's the dirty secret of the ETF industry. All of the innovation has led to a lot of failure. Many ETFs are zombies. They stagger on with few assets and little trading. Take ProShares UltraShort Telecommunications, ticker symbol TLL. The fund, which lets investors make a bet that telecom shares are going to crater, has $146,000 of assets, and some days no shares trade. The fund started in April 2008, so ProShares, which has 146 funds with total assets of $25 billion, has had plenty of time to market it, a tough job in a bull market. ProShares declined to comment on TLL, which was set to close in September.

THE BOTTOM LINE: MOST ETFs LIVE IN OBLIVION. ALL THE CLUNKERS SHOW JUST HOW REMARKABLE HACK IS. AND CHANIN KNOWS LUCK PLAYED A BIG PART.

There are so many zombie funds that Ron Rowland, a portfolio manager at Flexible Plan Investments in Smyrna, Georgia, chronicles them on his website, Invest With an Edge, in a section titled ETF Deathwatch. "You and I could create an index in the next five minutes," Rowland says. And because it's an index, we can show how it performed during, say, the last five years, and then, *voilà*, we have a track record.

Many ETFs fail because no one ever hears about them, Rowland says, despite catchy tickers and trendy themes. It's hard to stand out in a crowded field. "The bottom 50 percent of these things are untradable," he says. Just eight ETFs accounted for half the trading, in dollar volume, for all U.S. ETFs in June, Rowland calculated. More striking: 81 percent of all the listings totaled 2.4 percent of dollar volume.

The bottom line: Most ETFs live in oblivion. All the clunkers show just how remarkable HACK is. And Chanin knows luck played a big part. But Chanin, a hyper-driven millennial, was well prepared when good fortune arrived.

Kris Monaco heads the ETF venture group at index builder ISE. HACK tracks an index created by ISE.

He grew up in Mendham, New Jersey, and went to college at Tulane University, where he joined a club called the Jobs Group that aimed to put members in finance positions after graduation. During his senior year, a professor from the business school arranged for a group of students to go to New York for interviews. He signed up for one at Kellogg Group, a brokerage. On the way to the airport, Chanin got an e-mail list of the students scheduled for interviews. His name wasn't on it. He called, and the professor said she had decided to take just graduate students.

Irked, Chanin flew to New York anyway and showed up at Kellogg with 10 other Tulane students. They went in one at a time until Chanin was the only one left in the lobby. The hiring manager took pity on him and asked him in. He got the job. "It never hurts to try," he says.

At Kellogg, he became a market maker in ETFs, buying from sellers and selling to buyers and maintaining liquidity in various funds. He loved it. After two years, he went to Cohen Capital Group, another small New York brokerage.

He talked often with ETF issuers and suggested ideas for funds that Cohen would trade. One day, an issuer asked why he was giving away his best ideas. Why not build his own ETFs?

He and a friend from Cohen, Paul Zimnisky, considered it. "We thought you had to be a big banker to launch your own," Chanin says. Not so. He soon discovered the cottage industry that existed for building ETFs. All he needed was an idea, seed capital, and some money for expenses.

Chanin and Zimnisky left Cohen and started PureFunds in 2010. Zimnisky became CEO, Chanin COO. They had in mind three ETFs: one holding diamond miners, another tracking small silver producers, and a third made up of companies that service miners. Metals were soaring, so the new themes seemed like money magnets.

Chanin chose a New York company called International Securities Exchange to devise his indexes. ISE has cooked up indexes that track things like Wal-Mart's suppliers; Israeli tech stocks; and companies that make things that are bad for you: gambling, cigarettes, and booze. The symbol for a now-defunct ETF that tracked that last index (or SINdex, as ISE sold it) was PUF.

There's little that can't be outsourced in ETF-land. Chanin needed a prospectus, approval from the U.S. Securities and Exchange Commission, an exchange listing, and a hairball of other things that go along with launching a regulated investment company, which is what an ETF is.

He chose ETF Managers Group, in Summit, New Jersey, to make all that happen. Founder Sam Masucci is trying to be a one-stop shop for ETF entrepreneurs. He also helps with marketing and sales, which is the toughest part for small ETFs. "ETFs are sold, not bought," Masucci says. "You're fighting for shelf space." Chanin rolled out his three funds in November 2012. The diamond one sported the ticker symbol GEMS. Even so, it struggled to attract investors. Chanin tried to spread the word, appearing in videos on HardAssetsInvestor.com and other sites. GEMS and the mining ETF (MSXX) liquidated in January 2014.

Zimnisky left that same month (he didn't return phone calls asking for comment), and Chanin was on his own with one ETF, the tiny PureFunds ISE Junior Silver Small Cap Miners/Explorers ETF (SILJ). He hadn't been drawing a salary since starting PureFunds; he says he lived on a single slice of pizza for lunch, day after day. A small-cap silver fund wasn't going to pay the rent, not after metals plunged. But his friends at ISE were about to huck him a lifeline.

Like so many other crafts, building securities indexes has become something of a commodity. For years, ETF sponsors were required by the SEC to use indexes invented by other firms and to keep those firms at arm's length. Otherwise, a sponsor could develop plans to change an index by adding another stock, say, and at the

Chanin at ISE's New York offices. ISE collects a piece of the $10.5 million in fees HACK generates annually.

same time instruct employees to buy the stock. When the change in the index was executed, demand would drive the shares higher. Keeping the fund sponsor and the index provider separate would mitigate the risk of such front-running.

Then, in 2006, the SEC allowed WisdomTree Investments to "self-index," provided the methodologies behind its ETFs were rules-based and transparent.

Self-indexing is now widespread, and companies such as ISE have more competition. They have also lost some of the pricing power that brings them a chunk of an ETF's fee action. ISE, for one, became an ETF venture capitalist, investing money to get ETFs up and running, in exchange for more of the fees.

The idea for computer security struck ISE's ETF venture team, led by Kris Monaco, in 2012. Hacking was in the news, it was scary, and it was untapped. "There was no classification for computer security," Monaco says.

He reached out to some fund sponsors, but no one was interested. So he shelved the idea. Then more hackers attacked, and ISE dusted it off. Index manager Mark Abssy started digging into the industry, learning about attacks and sifting companies that defended against them.

When you make indexes, you make enemies, Abssy says. ETF wonks can have strong opinions about what mix of companies should represent an industry. "I get guys calling me up with plenty of vitriol saying, 'Why is this name in here?'" Abssy says.

For computer security, some companies are obvious, like Fortinet, which makes mostly hardware- and software-based firewalls. At other companies, like Cisco Systems, security is dwarfed by other businesses. But Cisco also controls 12 to 15 percent of the anti-hacker market, Abssy says. Monaco and Abssy decided that both focused upstarts and eclectic giants had to be included in their index.

Computer-security companies, in their analysis, fell into two broad categories: those that made infrastructure, like firewalls, and those that provided consulting and other services.

The formula for picking companies in those categories and setting their weights in the fund can be seen in the methodology guide for the ISE Cyber Security Index, a 23-page Levitical document written so strictly that the index probably could be resurrected even after an asteroid hit the Earth.

In the midst of the research, ISE reached out to Chanin at PureFunds. He loved the idea. So ISE pressed on and published the methodology on Sept. 2, 2014.

The HACK ETF launched on Nov. 12. The first headlines about the Sony hack hit Nov. 24. HACK jumped as cybersecurity stocks rallied. Then, in February, health insurer Anthem said computer intruders had stolen data on tens of millions of customers. HACK has been in orbit ever since, returning 21.7 percent from its inception through July 31, compared with 4.7 percent for the Standard & Poor's 500 Index.

With fees of 75 basis points and an asset base of $1.4 billion, HACK stands to toss off fees of $10.5 million a year, shared by ISE, PureFunds, ETF Managers, and some of their service providers. In July, Chanin launched two new funds, one tied to mobile payments (IPAY) and another tracking companies that work with so-called big data (BDAT). He plans to hire staff.

Being the only game in town almost certainly helped HACK corral assets. On July 7, it got a competitor: the First Trust Nasdaq CEA Cybersecurity ETF. Symbol: CIBR. It had $60 million of assets after a month in business.

Chanin is still blown away by how HACK took off. "It was timing," he says, "and a whole bunch of other things that I don't know about and that I wish I could bottle." BM

With assistance from **Eric Balchunas** and **Michael Weiss**.

BLOOMBERG TIPS

Hacking HACK

Type **HACK <Equity> MHD <Go>** to view the holdings of the ETF. As of Aug. 3, HACK held shares of 32 companies, and its largest position was in Fortinet, a Sunnyvale, California–based maker of firewalls. Type 1 <Go> and then type **CCB <Go>** to find similar firms with the Company Classification Browser. You can use the export icon in the upper-right corner of the screen to drag and drop the stocks to a monitor you can save. Next, type **HACK US <Equity> PORT /P <Go>**. Type 14 <Go> 2 <Go> to launch the Portfolio & Risk Analytics Optimizer. You can use the saved monitor with additional cybersecurity stocks as a trade universe when running an optimization on the ETF's portfolio. JON ASMUNDSSON