Overview

XTR is a fund-of-funds ETF that holds a number of income-generating ETFs. Like other income mutual funds, XTR pays a large and consistent distribution which is very appealing to income-focused investors. This document will cover:

- Where the large distribution comes from
- The actual yield of the fund (3.7%) versus its nominal yield (5.77%)
- Criticisms of XTR

Much of the following analysis is applicable to all Monthly Income Funds.

Where the distribution comes from

Normally, an ETF's distribution matches the dividend & interest income actually earned within the fund, because the ETF is supposed to be a transparent conduit of the underlying. The ratio (net investment income / total distribution) is usually around 100%. For example XIU 89%, and XBB 98% (semi-annual 2012).

For XTR, that ratio is approximately 66%, meaning that earned income only provides 66% of the distribution. The rest comes from capital gains (small), and the investor's own money – return of capital (ROC). You can also see this in the tax characteristics of the distribution. With ROC, capital is depleted over time.

Net of all fees, XTR's distribution comes from:

3.67% income yield + 2.10% liquidation of portfolio = 5.77% distribution yield

This is functionally equivalent to an investor holding a $100 portfolio, earning 3.67% yield, and additionally selling off 2.10% of assets annually to achieve a total cashflow of $5.77. The portfolio is left with $97.90 after one year.

This is a valid strategy for generating cashflow, but the investor must be aware that liquidation erodes the capital. If XTR's distribution stays constant and the underlying investments don't move in price or yield, in 10 years XTR will drop by -25%. In 20 years XTR will drop by -60%. The underlying investments must increase in price or yield to offset this persistent capital erosion.
Actual Yield and Compounding Returns

Based on the published 5.77% yield, an investor may be under the impression that they will earn 5.77% compounded return if they reinvest their distributions.

This will not work. If one takes the distribution (partly ROC) and reinvests it back into the fund, the ROC money is just being continuously recycled. Only the real investment earnings are being put to work, and the real earnings are 66% of the distribution. A quick calculation shows that:

$$66\% \times 5.77\% \text{ nominal yield} = 3.8\% \text{ actual yield (estimate)}$$

Investments in XTR can only grow at this actual yield, ignoring capital gains. Even if you reinvest the full distribution, the actual yield that results is only 3.8%.

This can also be illustrated with an example:

- Start with $1,000 capital, buying 100 shares XTR at $10, distributing $0.577 annually (that's the current 5.77% yield)
- In one year the ETF will pay out $57.70 [ $38.08 earnings + $19.62 ROC ]. Capital comes out of the NAV, so share price falls to $9.8038
- You reinvest the whole $57.70 distribution. Now you own 105.885 shares.
- In the second year it pays out $61.10 [ $40.33 earnings + $20.77 ROC ]. The share price falls to $9.6076

What have you ended up with after two years? The $61.10 distribution + accumulated XTR value 105.885 shares x $9.6076 = $1,078.40 total. The annualized return is $$(1078.40/1000)^{(1/2)} = 3.8\% \text{ yield}$$

So XTR actually earns (and can only compound) at 3.8%. An investor is just fooling himself by reinvesting... his own capital gets returned to him, repeatedly.

A more detailed portfolio calculation shows 3.70% actual yield:

At 2013-02-05

<table>
<thead>
<tr>
<th>Holding</th>
<th>Weight</th>
<th>Type</th>
<th>ETF yield</th>
<th>MER</th>
<th>Net yield</th>
<th>Yield contribution</th>
<th>MER contribution</th>
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<tbody>
<tr>
<td>XHB</td>
<td>19.8%</td>
<td>Bonds (mid grade)</td>
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</table>

**XTR actual yield (weighted average of holdings) after MER:** 3.70% 0.54%
Criticisms of XTR

Distribution yields of income funds can be misleading, if one does not understand where the distribution comes from. But my greater criticism has to do with the fact that this income fund takes the form of an ETF.

XTR is an actively managed fund-of-funds. Technically speaking, an ETF can do anything a mutual fund does, but I feel that it's contrary to the spirit of the ETF structure. Many income mutual funds and structured products play the game of misleading investors with large distributions, and that's bad enough. But an ETF doing that seems even more misleading to me. An ETF should simply hold a basket of liquid securities, and transparently pass the income stream from those securities.

With XTR, you don't know what you're buying. Traditionally, ETFs follow a sector index and it's very clear what kind of exposure you're buying. At the very least, you know whether you're getting stocks or bonds. However, the managers of XTR have defined the fund's mandate in a way that allows them to change the allocations to anything they want, at any time. Today it's a bond fund, but what will it be tomorrow? Nobody knows. I can not recommend this as a long-term holding, unless the investor is going to constantly monitor the fund's asset allocation. With an ETF, you're supposed to know what you're buying.

iShares does not publish the actual yield (3.70%). The fund provider generally does an excellent job disclosing, via web site, the holdings and yields of their ETF products. However, the page for XTR only shows one yield: the nominal 5.77%, which is somewhat misleading. The portfolio yield _can_ be calculated from the available data, as I demonstrated, but it would be far more investor-friendly if iShares simply published this along with the other daily information. It is a vital piece of information that shows the true rate of income.