ETF Note: Deutsche Bank X-Tracker Japan

JSE Code: DBXJP	**Tracks:** MSCI Japan Index	**Last updated:** 11 August 2010
Issuer: Deutsche Bank	**Risk level:** High, equity	**Performance YTD:** -4%

Characteristics:

The aim of this ETF is to give the investor direct exposure to the MSCI Japan index. This index includes up to 400 of the largest and most freely traded Japanese shares on the Tokyo Stock Exchange.

As the underlying shares are held in Yen, the instrument also provides a viable way of hedging one's exposure to one of the world's major currencies, as well as allowing investors to gain the benefits of offshore diversification without having to utilise their offshore investment allowance.

When purchasing the ETF in Rands, you are effectively locking in an exchange rate and a level of the index simultaneously (please see the example of how this works in Table A below). You are then entitled to your share of all the dividends that flow from these companies during the term of your investment. These dividends are aggregated and distributed to owners of the ETF twice a year. The current dividend yield stands at 1.78%.

The index is based on a free float market capitalization methodology, which selects the shares that go into the index based on the size of a company's free float. A company's free float is considered to be the average number of shares that are readily available to trade by the investing public.

Approximately 400 companies are included in the index, some of which are world renowned, such as Canon, Toyota and Sony. The combined market value of the companies represented is approximately $3 Trillion.

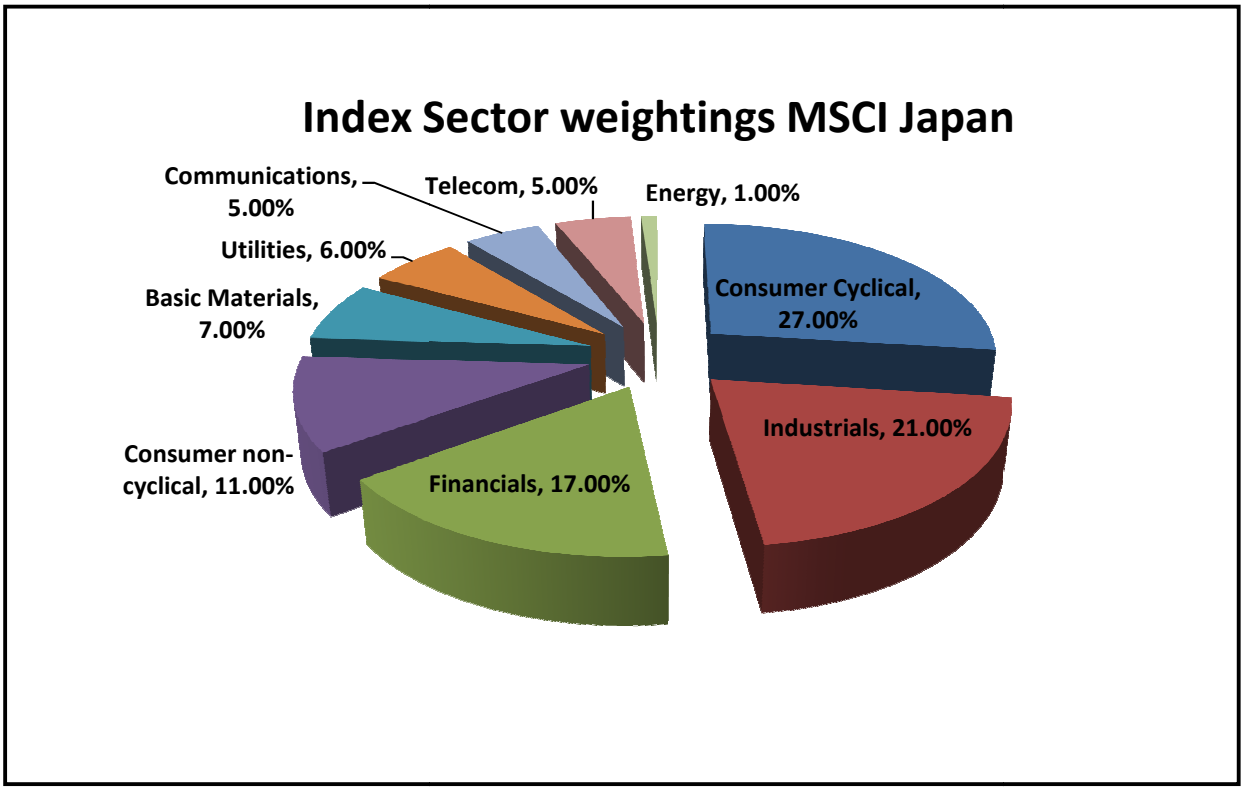
The companies that make up the index are based and head-quartered in Japan, and are all listed on the Tokyo Stock Exchange. All the major industries are represented, as shown in the graph below.

What the bulls say:

- Gives exposure to the world's 2nd largest economy.
- Protects your wealth against any depreciation in the Rand.
- No need to use your offshore allowance to invest in the product.

What the bears say:

- Japan has structural problems with its economy that will prevent a rapid turnaround.
- Further Yen strength against the Dollar, will make exports more uncompetitive.



As at 30 June 2010

Fundamental View

So how do we get a feel for the future performance of this ETF? First we take a look at the underlying economy that these companies operate in.

The average GDP growth rate for Japan in this decade (2000 – present) has been 1.49%, and in the decade before this, GDP growth averaged 1.5%. We think this lacklustre trend from the world's second biggest economy is likely to continue. There are two major reasons for this:

The first is that the government led by the newly elected Democratic Party of Japan, has a budget deficit equal to 180% of GDP, to deal with. This will dramatically affect the level at which Government can stimulate the economy going forward.

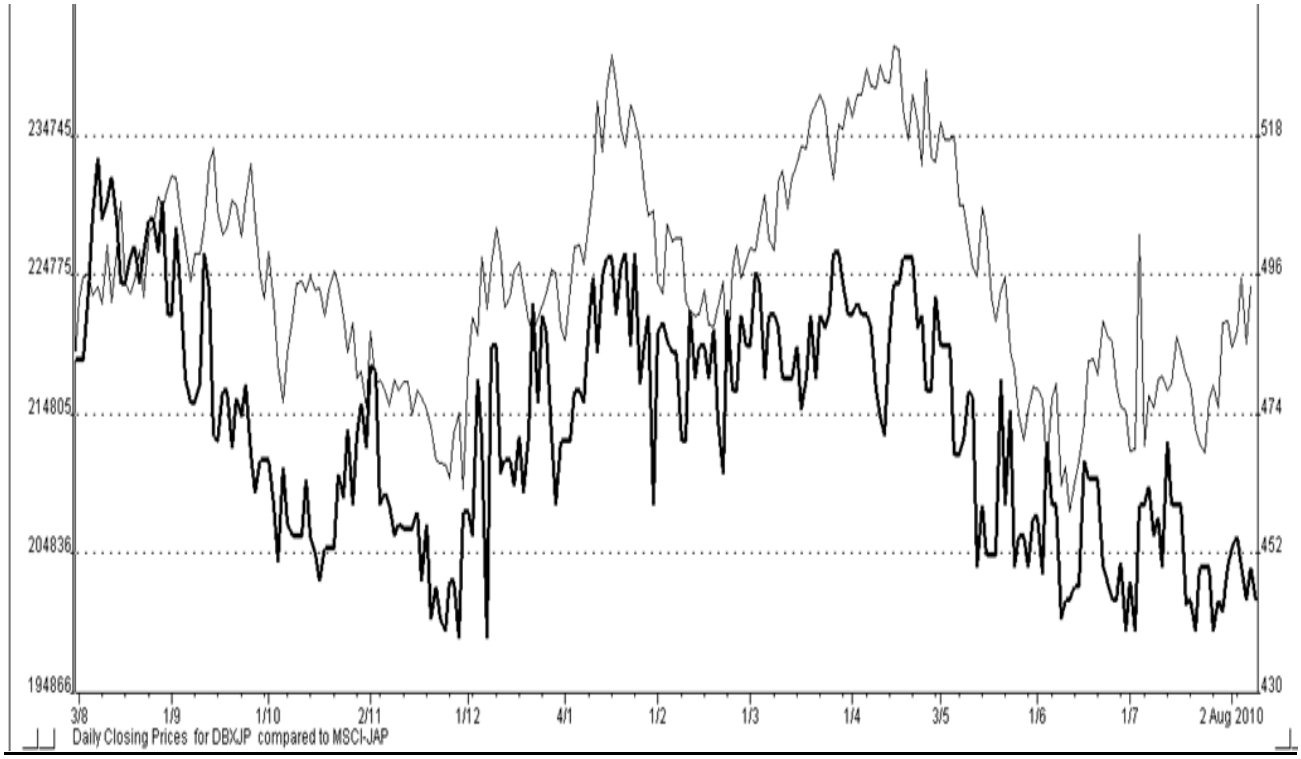
The second is that Japan suffers from a very low birth rate which has led to an ageing and shrinking population. The death rate exceeded the birth rate for the first time in 2008, meaning that there are more people dying than being born in any one year. This has begun a trend that will act as a long-term handbrake on the economy. The government has been reluctant to remove the barriers to immigration that would counteract this problem.

The performance of the index reflects the problems the Japanese economy faces, as we have described above. The return of the index (excluding dividends) amounts to an annualised return of 2.44% for the 8 years to end July 2010.

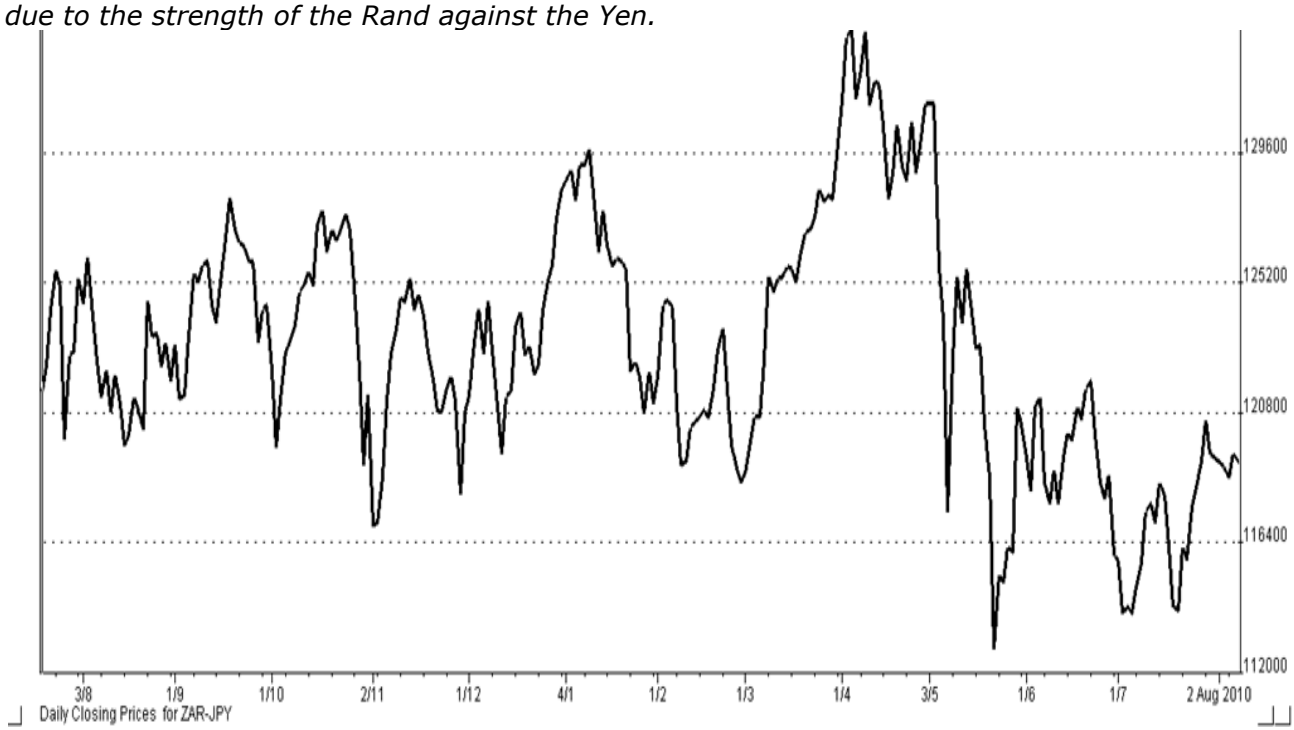
A glance at the graph below shows how the performance of the ETF has diverged from the performance of the Index. This is due to the strength of the Rand relative to the Yen. Remember that by investing in this ETF, you are effectively converting Rands into Yen and going and buying the shares denominated in Yen. So while the index can go up, if the Rand

continues to strengthen you will be receiving less Rands for your investment and consequently enjoying lower returns.

The flip side is that if the Rand depreciates, this investment will serve to protect your wealth and boost your returns.



1 Year performance of MSCI Japan Index (grey) vs DBX Japan ETF (black).The divergence is due to the strength of the Rand against the Yen.



1 year performance of the Rand against the Yen. Upward moves represent Rand strength.

TABLE A: An example of how the DBX Trackers reflect the movement in the exchange rate and index, in its Rand price:

On the 1st of May you decide to buy 1 ETF. It costs R4.

On the date and time you buy the ETF the Rand/Yen exchange is Y110 to R1. Your ETF in Yen is therefore worth Y440. The Nikkei Index is at 3000 points.

On the 31st of May you decide to sell your ETF. The index is now at 3300 points, an increase or return of 10%. This would mean that the price for your ETF has moved from Y440 to Y484. However:

The Y/R exchange rate is now at Y115.50, an appreciation of 5% by the Rand. Your Y484 ETF converted back to Rands is now R4.20 which represents a total return on your original investment of 5%.

This demonstrates how the gain in the index can be offset against a loss in the exchange rate. The price of the ETF in Rands, continually reflects the changes in the two variables.

Portfolio construction:

Investors looking for offshore diversification would use this product to gain exposure to the performance of the Japanese stock market, and implicitly, the Japanese economy.

The key benefit of the DB X Trackers is that you do not need to use your off-shore investment allowance (which is now limited to R4m per individual) to invest in the product.

So the idea would be to use the X Trackers to gain exposure to established stock market indices in Japan, the UK, the US and Europe. You would then use your offshore allowance to get exposure to a variety of other asset classes and industries not covered by the X trackers like Bonds, Property and Cash, and possibly alternative investments like Hedge Funds. When considering using products like this one, as well as investing overseas, we suggest you discuss your requirements with a registered financial advisor.

We are great fans of the benefits that come from Rand cost averaging as a result of purchasing ETFs through a regular investment scheme, and this can be done with the X –Trackers as well, through an investment scheme offered by AOS or ETFSA.

If you decide you would like to invest in this ETF through the investment scheme, there will be some additional costs involved. These include:

Monthly debit order fee of R4.50

For acquiring the ETFs: 0.1% of the monthly amount.

Then there is an ongoing /management fee based on the value of your total portfolio:

Amounts < R1m 1% p.a.

Amounts > R1m 0.55% p.a.

For selling your ETFs: 0.1% of the value of the transaction.

Fees and alternatives:

This is the only ETF of its kind available in South Africa that covers this particular index of stocks or any Japanese shares in general. The TER (Total Expense Ratio) of 1.14% is the same for all five of the products offered by Deutsche Bank and ranks third highest when compared with its peers on the JSE. However this is a crude comparison as there are no other ETFs available locally (outside of the DB X-Trackers) that give exposure to any offshore equity markets.

When compared with its peers overseas, for example the Barclays iShares MSCI Japan index the TER of 0.59% is a lot lower than the DB X Tracker's 1.14%. Much of this difference can be explained due to the Foreign Exchange conversion Deutsche Bank must enter into to purchase the underlying shares in Yen.

If you have Sterling or Euros available overseas you could look to invest in the Deutsche Bank version of the ETF (www.dbxtrackers.co.uk) which lists its TER at 0.50%.