OPER ETF Offers Retail Investors Exposure to the Institutional Lending Markets

By: Harrison Schwartz

Harrison Schwartz is an Investment Analyst in Chico California who focuses on interest rate sensitive assets including bonds, precious metals, and financial firms. He runs the Global Macro Outlook*, and an international investing research service on Seeking Alpha where he has over 2,500 followers. Harrison graduated from UCLA with a B.A in Economics where he focused on quantitative economic modeling. He also has previous work experience at a Private Equity search fund and with a Financial Newsletter provider.*

Summary:

- Investors have a habit of minimizing cash allocations when it offers the highest returns.
- With the Treasury yield curve flat and equity valuations historically high, it may be a good time to increase portfolio cash exposure.
- Ongoing Repo market volatility may be due in-part to regulatory constraints placed on commercial banks post-crisis.
- The Federal Reserve may need to raise short-term rates in order to protect U.S consumers from import price inflation, potentially boosting OPER's returns down the road.

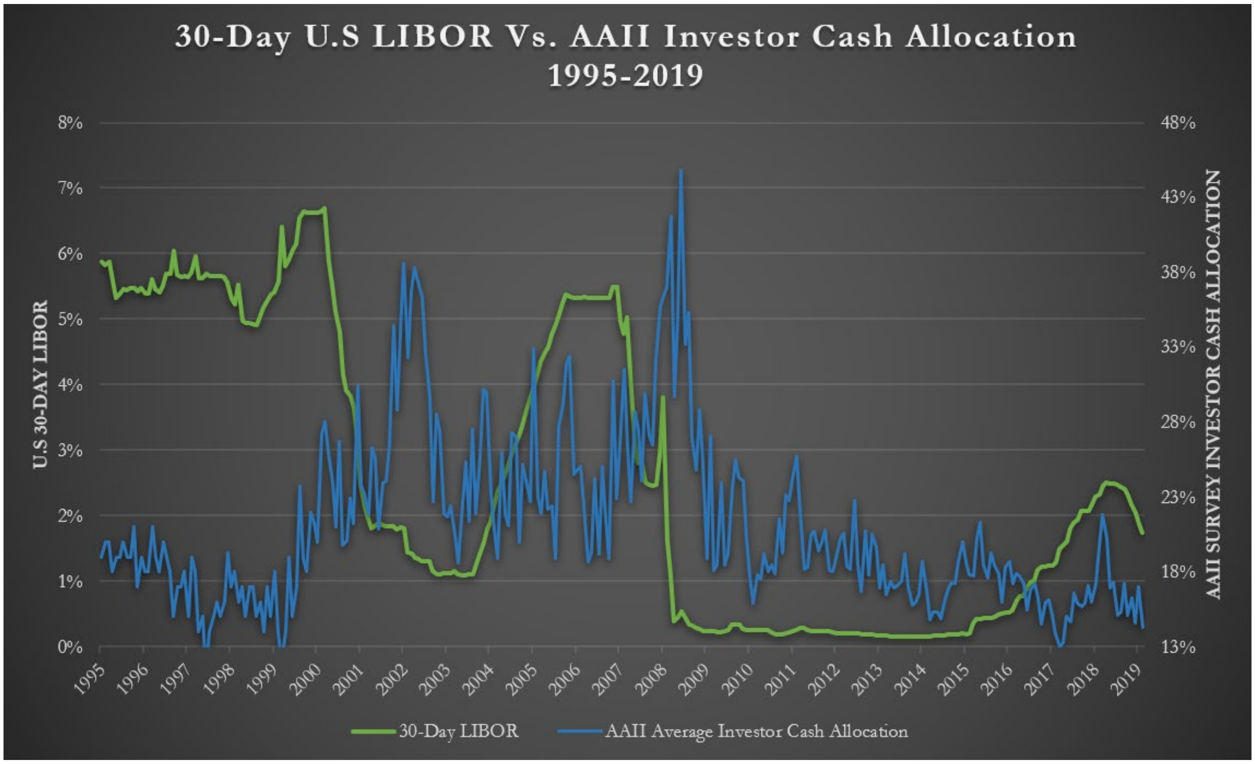
History tells us that, when financial assets are expensive, cash is king. Today a 30-year U.S Treasury bond pays a 2.2% yield and historical studies[1] indicate that U.S equities could deliver below 4% returns over the next decade based on current valuations and debt levels. Even investment-grade corporate bonds carry effective yields of only 2-2.5%. Of course, equities carry significant cyclical risks today while long-term bonds have considerably more interest rate volatility.

Back in September I wrote "OPER Vs. BIL: The Case for Both Repos And T-Bills" that covered ongoing Repo market volatility and the surprising opportunity that exists in ultra-short maturity funds today. I would like to reiterate some of the key points from the article and provide a longer-term view on the economic backdrop surrounding the Repo market.

The Case for Cash in Uncertain Times

Conservative investing is quite uncommon today. In fact, recent data from the American Association of Individual Investors[2] found that current average investor cash allocations are about the lowest since the top of the 1997-2000 "dot-com bubble."

Take a look at the annual return on a 30-day loan vs. cash portfolio allocations of U.S Investors:



(Federal Reserve, AAII)

Interestingly, it seems that investors often have the lowest cash holdings during the best times to own cash. From 1998 to 2000, a 30-day loan paid a 5.5-6.5% interest rate at virtually no risk. Equities were rising, but as you may remember, that meteoric rise ended with a bust. By late 2003 investors had high cash reserves, but the rate had fallen all the way to 1.1% and equities had declined tremendously. While cash allocations did not fall as far during the 2003-2008 bull market, they were notably low immediately prior to the equity market's 2007 peak. At the time, the cash rate had risen back up to 5.3% and would have offered far superior returns.

I believe it is fair to say a similar situation exists today. Cash allocations are exhibiting a very similar pattern as they did from 1997 to 2000, and despite a few cuts to the discount rate, short-term rates are historically high. Importantly, inflation is lower today than it was in 1999 and 2007, so the "real return" on cash is similar.

On top of that, I would argue that the general investment landscape today offers very few safe investments that deliver a reasonable expected return. As I mentioned earlier, U.S equity market valuations[3] are fluctuating around the highest levels in two decades, and non-financial debt is now twice as high as it was in 2000, significantly raising the risk-adjusted valuation of equities.

The U.S yield curve is also roughly flat meaning a 20-30-year Treasury bond pays nearly the same yield as an ultra-low-risk overnight loan. Importantly, it is common for the value of these long-term bonds to fluctuate 10-20%[4]per year, historically.

As investors hunt for yield they have moved toward riskier products. The high yield/"junk" bond market has seen tremendous growth since 2008 while the covenant quality[5] of the underlying bonds has declined. To a large extent, the same could be said for emerging market bonds[6].

To me, this makes alternative cash products, and specifically, ultra-short maturity funds an attractive investment. They have offered nearly the same returns as long-term Treasuries, but with far lower interest rate risk and virtually no volatility. In fact, I would go as far as to say that these funds possess attractive return prospects over the next 5 years when compared to equities and long-term bonds. Both equities and long-term bonds have decent positive momentum which may propel them temporarily higher. However, in my opinion, historical patterns as well as recent economic and financial data favor ultra-short maturity funds.

Active equity and bond managers may still generate considerable excess returns due to apparent valuation dislocations[7], but for the passive investor, ultra-short maturity funds seem like the place to be.

Sifting Through Alternative Cash Options

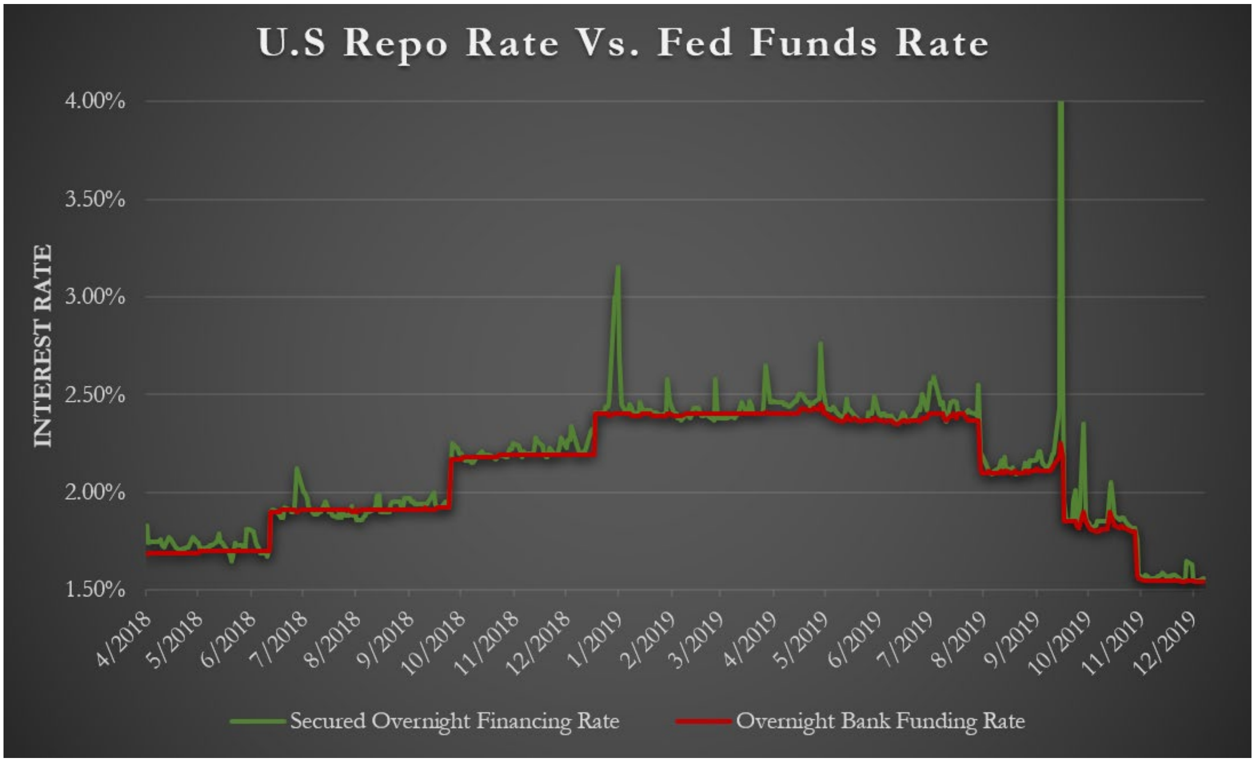
Surprisingly, cash management products are far from ubiquitous. They all buy securities or make loans to banks with a varying maturity, typically weeks to months in length. However, realized returns differ widely between products. I recently spoke with a woman who told me she's been investing in CD's for a decade only to find she made a roughly 0.40% annual return. Her bank likely generated considerable returns off her money since they likely lent it at 3%+. Using an ultra-short maturity ETF, she could have received much higher returns with essentially the same or better risk exposure. Even more, she would not have had her money locked into a multi-year contract with a potential early withdrawal penalty.

The most popular way to invest in cash management products has been in CD's, money market funds, and through Treasury Bill ETFs and mutual funds. These funds buy U.S government debt that will mature within a year. They usually pay a yield around the Fed Funds rate which is currently 1.5%. Slightly higher returns could be found in short-term corporate debt funds, but they often come with higher expense ratios of 30 bps or more and can experience drawdowns during volatile periods.

In my opinion, one of the best ways to invest in cash is in the repurchase agreement market. A repurchase agreement or "Repo" is simply an ultra-short-term loan where one party lends cash in return for collateral (usually government securities). Then days or weeks later (depending on the term) the lender receives their cash back with interest as the borrower takes back or "repurchases" the government securities (collateral). Since the agreement is typically backed by government securities, they carry negligible risk[8] but often deliver slightly higher returns than Treasury Bills. In most cases, the lender receives collateral worth more than the loan amount, and this "over-collateralization" provides even more protection for the lender.

The principal lenders in the Repo market are large institutions like banks, and more recently the Federal Reserve. Firms with large securities portfolios like market-makers, broker-dealers, and investment banks are the primary borrowers.

As you have likely heard, there has been an increase in interest rate spikes in the Repo market. To illustrate, take a look at the Secured Overnight Financing Rate (The Treasury Repo rate) vs. the Overnight Bank Funding Rate (Set by the Federal Reserve):

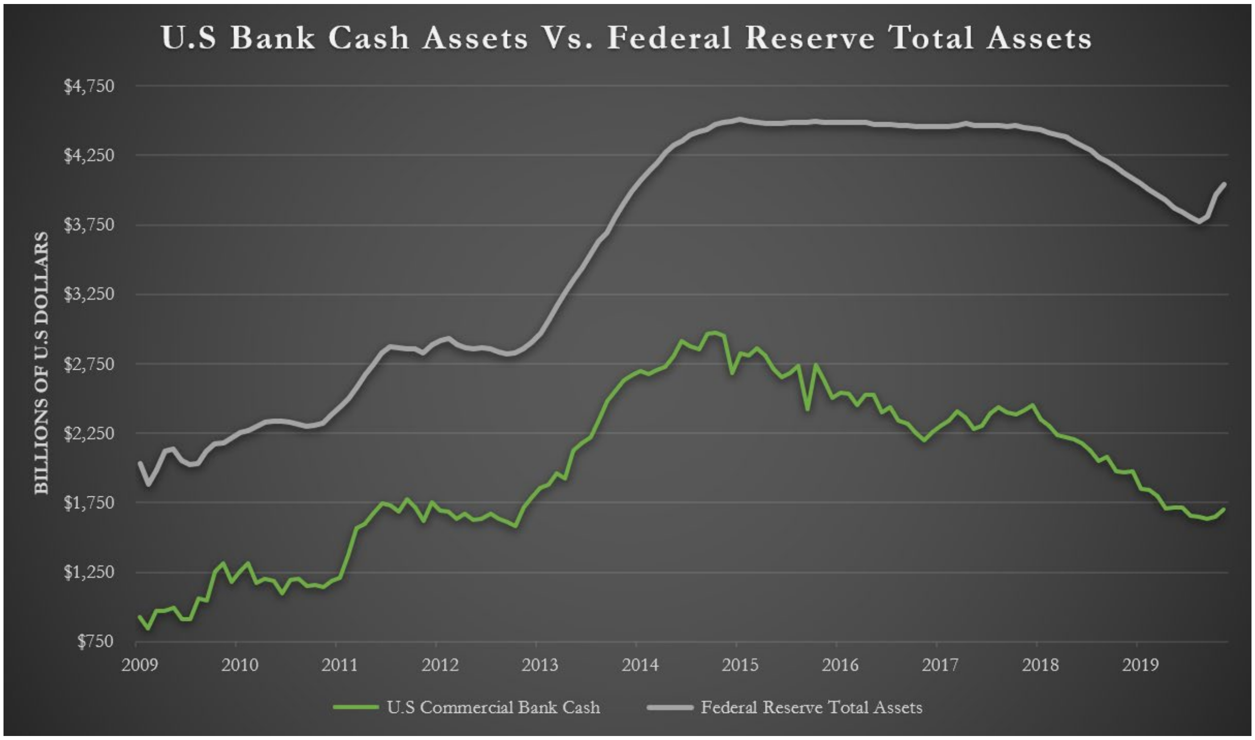


(Federal Reserve)

As you can see, the repo rate is usually above the funding rate and has recently had a habit of spiking much higher.

It is still not entirely clear what is causing the volatility, but there are a few possible causes. Put simply, the spikes indicate there is usually more demand for repurchase agreements than there is in supply of available funds. Banks who usually offer that supply have a decent amount of cash today, but far less than they did years ago. Historically, these spikes were reserved for quarter or year-end financial reporting periods as banks reduced their balance sheets, but a significant outlier event occurred in mid-September of this year that exacerbated a potential structural issue in the funding markets.

To illustrate, look at the total U.S commercial bank cash assets vs. the U.S Federal Reserve balance sheet below:



(Federal Reserve)

You can see the impact of quantitative easing quite clearly in this chart. In the United States, QE began in late 2008 and lasted until 2015, precisely when bank cash reserves peaked. Comparing it to the Federal Reserve's balance sheet in gray, you can see that the impact of quantitative tightening (balance sheet reductions) since 2015 has had an exaggerated negative impact on bank cash reserves.

Banks still have higher cash reserves today than they did in the 2000s but increased regulatory scrutiny on bank leverage and the introduction of the Federal Reserve annual stress tests may mean that banks have less cash *available* to lend.

Additionally, since 2015 the total outstanding notional value of over-the-counter derivatives has increased from $500 to $640 trillion[9] with most of the increases stemming from U.S dollar interest rate contracts, which now have a $200 trillion notional value. Importantly, the total value of OTC contracts declined considerably in the years leading up to 2015 and are now back to 2007 levels. Even more, they are off-balance sheet items so they are not accounted for in calculating bank cash. This factor *may* be playing a role in limiting available bank cash to lend in the Repo market.

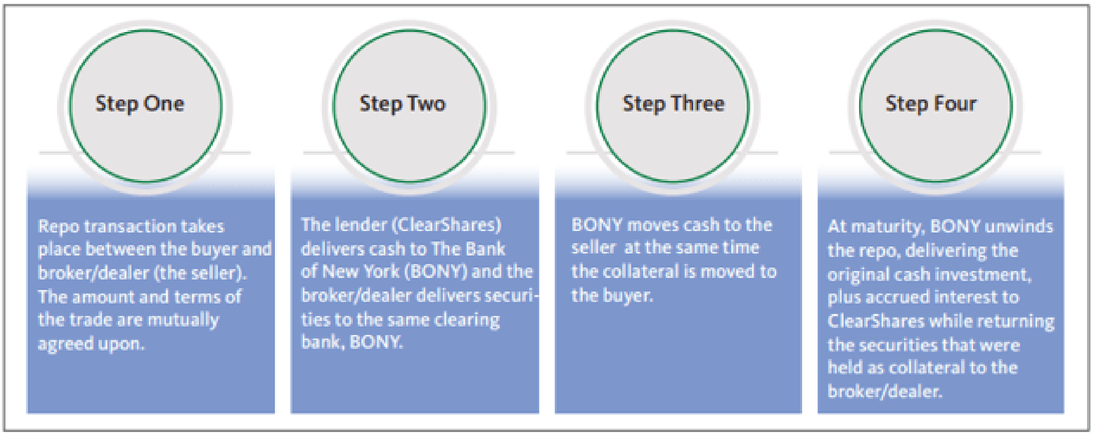
Investing in Repurchase Agreements With an ETF

No matter the reason, many institutional traders and investors[10] have been able to generate higher profits during periods of increased volatility by purchasing Repo agreements at 3%+ yields during spikes in short-term funding rates. Most believe that access to these markets is limited to big institutions but, the Repo market is now available to **all** investors through the ClearShares Ultra-Short Maturity ETF (OPER) which was launched last year.

Specifically, the fund invests in "Tri-Party" repurchase agreements wherein the fund lends to a broker-dealer or market-maker through a clearing custodian. The clearing custodian, or "tri-party", ensures the proper movement of cash and collateral, and certifies that the lender is fully collateralized per the lending agreement. These loans typically have a term of days to weeks, and are backed by Treasuries and other government securities, making them virtually risk-free.

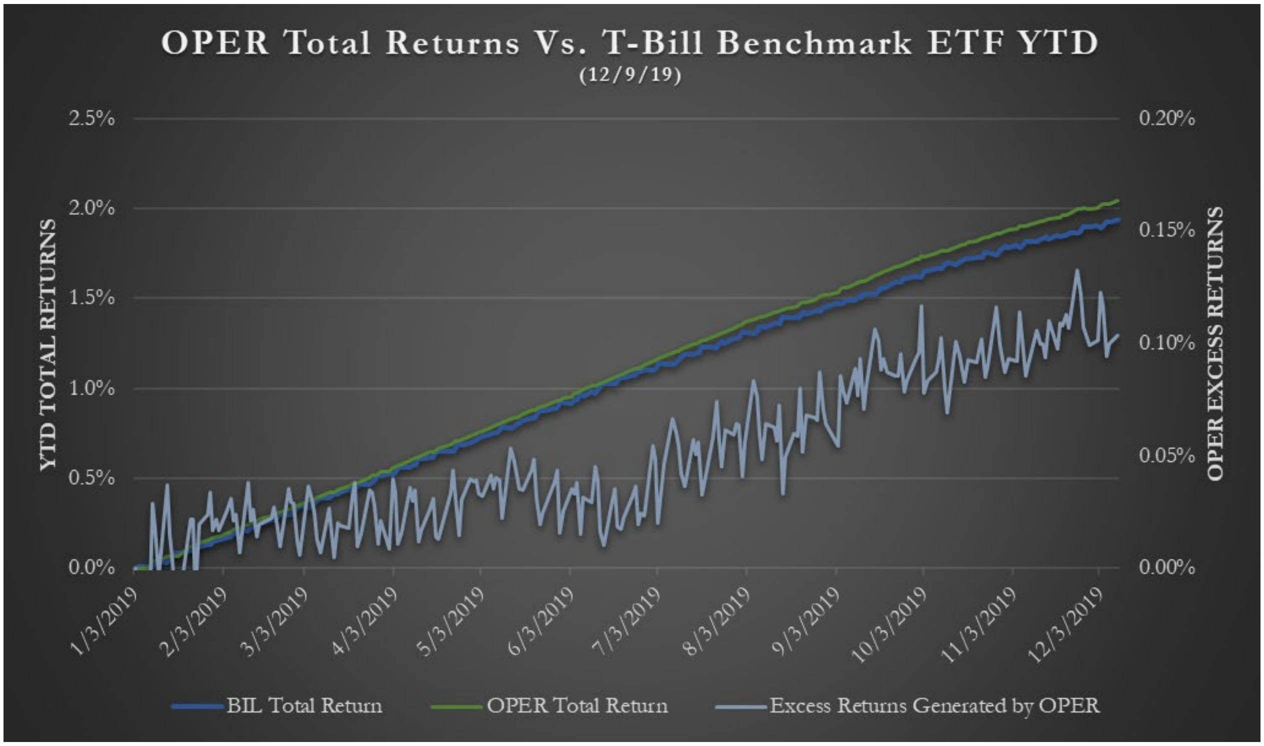
To illustrate the fund's operations, look at this diagram from its profile:

THE TRI-PARTY REPO PROCESS



OPER is the only[11] ETF focused exclusively on the Repo market available to investors and has seen its total assets under management nearly triple this year. It currently has an AUM of about $95M making it a highly liquid vehicle. The fund also has a reasonable expense ratio at 20 bps. The fund's current SEC yield is 1.51%[12] (interest is paid monthly).

In my view, the best comparable product to OPER is the popular 1-3-month T-Bill ETF BIL though other T-Bill funds could be used for comparison. Take a look at the total returns of OPER vs. BIL for 2019:



The performance data quoted represents past performance. Performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost and current performance may be lower or higher than the performance quoted. Performance current to the most recent month end can be obtained by calling OPER: 212.359.0269 or visit: www.clear-shares.com *and BIL: call 1-866-787-2257 or visit* www.spdrs.com.

Returns below are average annualized except for periods less than one year.

OPER Total Returns as of 12/31/2019 (inception 7/11/2018):
NAV (%): 1 Year 2.15, Since Inception 2.07
Market (%): 1 Year 2.15, Since Inception 2.08
Gross Expense Ratio: 0.20

BIL Total Returns as of 12/31/2019
NAV(%) 1 Year 2.05, 5 Year 0.89, 10 year 0.42
Market(%) 1 Year 2.06, 5 Year 0.89, 10 year 0.42
Gross Expense Ratio 0.1359

As you can see, OPER has generated significant excess returns compared to BIL, even after fund expenses (**see Important Disclosures**). This is likely due to a combination of briefly higher Repo market rates and the expertise of OPER's traders. Most importantly, it has been **consistent.** It is possible that the fund could continue to generate alpha, particularly if the repo markets remain constrained.

A Quick Look at Federal Reserve Policy

Overall, in my opinion, OPER is a solid investment choice for cash allocations. It seeks to achieve higher returns than T-Bills and other cash options with the same or similar risk profiles.

Over years to come, returns will depend highly on Federal Reserve policy actions. The Fed recently lowered rates from 2.5% to 1.5% and has made it clear that they do not plan to cut rates further. If the U.S economy continues to slow, they may cut more, but it would likely coincide with a significant drop in equity markets.

Another point against future interest rate cuts that I have not heard in financial media relates to the U.S dollar. With interest rates significantly higher in the U.S than in Europe and Japan, U.S dollar exchange rates have risen considerably in recent years. This rise has largely offset the price impact of tariffs and has caused U.S import prices to fall since the beginning of 2018, resulting in increased purchasing power of U.S consumers.

There is a widespread concern that tariffs will create a tax on consumption, but if the U.S dollar does not depreciate, the impact will continue to be largely offset. Additionally, overseas investors are major lenders to the U.S government and corporations due to the strong dollar and higher available yields. Thus, it is likely in the best interests of the Federal Reserve to keep rates higher in order to keep import inflation at bay and protect the health of funding markets.

I expect the Federal Reserve to keep interest rates steady for now and possibly return to a hiking cycle in 2020, particularly if other global central banks raise their discount rates.

The Bottom Line

With investor and bank cash available to invest at historical lows and asset markets looking awfully expensive, I believe that it is an excellent time to increase cash allocations. Even more, the strong liquidity profile of cash alternatives allows investors to save cash that can be deployed at a time when asset prices appear to offer better risk-adjusted returns.

One could invest in T-Bills, or they can look for an alternative source of return generation in the Repo market. The OPER ETF has successfully generated excess returns over BIL and allows investors the opportunity to allocate into a traditionally “institutional only” asset class. I’ll be looking forward to following the fund’s performance over coming months. I have a positive outlook.

Notes and Sources:

1. Star Capital: https://www.starcapital.de/en/research/stock-market-valuation
2. American Association of Individual Investors: https://www.aaii.com/assetallocationsurvey
3. Schiller PE Ratio: https://www.multpl.com/shiller-pe
4. iShares: https://www.ishares.com/us/products/239454/ishares-20-year-treasury-bond-etf
5. MarketWatch: https://www.marketwatch.com/story/junk-bonds-are-getting-worse-and-investors-are-starting-to-take-notice-2019-08-15
6. Seeking Alpha: https://seekingalpha.com/article/4303594-emb-global-wave-in-emerging-market-debt-defaults-is-beginning
7. Seeking Alpha: https://seekingalpha.com/article/4288578-michael-burry-is-correct-passive-investing-is-proof

8. Repurchase Agreements are loans collateralized by securities, typically in the fixed income asset class. In the case of OPER, the securities received as collateral are issued

or backed by the United States Government, have a current market value during the loan period in excess of the loan principal, and are held by BNY Mellon as Tri-Party Custodian. Risks related to Repurchase Agreements may include, but are not limited to: counterparty default, insufficient collateral in the case of a counterparty default, and illiquidity in the market for the securities collateral in an event of default and subsequent portfolio liquidation. Please visit the ClearShares website for more information on Repurchase Agreements: https://clear-shares.com/oper/why-clearshares.html
9. BIS: https://www.bis.org/publ/otc_hy1911.htm
10. Bloomberg: https://www.bloomberg.com/news/articles/2019-10-30/ex-prop-traders-who-won-big-on-repo-are-ready-for-next-big-spike
11. Based on the universe of Ultra Short-Term ETFs designated by ETF.com as of 10/8/19
12. 30-Day SEC Yield as of 11/30/19

Important Disclosures

ClearShares LLC, a SEC registered advisory firm and advisor to the OPER ETF, compensated the author for this informational report. The ClearShares ETFs are distributed by Quasar Distributors, LLC.

For purposes of the comparison, Blackrock iShares Core Cash ETF ("BIL") employs a passive investment strategy that aims to provide investors with the performance of the S&P/ASX Bank Bill Index (before fees and expenses). The Fund offers the ability to achieve capital preservation and regular income with a diversified portfolio of high-quality short-term money market instruments. The Fund is truly liquid and only holds investments in instruments that can be sold on a same day basis.

The performance results displayed in this presentation represent the actual results of the OPER ETF and the BIL. The performance results reflect the reinvestment and other account earnings, and are net of applicable account transaction and custodial charges, and advisory fees. This presentation is for informational purposes only and is not intended to be relied upon as investment advice, and is not a recommendation, offer or solicitation to make any specific investment, adopt any investment strategy, or to buy or sell any securities.

NAV -The market value of a mutual fund's or ETFs total assets, minus liabilities, divided by the number of shares outstanding. Market Value - Determined by the midpoint between the bid/offer prices as of the closing time of the New York Stock Exchange (typically 4:00PM EST) on business days

Alpha is an annualized return measure of how much better or worse a fund's performance is relative to an index of funds in the same category, after allowing for differences in risk.
Basis Point is a unit that is equal to 1/100th of 1% and is used to denote the change in price or yield of a financial instrument.
Covenant quality: A bond violation is a breach of the terms of the covenants of a bond. A bond with a low covenant quality rating is an indication that covenants are being violated consistently.
Junk Bond: Junk bonds are bonds that carry a higher risk of default than most bonds issued by corporations and governments.
The London Interbank Offered Rate **(LIBOR)** is a benchmark interest rate at which major global banks lend to one another in the international interbank market for short-term loans.
A certificate of deposit (CD) is a product offered by banks and credit unions that offers an interest rate premium in exchange for the customer agreeing to leave a lump-sum deposit for a pre-determined period of time.

All investments involve risk and there are no guarantees that any such investment will be profitable.

Past performance is not indicative of future results. *Portfolio risk cannot be completely controlled.*

Before investing you should carefully consider the Funds' investment objectives, risks, charges and expenses. This and other information can be found in the OPER and BIL prospectuses, a copy of which may be obtained by: OPER: call 212.359.0269 or visit *www.clear-shares.com and BIL: call 1-866-787-2257 or visit www.spdrs.com. Please read the prospectuses carefully before you invest.*

Investing involves risk, including the possible loss of principal. Shares of any ETF are bought and sold at market price (not NAV) and may trade at a discount or premium to NAV. Shares are not individually redeemable from the Fund and may be only be acquired or redeemed from the fund in creation units. Brokerage commissions will reduce returns. The Fund invests in fixed income securities, that involves certain risks including call risk, credit risk, event risk, extension risk, interest rate risk & prepayment risk. Repurchase agreements may be construed to be collateralized loans by the Fund, and if so, the underlying securities relating to the repurchase agreement will only constitute collateral for the seller's obligation to pay the repurchase price. If the seller defaults on its obligation under the agreement, the Fund may suffer delays and incur costs or lose money in exercising its rights under the agreement. A seller failing to repurchase the security coupled with a decline in the market value of the security may result in the Fund losing money. The Fund may invest in repurchase agreements that are deemed illiquid due to having a term of more than seven days. Please refer to the prospectus for additional risks of investing in the fund. Investment Company Risk. The risks of investing in investment companies, such as the Underlying Funds, typically reflect the risks of the types of instruments in which the investment companies invest. By investing in another investment company, the Fund becomes a shareholder of that investment company and bears its proportionate share of the fees and expenses of the other investment company. The Fund may be subject to statutory limits with respect to the amount it can invest in other ETFs, which may adversely affect the Fund's ability to achieve its investment objective. Investments in ETFs are also subject to the following risks: (i) the market price of an ETF's shares may trade above or below their net asset value ("NAV"); (ii) an active trading market for an ETF's shares may not develop or be maintained; and (iii) trading of an ETF's shares may be halted for a number of reasons.

Stocks are generally perceived to have more financial risk than bonds in that bond holders have a claim on firm operations or assets that is senior to that of equity holders. In addition, stock prices are generally more volatile than bond prices. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. The tax treatment of returns of bonds and stocks also differs given differential tax treatment of income versus capital gain. Treasury Bills are guaranteed as to the timely payment of principal and interest and are backed by the full faith and credit of the U.S. Government.