



Private Banking  
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# INVESTOR'S REVIEW

ESPECIALLY FOR LEUMI UK PRIVATE BANKING CLIENTS

## Macro Economic Review

By: **Eyal Raz**, Head of Economics Department, Finance and Economics Division

**"Leumi - The Best Private Banking in Israel"**

(Euromoney Survey, February 2009)

### What's in "Investor's Review"

- Macro Economic Review
- The New Tax in Brazil
- Mutual Funds vs. Exchange-Traded Funds

### Select Indices

	Rate	Return in % October	Return in % 2009
TA 100	957	3.19	69.71
TA 25	1,022	2.70	56.09
DOW JONES	9,962	2.48	13.52
NASDAQ	2,097	- 1.17	33.01
NIKKEI 225	9,891	- 2.39	11.64

Representative rates October 31, 2009

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### *The composite state-of-the-economy index indicates rapid growth in the third quarter*

The composite state-of-the-economy index rose 1.2% in September. This is the fourth consecutive month in which the index has increased, following 11 straight months of declines. According to the index, it appears the duration of this recent recession was similar to the average duration of recessions seen over the last three decades. The third quarter of this year is showing signs of being a quarter in which growth accelerated in the country's business sector; while the Bank of Israel (BoI) notes in its announcement of the state-of-the-economy index that its increase "strengthens the assessment that a positive turnaround in economic activity is occurring."

The components of the index indicate a recovery in activity in the industrial sectors, alongside a continuation in the expansion of activity in the trade and services sectors, in which there began a change in the trend already six months ago. Since the industrial, trade and services sectors account for a majority of the business sector, it appears the economic recovery reflects today a positive trend in an increasing variety of sectors.

### *The results of the most recent companies survey strengthens the feeling of improvement in economic activity*

The third quarter companies' survey of the BoI indicates a continued recovery in economic activity in Israel's business sector, while the net balance of responses (the difference between the rate of companies and businesses that reported an increase in activity and the rate that reported a decline) indicates a slight increase, primarily influenced by the moderate increase in domestic activity. This trend can also be seen in an analysis of the retail and construction sectors, as well as in the industrial sectors. Regarding the final quarter of the year, companies in the industrial (especially the export sectors), retail, business services and construction sectors all expect an increase in economic activity. When taking a look at the business constraints noted by companies in the economy, we see that in the area of supply constraints only one "slight" constraint stands out in most sectors – and that is in the realm of financial constraints (the exception is in the construction sector where this constraint ranges between "slight" and "medium").

Against the backdrop of the aforementioned, there appears to be congruence between the macro-economic data recently published and which is also reflected in the composite state-of-the-economy index, and company reports that, in retrospect, it turns out presented in the past a pessimistic outlook relative to the economic reality: the recovery came faster than expected.

### *No change in the interest rate of the BoI*

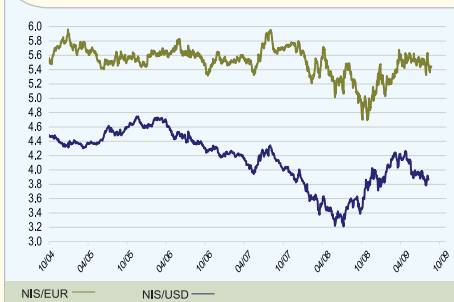
On October 26 the BoI announced that its interest rate for November will remain unchanged at 0.75%. BoI noted in its announcement the turnaround in economic activity that is continuing; and this while maintaining inflation (excluding seasonality and the impact of the rise in prices that stem from taxes and levies) at an annualized rate near the middle of the price stability target range (1-3%). Inflation expectations derived from the capital market are close to the middle of the target range. Regarding the global economy, it was noted in the BoI interest rate announcement that the estimates are that inflation around the world will remain low; and therefore, monetary policy in many countries will continue to be expansionary in the coming months.

It appears the following list of factors will continue to hold significant importance and weighting in upcoming interest rate decisions: (1) an inflation environment within the target range; (2) uncertainty regarding future economic growth due to the dependence of Israel's rate of recovery on the global economy; and, (3) the expectation that global interest rates will remain low in the near term. These factors combine with the assessment that the BoI is less concerned today about the impact a negative real interest rate has on inflation in the economy, and thus is overweighting support for economic activity. Looking forward, this approach, if it will be maintained, means that in the absence of any extraordinary data, the interest rate is expected to remain at its current level also in the coming months.

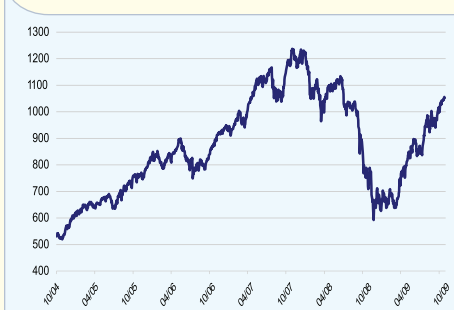
# The New Tax in Brazil

By: **Ofer Hillel**, Senior Analyst, International Markets, Leumi International & Private Banking Division

EUR and USD vs. NIS



TA25



Oil prices per barrel (USD)



Gold prices (USD)



On 20/10/2009, the Brazilian government launched an IOF tax (Imposto sobre Operações Financeiras - Tax on financial operations) of 2%, applicable to foreign exchange inflows related to the purchase of any instruments (such as equities and bonds) in the Brazilian market, in the local currency.

The tax is levied once, on capital flow into the Brazilian securities markets. Once it is paid, additional transactions are exempted from additional tax payment. Furthermore, the tax is only applied to foreign capital converted it into Brazilian Real and invested in Brazilian capital markets (equities and bonds), where ADRs, Eurobonds, imports and exports and direct investments in the country are not affected by this new tax.

As an example of the IOF tax methodology, let's consider an investor who needs a total amount of BRL 100,000 to fund local purchases. The amount required for the FX would equal  $BRL 100,000 / (1 - 0.02) = 102,040.81$ . To put this another way, the purchase price represents 98% of the total FX requirement, with the remainder being the IOF payment.

This new law's declared goal (according to Brazilian Minister of Finance, Mantega) is to prevent a further strengthening of the domestic currency, after it had appreciated by approx. 35% since the beginning of the year. We reiterate that a similar tax was imposed in Brazil at the beginning of 2008, but even then, similarly to the present, the decision enjoyed a most limited success over a short period of time, however the currency continue appreciating immediately afterwards. That same tax was canceled in October 2008, in view of the credit crisis.

The previous tax of 1.5%, (in contrast to the current 2%), was imposed only on bonds while no tax was imposed on equities. Surely this time the goal is different. As may be recalled, the declared reason for the first round of tax charges on foreign capital was to prevent interest rates arbitrage. A similar action at present would not be effective, since within the foreign capital inflow of approx. \$26 billion into Brazil since the beginning of 2009, only \$6 billion was directed at the bonds market while approx. 20 billion was diverted to investments in equities! (Therefore, it is truly surprising that in dollar terms, the Brazilian capital market crawled at only approx. 180% over the past year).

If Brazil continues to exhibit solid and continuous signs of recovery, along with continuing signs of economic improvement, indubitably, this new-old tax will have no effect on investors, who perceive investment opportunities in a growth orientated country. There is the risk that the action will not produce the expected results and, therefore, will result in damage to exports, an increase in the government deficit and an increase in the current account deficit, as domestic demand would be limited to the growth rate of the domestic economy's output only, following a slowdown in capital movements, which go hand-in-hand with capital investments. On the other hand, if the procedure is effective, it could stimulate the central bank to raise the domestic bank rate higher than expected. In any event, it appears that, currently, an investment in Brazil embodies a fairly high risk.

# Mutual Funds vs. Exchange-Traded Funds

By: **Galia Ozdogan**, Product Services Manager, Leumi International & Private Banking Division

Most investment professionals agree that diversification among various financial products and industries, is the most important component of reaching long-term financial goals while minimizing risk. The simplest and most convenient tools for such diversification are mutual funds and exchange-traded funds.

## The basics

Mutual funds – which are a collection of stocks, bonds or other investments – are considered the simplest way to access wide segments of the stock and bond markets. The money invested in a mutual fund is pooled with other investors' and used to buy dozens or hundreds of different securities that provide instant diversification that is often too expensive to achieve directly. Exchange-traded funds (ETFs) are similar to mutual funds and typically represent a basket of securities that correspond to a specified financial index.

## Investment diversification

Thousands of mutual funds offer access to most types of investments – from the broadest reach to international markets to niche categories. Historically, ETFs have covered specific markets as opposed to broad markets (in fact, out of nearly 2,200 ETFs on Morningstar's database, only five global equity ETFs have five-year track records). These days, one may find both mutual funds and ETFs that fit investment needs.

## The mechanics

The pooled money in a mutual fund is used to purchase a wide variety of securities. Investors do not actually own the underlying stocks or bonds; instead, they own shares in the fund itself. As the value of the underlying securities rises and falls, so does the net asset value (NAV) of the shares. Most mutual funds are actively managed, whereby a portfolio manager looks for securities that fit the fund's overall objective, with a goal to outperform its benchmark.

ETFs, on the other hand, seek to track an index – either fully, by purchasing the same securities with the same weightings, with the aim of providing low tracking error, or synthetically, via equity-linked or total-return swaps. ETFs using swaps are very common, so counterparty risk is an important consideration – where investors think they are buying an index, they are actually buying futures and, in some cases, only a portion of the names in the index.

## Costs

The average active mutual fund costs 1.4% annually, while the average ETF charges 0.55%. Actively managed funds are more expensive as a result of due diligence – fund managers often meet with management, talk to customers and analyze financial statements – in an effort to outperform the benchmark. ETFs "simply" track the performance of various indices, which do not change their underlying components

very often, leading to fewer trades and lower costs. Still, ETFs are getting pricier as a result of narrower focus and increasingly complex strategies.

Additional fees require attention – ETF transactions trigger brokerage commissions and some mutual funds charge "load" fees when buying or selling shares. If making regular contributions over time, buying a mutual fund may be more cost-effective. If rolling over a lump sum, however, an ETF may be a better vehicle.

## Pricing and trading

Mutual funds trade once daily, at the end of the business day, because the price of the shares is based on the NAV of all underlying holdings. A mutual fund share price, therefore, accurately reflects the value of the underlying assets, but is known only after the trade. Share prices of ETFs, which trade continuously, are determined by supply and demand among investors throughout the day, with the potential for trades above or below the true NAV.

## Dividend differences

Most mutual fund investors take advantage of their fund's automatic dividend reinvestment feature. That saves them the hassle of deciding what to do with the cash that comes their way periodically. If and when the mutual fund pays out a cash dividend, it is automatically reinvested in shares, or partial shares of the fund.

With dividend-paying ETFs, dividends wind up in the brokerage account instead, just like the dividend on a regular stock. To reinvest that cash, one must make another purchase with brokerage fees in toe.

## Tax issues

ETFs are quite tax-efficient, as they allow an investor to pay most of his capital gains tax upon final sale of the ETF. Delaying it until the very end is valuable because the amount that would have been paid to taxes can continue to accumulate wealth. Exactly how much an investor benefits after-tax depends on their marginal tax rate, the return of the investment, and how long they hold the investment.

Traditional mutual funds accumulate unrealized capital gains liabilities for stocks that have risen in value. Upon sale of these stocks the fund calculates and periodically distributes the capital gains to its investors in proportion to their ownership.

## In Summary

The lines between the asset classes are getting blurry as various mutual fund managers offer index-tracking funds and some ETFs actively manage the investments or use sophisticated quantitative models to choose securities. However, both mutual funds and ETFs provide diversified access to global and niche markets, each with its unique advantages and disadvantages.

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