Intellectual Property: The world's great unknown asset class

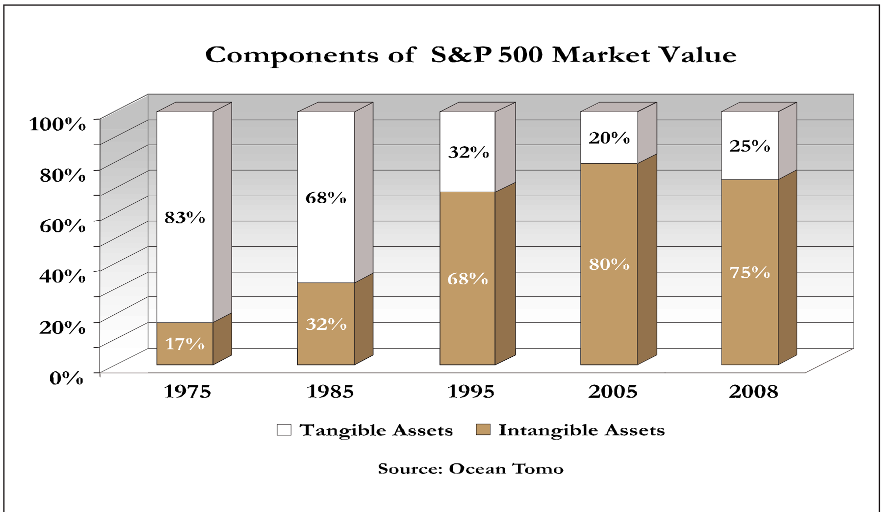
Intellectual property (IP) is not only the biggest asset class on the planet, but likely the most opaque, too. As to date, no transparent market or price discovery mechanism exists, and investors find it difficult to leverage their positions according to IP. Now, four IP-enhanced indexes spearhead IP as an investable asset class.

Though you may not be aware of it, intellectual property (IP) is the biggest asset class on the planet, estimated at more than $5.5 trillion, in the U.S. alone *(The Economic Value of Intellectual Property. Hassett and Shapiro)*. That's bigger than the GDP of any country. Moreover, in the last 30+ years there has been a shift in corporate value from tangible assets like factories, machines, and land, to intangibles, such as patents, copyrights, trademarks, industrial design rights, and trade secrets. Consider the following research from Ocean Tomo (OT), a leading merchant banc in the IP space. The data shows that in 1975, only 17% of the value of S&P 500 companies was found in intangibles. In 2008, by contrast, 75% of the value of these companies is in intangibles. Additional OT research on intangible versus tangible assets, in non-U.S. markets such as Europe and China (using the Euro Stoxx 50 and Shanghai Composite indexes as benchmarks), shows similar results. The message is, that value in the companies the world cares about most, resides in their protected ideas, rather than in hard assets.

To traders and investors looking for an edge, there is a clear take-away from this data. If you want to find corporate value, you must be able to identify key IP metrics. This is not to say that traditional metrics commonly used to gauge growth and predict stock price targets are obsolete. It is still reasonable, for example, to analyze earnings, read SEC filings, consider macroeconomic factors, monitor insider transactions, and look at technical indicators, just to name a few, widespread investment due diligence practices. However, if the majority of a company's value resides in intangibles, it seems self-evident that understanding that value repository gets you closer to knowing what the company is worth. In other words, rather than trying to determine what the company's P/E ratio ought to be or whether to be a buyer or seller of the stock at the 200-day moving average, go to the real source of value, look to the IP.

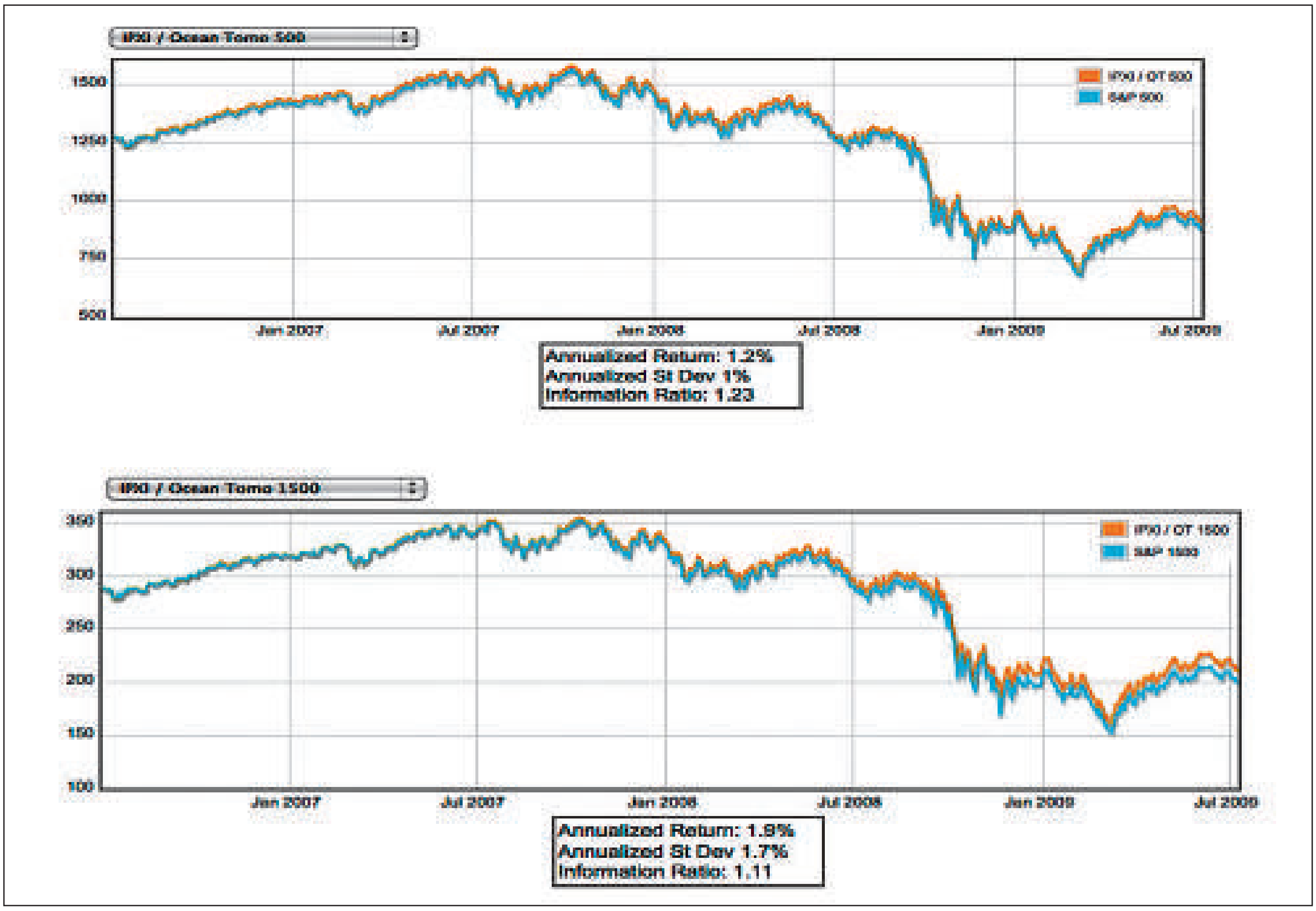
"Intellectual property is the biggest asset class on the planet."

To put an especially fine point on the subject, it is fair to say that the value of a corporation's IP is a unique, forward-looking indicator of corporate value. The reason for this is intuitive: the most innovative companies, i.e., those companies with the strongest IP portfolios, tend to outperform their peers as a result of: a) the government granted monopoly on the production of the patented, copyrighted or trademarked product or service; b) related economies of scale; c) premium pricing associated with unique features; and d) lower costs due to protected methods of manufacturing.



So, what sort of data should the prescient trader or investor consider? The following is a good starting list:

- How many patents does a company own?
- Which technologies do those patents cover?
- What is the average age of those patents (patents have a finite life, for example, 20 years in the U.S.)?
- How many new patents is the company bringing through the pipeline and how many patents is it abandoning (companies abandon more than 60% of their patents by Year 12 because they cost more to maintain than they produce in revenue)?
- What is the value of the company's brand?
- Does the company own valuable trade secrets?
- What is the effect of interest rate fluctuations on the company's research and development budget?

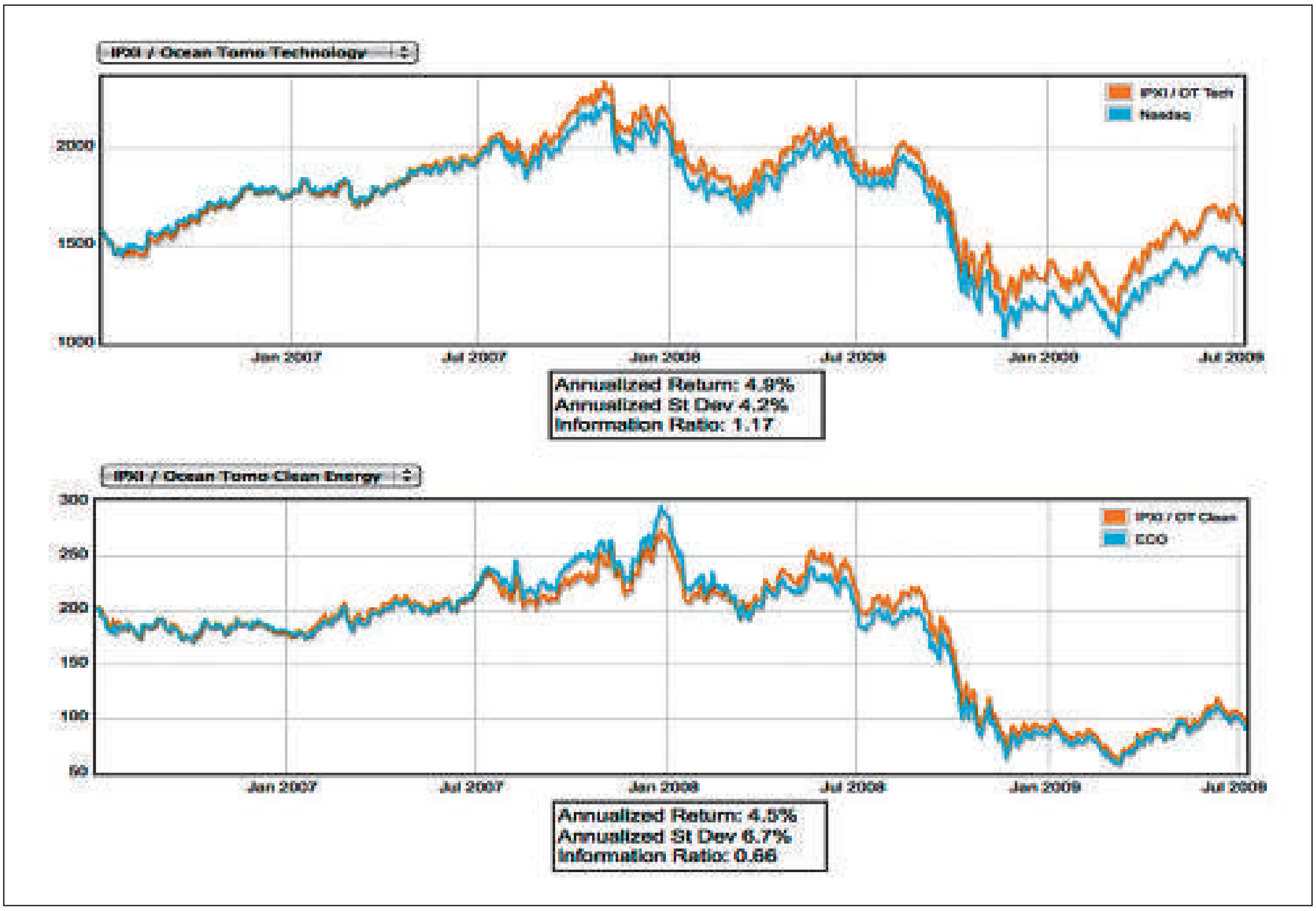


- Is there significant litigation surrounding a company's IP?
- What is the effect of merger and acquisition activity?
- Are there paradigm shifts in a particular technology that will fundamentally alter the way people utilize a product or service (e.g., Blu-ray, a cure for cancer, or hybrid automobile technology)?

Some of this information is readily available. For example, the United States Patent Office produces a voluminous amount of data about issued patents. In reality, however, it is enormously difficult for most traders or investors to incorporate IP metrics into an investment strategy or trading model. Because there is no central marketplace for IP transactions, as in the cases of foreign exchange, interest rates, equities or commodities, there is virtually no transparency as to IP transaction prices or volumes and this inhibits even the most motivated market participants.

Because markets abhor a vacuum, OT, in partnership with its affiliate, the Intellectual Property Exchange International (IPXI), has developed a family of IP indexes and related exchange traded funds that IPXI will introduce to the marketplace in 2010. Based on a patented database called Ocean Tomo PatentRatings® system, that allows for the rating of any of the 7 million U.S. patents (a European patent ratings system developed jointly by OT and the French bank Caisse des Depots will be introduced in the fourth quarter of 2009), these trading products will enable money managers, investors, and traders to generate *excess returns with less risk*, in a transparent, liquid marketplace.

Here's how the IP indexes work. An existing underlying index is chosen, such as the S&P 500, and enhanced by IPXI/OT using a 130/30 weighting; increasing weights in companies with long IP signals and reducing weights in companies with short IP signals (in both cases 30% is in total). Thus far, IPXI/OT has developed 4 IP-enhanced indexes, based on, respectively, the S&P 500, S&P 1500, Nasdaq 100, and Wilderhill Clean Energy Index, and IPXI has the



capability to create any IP-based absolute return or benchmarked fund for which size, style and sector criteria are specified. With respect to the current 4 indexes, the enhanced index outperformed the underlying index with a better information ratio in each case (see charts above).

Achieving such performance is like finding a unicorn or getting a clear photo of the Loch Ness Monster; it is what every index developer hopes to find: more alpha, less risk. With the IPXI/OT enhanced IP indexes, investors and traders can easily implement two discreet strategies to capture the IP alpha. They can simply buy the enhanced index in place of the underlying, or execute a spread between the underlying and enhanced index and lock in a risk-free profit. While these are the most obvious strategies, it is expected that when the IP-enhanced ETFs are actively trading, additional strategies will be implemented by traders and investors attracted by the appeal of IP alpha.

IP-enhanced indexes are an exciting innovation but, ultimately, nothing more than a means to an end. IP is a vast and vastly inefficient market. At even a quick glance to any seasoned market participant, the IP market looks a lot like FX or interest rate markets in the 70s, or energy and stock indexes in the 80s. In each of these cases, the markets in question were, themselves, vast and vastly inefficient. However, because the world needed price discovery and liquidity, markets developed. There were fits and starts, nothing as massive as the creation of a global market happens without some amount of chaos, but there was never any doubt that the markets would grow. So too with the IP market. Indexes and ETFs are only the beginning. It won't happen overnight, but as the world's largest and most important asset class, IP is destined to become as transparent and liquid as any market on the planet.

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