Spreading the word

As word of mouth spreads about **exchange traded funds** (ETFs), increasingly more investors are asking about their uses and benefits. **Axel Lomholt**, head of ETF products at iShares, takes an in-depth look at the instruments

Exchange traded funds (ETFs) combine the advantages of both index funds and stocks. They are liquid, easy to use and can be traded in any quantity just like stocks. At the same time, an ETF provides the diversification, market coverage and low expenses of an index fund.

These characteristics combine to create an investment tool that provides investors with the broad exposure they require, at the level they want and at the moment they need it. As such, they are fast gaining a reputation as an innovative investment solution – a claim greatly supported by the accelerated growth in ETFs.

In recent years, we have seen a dramatic expansion in the number of indices, styles and asset classes covered by ETFs, with a particular emphasis on country-related products, single-country exposure, regional indices and sectors. The primary asset classes in which ETFs are available include:

- Large cap stocks
- Mid cap stocks
- Small cap stocks
- Growth stocks
- Value stocks
- Sector stocks
- International stocks
- Emerging markets stocks
- Long-term bonds
- Mid-term bonds
- Short-term bonds
- Reits and listed property.

ETF growth

According to the Barclays Global Investors ETF landscape Q3, 2008 report, significant activity continues to take place. Globally, there were 1,499 ETFs, managed by 86 managers on

Source: Getty Images

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43 exchanges and with assets of $764.1bn. In addition, there were 268 equity trading permits (ETPs), with 521 listings and assets of $58.3bn managed by 26 managers on 14 exchanges.

BGI forecasts the ETF industry to grow in Europe to $200bn and globally to $1,000bn in 2009, reaching $2,000bn in 2011. The numbers of ETFs increased in the third quarter of this year, and in the year to date, 356 ETFs have been launched. There are plans to launch a further 601 ETFs: 55 in Europe, 486 in the US and 60 in the rest of the world.

The rapid growth of the ETF market has made it more important than ever to understand how to differentiate between products that, at first glance, appear very similar. Choosing the wrong ETF can negate the advantages of the product; namely, the ability to access an asset class cost-effectively and transparently. It is important that investors understand the differences between individual ETFs to ensure that the right ETF is selected for client portfolios.

iShares believes that there are five criteria to take into account when evaluating an ETF.

1. Know what the ETF owns

What securities does the chosen ETF index contain and how will this impact portfolio performance? Indices indicate the health of a market on a daily basis.

Indices also form the benchmark for an ETF's performance. It is therefore essential to understand the characteristics of an ETF's underlying index and whether this index is the most appropriate for a client's investment objectives. In many cases, there is no right or wrong index to use.

2. Consider total costs

The total expense ratio (TER) is only one cost factor to consider when owning or managing ETF portfolios. Costs are a key consideration when selecting an ETF.

Understandably, the TER – the total paid to cover the costs of fund management, trustees, licensing and operational costs – is an integral part of the decision-making process. However, an ETF's TER forms just one element of its total costs.

Investors should also consider the impact of additional implicit costs, such as trading costs and portfolio rebalancing. On the other hand, ETF portfolio managers can also take a number of actions that provide additional revenue which can be used to offset these costs. Any proper evaluation of the different ETF options should also consider the likely impact of these extra revenue sources.

3. Look inside liquidity

The liquidity of an ETF is another key consideration. The more liquid an ETF, the easier and more cost-effective it will be to trade. Conversely, poor liquidity can translate into difficulties in entering and exiting positions, alongside higher trading costs.

ETFs offer two levels of liquidity – traditional liquidity on-exchange or OTC (both referred to as the ETF secondary market) and the liquidity provided on the primary market by the creation/redemption mechanism. This creation/redemption mechanism allows authorised participants (APs) to exchange baskets of securities or cash for ETF shares (and back again) without meaningful impact to the underlying market.

This ability to create or redeem shares at any time maintains an ETF's price in line with its underlying net asset value, and ensures that liquidity is derived largely by the underlying securities within the ETF. While most investors trade on the secondary market, both secondary and primary markets need to work well to ensure an efficient market with tight spreads, translating into lower costs.

There are two questions to ask when deciding the best way to trade an ETF:

- what is the spread?

The spread on the ETF is the difference between the bid and the ask; it is the cost to the investor, imposed by the market-maker, of buying or selling the ETF. The spread should be as tight as possible around the mid price to make the purchase/sale competitive.

- what is the depth of the market?

The depth refers to the size of order an investor can execute. If the order book indicates an investor can buy/sell 10,000 units, then up to that amount of units can be bought without a need to consider any other method of execution. Larger transactions (typically the higher of 20 per cent average daily volume or five times the average order book) may require one to trade OTC directly with a market-maker.

4. Assess the structure

There are different types of ETFs, which carry their own unique exposure, risk and tax implications, so portfolio managers need to research these areas before selecting the most suitable product for client portfolios. There are three major types of exchange traded products: in specie-based ETFs (or cash-based), swap-based ETFs and ETCs (exchange traded commodities), also known as ETNs (exchange traded notes).

The following describes exchange traded funds and exchange traded notes.

There are two main types of ETFs, namely in-specie and swap-based ETFs. In-specie ETFs are often also referred to as cash-based or physical ETFs, as they hold the underlying securities of the index.

Swap-based ETFs invest in a swap offered by brokerage firms and banks to provide index exposure. The fund holds the swap plus a basket of non-benchmark securities.

ETNs are debt instruments and are not funds, but they do share several characteristics with ETFs, as both structures are linked to the return of a benchmark index and trade on exchange. Special types of ETNs are exchange traded commodities (ETCs), which are linked to commodities or commodities indices. Some ETNs are backed by physical assets, whereas others are backed by the issuer or a guarantor.

Product features common to ETFs, ETCs and ETNs are:

- Exchange traded
- Easy accessible investment vehicles for a wide range of asset classes
- Low tracking error
- Low costs
- Exposure to market risk of the asset class/index.

Specific to in-specie ETFs are

- Fund holds underlying securities in a ringfenced separate account exposing the investor to no counterparty risk of the issuer. In the case of failure of the fund issuer, the investor has recourse directly to the pool of underlying shares or bonds
- High transparency with regards to the holdings of the fund
- Opportunity for additional income to further reduce costs (i.e. through securities lending inside the ETF) is better than for other ETPs, as in-specie ETFs hold index securities
- Multiple market-makers can create and redeem new shares with the fund company, promoting a highly competitive pricing, both on and off exchange ("multi-dealer model")

Specific to swap-based ETFs are

- Fund holds a basket of securities (which can be different from the underlying index securities) and an index swap. The swap counterparty risk is limited to a maximum of 10 per cent of the value of the fund under Ucits rules. The investor has recourse to the basket of securities in the case of failure of the fund issuer
- Structure allows compliance with Ucits rules on more indices than cash-based ETFs (i.e. commodity ETFs)
- Tax advantages sometimes possible (i.e. avoidance of stamp duty)
- While multiple market-makers can price swap-based ETFs on and off exchange, every creation and redemption with the fund company generally involves a single swap counterparty.

Specific to ETNs, ETCs

- Investor owns a note, fully exposing the investor to counterparty risk of the note issuer. This risk is sometimes reduced through collateral or guarantees
- More flexibility to issue products, i.e. on single commodities and currencies
- Possible access to structured product-type solutions.

Table 1 highlights the differences of ETFs and ETNs with an emphasis on counterparty risk.

5. Evaluate the provider

Experience matters. Size, scale, expertise and commitment can vary significantly between ETF providers and these differences can impact on costs.

Portfolio managers should evaluate a provider's:

- Scale of operations to minimise costs and manage market impact
- Track record in index portfolio management, minimising tracking error and trading costs
- Dedication to providing servicing support and resources to investors, intermediaries and market participants
- Knowledge of index construction and methodology
- Commitment to product development.

ETF providers should have extensive experience of managing index investments, proven portfolio management skills and dedicated research teams. However, just as important should be the ETF provider's commitment to educating primary and secondary market investors on any new developments within the sector.

Conclusion

As we can see with the rapid growth of ETFs, there are a number of factors to take into account before selecting an ETF, not just cost. Evaluating ETFs often involves trade-offs. As an example, a client may prefer to invest in an ETF that is very liquid, with a low trading spread, even if it has a history of tracking error, because of its lower trading costs.

All clients have their own investment requirements and their own tolerance of risk versus return. The question portfolio managers should ask therefore is not: "What is the best ETF?" Rather, "what is the right ETF for this client's portfolio?" ■

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Core benefits

The core benefits of exchange traded funds are:

Transparency – investors know exactly which securities are held by the fund at any given time.

Flexibility – ETFs are listed on stock exchanges and can be traded at any time the market is open, meaning investors access continuous, real-time prices throughout the day.

Diversification – ETFs provide immediate exposure to a diversified portfolio of securities, while also providing access to a wide range of markets and asset classes that can help to diversify an existing portfolio.

Easy to use – ETFs are potent tools which are traded over the stock exchange, meaning that investors can buy and sell ETFs exactly as they would trade local shares – no additional operational setup is required, as is often the case with derivatives, and no new accounts need to be opened.

Liquidity – The unique primary and secondary market mechanism ensures that ETFs are highly liquid, and that liquidity will always be available for investors looking to buy or sell ETFs.

Cost effective – ETFs offer a cost-effective route to diversified market exposure. The average total expense ratio (TER) for equity ETFs in Europe is 49bp, while the average TER for the average equity mutual fund in Europe is 120bp (Fitzrovia 2008).

Table 1

	In-specie ETF (physical/cash-based)	Swap-based ETF	ETNs (ETCs)
Structure	Mutual Fund	Mutual Fund	Note
Underlying Holdings	Index securities	Index swap plus a basket of non-index securities	NA
Counterparty risk			
Fund/note issuer risk	No mutual funds hold assets in ring-fenced segregated accounts	No mutual funds hold assets in ring-fenced segregated accounts	Yes bears full exposure to credit-worthiness of note issuer
Swap counterparty risk	No	Yes Limited to 10% under Ucits	NA
Other risk considerations	Securities lending and dividend enhancement activity	Securities lending and dividend enhancement activity	NA
Transparency	Yes, full holdings disclosed	Limited	Limited
Exchange listed	Yes	Yes	Yes
UCITS Fund	Yes*	Yes*	No

* with exemptions possible