

## ETF Education Guide

### Summary

#### Exchange Traded Funds

ETFs are a hybrid of a share and a pooled index fund. They are traded on a stock exchange like a single share throughout the day. They have the advantage of providing instant diversification like a fund by tracking an index. The performance of ETFs closely matches that of the relevant underlying index. Clearing and settlement of ETFs is dealt with like any other share and can be bought and sold through any stockbroker.

Dividends accumulate over time and are paid out at regular intervals with the management fees being deducted directly from the dividend yield. At present ETFs do not incur stamp duty.

ETFs are simple low cost, diversified investments with no hidden charges.

#### Concept

ETFs represent a natural evolution of investing in shares and funds by combining the benefits of both.

Benefits of shares

#### Ease of clearing and settlement

Existing UK ETFs at the London Stock Exchange trade on SETS (stock exchange trading system) and settle in CREST electronically. There is no paper based certification or settlement - the whole process is "dematerialised".

#### Intra day trading during market hours

ETFs, like any share on the market, trade continuously throughout the day within market hours. This means that there is price transparency in real time and investors can see the value of their investments before, during and after any decision to trade.

#### Well regulated trading environment

ETFs trade on a stock exchange. This offers investors the comfort of a secure and orderly environment in which to conduct their investment transactions.

#### Available through any stockbroker

Like a share, ETFs can be bought or sold through a stockbroker allowing investors the choice of service they require (online / traditional / advisory / execution only).

#### Benefits of funds

##### Instant diversification

ETFs are collective investments and as such they represent immediate access to a diversified portfolio through the purchase of one single share. Broad market exposure reduces stock specific risk.

##### Active versus passive

Existing UK ETFs are passively managed which means that the stocks held within the fund are determined by an index. Therefore, the performance of the fund does not rely on the expertise or strategy of an individual manager.

##### Low cost

ETFs are pooled investment vehicles and therefore investors benefit from the economies of scale available to the entire scheme. Annual costs are in the region of 0.5%.

## Benefits of ETFs

### Open ended versus closed ended

Unit Trusts are open ended investments that are bought and sold directly with a Fund Manager.

Investment Trusts are closed ended investments that are bought/sold through a stockbroker.

	PRICE	DEALING
UNIT TRUSTS	<u>Advantage</u> subscribers buy their units of the scheme assets at around the net asset value	<u>Disadvantage</u> historic pricing / paper processing / admin in hands of single counterparty / slow settlement
INVESTMENT TRUSTS	<u>Disadvantage</u> investors do not buy in or sell out at prices that directly reflect the value of the scheme assets due to premiums and discounts	<u>Advantage</u> dealing and settlement are transparent, electronic and customer friendly - effectively they trade like stocks
ETF	<u>Advantage</u> price always very close to NAV with tight spreads	<u>Advantage</u> easy to deal just like a stock expect NO Stamp Duty

Exchange Traded Funds capture the benefits of both Unit Trusts and Investment Trusts (i.e. both efficient pricing and efficient dealing).

### Primary versus secondary market

The exchange traded fund structure enables authorised participants in the ETF to create new units in the fund at NAV whenever they choose. This is done in large size, typically worth more than £1 million, with a Creation basket usually to satisfy demand. The equities within this basket are in the precise proportions of the existing holdings of the fund. New ETF units are thereby created and available to investors within the secondary market, which is the listed environment on the stock exchange. ETFs should trade at a price very close to their net asset value, because if a premium or discount were to be sustained, an arbitrage on the price Vs NAV would offer a risk-free profit to authorised participants. They would either create new units or redeem old units by the physical transfer of the underlying fund constituents similar to a Unit Trust.

### Low cost

#### Pricing

#### All investors are treated equally

ETFs represent fair value to all investors, smaller individual investors and large institutions alike. The benefits of the structure are equally available to all.

#### No inherent gearing

There is not usually any leverage within an ETF. This means that the fund cannot borrow to increase its exposure to the marketplace. Accordingly, £100 invested will typically represent £100 value of equity exposure. This is not so with Investment trusts where gearing is allowed.

#### Volume is not the same as liquidity

Volume is defined as number of shares traded. Liquidity is the number of shares available to be traded. Therefore if volume is low this is not an indication that large orders to buy or sell an ETF cannot be placed in the market. The liquidity of the ETF relates to the liquidity of the underlying basket of shares. Large orders will usually often be transacted within the visible market price even when volume is low.

#### Premium/discount

The Exchange Traded Fund delivers a good deal to the client by trading at a price that is very close to the exact

value of the underlying stocks. The mechanism for creating new shares and redeeming old shares will prevent sustained premiums and discounts from occurring.

Fees

### **No hidden charges**

Unlike other collective investment schemes, Exchange Traded Funds DO NOT incorporate charges within their secondary market pricing mechanism. The share price will reflect the underlying value of stocks and market movement.

Furthermore since the fund is registered in Ireland an investor in the secondary market will not be liable to pay stamp duty under current regulations.

### **Low internal costs**

The costs involved within an ETF are exceptionally low. The costs of passive management is small and the administration/custodial charges are available to large funds at very competitive rates.

### **Trading costs are external to the fund**

Much of the expense of the investment process is external to the fund - i.e. broker commission, savings plan costs etc.

## **ETFs are global**

### **North America**

#### **Birth of ETFs**

The Exchange Traded Fund market has been established in the United States for some years now, where ETFs are listed and traded as securities (primarily on the American Stock Exchange in New York). To date all ETFs have been index tracking funds. The most well known are SPDRs (first launched in 1993) and QQQs (first launched in 1999) which track the S&P 500 and NASDAQ 100 respectively.

#### **Development of user base**

ETFs are accessible to all and hold many benefits. Retail investors are attracted by the simplicity of the product, not to mention low fees. Public Funds, Hedge Funds, Passive/Active Asset Managers and users of Futures Contracts have all participated in the benefits of ETFs.

#### **Range of uses**

ETFs can be used in a number of advanced investment strategies:

Instant Cash Equitisation ETFs can be used to effect the equivalent of say 500 trades in one deal.

Hedging ETFs can be borrowed and therefore can be used to sell short.

Optimisation Strategies Portfolios may have a company deleted from the index, ETFs can reduce the tracking error.

Relative Value Long/short baskets can offer market neutral opportunities on sectors, countries and asset styles.

### **Europe**

The first Exchange traded funds in Europe were launched on the Deutsche Borse and began trading in Germany. On April 28 2000 the UK's first Exchange Traded fund was launched: iFTSE100 on the London Stock Exchange under its new market segment extraMARK.

#### **Europe is different**

Unlike the single US market, ETFs that come to be listed on various European stock exchanges will have to be governed by various regulators. Furthermore creators of ETFs in Europe will confront many issues including differing taxation regimes and currencies. European investors will get products specifically designed for their specific domestic markets with all the tax / currency / trading advantages possible.

## **Value for money**

ETFs offer transparency and openness.

No frills

#### **Pure exposure to equities**

A fund whose assets comprise equities in the ratios determined by an index, offers a simple and transparent means to equity ownership. Since the fund is identified by the relevant index the nature of the equities owned

within the fund are self evident. So a country index will reflect the equities of the relevant country and a sector the direct holdings as indicated by the chosen benchmark.

This means that the ETF is an efficient investment tool that offers a pre-specified outcome to its investor

### **Product development potential**

ETFs are not burdened by the complications of elaborate investment strategies and the consequent fees structures. This means that the fund is an effective and low cost means to investment.

Accordingly product providers may want to use ETFs within their own new schemes that they establish to allow regular savings plans that meet the necessary criteria for ISAs or Pensions, with or without CAT marks.

The product provider would thereby simply be making a proposal to an investor on how to save/invest by offering administration services, when the actual process of equity investing is handled by the ETF.

Openness

### **Benefits of competitive arbitrage**

As an ETF grows it provides units in itself to new investors. Most open ended funds do this by accepting cash for subscriptions; this does not happen with an ETF.

The critical feature of an ETF is that professional securities dealers facilitate the subscription process with a transfer of physical shares. To meet subscriber demand new units are created when the shares are transferred into the fund, so enlarging the assets of the ETF. The process is completely transparent since the constituents of the fund are known, the price of the fund is known as are the constituents.

The mechanism of arbitrage available to the professionals in creating new units and redeeming old units should continually correct the price to accurately reflect the underlying assets.

### **Institutional expertise available to all**

The arbitrage activity and basket trading that it requires remains the preserve of institutional traders. Similarly the low cost of management charges levied against the ETF are usually only available to substantial investors who can create economies of scale for their managers.

However due to the ETF being available on an exchange and equally available to investors large and small, anyone can now participate in the benefits of such institutional expertise.

### **Disclaimer**

**The Investment Research Partnership does not act as an advisor or seller of any investment products. This information is only published as research material and cannot be relied upon as suitable advice for any investor. You are advised to consult with a qualified financial advisor before making any investment decisions regarding this or any other product.**