

For professional investors only

# Understanding Exchange Traded Funds (ETFs)





# What are Exchange Traded Funds (ETFs)?

Exchange Traded Funds are open-ended funds listed on a stock exchange, which are bought and sold like shares during regular trading hours. ETFs can contain a mix of assets such as shares, bonds or commodities and usually aim to track the performance of an index.

## What are the benefits of ETFs?



### Lower cost

As ETFs tend to offer passive exposure and aim to replicate a defined index, they are usually associated with lower management fees than actively managed funds.

ETF investing also offers lower commission fees than independently purchasing each security because one fee covers the entire transaction. Overall, these lower costs mean that more of your money is working for you.



### Portfolio transparency

Investors can easily view an ETF's current trading price and portfolio composition at any time. This provides constant transparency, which can be particularly helpful during volatile market conditions. It is also useful when creating a portfolio of ETFs in considering any overlapping exposures.



### Tax efficiency

Buyers and sellers typically trade ETF units on a stock exchange, without the need for interaction with the ETF provider. This means that transaction oriented taxes, such as stamp duty, are often lower.

Similarly, the tendency for ETFs to have lower portfolio turnover than many actively managed funds means there are often fewer transactions and therefore potentially lower taxes flowing through to ETF holders.



### Liquidity

Unlike other open-ended mutual funds, ETFs enable investors to buy and sell at any point while markets are open. This can be particularly valuable during periods of market volatility. Since ETF units can be created or redeemed at the Net Asset Value (NAV) every day, the liquidity of the underlying securities reflects the true liquidity of an ETF.



### Diversification

ETFs aim to replicate a specific index or market return, either by incorporating all qualifying securities or a representative sample. This therefore offers investors lower portfolio variability and can reduce the impact of volatile markets, particularly when compared to holding individual securities.

### Key risks:

The value of investments and income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

Shares purchased on the secondary market cannot usually be sold directly back to the Fund. Secondary market investors must buy and sell ETF Shares with the assistance of an intermediary (e.g. a stockbroker) and may incur fees for doing so. In addition, investors may pay more than the current Net Asset Value per Share when buying ETF Shares and may receive less than the current Net Asset Value per Share when selling them.

## How ETFs can be used

### Tactical Market Movement Opportunities (Short Term)

**Tactical adjustments** – Temporary shifting under- or over-weights by asset class, sector or region.

**Cash equalisation** – Maintain a fully invested portfolio, upon the receipt of client inflows or income.

**Transition and rebalancing** – Keep invested while switching between active managers or executing large trade lists.

**Hedging** – Reduce market exposure, no need to sell underlying holdings.

### Strategic Investment Objectives (Long Term)

**Portfolio completion** – Access asset classes traditionally available exclusively to institutional clients.

**ETF overlay** – Keep a liquid sleeve to fund trading and redemptions.

**Core vs. satellite approach** – Either by region or asset class, or by pairing active and passive.

**Portfolio building** – Effective solutions to create a complete portfolio.

# Get selective

With a large and growing number of ETFs now available there are a number of factors you need to consider when thinking about picking the right options.

## Evaluating ETFs

### Choose your exposure

Consider the various diversification benefits and drawbacks and then select desired level of exposure. This could be a broad market ETF with wide exposure or an ETF seeking superior performance by focusing specifically on one industry.

### Choose how to access the exposure

The majority of ETFs attain exposure through physical replication, while others use total return swaps. The latter receive the return of an index from a financial institution without hedging the underlying securities. Potential investors should analyse the counterparty risk and fees associated with the swap against the advantages the swap offers, such as a narrower tracking difference\*.

### Choose how the portfolio is weighted

While ETFs may target the same market segment or industry, they could use a different weighting scheme such as market capitalisation, equal weighting or factor weighting. The appropriate choice may differ across asset classes or through the preferences of specific investors.

### Choose a trusted provider

When selecting a provider, it is important to consider the following factors:

- Track record
- Product range
- Ability to recognise investment trends
- Capability to initiate industry development
- Financial stability.

#### \* Tracking Difference

This looks at how closely an ETF follows the performance of its chosen index. The tracking difference can be either positive or negative, depending on whether the underlying holdings have out- or under-performed the index.

Tracking difference is an important factor when assessing the total ownership cost of an ETF, and when comparing competing ETFs, as long as they track the same index.

## Building portfolios with ETFs

Due to their flexibility, low cost and wide range of investment options, ETFs can be a valuable tool in strategies to build an optimal portfolio.

### Three possible Portfolio Building Strategies using ETFs

- 1 Blending index and actively managed funds**  
Indexed funds offer market performance which matches the beta, or returns of the overall market or of a specific segment of the market. Active management, meanwhile, provides the potential for alpha (outperformance relative to the market) through individual security selection, sector allocation or other active strategies. Get the benefits of each type of investment by incorporating both into your portfolio.
- 2 Mix core and satellite investments**  
The core may be comprised of major asset classes combined to achieve a particular risk and reward profile. It is beneficial to use low-cost passive instruments for these exposures. Satellites have the potential to add value when combined with your core, but may be associated with additional risk and the inclusion of which are usually dependent on the market environment. For example, investors who want exposure to a less correlated asset class with a higher income potential could invest in an ETF that has historically exhibited these characteristics in the identified market cycle.
- 3 Employ a tactical short-term strategy**  
ETFs are an efficient means to dynamically adjust portfolio exposure through specific sector or segment investments on an on-going basis.

## Fixed income investing using ETFs

ETFs are a game changer for fixed income investing as they bring an over-the-counter (OTC) asset class to the stock exchange.



**Efficient Exposure** – the bond universe comprises a wide spectrum of risks, returns, credit qualities, durations, sectors and maturities. Rather than build a portfolio consisting of many individual bonds, fixed income ETFs provide investors with quick and cost effective access to diversified bond portfolios. These can either give broad exposure or target specific sectors and credit qualities, for example. Depending on individual and market circumstances, fixed income investors can choose specific sectors and maturities for their portfolios in order to get the precise exposure required.



**Pricing** – ETFs typically enjoy narrower spreads than individual fixed income securities as they can take advantage of aggregated volume on the exchange. This advantage of scale is similar to the difference between wholesale and retail pricing for consumer goods. The process of bond trading is often inefficient because the information necessary to make a sound investment decision is not easily accessible. The democratic nature of ETFs allows for price discovery since there are a wider range of market participants making their views known through their transactions.



**Liquidity** – certain fixed income securities are more difficult, time consuming and expensive to trade. ETFs provide access to fixed income asset classes that are difficult to access, such as convertible bonds.



‘We expect the ETF industry to continue on its current growth trajectory, buoyed by increased investor adoption.’

**Rob Thorpe, Head of Distribution, UK Intermediary,  
BMO Global Asset Management**

## Equity investing using ETFs

By using ETFs, equity investors receive a transparent investment vehicle that can be tailored to their specific goals or investment strategies.

### **Broad Market ETFs**

Often follows a country’s market index, giving exposure to a range of companies without specifying the industry. Reproducing the world’s indices would ordinarily require owning hundreds of securities and conducting regular portfolio rebalancing. However, with an ETF, the investor receives all the exposure at a fraction of the cost. This return after fees can have a large impact as your investment in the ETF compounds over time.

### **Sector Specific ETFs**

Provide exposure to a more precise group of companies based on their operating sector, such as small cap, utilities and socially responsible. The aim would be to identify macroeconomic sectors which will outperform the broad market.

### **Factor based ETFs**

These specify a set of criteria and rules, which investments must meet to be included in the ETF. Investors can therefore benefit from an investment strategy without having to build the strategy themselves. Examples of popular factor based ETFs are those focused on high dividend, low volatility or value stocks.

# Efficiencies of ETFs – expanding opportunities

Democratisation of investing – providing all investors with access to more niche asset classes, along with strategies and pricing traditionally available only to institutions.

The most well known example of ETFs expanding investment opportunities is with gold. Previously, gold was only bought directly through mints, dealers and jewellers. However, thanks to ETFs, gold can be traded in the same manner as a share, enabling smaller trade sizes, increased number of trading strategies, and greater trading convenience.

In addition, ETFs allow for very efficient trading through the matching of buyers and sellers on the exchange. As an ETF matures, the volume on the ETF will trade at narrower spreads, through natural liquidity, as more investors buy and sell on the exchange.

So not only do ETFs provide better access to asset classes, they can do so more efficiently as well.

## The true liquidity of ETFs

As an ETF comprises a basket of securities, its liquidity is best measured by the underlying securities which it holds.

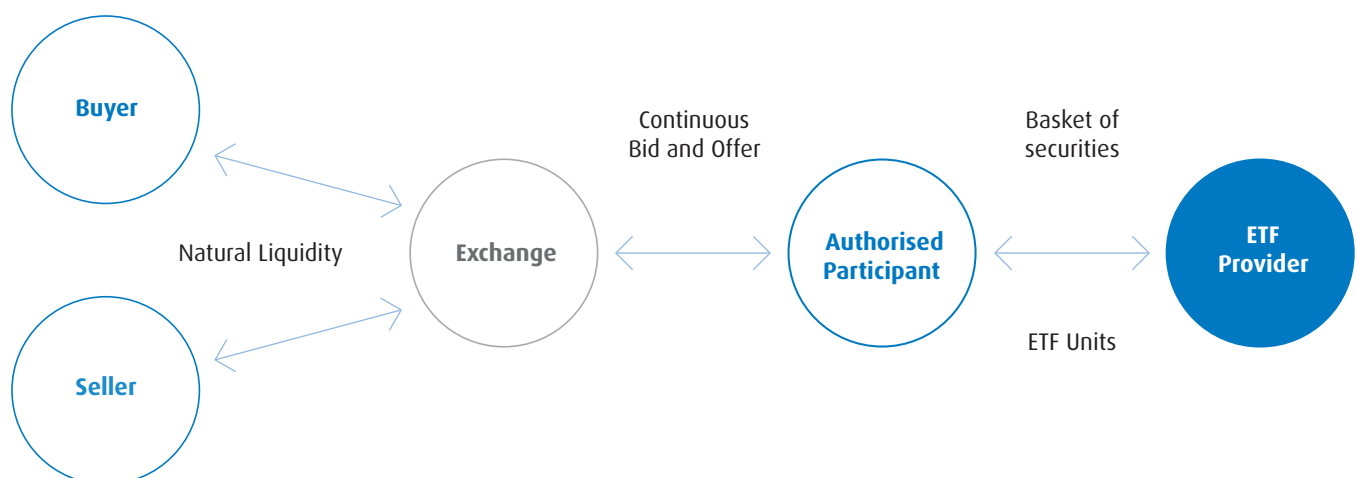
① High underlying trading volume = **Liquid**

② Low underlying trading volume = **Illiquid**

However, an ETF's underlying liquidity is also indicated by the difference between its buying and selling price, or the "bid-offer spread". Tighter spreads tend to suggest a more liquid ETF, even if the trading volume is low.

Another reason why seemingly similar ETFs may have different levels of liquidity is that they could use a different weighting scheme such as market capitalisation, equal weighting or factor weighting. The appropriate choice may differ across asset classes or by the preferences of specific investors.

## Liquidity mechanism



## How does the ETF liquidity mechanism work?

**1 First level of liquidity** – The natural liquidity created by interaction between buyers and sellers on the exchange. In fact, ETFs with high transaction volumes can develop even greater liquidity than their underlying holdings.

**2 Second level of liquidity** – Authorised participants post bid and offer prices on the exchange. This enhances liquidity and allows a buyer or seller to transact with minimal trading costs.

**3 Third level of liquidity** – Unit creation based on underlying securities. Authorised participants can offset an increase in demand by creating more units or offset a decrease in demand by redeeming units to tighten supply. For example, when a large buy order occurs, the authorised participant will buy the basket of securities and initiate a creation order with the ETF provider.

It is important for liquidity to be the foremost consideration when designing ETFs. Whilst keeping in mind that they have critical diversification benefits, ETFs are still subject to the liquidity of the underlying asset classes, just like other open-ended vehicles. As an ETF matures and becomes more popular, it usually becomes more liquid than its underlying portfolio as secondary trading between investors occurs.

When evaluating ETFs, the underlying liquidity is what matters. The true liquidity of an ETF is best measured by the liquidity of its underlying securities and allows for significant trade orders without having an impact on the price of the ETF itself.

We hope this brochure has helped you to better understand the world of Exchange Traded Funds and how they could be used to enhance portfolio returns.

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Telephone calls may be recorded.

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