

Exchange Traded Funds (ETFs)

Exchange Traded Funds, or ETFs, were created over 15 years ago in the US originally to provide a more efficient way for investors to track equity markets. They have evolved so that today investors can purchase ETFs which provide easy access and exposure to a wide variety of different and alternative assets.

Gaining direct exposure to these assets, such as timber, infrastructure or commodities (metals, wheat, livestock etc.), can be difficult for private investors as it often involves significant capital outlay. The assets themselves may only be traded on certain markets, there may be a limited number of market makers and access to capital may not be available daily. ETFs enable investors to share in the fortunes of these assets without being exposed to the same level of risk associated with direct investment. ETFs are a simple way to access a wide range of alternative asset classes.

What are Exchange Traded Funds?

An ETF is a pooled investment whose value is linked to an index which itself is based on a basket of assets. The index may be based on equity markets, specific sectors, bonds, commodities or even currencies, allowing a great diversity of investment opportunities.

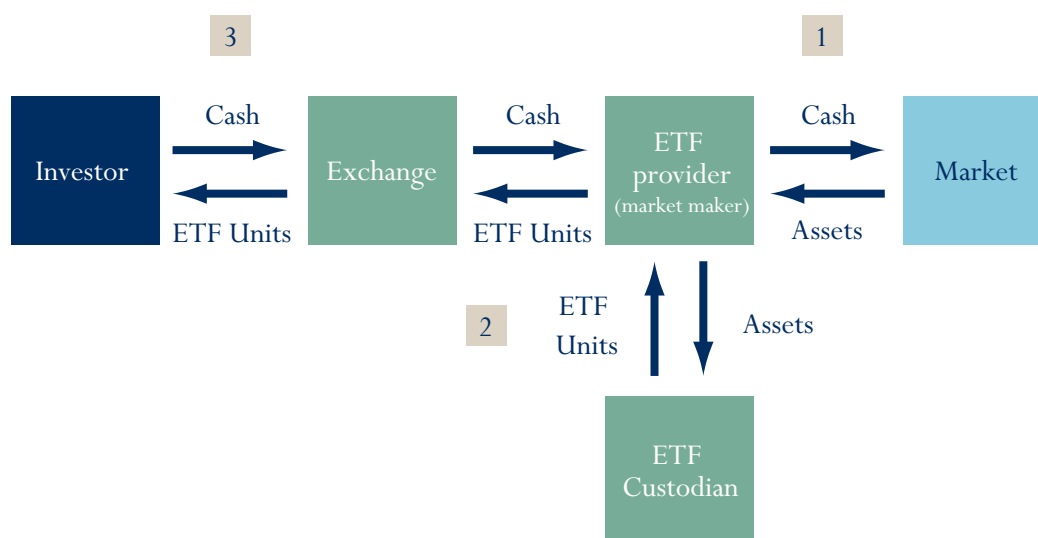
However, unlike traditional funds they can be traded like individual stocks and shares, on an exchange such as the London Stock Exchange, and can be bought and sold through brokers in the same way as any other listed share.

The first ETF was launched on the New York Stock Exchange in the US in 1993 and was based on the American S&P500 index. ETFs maintained a low profile in the financial world for a decade, used mainly by professional traders and fund managers. However, in the past few years awareness of them, and hence their popularity, has increased and in the US alone there are now over 600 ETFs. The first London Stock Exchange listed ETF launched in 2000 and the number of UK listed ETFs exceeded 100 late in 2007. At the end of 2007 the global ETF market was worth close to \$800bn. It is expected that global ETF assets under management will exceed \$2 trillion by 2011.

How do ETFs work?

An ETF is simply a basket of assets that trades like a single equity. It combines the benefits of a collective investment fund with those of owning an individual share. As ETFs are listed securities, trading occurs at market prices rather than at the net asset value (NAV). This means that although their price is expected to be close to the value of the underlying investments they can fluctuate depending on the supply and demand for the ETF shares.

The operation of ETFs can be separated into 3 distinct flows or transactions;



1. The ETF provider, or market maker, purchases a basket of assets, as specified by the ETF custodian, for cash.
2. This basket of assets is then exchanged with the ETF custodian for a set number of ETF units or shares (known as creation units).
3. The provider then has an inventory of ETF shares to sell investors on the open market.

If the constituents of the index being tracked change, the custodian informs the provider who purchases the new constituents and sells the old ones after they have been returned by the custodian.

How do ETFs replicate indices?

There are 3 main techniques for replicating indices used by ETFs:

Full replication – this technique involves buying each of the representative assets in the same proportion to their weighting in the index. So, an ETF would hold shares in each FTSE 100 company in its relevant market proportion to replicate the FTSE 100. Whilst this is the most accurate method for tracking the underlying asset, it is also the most expensive as each element of the index has to be bought or sold daily as the constituents of the index vary in value.

Strategic sampling – those assets which make up, for example, over 40% of the total index will be purchased by the ETF. The remainder of the index is ‘sampled’ by purchasing representative elements of the remaining sectors or regions. Using the FTSE 100 as an example, the top ten companies may be purchased which account for over 40% of the index. Then, since these are predominantly Mining, Financial and Oil & Gas related, the ETF may buy Tesco to represent Food & Drug Retailers and other stocks from other sectors in the FTSE 100. In addition, financial derivatives (*see Investment Bulletin 4*) may be used to passively track the market.

Synthetic replication – this technique will typically involve the manager investing directly into a portfolio of assets, usually readily available such as stocks and shares, but not those they wish to track. The returns on these assets will in turn be swapped for the return on a particular index or basket of other assets which are not as easily accessed but already held by another manager. For example a manager may buy 30 stocks from the FTSE 100 and swap the return on these for returns from a manager holding a collection of oil and natural gas futures contracts to gain access to energy commodity returns in a cost efficient manner.

What benefits do ETFs offer?

Diversification – Although this is possible by investing in a large number of assets across a range of sectors or markets, a single ETF share can provide a similar level of diversified market exposure. For example combining 5 ETFs, each replicating the UK, US, Europe, Japan and Asia, can provide a global portfolio more easily than investing directly, although clearly they do not benefit from the skills of an active manager.

Liquidity – Like shares, ETFs trade in real time on stock exchanges. They are liquid and can provide greater investment flexibility than other collectives, which tend to trade only once a day. The relative liquidity of different ETFs depends to a large extent on the liquidity of the underlying holdings. However, as a tradable asset in its own right, it is possible for ETFs to be liquid even if they have low trading volumes.

Accessibility – Sectors or markets are rendered more accessible even if they are small or only have a limited number of underlying constituents. Rather than try and buy all the constituents of the Brazilian stock market, a Brazil ETF allows equivalent access. Investors can gain exposure to literally hundreds of companies through a single transaction. ETFs allow access to specialised, traditionally difficult to access asset classes such as emerging markets, water and private equity.

Transparency – For ETFs, information on underlying assets is published daily. With many types of pooled investments this is not possible. This enables an investor to ascertain exactly what is being invested in and that it satisfies their investment criteria, keeping decision making simple.

Cost Efficiency – ETFs tend to have relatively low annual expense ratios. Due to the passive nature of index investing and the potentially reduced marketing, distribution and accounting expenses, expense ratios for ETFs are typically lower than those for collective funds. However, investors must still pay a brokerage commission to purchase and sell shares so active trading can increase costs.

Are there any risks involved in ETFs?

Tracking Error – An ETF typically pays out dividends and income received from the underlying assets on a quarterly basis. However, the underlying assets may pay dividends or income throughout a quarter. Therefore, the ETF may hold cash for various time periods throughout the quarter, even though the underlying index is not composed of cash. This is especially true with ETFs which cannot reinvest income and must hold cash. This can impact the performance, both positively and negatively depending on market conditions.

Market Forces – Also because an ETF's price can be impacted by market forces, i.e. supply and demand, the performance may not completely replicate the performance of the underlying index.

Why are ETFs described as passive?

Actively managed funds typically aim to beat the performance of the index of the market or sector to which they belong. In order to do this the manager must actively make decisions as to what underlying assets are held in the fund.

Index-based products such as ETFs on the other hand have a clear objective of matching the performance of a specified market or sector index. In order to do this the mix of underlying assets within the ETF is based on the underlying index and therefore there does not need to be any active management. Hence a 'passive' approach.

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