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Exchange Traded Funds

An introduction, provided by SPA Exchange Traded Funds.

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What is an Exchange Traded Fund?

An Exchange Traded Fund (ETF) is a collective investment vehicle that seeks to mirror the performance of a chosen index and trades like a single stock. This means that it provides the diversification benefits of an index tracking fund with the liquidity benefits of trading an individual share. ETFs generally track the performance of a stock, bond, or commodity index. Similar to individual stocks, each ETF has a ticker, SEDOL and ISIN number and is traded on a stock exchange.

The first widely recognised ETF originated in the early Nineties in the U.S. and was based on the American S&P500 index. From this beginning, Morgan Stanley now estimates that global ETF assets under management will exceed US $2 trillion by 2011 and at the end of 2007, the global ETF market was worth close to $800bn.

After the subsequent successful development of the U.S. ETF market, the European ETF market is today one of the fastest-growing segments of the European asset management industry. There were over 100 new ETFs launched in Europe in 2007 and in particular, the UK market has flourished, showing particularly strong growth since the recent removal of stamp duty levy on overseas-listed ETFs.

Worldwide ETF and ETP Growth

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
ETF Assets USD Billions	$0.81	$1.12	$2.30	$5.26	$8.23	$17.60	$39.61	$74.34	$104.80	$141.62	$212.02	$309.80	$412.09	$565.59	$796.60
ETF Commodity Assets USD Billions									$0.04	$0.11	$0.32	$0.46	$1.20	$3.38	$6.32
ETF Fixed Income Assets USD Billions								$0.12	$0.10	$3.97	$5.83	$23.05	$21.32	$35.75	$59.93
ETF Equity Assets USD Billions	$0.81	$1.12	$2.30	$5.26	$8.23	$17.60	$39.61	$74.34	$104.66	$137.54	$205.87	$286.28	$389.57	$526.46	$730.28
ETP Assets USD Billions													$15.58	$28.11	$45.87
# ETFs	3	3	4	21	21	31	33	92	202	280	282	336	461	714	1,171
# ETPs													23	70	134

spa exchange traded funds

SPA ETF is a specialist provider of Exchange Traded Funds. SPA's ETFs utilise the performance of innovative stock indices created by MarketGrader, an independent research provider used by some of the world's leading investment houses.

How do ETFs work?

An ETF is simply a basket of securities that seeks to mirror the performance of a chosen index and trades like a single stock. This means that it provides the diversification benefits of a collective investment vehicle and the liquidity benefits of trading an individual share. ETFs generally track the performance of a stock, bond, or commodity index. Similar to individual stocks, each ETF has a ticker, SEDOL and ISIN number and is traded on a stock exchange.

Because they are listed securities, trading occurs at market prices rather than at the net asset value (NAV). Generally, an ETF is expected to trade close to the NAV of the underlying shares but the market price will fluctuate in accordance with changes in the NAV and the supply and demand for the ETF shares.

Investing in an ETF

The most common way to buy or sell shares is through a broker, such as SelfTrade, in the way you would a normal share. Purchasing ETF shares on the London Stock Exchange does not incur stamp duty in the United Kingdom. ETFs listed on the London Stock Exchange are eligible for inclusion in both Individual Saving Accounts (ISA) and Self Invested Pension Plans (SIPPs).

Some common questions:

How are Dividends treated?

ETFs attract the dividends of the underlying investment in the same way as a normal fund. Whether these dividends are distributed on a regular basis or accumulated to the fund depends on the individual ETF.

How liquid are ETFs?

The relative liquidity of different ETFs depends to a large extent on the liquidity of the underlying stocks. The more liquid the underlying stock is, the easier it is for Authorised Participants or Market Makers to assemble the creation units which facilitate trading. This means it is possible for ETFs to be liquid even if they have low trading volumes.

Can you short sell ETFs?

It is possible to sell an ETF short (sell an ETF one does not own in anticipation of its price falling), but availability for private investors will often depend on the type of account they have. Short ETFs have recently been developed that move contrary to the index, enabling private investors to speculate on price falls.

Can ETFs be included in tax efficient wrappers?

Yes, provided the funds are compliant with UCITS III regulatory standards, ETFs can be held within ISAs, SIPPs and Investment Bonds.

ETFs vs other investment vehicles

	ETF	Open Ended Investment Fund	Investment Trust	Listed Closed End Fund
Trading	Any time during stock exchange trading	Once a day at most	Any time during stock exchange trading	Any time during stock exchange trading
Accessibility	Via a stockbroker	Via fund manager or fund supermarkets	Via a stockbroker	Via a stockbroker
Price vs Net Asset Value	ETFs' market price tends to trades in-line with the NAV of the fund	Price related to NAV	Typically trade at discount or premium	Typically trade at discount or premium
Transparency	Daily information on portfolio and intraday prices	Monthly updates	Monthly updates	Monthly updates
Dividends accrued	Yes	Yes	Yes	Yes
Long/short	Possible to invest long and short	Possible to invest long and short	Possible to invest long and short	Possible to invest long and short

The benefits of ETFs

Diversification
Through just one ETF share you can gain diversified market exposure

Liquidity
As ETFs trade in real time on stock exchanges, they are liquid and can provide greater investment flexibility than mutual funds, which tend to trade only once a day.

Transparency
With ETFs, information on underlying securities is published daily. With many types of pooled investments this is not possible.

Cost Efficiency
ETFs tend to have relatively low annual expense ratios. There is no stamp duty or load fee, so costs are often significantly lower than those associated with traditional unit trusts and Open Ended Investment Companies (OIECs), so for many investors ETFs will represent a lower cost investment tool.

What should I consider when I evaluate an ETF?

Before buying an ETF, there are a number of general factors to consider – clearly you need to review all of the documentation published by the ETF provider and understand the risk of the investment. It is always worth checking for specific risks and any tax implications. ETFs with international exposure may well expose you to currency risk, for example. Once you have decided on a strategy to pursue, there are a few key areas to look at when comparing ETFs.

Tracking error – the difference between the fund's return and the index return. The main causes are:

a. **Transaction costs** – Each trade involved in tracking the underlying index properly involves costs, including the spread between the bid and ask prices for each underlying equity.

b. **Annual fees** – a fee charged by the ETF Provider to cover the cost of running the ETF

Bid offer spreads – the difference between the bid and offer price for an ETF. This is the price you pay to invest or to sell, rather than the NAV price. Bid/ask spreads should be within a tight range of the NAV.

Different types of ETF

Equities
ETFs that track equity indices can be put into two broad categories – those that track well known benchmarks of a particular country's stock market (often weighted according to the Market Capitalisation of the components) and those that use an alternative weighting strategy based on one or more company fundamental factor, which are designed to outperform the benchmark Market Capitalisation indices.

"Market Capitalisation ETFs"
Most stockmarket indices are weighted by the market capitalisation of a company i.e. the value of the current share price, multiplied by the number of shares outstanding. These include some of the most famous benchmark indices such as the FTSE 100 in the UK or S&P500 in the US. A wide range of ETFs focused on emerging markets are also available in this category, giving investors access to the returns of a diverse range of markets such as Vietnam, China, Turkey or Russia.

"Fundamental ETFs"
An index which selects by market capitalisation alone will often overweight stocks which are overvalued, and underweight undervalued stocks. However, within a fundamental index, companies are selected using 'fundamental' criteria, such as profitability or growth, to compile an index of stocks with high performance potential. Academic research has proven that selecting stocks according to a rigorous and objective framework of fundamental analysis produces higher long-term returns compared with a market-cap based index.

Commodities – Exchange Traded Commodities
Exchange Traded Commodities (ETCs) enable investors to gain exposure to commodities. ETCs are very similar to ETFs because they are both open-ended, continuously traded and have multiple market makers. With ETCs, investors can gain access to a wide variety of commodities from oil to coffee, gold to corn and cotton to soybeans.

Fixed income
ETFs are available that track the main bond markets, covering treasury, corporate and government bonds.

Alternative assets
There are an increasing range of ETFs available to UK investors that give exposure to alternative investment classes such as property, private equity, infrastructure or alternative energy.

ETF providers in the UK

DB-X Trackers	Selection of ETFs tracking main UK, European benchmarks and various emerging markets	www.dbxtrackers.co.uk
ETF Securities	Wide selection of commodities funds. Recently launched leveraged and short versions of many of their main products.	www.etfsecurities.com
Invesco Powershares	Performance ETFs built around FTSE RAFI methodology. Have also recently listed some alternative energy funds.	www.invescopowershares.net
I-shares	Large range of ETFs in property, equities and bonds covering most major emerging and developed markets.	www.ishares.co.uk
Lyxor	Broad ETF offering offering access to developed and emerging markets and private equity.	www.lyxoretf.co.uk
SPA ETF	Specialist provider of ETFs which are designed to outperform the US stock market. Tracks indices created by MarketGrader, a US stock research company that selects stocks on strengths of its fundamentals	www.spa-etf.com

New funds, new criteria

With the launching of new ETFs in the market, the types of available ETF are now increasingly diverse and should not be considered as a homogeneous group. New funds that aim to outperform their benchmark should be viewed in much the same way as you would a traditional collective investment scheme – considering factors such as returns versus traditional active funds in a similar sector.

Using ETFs within a portfolio

ETFs can be used as the building blocks to enable an investor to create an investment portfolio. With the increased availability of ETFs, any investor can use them to compose a portfolio in an efficient and effective manner. A well diversified global portfolio consisting of a mix of equities, bonds and commodities can be assembled easily and cheaply by buying just a few ETFs.

Index investing has been proven to be an effective way of investing, built on a simple principle – instead of trying to beat the market, investors should own the market. This concept is based on research which proves that, on average, active managers fail to consistently beat the market in the long run.

Indeed, from 1980 to 2005 the Vanguard 500 Index (tracking the S&P 500 in the United States) produced 12.2% compound annual rate of return per year, whereas the average Equity Fund produced returns of around 9.9% per year. The 2.3% gap is around the level of average all-in costs incurred by an average equity-based mutual fund.[1]

[1] Source: "The Chief Cornerstone," John Bogle, Journal of Indexes, March/April 2006.

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