Factsheet – Exchange Traded Funds (ETFs)

An ETF is an investment fund traded on stock exchanges. An ETF holds assets such as stocks, commodities, or bonds, and most ETFs track an index, such as the FTSE 100 Index. Some index ETFs invest 100% of their assets proportionately in the securities underlying an index offering full "replication". Other index ETFs use "representative sampling", investing 80% to 95% of their assets in the securities of an underlying index and investing the remaining 5% to 20% of their assets in other holdings, such as futures, option and swap contracts, and securities (not in the underlying index), that the fund's adviser believe will help the ETF to achieve its investment objective.

There are 2 types of ETFs – physical backed and swap based.

<u>Cash / Physical backed ETFs</u>
Cash-based ETFs hold all or a representative sample of an index's constituents. This makes them transparent and fairly easy to understand.

With cash/physically-backed ETFs assets are held in the index securities themselves, bringing no counterparty risk, although some risk is incurred if the ETF issuer lends the underlying securities under stock loan programmes to other parties as these parties may default.

There are physically-based ETCs with no counterparty risk as the assets are held in the index securities themselves, and cannot be loaned out.

<u>Swap based ETFs</u>
An increasing number of ETFs are actually synthetically structured - that is, the ETF itself does not physically hold an index's component shares, but it tracks an index through derivatives.

Swap-based ETFs use swap arrangements to replicate markets where access may be difficult and liquidity poor. In these ETFs, the fund holds a basket of securities, which may be completely unrelated to the index it is tracking. It enters into a swap arrangement with a counterparty where the latter undertakes to deliver the performance of the index to the fund. The fund will deliver the returns on its basket of securities.

One advantage of swap-based ETFs is that it results in a closer replication of the index, thanks to the undertaking by the swap counterparty.

In the case of swap-based ETFs counterparty risk can be no higher than 10% under Ucits III regulations. Assets are held in a basket of non-index securities, with counterparty funds making up the difference between the performance of the basket and that of the index it tracks.

DB and Lyxor's ETFs are swap based. iShares, a giant in the ETF arena, offers both cash-based and swap-based ETFs.

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ETFs and ETCs
They may sound like similar products, but there are crucial differences between exchange traded funds (ETFs) and exchange traded commodities (ETCs).

Unlike ETFs, where the bulk of assets are held in securities, funds invested in some ETCs are wholly held by a counterparty.

With ETFs, however, counterparty risk is much lower.

Pricing
An ETF combines the valuation feature of a unit trust/OEIC, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value. As such, ETFs do not sell or redeem their individual shares at net asset value, instead, financial institutions purchase and redeem ETF shares directly from the ETF. These institutional purchases and redemptions are generally in kind, with the investor contributing or receiving a basket of securities of the same type and proportion held by the ETF.

The ability to purchase and redeem creation units gives ETFs a pricing mechanism which can help to minimize the potential difference between the market price and the net asset value of ETF shares.

There are 3 key parties involved in ETFs:

The sponsor
The "iShares" or "DB" or "Lyxor" brands are groups of ETFs sponsored by Blackrock (previously Barclays), Deutsche Bank and Societe Generale respectively. The role of the sponsor is to assume certain administrative and marketing expenses on behalf of the trust in exchange for a fee (paid out of the trust).

The sponsor does have certain rights to select a new trustee or custodian, but does not have any oversight of the day-to-day operations of the trust. **Importantly, the sponsor does not hold any of the assets or liabilities of the fund**.

Trustee
The trustee is responsible for the day-to-day transactions of the trust e.g.- The Bank of New York, as the trustee of iShares COMEX Gold Trust, is responsible for the day-to-day transactions of the trust. The trustee's duties include the creation and redemption of shares, coordinating with the custodian for the receipt/delivery of gold in response to share creation/redemption, selling the trust's gold in order to cover the trust's expenses, and also maintaining financial statements.

Custodian
Has custody rights e.g. for ishare COMEX Gold, the Bank of Nova Scotia serves as the custodian or "safe keeper" of the gold held by the trust.

Key differences between ETFs and OEICs

	ETFs	OEICs
Overview	Exchange Traded Funds or 'ETFs' are open-ended investment funds traded on a stock exchange. ETFs represent a portfolio of shares, which aim to match the performance of a particular market index. Many ETFs are based in Ireland A UCITS (standing for Undertakings for Collective Investment in Transferable Securities) fund is a regulated fund registered in a European jurisdiction (usually Luxembourg or Dublin). It is a collective investment scheme whereby individuals typically purchase units in a fund that invests in a range of assets on behalf of the unit holders	An OEIC is a UK-registered fund that is a form of mutual fund that satisfies certain regulations regarding the composition of the underlying assets, pricing, availability etc. OEIC is an acronym for Open-Ended Investment Company. In the UK, many funds that were previously structured as Unit Trusts have converted to OEICs in order to have a single price rather than two prices for buying and selling units. Structured Products can be written against these funds and in many cases returns are subject to capital gains tax. Pooled assets, which invest in defined investment classes dependant on fund.
Risk overview	Assets are usually held by the individual trusts set up for the ETFs. Each fund has separate liability. Cash - May not invest more than 5% of the total assets in cash or transferrable assets in any one body except if this is guaranteed by the state in which case it can invest 35% **Investments –** Investments in one single fund must not exceed 20% **Securities Lending Risk** The Company engages in a securities lending programme through the Investment Manager. Fund Investments can be lent to counterparties over a period of time. There is a risk that such companies may default on payment. **Currency fluctuations** – If invested in foreign stock markets these are	**Currency fluctuations** – If invested in foreign stock markets these are invested in that countries currencies and so may be subject to currency fluctuations.

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Q&A

Q: What happens if an ETF manager fails?
ETFs are mutual funds so their assets are segregated and held by a trustee or custodian. 'As such, the failure of the manager will not result in direct loss of assets.' Should an offeror go bankrupt, the depository or custodian with the regulator could try to find a replacement manager.

Q: What about the failure of a swap counterparty? Under UCITS III, losses arising from a single counterparty are limited to 10 per cent, but is this a guarantee?
Theoretically, the value of the fund will be reduced by the value of the swap issued by a counterparty that has defaulted, less any collateral value. The actual loss to the fund will depend on the weight of the swap at the time of the failure.
So it important to choose an ETF manager who has a strong heritage of performing fiduciary duties and actively monitors counterparty exposure. Investors should also take note of the quality of collateral used to back the ETF.'
UCITS III limits the exposure to a swap provider by up to 10 per cent.

Q: What sorts of securities do your ETFs hold? Are these disclosed to investors and are they related to the index the ETF tracks?
As the ETF receives the benchmark performance through the swap arrangement, and the stock basket's performance is given away, no performance issue arises from the stock basket.
The only time the stock basket plays a role is if the swap issuer fails and the fund needs to liquidate the basket. For this reason, it is usually made up of bluechip stocks that are liquid and cost the least to trade.
The swap counterparty can only post cash or liquid securities according to UCITS III regulations.
The actual securities may change from time to time and are not usually set out in the prospectus. For swap-based ETFs, the type of derivatives used and counterparty exposure is also disclosed daily.

Q: Swap-based ETFs may be seen by some as structured products. Is it a misnomer to call them ETFs given their complex structure?
Swap-based ETFs are structured as mutual funds or collective investment schemes. This is distinct from structured products, which are bespoke arrangements, where counterparty exposures are mostly 100 per cent. As structured products are not listed on exchanges, liquidity is also an issue and valuation isn't transparent.
UCITS III funds allow the use of derivatives subject to limits.
Swap-based ETFs are common.

Q: How appropriate are swap-based or synthetic ETFs for retail investors?
All direct and synthetic replication techniques involve risks.