Stock Market Review

Introducing exchange-traded funds to portfolios

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Exchange Traded Funds, or ETFs as they are more commonly referred to in the investment world, are funds that are traded on the major global stock exchanges similar to shares. They have become very popular with investors especially in the US and in the UK due to the broad range available enabling investors to gain exposure to a wide array of various underlying investments.

Nowadays, ETFs cover practically any investment theme that most investors may wish to get exposed to as part of a diversified investment portfolio. ETF providers offer investors the opportunity to either track a particular index (such as the FTSE 100 or the S&P 500), a specific sector (financials, telecommunications, housing, etc.) or even certain countries or geographical areas such as Brazil, China, emerging markets or Europe, excluding the UK. ETFs are also available for commodities such as oil, gold, silver, soybeans and timber, as well as for exposure to various currencies.

In essence, an ETF trades like an equity but it has the structure of a collective investment scheme. ETFs provide investors with the broad diversification benefits of a fund coupled with the advantages of the easier tradability of an individual share as opposed to a collective investment scheme. Each ETF has its own unique exposure, risk and tax implications, so investors and financial advisors need to perform adequate research before selecting the most suitable product.

Some of the more common promoters of ETFs are Blackrock with the highly popular iShares range of funds, State Street Global Advisors, ProFunds Group, and Deutsche Bank with the DB X trackers.

ETFs have grown rapidly over the years, and there are currently more than 140 ETF providers with their products tradable on around 50 stock exchanges. As an example, more than 600 ETFs are today listed on the London Stock Exchange. The total assets under management of the different ETFs run into trillions of US Dollars.

An important distinction is that between an ETF and a collective investment scheme. Locally, many investors possibly still associate a 'fund' with a collective investment scheme. Such traditional funds are not traded on a stock exchange but they are only listed mainly for tax considerations. Therefore, subscriptions or redemptions of traditional funds can only be made periodically and directly through the fund manager or the fund administrator within specified timeframes unlike the facility of daily trading on a stock exchange for ETFs.

Moreover, while the price of a collective investment scheme is established periodically (daily, weekly, monthly), the price of an ETF fluctuates regularly throughout the day on the stock exchange.

The continuous pricing mechanism and the ease of trading are two major advantages of ETFs over traditional funds. Investors wishing to trade regularly based on price fluctuations in the market have easier and quicker access to the market rather than through a fund administrator. Moreover, the pricing is more transparent since it fluctuates constantly throughout each trading day depending on market circumstances. As such, investors can take quick decisions based on market movements.

> **"In view of the higher risk nature of such products, geared ETFs should only represent a small allocation in an investment portfolio"**

Meanwhile, traditional collective investment schemes may be popular with certain types of investors since they enable regular periodical contributions to be made as part of an overall savings plan mechanism. This is possibly one of the major advantages over an ETF. On the other hand, ETFs are more suitable for those investors deploying larger sums of capital rather than small subscriptions regularly.

ETFs are not only focused on equity indices or commodities but there are ETFs that are also exposed to bonds, allowing investors to gain exposure to government and corporate bond markets. The iShares suite of funds have the euro corporate bond ETF, the euro government bond ETF, and for those investors seeking potential higher returns, there is also the iShares market iboxx euro high yield.

There are two main structures in which ETFs replicate the underlying index it is tracking. Physical or cash-based ETFs are normally made up of the actual assets of the entire underlying index and this is known as 'full replication'. On the other hand, synthetically-backed or swap-based ETFs use derivatives to gain exposure to certain markets which may not be easily accessible. Some markets may have some ownership restrictions for international investors or may be costly to access. As such, these ETFs use swap agreements to provide the returns of the underlying securities.

Other types of ETFs have an element of leverage. However, these may be too complex for retail investors and one would need to adopt a cautionary approach when looking into the suitability of such products. Leveraged funds provide magnified exposure to a market index or a specific benchmark, for example two times the index return on a single day. Such an ETF would rise by about two per cent when the benchmark increases by one per cent and likewise it will drop by two per cent if the index eases by one per cent.

An example of a leveraged fund is the 'ProShares Ultra S&P500'. This ETF seeks returns that correspond to twice the daily performance of the S&P 500 Index. Likewise, the 'ETFX DAX 2x Long Fund' is designed to deliver a leveraged return to shareholders which corresponds to twice the daily percentage change in the level of the DAX Index.

Meanwhile, inverse ETFs allow investors to protect against the downside or take advantage of this by moving in the opposite direction of the benchmark. As an example, a -2 times ETF, would rise by about two per cent on a day when the benchmark falls one per cent. However, if the index rises by one per cent, the ETF would drop by two per cent. As an example, the 'Direxion Daily Financial Bear 3x Shares' seeks to provide daily investment results of three times the inverse of the price performance of the Russell 1000 Financial Services Index. This index measures the performance of the financial services sector from among the large cap equities in the US. This fund will increase steadily if share prices of financial companies are dropping and likewise it will suffer if markets are on the rise as was the case over the past three months.

Such geared ETFs amplify the potential gains or losses for investors and as such they need to be actively monitored in view of the volatility even during a single trading session. In view of the higher risk nature of such products, geared ETFs should only represent a small allocation in an investment portfolio. Professional investors may also combine standard ETFs and geared ETFs to minimise volatility to a portfolio of securities.

ETFs can prove to be a good way for investors to gain exposure to a wide range of international markets since they obtain diversification and eliminate the risks and lengthy process of individual stock picking. However, although the more complex ETFs may be tempting especially when markets are very volatile since their leverage can produce sizable movements in very short periods of time, these are risky instruments which are suitable only for professional investors.

In Malta, there are no ETFs tracking the local market. In view of the small size of the market and the few companies listed within the same sector, it is not possible to create an instrument that would be sector-specific. However, an ETF covering the whole spectrum of the local equity market ought to be explored by certain investment houses or the Malta Stock Exchange itself, as this may encourage more retail investors to gain a better exposure to the local market.

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