Exchange Traded Funds (ETFs): An innovative breakthrough

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Exchange-Traded Funds, or ETFs, can be viewed as a hybrid that blends the investment characteristics of an index fund with the trading characteristics of stock as it is traded on a stock exchange. Its performance tracks an underlying index, which the ETF is designed to replicate. ETFs can be compared to traditional 'tracker' funds in the manner that they try to track the performance of an index (such as the KSE 100) or other instruments (such as commodities). Most of the times, such tracking techniques offer investors ease, low cost and tax efficient structure when compared to direct investment. Compared to mutual funds, ETFs are relatively new. ETFs began in the late 1980s and quickly gained popularity as investors started looking for alternatives to mutual funds. Investors, both institutional and individual, could see the benefit of holding a specific group of stocks with lower management fees and higher intraday price visibility. Although the first ETFs tended to track broad market indices, more recent ETFs have been developed to track sectors, fixed income, global investments, commodities and currencies.

An ETF holds different instruments like stocks, commodities or bonds and trades close to its Net Asset Value ("NAV") over the course of the trading day. Most popular indices such as S&P 500 and Deutsche Bank Commodities indices are tracked through ETFs by indexing, a simple strategy designed to track market returns. Indexing or investing in the entire stock market, is one of the easiest, least risky, and yet most effective investment strategies available. According to John Bogle of Vanguard Funds, this strategy has consistently beaten 70 percent or so of all growth funds over the years.

Importantly, ETFs tend to have very low charges (like tracker funds) because they are 'passive' funds, i.e. they are managed according to pre-defined parameters and do not require active fund management. On the other hand, with lower management charges of the fund, the burden is placed on the investor to select a proper investment.

ETFs are a very efficient way to own a basket of stocks. According to a presentation by Deborah Fuhr, Global Head of ETF Research at Blackrock, Investments in ETF's grew 30% between April 2010 and April 2011, increasing from USD 1,113 billion to USD 1,470 billion and an average daily trading volume is USD 54.5 billion.

ETFs vis-à-vis Mutual Funds

ETFs represent shares of ownership of a unit investment trust (UIT), which holds portfolios of stocks, bonds, currencies or commodities. ETFs are often compared the mutual funds. Like a mutual fund, an ETF is an investment structure that pools the assets of its investors and uses professional managers to invest the money to meet clearly identified objectives, such as current income or capital appreciation. And, like a mutual fund, it also has an offering document or a document known as a product description, which summarizes key information about the ETF.

A mutual fund investor purchases or redeems directly from the fund, at the mutual fund's net asset value (NAV), which is calculated at the end of each trading day. An investor who buys an ETF purchases the shares on a stock exchange in a process identical to the purchase or sale of any other listed stock. Although most mutual funds are actively managed a number of index funds are available which are passively managed. Although most ETFs are passively managed - designed to track specific indexes - a few actively managed ETFs have been introduced.

The creation and redemption process for ETF shares is almost the exact opposite to that of mutual fund units. When investing in mutual funds, investors send cash to the asset management company, which then uses that cash to purchase securities and issue additional units of the fund. When investors want to redeem their mutual fund investment, the units are returned to the asset management company in exchange for cash. The creation of an ETF, however, does not involve cash.

Creation

ETFs are security certificates that state the legal right of ownership over a portion of a basket of individual stocks. Creating

an ETF in the U.S. first requires a fund manager to submit a detailed plan to the Securities and Exchange Commission (SEC). The plan describes a set of procedures and the composition of the ETF. Typically, only the largest asset management firms, with experience in indexing, can create and manage ETFs. These firms are in touch with major investors, pension funds and money managers throughout the world, which have the pool of stocks required for ETF creation. The firms also create demand by lining up customers, either institutional or retail, to buy a newly introduced ETF.

The creation of an ETF officially begins with an authorized participant, also referred to as a market maker or specialist who is empowered to create or redeem ETF shares. (In some cases, the authorized participant and the sponsor are the same). These are middlemen who borrows shares of stock, often from a pension fund, or otherwise assembles the appropriate basket of stocks, typically enough to purchase 10,000 to 50,000 shares of the ETF. The basket of shares is placed in a trust, usually with a designated custodial bank and are used to form creation units of the ETF. The minimum basket size is called a creation unit. Creation units are bundles of stock varying from 10,000 to 600,000 shares, but 50,000 shares is what's commonly designated as one creation unit of a given ETF. Then, the trust provides shares of the ETF - which are legal claims on the shares held in the trust (the ETFs represent tiny slivers of the creation units) - to the authorized participant. Once the authorized participant receives the ETF shares, they are then sold to the public on the open market just like shares of stock.

When ETF shares are bought and sold on the open market, the underlying securities that were borrowed to form the creation units remain in the trust account. The trust generally has little activity beyond paying dividends from the stock held in the trust to the ETF owners and providing administrative oversight because the creation units are not impacted by the transactions that take place on the market when ETF shares are bought and sold.

Redemption

To redeem the shares, an authorized participant buys a large block of ETFs, forwards them to the custodial bank and receives an equivalent basket of individual stocks.

When investors want to sell their ETF holdings, they can do so by one of two methods:

- The first is to sell the shares on the open market. This is generally the option chosen by most individual investors.
- The second option is to gather enough shares of the ETF to form a creation unit and then exchange the creation unit for the underlying securities. This option is generally only available to institutional investors due to the large number of shares required to form a creation unit. When these investors redeem their shares, the creation unit is destroyed and the securities are turned over to the redeemer. These stocks can then be sold on a stock exchange although they are usually returned to the institution that loaned the shares.

Because of the limitations placed on the redemption of the ETFs shares, they cannot be called mutual funds.

Advantages of ETFs

- Lower costs – Being passively managed funds, ETFs have lower transaction, distribution and accounting costs.
- Buying and selling flexibility – ETFs can be bought and sold all day long at market prices which hover close to their NAVs. As publicly traded securities, investors can use stop/ limit orders, as well as other hedging strategies while investing/trading in them.
- Tax efficiency compared to direct investment – Due to the typically low turnover of their portfolio securities, ETFs generate low capital gains. They are more tax efficient as they do not have to frequently sell securities to meet investor redemptions.
- Market exposure and diversification – ETFs offer exposure to a variety of markets, indices, international and country-specific indices, industry sector indices, bond indices, and commodities. They are thus an economical way to own or participate in an index.
- Transparency – ETFs have transparent portfolios, with some funds disclosing their holdings on a daily basis.

Disadvantages

- Intraday Pricing Might Be Overkill
  In specific types of ETFs where the holdings are reported on a daily basis, the investors can track their investment in almost real time. This kind of transparency has its own flaws as the high frequency trading could whipsaw the ETF. It is almost like a speedboat that has chances of flipping over. Longer-term investors have a

longer time horizon so they may not benefit from the intraday pricing changes.

- Bid-Ask Spread Can Be Large
  As more niche ETFs are created you might actually find an investment in a low volume index. This could result in a high bid/ask spread. You might find a better price investing in the actual stocks (usually large institutional investors) or maybe even a managed fund.

- Costs Could Actually Be Higher
  Most people compare trading ETFs with trading other pools of stocks such as mutual funds, but if you compare ETFs to investing in a specific stock the costs are higher. The actual commission paid to the broker might be the same, but there is no management fee for a stock.

Types of ETFs

Most ETFs are index funds that replicate specific stock indices while holding securities. However another popular category of ETFs invests purely in commodities (either single such as gold or a sub-group such as energy commodities). Bond ETFs, on the other hand, invest in corporate and government bonds and thus thrive during economic recessions. Other variations of ETFs employ actively managed and leverage strategies.

ETFs in Pakistan

At the moment there are no ETFs in Pakistan. However Securities and Exchange Commission of Pakistan (SECP) has recently notified the rules to launch the product which are likely to lay the groundwork for asset management companies.

Thus so far, an investor in Pakistan can take exposure to ETFs through those mutual funds in Pakistan which invest a portion of their investments internationally through ETFs.

Caveat Emptor

In the end, while marketing material for most investment instruments already come with adequate disclosures, investors sometimes do not pay the required attention to understand them. Hence it is recommended that potential investors should dedicate enough time to comprehend the investment philosophies, as well as the accompanying disclosures, before choosing the optimum ETF for investment. The Latin phrase Caveat Emptor, literally translated, means "let the buyer beware." Throughout the Roman Empire this sign appeared in marketplaces to warn the buyers to carefully examine what they were purchasing, so that in case of later disappointment they themselves (and not the seller) would be held accountable.