



London  
Stock Exchange

# ETFs for Financial Planners

EXCHANGE TRADED FUNDS - A GUIDE FOR INDEPENDENT FINANCIAL ADVISORS



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# Introduction

*Exchange Traded Funds (ETFs) have continued to show strong growth over recent years, even throughout the financial crisis, as more and more investors have become aware of the benefits and advantages of these flexible products.*

With the advent of the FSA's Retail Distribution Review (RDR) and a growing appetite amongst Independent Financial Advisors to offer a broader range of investments to their clients, ETFs, with their simple, low-cost and transparent features, have become particularly attractive to investors.

In particular, the flexibility offered by ETFs, the various strategies in which they can be used and their cost-effective nature suggest that these products are set to become a common feature in retail investors' portfolios.

This guide aims to provide IFAs with an introduction to ETFs, the various investment strategies they offer and how IFAs can access this fast-growing and developing market. The guide comprises an overview of the key characteristics of ETFs on the London Stock Exchange and is complemented by a series of feature articles by leading market experts.

# THE GROWING TREND IN PASSIVE INVESTING AND THE EFFECTS IT WILL HAVE ON IFAs



assetfirst  
CO UK

Andrew Whiteley, Director, AssetFirst

*The lower costs associated with passive funds are a happy by-product of this approach and allow the adviser greater margin to charge fees without imposing prohibitive costs on the investor.*

In its purest form an effective multi-asset, risk-graded, asset allocation strategy should in my view (where possible), utilise passive funds to fulfil each of its specific asset class investment requirements. How else can you be sure that your risk/reward integrity is not compromised by the best intentions of an active fund manager who pushes the envelope of his or her fund's mandate to try and eke out a bit of that elusive alpha?

But where there used to be a handful of passive funds to choose from to populate your opportunity set there are now hundreds of Index Tracking OEICS and Exchange Traded Funds (ETFs). Not all of these are structured the same way, some physically hold the constituents of the index that they track, while others ensure the return of the underlying index through swap-based replication, but all share the same characteristic in that they offer low cost access to a specific asset or sub-asset class. In the early days when wraps were things your granny wore and before counterparty risk was a topic of conversation at dinner parties, the passive

IFA's stock selection due diligence process would have been to find the lowest cost index tracking unit trust from a reputable firm and retire to the pub.

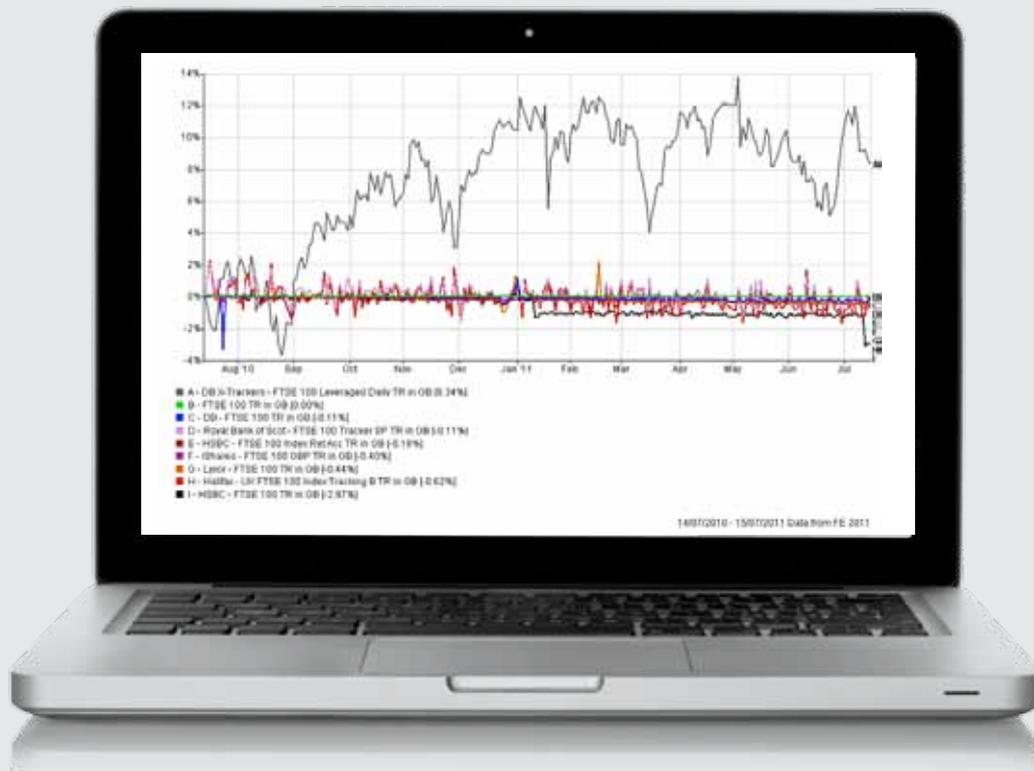
Not so now! Not only are there many more ways to track the rise of an index such as the FTSE 100, you can actually profit from any fall....twice over if you fancy! The chart opposite tracks the relative performance over 12 months of a selection of funds and ETFs which have FTSE 100 in their name and shows - as well as the obvious divergence from the index of the leveraged fund - just how different the end result can be from what ostensibly is an identical investment! Woe betide any adviser who does not keep an eye on their chosen tracker to make sure it is doing exactly what it says on the tin!

To add to the confusion, IFAs can these days choose to include components in their clients' portfolios that they would never have dreamt of including before - Brazilian equities, Zinc, Timber, Lean Hogs, the list is seemingly endless. Add to this just about every

type of fixed interest index you can think of and you could be forgiven for wanting a lie down.

So what is any self-respecting IFA to do? One option is to delegate the responsibility to a third party either a Discretionary Fund Manager (DFM) or a Fund of Funds (FOF) Manager. This might suit some IFAs - particularly those that buy into the theory that active management can lead to consistent outperformance - but for many who either don't, or just don't know, it is another daunting step. And, if you find the stock selection due diligence process too difficult, how do you undertake due diligence on the due diligence processes of the DFM or FOF Manager? What about assessing the true cost of the DFM/FOF proposition including dealing costs and underlying fund management costs?

Furthermore, whilst we may all like to think that all our clients value us for our cash flow-modelling and for remembering their favourite drink and biscuit brand at reviews, you can bet your bottom dollar that that will all go out the window if you



cannot explain why their portfolio has fallen by 10% when that of the “the chap at the golf club” has gone up by 10%.

Conversely, if the DFM is doing such a good job of managing your client’s portfolio, what is to stop them being tempted to look at their financial planning arm? (if they haven’t got one yet they will have one soon) Unlikely perhaps, impossible, certainly not!

There is another option which keeps the IFA right at the heart of the client relationship. Using effective asset allocation and investing in low cost passive products is a strategy that is consistently proven to deliver results and so is becoming increasingly popular, but herein lies the problem. Passive fund due diligence is becoming as complex and costly as that for active funds – AMCs, TERs, tracking error, stock lending policies, counterparty strength, liquidity, collateral quality, base currency, tax treatment, etc.

By “insourcing” from a firm that specialises in this area, IFAs can construct and maintain their own range of risk-graded, multi-asset model portfolios on the platform of their choice. The proposition must be backed up by robust, independent research with a bespoke Investment Manual detailing the full methodology behind the top-down approach to the construction of the portfolios alongside thorough due diligence on the passive or active (yes, sometimes this can be the best option!) stock selection criteria used to fulfil each asset class requirement.

The benefit of this top-down approach - with fund selection the last rather than the first consideration - is that it allows for a formal process of risk management to be effectively incorporated in your investment management service. The lower costs associated with passive funds are a happy by-product of this approach and allow the adviser greater margin to

charge fees which are appropriate for the work involved in providing a high calibre financial planning and investment service without imposing prohibitive costs on the investor.

Ultimately there is no right or wrong answer, but with RDR bringing the focus squarely on client charges, an independent, well researched range of low-cost, risk-graded, multi-asset model portfolios investing in ETFs and index tracking funds seems a very compelling proposition indeed.

*Andrew Whiteley is a Director at Assetfirst. The views expressed in this article are his and do not necessarily reflect those of the London Stock Exchange. ■*



## What are ETFs?

ETFs are pooled investment funds which are bought and sold on a stock exchange and aim to track as closely as possible the performance of a given underlying.

All ETFs on the London Stock Exchange are supported by dedicated on-screen market makers committed to providing continuous two-way pricing throughout the trading day. Investors can trade in and out of ETFs just as they would with shares.

ETFs trade on the London Stock Exchange's Main Market, an EU Regulated Market under MiFID, ensuring the highest levels of transparency and regulatory oversight.

ETFs are eligible to be held in an Individual Saving Account (ISA) or a Self Invested Personal Pension (SIPP) and are not subject to UK stamp duty when purchased on-exchange.

- ETFs combine the advantages of stocks (tradability and liquidity) with the key features of traditional index funds (low costs, diversification and regulated infrastructure) into one product
- They can be traded intra-day on the London Stock Exchange
- ETFs can provide exposure to a wide range of major indices for stocks and shares, bonds, commodities and other asset types
- ETF shares are a flexible investment that can be traded in any size, from as little as one share.

### Regulation – ETFs are highly regulated and transparent

- All ETFs on the London Stock Exchange must be UCITS compliant
- The UCITS regime provides high levels of risk mitigation and investor protection for ETF investors and sets out clear rules and processes that must be in place to ensure that the ETF assets comprised in collateral or substitute baskets are liquid and diverse
- Key elements of the UCITS regime ensure a clear focus on risk management, asset segregation, conflict of interest, collateral use, disclosure requirements
- All ETFs distributed in the UK are subject to recognition by the Financial Services Authority (FSA) and must comply with the listing rules of an EEA-Regulated Market under MiFID.

# SELECTING EXCHANGE TRADED FUNDS – WHAT TO LOOK FOR



Alan Miller, SCM Private

There are numerous reports and advice pieces on choosing an Exchange Traded Fund (ETF) which typically tend to cover the importance of selecting the right ETF in terms of structure, cost, size, liquidity and many other factors but in our view this misses the primary decision – which precise index or asset category should an investor pick? This decision is paramount, particularly when choosing an ETF.

## First Things First

Before choosing the best individual ETF, an investor's decision making process should be as follows:

- First consider which 'broad' asset class (equities or bonds or commodities etc)
- Then which 'micro' asset class (e.g. UK equities vs emerging market equities)
- Then which 'tilt' if at all (e.g. value or growth stocks, small or large stocks etc).

Only after these decisions have been reached should the choice of most suitable ETF come into play.

When selecting a traditional UK active mutual fund, the difference

between the top and the bottom fund in this sector will be colossal - for example a staggering 33% in Q1 2012 alone. But the difference between the top and bottom performing FTSE 100 ETF was just 0.12% over the same period. There is no doubt that it is prudent to minimise the cost of 'bad selection' but it is paramount that this does not distract investors from these important decision making steps before evaluating the index itself and its underlying constituents in order to pick the right index.

## Beyond the Label

There can often be times (like this year) when there are significant divergences between the performance of various broadly based indexes investing in a similar asset class. So far in 2012 small cap and mid cap shares have significantly outperformed large caps in the UK. The divergence has been so great that even though the big caps in the UK (FTSE 100) represent over 86% of the total market (the FTSE All Share Index), it has not stopped the All Share Index outperforming the FTSE 100 by 1.5% in the first quarter of 2012. This clearly shows that choosing a FTSE 100 tracker over a FTSE All Share tracker purely

on cost would have been an expensive mistake recently. An investor could easily have saved 0.1% pa headline charges by choosing a low cost FTSE 100 ETF over a low cost FTSE All Share ETF but then lost the extra 1.5% of performance. Cost is an important part of the evaluation equation but underlying performance is equally as important.

Warren Buffet has always preached the importance of assuming when you buy one share in a company, that you own the whole company. Vital questions are: What are the long term characteristics? What is the growth potential and risks attached? And how much cash is the investment likely to pay back to investors? The irony is that forecasts for individual companies are inherently volatile and unpredictable on a singular basis but much more accurate and less volatile on an index basis.

When buying any index investors should look at the underlying fundamentals. How well diversified is it? What is the current index valuation in terms of tried and tested fundamentals eg Price Earnings Ratio, Price to Book, Price to Cash-flow, Yield etc.

There are a number of research tools that aggregate the bottom up analyst

forecasts for many well known indexes so it is possible to see over the next few years what the market thinks the growth will be of the current underlying index constituents. Of course these will change over time and an index may be highly concentrated with a single stock representing over 10% of the index. For example, Samsung Electronics currently represents 23% of the Korean Stock market. In our view if an investor does not understand or feel comfortable with the meaningful individual constituents and their individual valuations; that investor should simply not invest.

*In the UK ETFs are on a growth curve and now cover almost every asset category and are a truly excellent way of accessing markets in a disciplined, diversified and low cost manner.*

#### **Costs and other Factors When Choosing an ETF**

The next stage in the decision making process once the decision has been made in terms of how much to invest and which index is attractive, is to decide which particular ETF. If you are a UK taxpayer, the first filter to apply is whether or not the ETF has reporting status. If it does not, any capital gains may for some investors be taxed as income rather than capital, thereby often attracting a higher rate of taxation.

On the issue of cost - the real cost is the difference between the actual return and the index, referred to as tracking error. In fact the reported costs as measured

by the TER may be a poor measure of tracking error as many ETFs will benefit from securities lending income or other 'enhancements' which can often benefit investors. It can also be that some index ETFs do not exactly match the index, e.g. through optimized sampling rather than fully replicating an index. This can reduce or sometimes improve returns to a material degree relative to any reported headline charges. This can be particularly important when looking at commodity ETPs as sometimes they are invested in the physical assets, sometimes via futures.

The other element of cost often ignored is the stock market spread of an ETF, which relates to the liquidity of the particular ETF and its underlying holdings. In the main, spreads and liquidity are excellent but some ETFs may have a narrower spread when their underlying market is open; for example a US equity ETF listed in London may have a comparatively high spread when the US markets are closed in the morning or an ETF investing in local currency emerging market bonds which may have a higher spread to reflect the larger inherent costs of buying and selling such bonds.

Different ETFs will have different structures and methods of investing. There has been much debate, often erroneously, over the differences and preferences between 'physical' and 'synthetic' ETFs. In essence the risks can often be similar in terms of counter-party risk but can vary significantly not just by issuer, but by individual funds within an issuer.

Investors need to research the following:

- How much stock lending is taking place?
- How much of this income is received by the ETF investors?
- Who are the borrowers and what is the collateral against such loans?
- Who bears any losses should there be problems from such lending?

In synthetic ETFs investors should be aware of the extent and precise

nature of the collateral held and the creditworthiness of the counterparty / counterparties. However, a sense of perspective is vital as similar issues arise in almost all funds, traditional and modern, in some shape or form. Debate has centred on ETFs mainly because of their inherent transparency which has brought these issues to the fore. In many traditional funds they are hidden but no less significant.

#### **The Odds Are in Your Favour**

There is never a completely 'free lunch' in investments but ETFs used sensibly are about as close as you can get. Not just because there is significant evidence that over time, simply as a function of cost, an index fund will produce more performance at less cost and with lower volatility than a conventional active fund. Of course there will be exceptions but the odds definitely are working in investors' favour when using ETFs. In addition there are significant advantages particularly in today's volatile markets of knowing the price before you deal rather than after.

In the UK ETFs are on a growth curve and now cover almost every asset category and are a truly excellent way of accessing markets in a disciplined, diversified and low cost manner. They offer the ability to quickly, efficiently and cost effectively change asset allocation. Using ETFs for Multi-asset portfolios really maximises their inherent advantages but an investor should always understand the underlying index, and that whilst cost is important, so too is risk and return. With discipline and determination an ETF can provide more return for less cost and with less risk; that is why they are here to stay.

*Alan Miller is founder and CIO at SCM Private. The views expressed in this article are his and do not necessarily reflect those of the London Stock Exchange. ■*

# Advantages of ETFs

## Transparency, liquidity and cost

The fee chargeable for an ETF is the Total Expense Ratio (TER), which is usually expressed as a percentage or in terms of basis points (bps). This is an all-in fee ensuring there are no other hidden charges and there is full transparency on cost.

- Can be traded cost-effectively through a stock broker or wrap platform
- No stamp duty due on London Stock Exchange ETFs traded on the secondary market
- No upfront or exit fees.

As the leading exchange for ETFs, the London Stock Exchange maintains a strong commitment towards promoting liquidity and transparency across its ETF market. Committed market makers play an important role in ensuring that markets

remain liquid and transparent. Multiple market makers in an ETF help increase competition, thereby providing tighter spreads which helps to increase overall liquidity. Every listed ETF on the London Stock Exchange must be supported by at least one official market maker, who is required to maintain continuous two way quotes in a minimum size and a maximum spread for at least 90% of the trading session. In addition to the market makers, there are other "liquidity providers", one or more operators who, without fixed obligations, support the liquidity of ETF by providing regular on-screen prices.

The liquidity of an ETF depends on a number of factors, including liquidity in the underlying securities, the trading volumes of the assets or securities making up the ETF and other less quantifiable factors such as the level of competition among market makers for an ETF.

## Advantages of using ETFs

### **Security**

- Fully-integrated clearing and settlement
- Counterparty risk is removed with central counterparty for ETFs traded on the London Stock Exchange electronic order book.

### **Tradability & Liquidity**

- ETFs can be traded intra-day
- Dedicated market maker support ensures continuous pricing throughout the trading day.

### **Transparency**

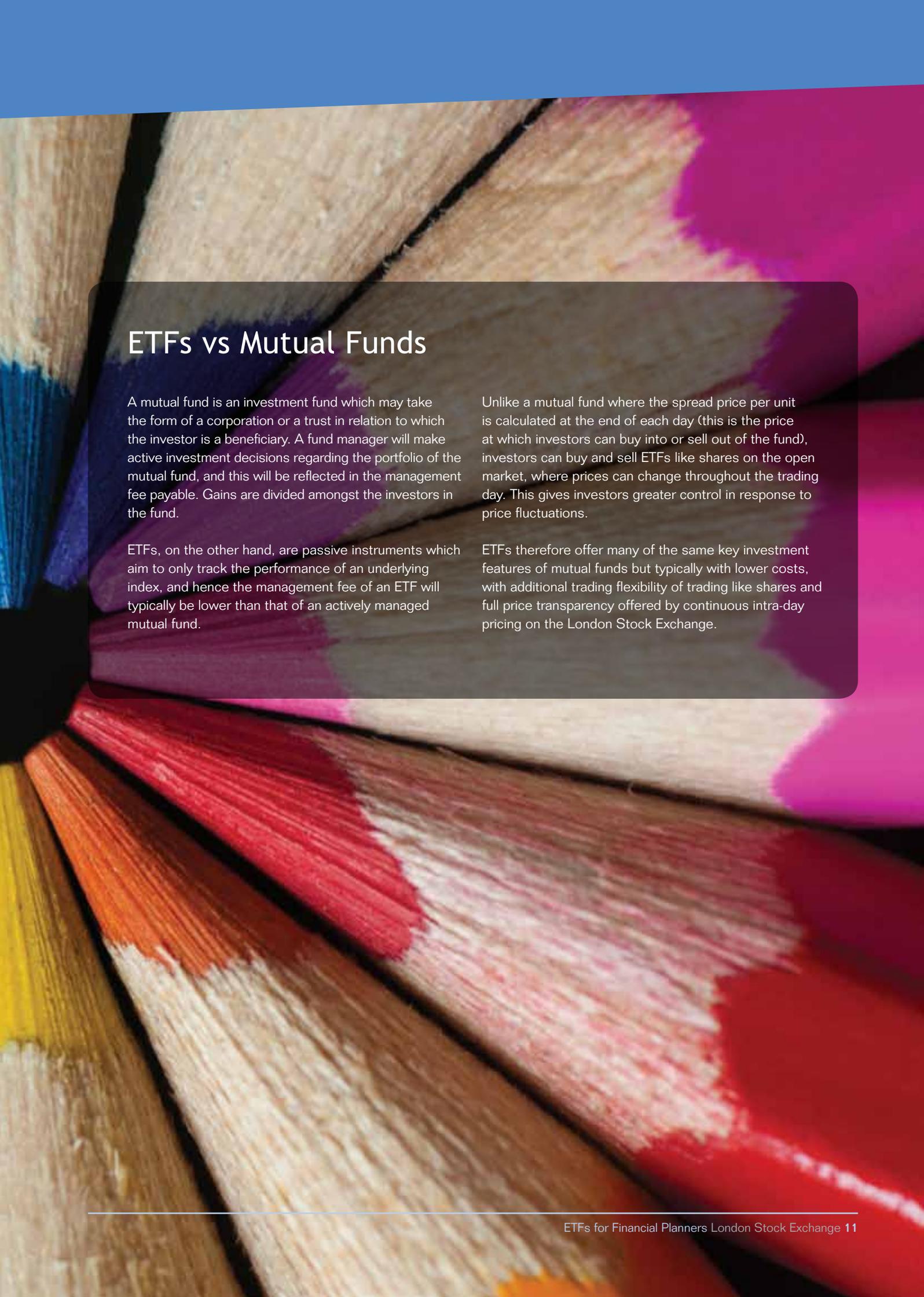
- ETF portfolio holdings, the ETF performance and costs are easily accessible and published on product providers' websites
- ETFs are listed instruments on a Regulated Market and are subject to high levels of disclosure and regulatory oversight.

### **Low cost**

- ETFs provide instant market access at a very low cost.

### **Diversification**

- ETFs allow access to a diversified basket of securities and hence reduced risk of investment
- Broad product range, covering diverse range of global markets and asset classes, is available on the London Stock Exchange.



## ETFs vs Mutual Funds

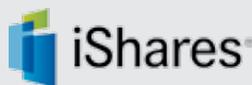
A mutual fund is an investment fund which may take the form of a corporation or a trust in relation to which the investor is a beneficiary. A fund manager will make active investment decisions regarding the portfolio of the mutual fund, and this will be reflected in the management fee payable. Gains are divided amongst the investors in the fund.

ETFs, on the other hand, are passive instruments which aim to only track the performance of an underlying index, and hence the management fee of an ETF will typically be lower than that of an actively managed mutual fund.

Unlike a mutual fund where the spread price per unit is calculated at the end of each day (this is the price at which investors can buy into or sell out of the fund), investors can buy and sell ETFs like shares on the open market, where prices can change throughout the trading day. This gives investors greater control in response to price fluctuations.

ETFs therefore offer many of the same key investment features of mutual funds but typically with lower costs, with additional trading flexibility of trading like shares and full price transparency offered by continuous intra-day pricing on the London Stock Exchange.

# ASSET ALLOCATION AND THE ROLE OF ETFs



David Bower, Head of iShares UK, BlackRock

*Growing recognition of the power of asset allocation has contributed to strong growth in demand for ETFs as efficient asset allocation tools.*

## Introduction

It is widely accepted that asset allocation is the main driver of portfolio returns. For the past 20 years, academic studies have shown that over 90% of variation in returns from a typical portfolio is generated by asset allocation. In other words, the allocation of capital across asset classes is more important than which individual securities you own.

This makes devising an allocation strategy among the most valuable services provided by a financial adviser. However, determining where to invest a client's assets can be a complicated

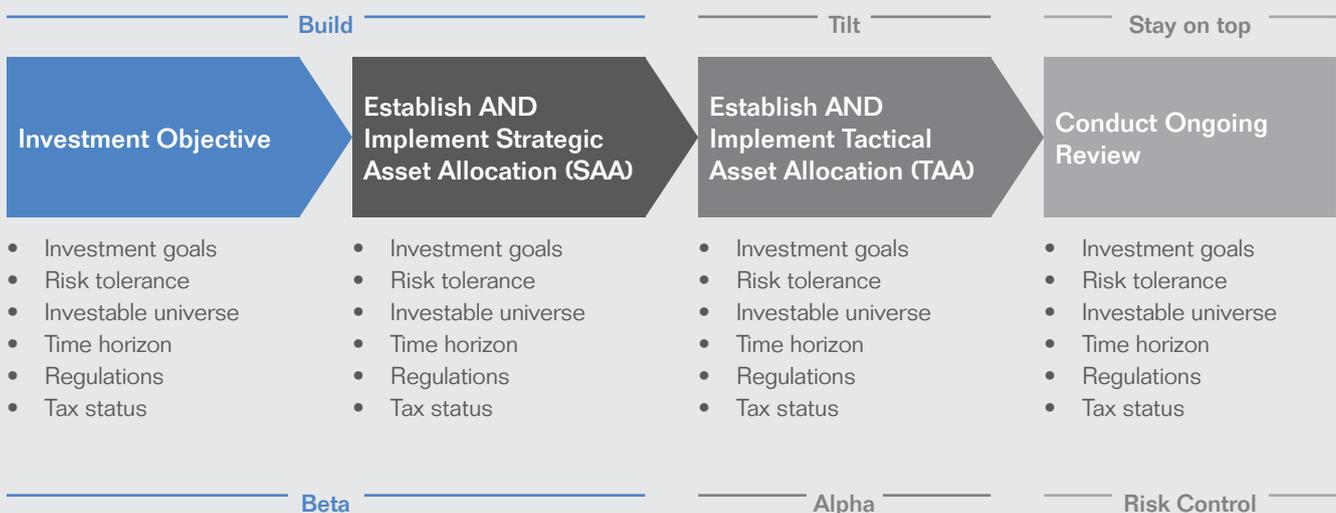
process and one that demands significant time, knowledge and resources.

The recognition of the importance of asset allocation has also driven demand for efficient, simple tools that can be used to build effective strategies. In turn, ETFs have enjoyed growing demand as the ideal building blocks to implement a wide range of asset allocation strategies.

## Recap on Asset Allocation

Asset allocation can be tackled in an efficient manner by breaking the process down into a series of decisions or steps, as summarised in the figure.

## Asset Allocation Process



Source: BlackRock. For illustrative purposes only.

### Strategic Asset Allocation (SAA)

Strategic Asset Allocation (SAA) involves long-term views, focused on determining the appropriate split of capital across asset classes to produce an overall return in line with client objectives and risk tolerance. This asset allocation can be across a range of geographies, sectors and styles.

### Investment Objective

The client's profile will determine the trade-off between risk and return in selecting suitable asset classes for investment. This includes their overall investment goal, time horizon, risk tolerance, tax status and regulatory considerations.

Most asset classes fall under the five broad categories of equities, fixed income, alternatives, cash and cash equivalents and commodities. Under these categories, numerous subcategories exist. For example, equities can be further classified by growth or value, large-, mid- or small-cap, sector, domestic, international developed or emerging market equities.

The fixed income universe can be further subdivided by issuer such as governments or corporates, by

geography, maturity of underlying bonds, credit ratings and types of bonds such as inflation-linked or asset-backed securities.

Once an asset class has been selected, the next decision is what proportion of the portfolio should be allocated to it. In the context of the client's investment objective and risk tolerance, making this choice usually involves analysing historical and expected data to select the mix of assets that maximises returns for a predetermined level of risk, or minimises risk for a certain return.

A set of 'optimal' portfolios providing this ideal balance of risk and return can be used to plot the 'efficient frontier', which is illustrated.

The efficient frontier was first defined by Harry Markowitz in 1952 and is referred to as Modern Portfolio Theory (MPT). This considers a universe of individual risky assets and explores what might be an optimal portfolio based upon those possible investments. MPT states that by combining risky assets (domestic equities, foreign equities, real estate, commodities, etc.) in a portfolio, you can increase your expected return, reduce your risk, or both. It centres on creating

a portfolio with less collective risk than any of its individual components. At the end of this section, we provide a case study that illustrates three examples of Strategic Asset Allocation portfolios that would be suitable for three different client risk profiles – conservative, balanced and aggressive.

Often described as 'the investor's only free lunch', diversification offers the prospect of a higher level of return for a given level of risk.

In practice, diversification depends upon investing in a number of different sources of return. Combining a range of asset classes adds diversification, as they react differently to economic news and their performance is not in step, or correlated. The same relationship holds true for active returns and market returns – typically, they are not correlated and so bringing them together adds to the diversification benefits.

Correlation measures the strength of the relationship between two investments. It is a useful tool when establishing a portfolio's asset allocation. Correlation values range between +1 and -1. Assets that are perfectly correlated, or move together in the same direction,

Expected Return



Expected Risk

have a positive correlation of 1. Those that exhibit an inverse relationship (moving in opposite directions) have a correlation of -1. A correlation of zero implies that there is no relationship.

Correlation plays a critical role in the design of a strategic, or long-term, asset allocation. As the global capital markets have evolved, opportunities for advisers to find uncorrelated asset classes have grown. Advisers can now expand core portfolios of traditional investments into non-traditional areas such as emerging equity, emerging bonds and alternatives. These less correlated asset classes offer diversification opportunities not available through domestic stocks and bonds.

When thoughtfully applied, correlation allows otherwise risky investments to become valuable portfolio constituents that add diversification.

Capturing the benefits of diversification allows advisers to deliver a better balance of risk and return for clients

### Implementation of Strategic Asset Allocation (SAA)

An example of SAA can be illustrated with target risk portfolios which are often broadly classified across the risk/return spectrum as conservative, balanced and aggressive. They are generally constructed using traditional assets such as equities, bonds and cash. A portfolio with higher allocations to fixed income

tends to be less volatile than those with higher equity allocations.

The table below shows the SAA benchmark of each target risk portfolio and the associated key performance and risk data versus an investment solely in UK equities. The portfolios have been derived by using an asset allocation model that selects and allocates to the most attractive asset classes in terms of expected return, risk and low correlation.

The portfolios are strategic portfolios derived for a long term investment horizon and are not intended to time the market, i.e. there is no Tactical Asset Allocation (TAA). The allocations are designed to provide the maximum diversification benefits for each level of risk. Each portfolio is invested in multiple underlying iShares ETFs and in doing so have gone beyond traditional assets and include alternatives such as emerging markets, property, infrastructure and commodities. Before the advent of ETFs, many of these alternative assets were difficult to access, expensive and illiquid.

ETFs are cost effective instruments for implanting asset allocation views, with the average TER in Europe being 37bps for equity ETFs and 16bps for fixed income ETFs. (Source: Strategic Insight Simfund Global, Global ETF Research and Implementation Strategy Team, BlackRock, data as at end January 2011.)

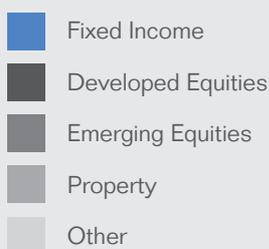
*ETFs are the ideal building blocks to implement a Strategic Asset Allocation framework.*

### Tactical Asset Allocation (TAA)

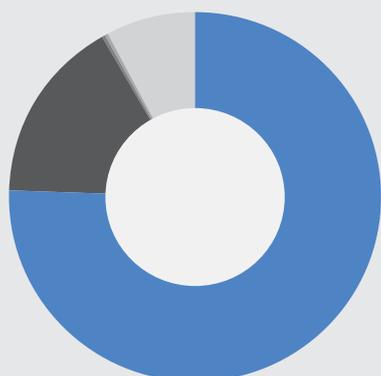
Once a client's SAA has been set, you may decide there are opportunities to improve performance by making short-term tactical asset allocations, or 'tilts'.

TAA seeks to enhance returns and limit risk through shifts away from the strategic mix. ETFs are useful vehicles for tactical strategies such as sector rotation.

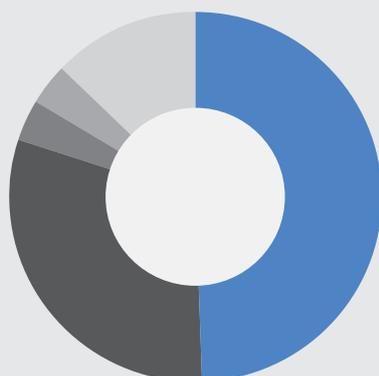
A portfolio can quickly be positioned to be overweight or underweight in entire sectors by using ETFs. They can also seek relative outperformance



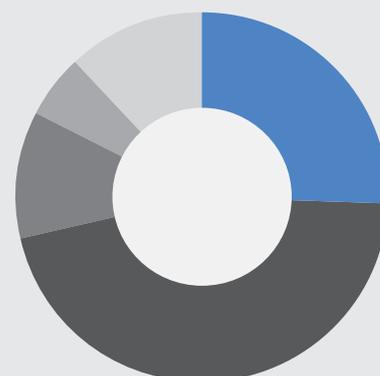
Conservative



Balanced



Aggressive



Economy	Full Recession	Early Recovery	Full Recovery	Early Recession
Asset class	Bonds Cash	Equities Commodities	Equity Commodities	Bonds Cash
Sector rotation	Non-cyclicals	Cyclicals	Cyclicals	Non-cyclicals
Style and size rotation	Large-cap value	Large/mid-cap value	Small-cap growth	Large/mid-cap growth
Bond market rotation	Long maturity Treasuries	Corporate bonds Emerging Market bonds	Corporate bonds Emerging Market bonds. Move to shorter maturity	Treasuries Short maturity

Source: BlackRock. For illustrative purposes only.

among different market cap sizes or styles. Fixed income ETFs can be used to increase or reduce duration (the sensitivity of the portfolio to changes in interest rates) and credit risk among bond portfolios.

For example, if a client wanted to implement an underweight or overweight exposure to fixed income asset classes, the adviser could choose from a variety of corporate, government or inflation-linked iShares ETFs to execute the tactical strategy.

Short-term tactical opportunities offer the prospect of enhanced returns – ETFs help advisers position portfolios quickly and efficiently.

The table above illustrates which asset classes, sectors, styles and types of bonds are typically expected to perform best at different points in the economic cycle. A TAA strategy could be based on these views.

### Ongoing Review of Asset Allocation

Striking the right balance between risk and return is not a one-off decision. Rebalancing ensures a portfolio continues to meet your client's original objectives through changing market conditions.

Rebalancing simply moves allocations back to SAA weights following market movements, as opposed to more deliberate tactical moves. The process of rebalancing requires a focus on risk as well as return, often resulting in the sale of a portion of the best performing investments in the portfolio.

A predetermined rebalancing strategy, based on how far a portfolio can deviate from its SAA and the frequency of review, is accepted as best practice. This strategy should include careful consideration of transaction costs versus the tracking error, or deviation of the portfolio from the SAA.

A portfolio consisting of ETFs improves the ability to monitor and rebalance the allocations as the underlying ETF building blocks are transparent, liquid and flexible. These advantages allow portfolios to be rebalanced efficiently.

In addition to rebalancing, your client's original investment objective should also be reviewed and ongoing research should be carried out to assess the potential of introducing new asset classes to the portfolio, as well as enhancements to the asset allocation process itself.

Effective portfolio rebalancing ensures the strategic allocations are maintained through time, regardless of market conditions.

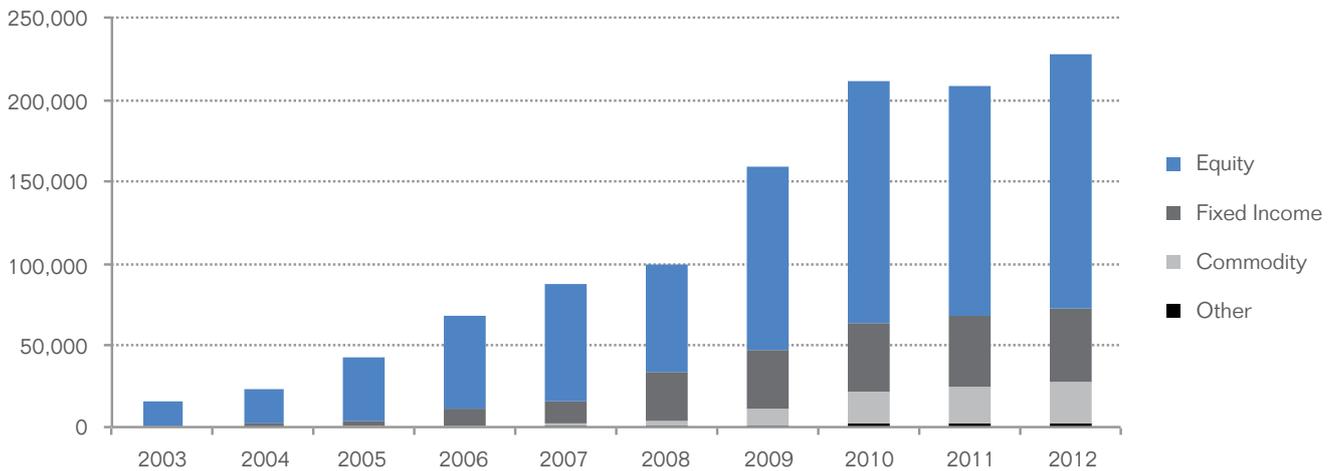
*David Bower is Head of iShares UK. The views expressed in this article are his and do not necessarily reflect those of the London Stock Exchange. ■*

# ETF Market Growth

The London Stock Exchange is one of the key global markets for ETFs and our offering has grown from the first listing in April 2000 of a single ETF on the FTSE 100 Index, to a product range today of over 600 ETFs. This continued growth has seen considerable expansion in the range of product types offered and in the breadth of underlying indices and asset classes to which ETFs now offer exposure.

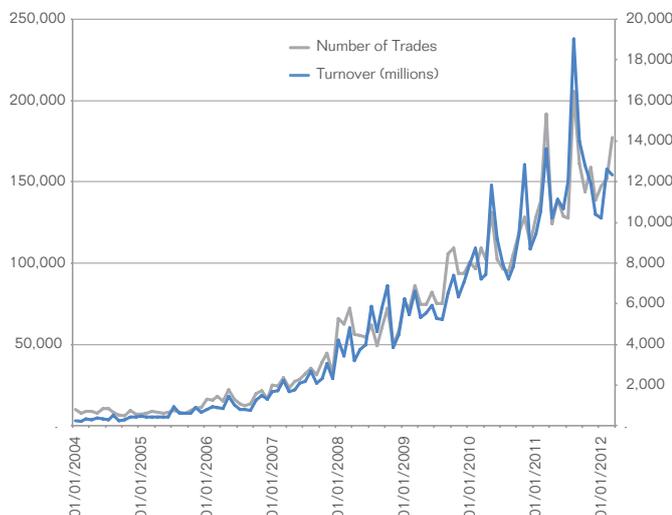
With the expansion of the market, the diversity and choice of products offered by a growing range of ETF providers has encouraged continued innovation and has offered investors even greater choice. Not only can investors use ETFs to access a wide range of equity indices such as developed, emerging markets, specialist theme and sector indices, but there are a growing number of fixed income ETFs which allow investors to gain exposure to government and corporate bond markets.

ETFs on the London Stock Exchange can be traded in up to three different currency lines of GBP, USD and EUR. A full list of ETF providers and products can be found on our website.



Source: Deutsche Bank Weekly European ETF Market Monitor, 28 March 2012

The London Stock Exchange's ETF market has seen significant growth in turnover and number of trades, particularly since 2007.



*'Largest Exchange for ETFs in Europe by Volume'*

8th Annual ETF Global Awards 2012

*'Best European Exchange for Listing ETFs'*

ETF Express Awards 2011



## How Can IFAs Access ETFs?

ETFs can be traded easily via a stock broker or an authorised wrap platform. Unlike mutual funds, ETFs can be traded at any time during the trading day, at any size and at a known, current market price.

ETFs listed on the London Stock Exchange trade and settle on a T + 3 settlement cycle through the UK domestic settlement system CREST in the same way as other securities listed on the London Stock Exchange. Trades executed on the electronic order book offered the added security of being backed by the clearing house's central counterparty (CCP) system.

# ACCESSING ETFs - THE ROLE OF WRAP PLATFORMS WITHIN THE ETF MARKET



As a key access point for ETFs, sales via wrap platforms have seen significant increases – at Ascentric the number of ETF transactions increased 155% in 2011 to 208,000 and the number of clients holding them nearly doubled to 6,390. The role of the wrap platform in the market is best understood by examining the interaction of the different platform operating models and the wider retail financial services industry.

In short, the role of the wrap platform in the ETF market is to provide the technology that gives advisers an easy way to access these products. At this point it's worth drawing a distinction between wrap platforms and fund supermarkets. Whilst similar, there are clear differences between the two operating models. Until very recently, access to ETFs was only available through wrap platforms due to their open architecture. In this context then, rather than simply providing access to a product, wrap platforms are giving access to choice

In recent years, the UK retail financial services market has been through a period of upheaval. The most significant factor for both the ETF market and wrap

platforms has undoubtedly been the Retail Distribution Review. RDR has focused on bringing transparency to the way advisers interact with clients, ensuring clarity as to what services are being provided, by whom and at what cost.

Over time investment propositions have widened to meet clients' increasingly complex requirements. But, being able to access ETFs and actually using them are two separate issues. Wrap platforms (as opposed to fund supermarkets) offer an unbundled pricing structure and provide a mechanism that allows advisers to provide a transparent fee-based service to their clients without having to limit the range of investment options to those paying commission.

In defining their advice propositions, many financial advisers have sought to reduce risk in their businesses by outsourcing their investment process to Discretionary Fund Managers. The wrap platforms' role in this shift is crucial for the ETF market place for two main reasons. Most importantly, the very nature of DFMs is that they need access to more than just unit trusts and OEICs, with ETFs high on their lists of

*With ETFs now firmly part of the mainstream and the post-RDR world almost upon us, there is no reason their increasing use will not continue.*

requirements, and with some running portfolios constructed solely with ETFs. Secondly, wrap platforms provide the functionality for the DFMs to manage their model portfolios.

With ETFs now firmly part of the mainstream and the post-RDR world almost upon us, there is no reason their increasing use will not continue.

*If you would like to find out more information about accessing ETFs please visit [www.ascentric.co.uk](http://www.ascentric.co.uk). ■*

The views expressed in this article are presented by Ascentric and do not necessarily reflect those of the London Stock Exchange.

## ETF Structures

The way in which an ETF replicates the underlying index it is tracking can vary with two main replication models used:

- Physical or 'cash-based' replication
- Synthetic or 'swap-based' replication.

Cash-based ETFs are funds which hold a portfolio of assets designed to track as closely as possible the performance of the underlying index. The creation process for these ETFs involves an authorised participant or market maker buying a basket of securities which reflects the composition of the benchmark index. These securities are then deposited with

a custodian bank who will hold these securities in return for issuing the authorised participant or market maker with ETF units. These ETF units can then be traded on the London Stock Exchange in the same way as shares.

Swap-based ETFs also allow for units to be traded like shares, but use an alternative approach to tracking the benchmark index. Instead of holding the constituents of the index being tracked, a synthetic ETF enters into a swap agreement with a counterparty who is contracted to provide the returns of the underlying index being tracked. This arrangement allows ETF providers to access markets which are less liquid or accessible, or which are more costly to reach.

### Physical-based ETFs

- Replication model typically involves holding some or all of the components of the relevant index
- Involves adjustments to mirror index rebalances and corporate actions
- Optimisation or sampling may be used particularly for broader-based indices or for indices where constituents stocks are less liquid
- High transparency, fund portfolio is typically fully disclosed on a regular basis
- Securities lending often used to generate additional revenue
- This can introduce counterparty risk, but it is important to note that securities lending is established practice in the investment management industry and is also widely used by mutual fund providers.

### Swap-based ETFs

- The ETF enters a swap agreement with a counterparty who guarantees to deliver the performance of the underlying index on a daily basis
- Typically offers more efficient index tracking, with lower tracking error
- Efficiencies offered by swap-based replication can often mean access to a wider product range
- According to UCITS, the value of the index swap must not exceed 10% of the fund's NAV
- Requirements for collateral are specified in the laws of the country where the fund is domiciled
- Many issuers set out rules which are actually more stringent than UCITS requirements
- Collateral is held in a segregated account with the custodian
- Rules and processes in place to ensure that the assets comprised in collateral or substitute baskets are liquid and diverse
- Collateral is monitored and valued on each business day that NAV is calculated.

# ETF MECHANICS – A LOOK UNDER THE BONNET



Deutsche Bank  
db X-trackers

*Manooj Mistry, Head of Product Development at db X-trackers, Deutsche Bank's ETF platform*

Most exchange-traded funds (ETFs) are designed to deliver to investors the risk and return of an investment index by replicating the performance of that index – a FTSE 100 ETF for instance will aim to track the daily movements of the FTSE 100 Index as closely as possible. In terms of replication techniques used, two main types are typically described: direct, physical replication and indirect, swap-based – which is often also referred to as 'synthetic' – replication.

This unofficial classification system is not fully informative, however. To better understand how ETFs work it is necessary to subdivide these categories further into full physical replication, partial physical replication with stratified sampling, partial physical replication with optimisation, funded swap-based ETFs and unfunded swap-based ETFs.

Full, direct physical replication involves buying and managing all the underlying constituent securities of the index being tracked. Managers of these ETFs have to dynamically trade their portfolio to keep up with changes to the index, which means transaction costs can impact tracking performance. Partly to mitigate this, providers often engage in securities lending, which involves lending out the physical securities held by the ETF. This exposes the ETF to counterparty risk – the risk that the

borrower of the securities will default and the ETF will suffer a loss. To limit this risk, the lender (the ETF), demands that the borrower deposit collateral with a third party custodian bank. The idea behind this is that if the counterparty fails then the collateral is liquidated in compensation to the fund.

Full physical replication can become difficult and/or expensive to implement when tracking broad indices that reference a high number of individual securities or when all or some of the underlying securities being tracked are relatively illiquid.

To overcome these problems, physical replication providers have developed tracking methods that involve only holding a portion of the underlying securities of the index. One method is called stratified sampling, and it involves the ETF provider holding a selection of 'representative securities' only. This could entail splitting the index into, for example, sector-based subgroups, and then purchasing a sample of securities from each group. The choice of which securities will form part of the sample may be taken by the ETF manager or by a computer-driven, quantitative model.

The main advantage of this approach is reduced costs to the fund. But it can also increase the possibility of the fund experiencing relatively significant tracking

difference vis-à-vis the underlying index. For example, the ETF could have an unintentional bias towards holding large-cap stocks as part of the sample, which means if small-cap stocks outperform then the fund will fail to reflect the true performance of the broader index it is aiming to track. Also, market exposure in a physical replication ETF using stratified sampling will not be as diversified as the actual index itself.

The other method is called optimisation. Again, this involves only holding some of the underlying constituents of the index being tracked. The difference with stratified sampling is that optimisation methods are entirely model-driven, with a computer system making the buy and sell decisions. The model might analyse historical data on a set of statistical factors – correlations between stocks could be one factor, for example – and from there create an 'optimal portfolio' of securities that constitute a portion of the index being tracked.

## Swap-based replication

Swap-based ETFs have been around since 2001. The premise of the swap-based method is the following: rather than the ETF itself dealing with the task of physical replication, this is instead handled by one or more investment banks,

## *In the case of the European ETFs, most fall under the UCITS framework which ensures that many of these risks are robustly controlled.*

which are expert in providing exposure to indices. Via a contractual agreement with the ETF – a swap agreement – it falls to the investment bank to deliver to the fund the exact index returns, before fees and replication costs, with the effect that the risks inherent to tracking are outsourced to a third party.

The advantage for the investor is precise tracking after fees and costs. Counterparty risk is also present with this arrangement, however. In a similar way to how physical ETFs that engage in securities lending create counterparty risk but then manage that risk by ensuring counterparts post other types of physical securities with an independent custodian, swap-based ETFs create counterparty exposure through their use of swap agreements but then manage that exposure by ensuring that physical assets are held by an independent custodian for the benefit of the fund, should a counterpart default.

Swap-based replication models can be further split into two main types: funded and unfunded. Unfunded swap-based replication involves the investor's cash being used to purchase a basket of securities from the swap counterparty (referred to as the 'substitute basket'), with the latter committed to delivering the performance of the reference index in exchange for the performance of the securities held by the fund. Another financial institution acting as independent custodian holds the substitute basket securities in a ring-fenced account.

The substitute basket must comply with the European UCITS fund regulations on asset type and liquidity, and often (depending on the policies of the provider) will also comply with UCITS-defined rules on diversification. The securities are held in a segregated account with a third-party custodian

where they are regularly independently monitored and verified.

Counterparty risk is measured as the swap 'mark-to-market' (the difference between the net asset value (NAV) of the ETF and the value of the substitute basket). Under UCITS, swap exposure to a single counterparty cannot exceed 10% of the prevailing NAV of the ETF. This means that, in the event of a default by the swap counterparty, the investor could lose up to 10% of the NAV of the ETF at the time of default. To manage this counterparty exposure the swaps will be reset if necessary to ensure that the ETF has no more than 10% exposure to the swap counterparty. But many ETF providers using this model set a more restrictive swap reset limit, further minimizing the level of counterparty risk.

It is possible for securities lending to take place with this model, but many swap-based ETF providers choose not to lend out the physical basket.

With the funded swap model, rather than use the investor's cash to purchase a portfolio of securities from the swap provider, the ETF instead delivers the cash to the swap provider, which in return commits to delivering to the ETF the performance of the index being tracked. At the same time, in order to ensure that the exposure of the ETF to the swap counterparty is kept within the UCITS counterparty exposure limits, the swap provider delivers a basket of securities as collateral to the custodian bank.

The collateral must be diversified in accordance with the Committee of European Securities Regulators (CESR) 2010 guidelines on collateral for derivatives, while some providers also apply other in-house rules to ensure quality of collateral.

Margin requirements are applied to the collateral. The aim of such margin

requirements is to ensure that the counterparty exposure is kept within necessary limits even if there was some decline in the value of the collateral. The collateral is independently monitored, verified and marked-to-market on a daily basis to ensure that the mathematical net counterparty risk exposure remains within UCITS requirements, although in many cases ETF providers will aim to reduce the swap counterparty exposure to zero.

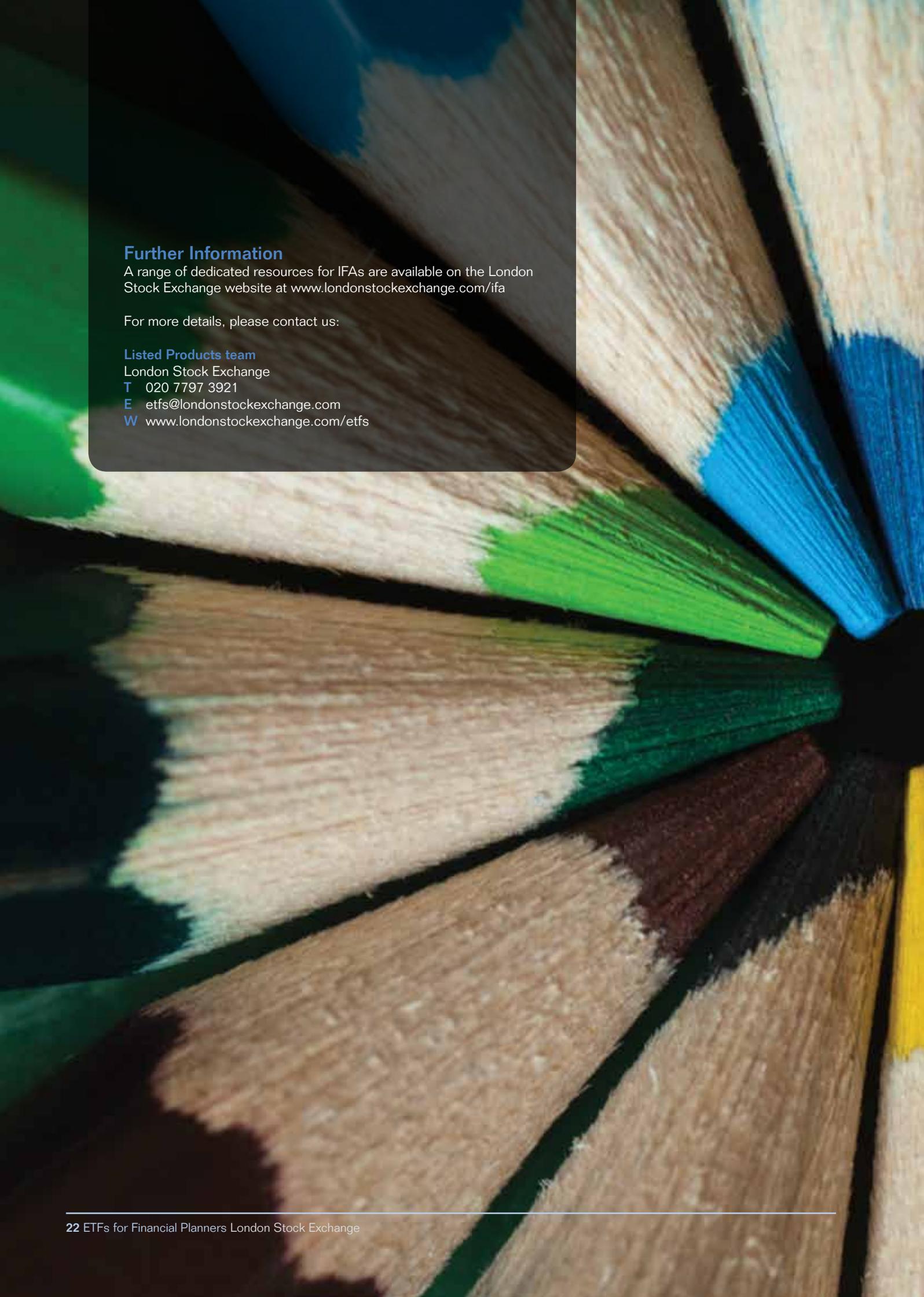
No securities lending takes place at the fund level with this technique.

### **Underlying risks**

All the replication techniques outlined above are used by ETF providers in Europe. All create underlying implicit counterparty, legal or structural risks which need to be effectively managed by the manager. However, these risks are not unique to ETFs – many mutual funds engage in securities lending, while many absolute return funds actively use derivatives as part of their investment policy.

A good starting point for objectively assessing underlying implicit risks is to look at how the product is regulated. In the case of European ETFs, most fall under the UCITS framework, which ensures that many of these risks are robustly controlled. Beyond this, many providers put in place additional measures to further lower or control underlying implicit risks (such as reducing counterparty risk below UCITS thresholds), to provide further protection to investors.

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### Further Information

A range of dedicated resources for IFAs are available on the London Stock Exchange website at [www.londonstockexchange.com/ifa](http://www.londonstockexchange.com/ifa)

For more details, please contact us:

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