The what, why and how of Exchange Traded Funds

Rebecca Sin, Head of ETF Sales Trading Asia at Commerzbank is a keen advocate of exchange traded funds (ETFs). She made a presentation to the Hubbis Investment Solutions Forum providing Asia-based high net worth individuals with further information on ETFs and trading strategies.

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THE GLOBAL ETF MARKET – covering equities and fixed income funds - has enjoyed a remarkable explosion in volumes to surpass USD5.0 trillion market share today. What are ETFs? They are securities that track the value of an index, commodities or a basket of assets and trade like a stock on the exchanges. Many ETF advocates see a great potential for them in Asia, where they are under-utilised, arguing that they are the perfect tool for portfolio construction, being cost-effective, liquid, transparent, and versatile in terms of asset class label.

REBECCA SIN
Commerzbank

A USD5.0 trillion juggernaut rolling into Asia

The USD5.0 trillion ETF industry began life only 30 years ago and a decade ago was worth around USD500 billion.

Since the global financial crisis, a decade on has brought the most explosive growth. But Asia is only a small portion of the overall market so far, and therefore offers opportunities for growth. One core reason for the ETF explosion is the ongoing shift over the past 10 to 15 years from active to passive investment.

This means that distributors, IFAs, advisers and private banks

have moved, or are moving globally, to fee-based advisory. It is a sensible shift from a situation where the product issuer has been paying rebates [retrocessions] to the distributors who then sell their products to investors.

This is driven, in considerable part, by regulatory tightening on retrocessions and other 'hidden' fees passed between product creators and the advisory community - that for example has helped the Australian ETF market volumes soar in recent years.

Sin began her talk by explaining that ETFs act like a mutual fund and a stock combined. "An ETF can be traded at any time, whereas a mutual fund only has one price at the end of the day, meaning there is more liquidity and transparency in ETFs."

ETFs act as building blocks in portfolios. "You can have active products," Sin observed, "you can have passive, you can have both. ETFs can be used as building block in a portfolio for diversification, quick market access, tactical asset allocation, and cash equalisation. For example, if there is cash in a portfolio waiting to be deployed in the right active stock selection, that cash can be 'parked' temporarily, in ETFs until an active strategy is found, or perhaps an anticipated event leading to a market change, for example if its expected that Italy will bounce back after a spate of bad news, but there's no time for the due diligence required to buy individual stocks, an ETF can be used instead to express views on the country as a short term play."

Sin also remarked that while ETFs are passive products that by definition will not beat the benchmarks, over time they are cost-efficient.

She said, for example, that an investor can buy the S&P 500 at just four basis points. "Passive ETFs are far cheaper than other active products, they are also diverse, liquid, and tax efficient."

Strategies for choosing ETFs

Selection of an ETF is more complex. "A lot of people make this mistake of selecting the ETF based on assets under management and the management fee," Sin noted, "They often choose the largest ETF with the cheapest management fee, all of which seems to make sense. But there are strategies that will help wealth advisers and their clients more accurately and logically select ETFs."

Sin first highlighted exposure. "Do you want a physical or synthetic ETF? Physical replication is the most common and popular. For example, if you buy an S&P 500 ETF, the ETF will physically own all 500 names of the index. On the other hand, a synthetic ETF will utilise derivatives such as futures and swaps. For example, it is not physically possible to move barrels of oils around so the most cost efficient way to do this is via a swap. For example, if you want exposure to oil, a practical form would be a synthetic ETF."

Sin then addressed structure. "What type of ETF are you buying? Is it smart beta, leveraged/ inverse, currency or commodities? There are many different structures to invest into, so make sure you pick the right structure for the exposure you want."

Sin then touched on performance. "This is the total cost of ownership. A lot of people simply look at the management fee and AUM, but they do not factor in how much it costs them to trade in and out of the ETF, the tax implications, the bid-ask spreads. So, when you think of an ETF, you have to look at these various components to determine if the ETF is suitable for your portfolio. "

Liquidity

Finally, Sin highlighted liquidity. "The key point here, without going into technicalities is that ETFs are as liquid as the underlying. It may seem like an ETF is illiquid, especially when you check in Bloomberg or other data sources but Commerzbank is a market-maker and can provide liquidity on ETFs. Via our proprietary platform, we make markets in 4,000 ETFs globally across all asset classes thanks to our state of the art electronic trading platform." Sin also explained that the bank offers research and advisory. "If you are thinking about using an ETF, we are not an issuer, so we can help you select the right ETF for your portfolio, we have no particular preferences or allegiances. We also provide custom solutions on ETFs to help clients build the right portfolio for their needs including model portfolios, custom baskets and funds of funds."

Sin closed her talk by noting that as market makers, Commerzbank provides liquidity on ETFs, even when markets are closed. "For instance, you do not need to wait for the US to open to trade US listed ETFs. You can trade US/European ETFs during Asian hours without having market impact."

Asia – a region of immense potential

Asia is a region of immense opportunity for ETFs, having lagged the worldwide ETF explosion. US still mainly dominates the worldwide landscape with a market shares of more than 70%, while Europe represents almost 16% of the market. Asia meanwhile represents less than 10% of global ETF valuations and that presents Commerzbank with a world of opportunity. ■