## Overview

An Exchange Traded Fund (ETF) is an investment fund that is designed to track the performance of an index or a sector but can be traded like a stock. An ETF is basically a bundled basket of securities that are traded on an exchange, which gives investors an innovative way to get effective exposure to specific markets or sectors.

An ETF is a hybrid financial product, a mix between a stock and a mutual fund. Like a stock it can be traded on a stock exchange, and like a mutual fund, it behaves like a diversified portfolio.

The first ETF was launched in 1989 on Toronto Stock Exchange and was called Toronto Index Participation Fund (Tips 35) tracking the largest 35 stocks on the exchange. This was followed by another ETF named SPDR (Standard & Poor's Depository Receipts) launched on American Stock Exchange (AMEX) in 1993 to track the S&P 500 index. Today, more than 100 ETF's worth around $30 billion are traded across the globe; such as Qubes, SPDRs, sector SPDRs, MidCap SPDRs, HOLDRs, iShares, Vipers and Diamonds.

Although ETFs were initially targeting institutional investors, their flexibility, diversification and convenience attracted individual investors over time. ETFs also enjoy the same features of a normal stock, varying from instant selling at anytime during the trading session, to short selling and margin trading.

## ETFs Main Features

- Newly created ETFs are delivered by the fund manager to a market maker in exchange for the underlying shares. These underlying shares are held by the fund manager, while the newly created ETFs can be traded by the market maker in the secondary market.

- ETFs units can be created and redeemed through the unique "in kind" creation and redemption process, which is typically used by large institutions and high net worth individuals. i.e the investor does not get cash in return when he/she redeems his/her ETFs, but the underlying shares.

- Each ETF has a net asset value (NAV) that is calculated with reference to the market value of the underlying securities.

- Unlike regular mutual funds, ETFs do not necessarily trade at its NAV. Instead, the market price of an ETF is determined by forces of supply and demand of the ETF, which is driven, to a large extent, by the underlying values of their portfolios, but other factors can and do affect their market prices. Since ETFs are traded on the open exchanges, they do not necessarily have to perfectly track the NAV of their holdings, and this disparity may give rise to arbitraging opportunities. For example, it is possible that each Spider would trade at a 2% discount to the value of the underlying shares. In theory, when such an imbalance occurs, arbitrageurs would step in and buy or sell shares in large blocks (called "creation units") and redeem them for the underlying shares. Premiums and discounts could arise, especially for thinly traded funds.

- Market Makers (licensed brokers or financial institutions appointed by the fund manger to market make for the ETF units in the secondary market ) are obliged to quote on a continuous basis bid and offer prices of the ETF units.

- ETFs are exposed to the economic, political, currency, legal or other risks of a specific sector related to the index that the ETF is tracking.

- ETFs investors pay annual charges to the fund manager, which are comparable to, or even lower than, unit trusts, open-ended investment companies (Oeics) and investment trusts. However, investors must pay a commission to brokers to buy or sell ETFs.

- Dividends paid by the underlying stocks held in the ETF are retained as cash until they are paid to investors. The management fees is usually taken from this cash on a daily basis.

## ETFs types

ETFs can be categorized into three types of funds:

- **Broad-Based**, which tracks a stocks' grouping from different industries and market sectors. For example, iShares S&P 500 Index fund is a broad-based ETF that tracks the S&P 500.
- **Sector**, which tracks companies of related industries. For example, iShare Dow Jones U.S. Healthcare sector Index Fund is a sector ETF that tracks the Dow Jones Healthcare Sector.
- **International**, which tracks a group of stocks from a specific country. For example, iShares MSCI-Australia tracks the Morgan Stanley Capital International index for Australian stocks.

## ETFs advantages

### 1. Short-term trading instrument:

ETFs act as short-term trading instruments since they can be used as a tool to park the money in till the investor takes the decision of what exactly to buy. For instance, if an investor decides to invest in UK equities, based on an information that the market is going up, but still he/she doesn't know which funds or shares to invest in, the investor can buy an iFTSE, which is a UK listed ETF, and hence has an immediate exposure to the market to participate in any rise till he/she decides what specific stocks he/she wants to trade on.

### 2. Diversification:

ETFs can cover sectors and indexes providing diversification among groupings of companies and businesses, thus reducing the price volatility risk for investors of a specific sector or security. In other words, ETFs broaden the number of invested companies, which increases the investor's degree of protection against individual stock decreases.

### 3. Short selling possibility:

Like ordinary stocks, investors could short sell ETFs of markets, sectors or indexes they expect to under-perform during the coming period. This is not applicable in other funds.

### 4. Liquidity:

ETFs are traded throughout the trading session at anytime, unlike unit trust funds that are usually traded at end-of-day prices. Furthermore, ETFs prices are readily available throughout the day in real time enabling investors to track the prices and values of their investment at anytime of the day.

### 5. Buying on margin:

ETFs can be bought on margin similar to individual stocks.

### 6. Cost:

In terms of the annual expenses charged to investors, ETFs are considerably less expensive than the majority of mutual funds. Yet the commissions paid to buy and sell ETFs could highly add up especially to those who regularly invest large sums of money and trade frequently.

**The following table compares an ETF with a mutual fund and an individual stock to illustrate similarities and differences**:

| Attribute | ETF | Index Mutual Fund | Individual Stock |
|---|---|---|---|
| Diversification | Yes | Yes | No |
| Traded throughout the day | Yes | No | Yes |
| Can be bought on margin | Yes | No | Yes |
| Can be sold short | Yes | No | Yes |
| Tracks an index or sector | Yes | Yes | No |
| Tax efficient as turnover is low | Yes | Possibly | No |
| Low Expense Ratio | Yes | Sometimes | Not a factor |
| Trade at any brokerage firm | Yes | No | Yes |

Source: Nasdaq

## Conclusion

ETFs are investment products representing a portfolio of securities and are designed to track the performance of an index, a sector or a sub-sector. They are traded like ordinary shares during trading session hours, bought and sold through the stockbrokers. The main advantages of ETFs include flexibility, diversification, lower risk, liquidity and transparency. Nevertheless, investors are advised to look carefully before they invest in ETFs as the cost advantage is not always valid as the trading costs can quickly add up.