

Price is what you pay, value is what you get

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This well worn *Buffettism*, provides a useful introduction into the role and risks of Exchange Traded Products in portfolios. As the financial services industry has evolved over the past few decades, so has the ability for institutions and private investors to efficiently access a diverse range of assets. Now Exchange Traded Products (ETPs) and, more specifically, Exchange Traded Funds (ETFs) are all the rage, attracting over USD2 trillion in global assets. The main appeal for investors remains the relatively low cost and perceived simplicity, albeit that the growing complexity of the various ETF products has also created a number of issues around their suitability for investors.

Due to their relative popularity, this article will focus on ETFs. With over 80% of the ETF market equity-based, there are a number of issues that require consideration when determining whether to recommend investment into an equity-based ETF. The first is not dissimilar to selecting any investment vehicle – determining whether the underlying features of the ETF match the investor's circumstances. Understanding the type of market conditions in which ETFs are likely to outperform, the structure of the ETF, and the impact on the investor's diversification at the asset class and portfolio levels are also important considerations (and often difficult to accurately assess).

The evolution of the ETF market has also increased the complexity of the underlying structures to include physical and synthetic ETFs. Physical ETFs directly invest into the assets, either by full replication where they aim to generate the same return as the index or by sample replication. The latter ETFs invest in a sample basket of the underlying index, and are popular when tracking indices comprising a large number of shares. However ETFs don't always follow the sector or exchange that they're supposed to due to a number of shortcomings impacting upon their tracking errors. The popular market capitalisation weighted indices are structured to represent the total market capitalisation of the companies weighted by the size of the overall market. This means that the performance of larger companies with a higher weighting in the index has a greater impact on the performance of the overall index. An ETF that replicates an index will buy the companies that have been outperforming and reduce their holding to companies that have been underperforming - meaning that the ETF may be buying increasingly expensive companies. Of course the opposite is true, as a company's share price falls and becomes cheaper ETFs will sell down their exposure in the company. This overweighting of overvalued companies / underweighting of undervalued companies may also contribute to a higher tracking error than expected.



It is not uncommon for physical ETFs to lend out securities without full visibility of the counterparties or the revenue generated. Last year it was disclosed that the iShares FTSE 250 had lent out 92% of its securities on average over the year. 60% of the revenue obtained by the securities lending practice was retained by the fund and 40% was taken as profit.

Synthetic ETF structures use derivatives to generate the same total return as the index, and include total return swaps, forward contracts, futures contracts and options. Whilst the synthetic participants advocate lower overall investment costs, reduced tracking error and access to markets which are difficult to be invested in physically, they tend to provide less transparency and greater levels of counterparty risk. The major synthetic providers are reacting to the growing negative sentiment towards synthetic ETFs by reducing counterparty risk through diversification across a number of participants, and resetting swaps on a daily basis. Despite this, providers are converting a number of

their ETFs from synthetic to physical, primarily it seems in response to the perception that *synthetic is bad*. The fact that more than three-quarters of the synthetic ETFs listed in Europe are at risk of closure after failing to attract sufficient inflows in their first three years since launching is also contributing towards this trend.

One area where synthetic ETFs have been used widely is with Commodity ETFs. In many cases, these track the price of a commodity through the futures markets, buying the contract closest to expiry. As the weeks pass and the contract nears expiration, the ETF provider will sell it (to avoid taking delivery) and buy the next month's contract. This operation, known as the "roll," is repeated every month. If contracts further from expiration have higher prices (contango), the roll into the next month will be at a higher price, which incurs a loss. Therefore, even if the spot price of the commodity stays the same or rises slightly, the ETF could still show a decline. The opposite is true, if futures further away from expiration have lower prices (backwardation), meaning that the ETF will have an upward bias. The divergence caused by this can be large. For example, a year or so after its inception in 2006, the United States Oil Fund trailed its benchmark, West Texas Intermediate crude oil, by 13%.

The business risk of ETFs has again come into the spotlight, with falling equity markets resulting in the highest level of failed trades in the ETF market for nearly two years. This has raised concerns about the structure and liquidity of these investments in times of volatility. Trades in ETFs tend to become more likely to fail in volatile markets because of the complex way in which new ETF shares are created. During these times large financial institutions exchanging the baskets of underlying securities with Funds Managers for new ETF shares can experience lengthy delays, leading to failed trades and a lack of liquidity. And this is not limited to equity ETFs. As interest rates trend higher, some market participants are expressing concerns over bond-related ETFs' ability to meet large redemptions. Last month, a major global bank who is an authorized participant creating and redeeming ETF shares, suspended redemptions on some ETFs, stoking liquidity concerns over the bond ETF market. That's not to suggest that ETFs are any better off than a Funds Manager facing a large redemption. As has been witnessed over the years, if the manager can't meet the sell requirements, then redemptions are temporarily suspended. However, investors should be aware that since ETFs are traded on an exchange, they would likely face a widening bid / ask spread instead any suspensions.

The magnitude of the operational risks associated with ETFs has also caught the attention of global regulators such as the Bank of International Settlements and Financial Stability Board, who have repeatedly warned investors about the potential significant systemic failures associated with ETFs. That is not to say that all regulation has been good, with US registered ETFs required to conform to the same rules as mutual funds. This means no more than 25% of assets are permitted in any one security and securities with more than a 5% share are restricted to 50% of the fund, creating challenges for ETFs tracking the performance of a sector where there are a lot of dominant companies. The iShares FTSE NAREIT Mortgage REIT, was off its benchmark because one REIT grew to over 50% of the index (offsetting the declines in most other mortgage REITs during 2008). The ETF could not participate fully in this gain because it had to keep trimming its position back to 25%.

As the demands for more ETF flavours have expanded, participants have been enticed into a number of thinly defined markets that focus on illiquid stocks, foreign stocks and bonds. While there is a belief that opportunities can be exploited through exposures to esoteric markets, these ETFs can be subject to diverse levels of tracking error. Whilst sector, international and dividend ETFs tend to have higher absolute tracking errors than broad-based equity and bond ETFs, the prominent contributor to tracking error appears to be high management expense ratios (MERs).

As with managed funds, ETFs pool investor assets and buy stocks or bonds according to a basic strategy spelled out when the ETF is created. Because they trade like stocks, ETFs can be sold short, with many having related options contracts, allowing investors to control large numbers of shares with less money than if they owned the shares outright.

The *wisdom* for including index-type ETFs in a portfolio is that active fund managers are unable to add value to stock selection net of the active fee levels, as markets are perfectly efficient. With some investment advisers demonstrating that they can consistently select active fund managers that outperform relative indices after fees, ETFs may not be appropriate contributors towards achieving investor's risk-return objectives. Active fund managers have a greater ability to outperform at times when the performance and valuations of companies and sectors have a high level of variability, and can consider macro-economic factors in their decision making and adjust their portfolio accordingly.

Advisers using ETFs, need to be fully aware of the implications of investing in an ETF in terms of the investor's specific circumstances and objectives and their overall impact upon portfolio's risk profile. As is often the case in life, you get what you pay for.