

Investing in Exchange Traded Funds

What are ETFs?

ETFs (exchange traded funds) are index-tracking open collective funds listed on the London Stock Exchange, which combine the ready-made diversification of unit trusts with the simplicity of shares and equities. They are eligible for ISAs but attract no stamp duty,

ETFs have some of the lowest annual charges of all collective investment schemes and were first introduced in 2000. There are now a vast number of ETFs available, tracking equity and fixed income indices in the UK and around the world.

In 2006 the London Stock Exchange became the world's first exchange to offer a multi-currency trading service for ETFs giving investors a tax-efficient and currency risk-free alternative to buying ETFs in the US markets.

Trading strategies

ETFs can help in a range of investment strategies:

Rebalance portfolios and steer investment strategy quickly and easily

The flexibility that ETFs offer means that asset allocation decisions can be executed instantaneously and cheaply. An investor can achieve broad exposure to equity, bonds, the US or Europe very easily. Subsequent rebalancing can take place with just a couple of trades. ETFs also allow even the smallest portfolios to achieve broad diversification.

Core / satellite approach

No investor or even investment professionals can follow every instrument in every market, at all times. Exchange traded funds allow investors to build a core market portfolio while concentrating on those instruments they follow closely and add their stock picks for additional out performance. In this way, passive (tracker) funds can form part of a very successful active strategy.

Tactical investing in the short term

Sometimes markets move very fast indeed and the ability to pick up the phone, receive a real time price and trade there and then can make all the difference.

Unlike unit trusts, where you may not be able to deal for 24 hours and will not find out the price until afterwards, Exchange traded funds allow you to both take advantage and avoid the pitfalls of fast markets.



A summary of how Exchange Traded Funds compare to similar products:

	ETF	Unit Trust	Investment Trust
Structure	Open-ended Price linked to NAV	Open-ended Price linked to NAV	Close-ended Price indirectly linked to NAV, and driven by market
Trading	During market hours/ Real prices	Once a day/ Future prices	During market hours
Buy	Through a broker	Fund Manager. Supermarket or IFA	Through a broker
Unit/Share Price	Close to NAV	At NAV	At discount/premium
Investment Style	Index Tracker	Active/Index Tracker	Active/Tracker
Stamp Duty	No	No	Yes
Initial Charges	0+ Broker Fee	0+ Broker Fee	0+ Broker Fee
Annual Charges	0.20-0.75%	Up to 2%	Typically 1%
ISABLE	Yes	Yes	Yes

ETF fees are minimal, and trading is more convenient.

How they work

Trading platform

ETFs trade on the SETS trading system, which combines the benefits of order book trading with market maker support.

Creation/redemption

As the diagram shows, the operation of ETFs can be separated into 3 distinct flows or transactions:

1) The market maker purchases a basket of shares (in the stock), as specified by the ETF custodian, for cash.

2) This basket of securities is then exchanged with the ETF custodian for a set number of ETF units or shares (creation).

3) The market maker then has an inventory of ETF shares through which to satisfy market demand for buy/sell orders.

Redemption is simply this process in reverse whereby a market maker will swap a defined number of exchange traded fund shares with the ETF custodian for the underlying basket of shares, which can then be sold for cash in the secondary market.

Creation/Redemption

