EXCHANGE TRADED FUNDS

An innovative investment solution

Combining the advantages of both index funds and stocks, ETFs carry a range of benefits for private clients. Eleanor Hope-Bell, head of wealth sales at iShares, explains

As word of mouth spreads about Exchange Traded Funds (ETFs), it will not come as a surprise that an increasing number of private clients are hearing about and asking their wealth managers about the benefits and uses of ETFs.

ETFs combine the advantages of both index funds and stocks. They are liquid, easy to use and can be traded in any quantity just like stocks. At the same time an ETF provides the diversification, market coverage and low expenses of an index fund. These characteristics combine to create an investment tool that provides investors with the broad exposure they require, at the level they want; at the moment they need it. As such, they are fast gaining a reputation as an innovative investment solution – a claim greatly supported by the accelerated growth in ETFs.

In recent years, we have seen a dramatic expansion in the number of indices, styles and asset classes covered by ETFs with a particular emphasis on country related products, single-country exposure, regional indices and sectors.

ETF GROWTH

As Deborah Fuhr of Morgan Stanley reported in February, 2007 was another year of significant growth for the ETF industry revealing there are now:

- 1,171 ETFs with 1,909 listings on 41 exchanges around the world, which represents a 64 per cent year on year increase in the number of ETFs at the end of 2007.
- Worldwide ETF AUM increased by 40.8 per cent YTD, which is greater than the 7.1 per cent rise in the MSCI World benchmark in USD terms. Europe listed ETF AUM increased by 43.1 per cent and ETFs in the US increased by 42.7 per cent.
- The US has the largest number of products and assets under management; 601 ETFs and $580.7bn (€396.8bn), followed by Europe with 423 ETFs and $128.4bn.

This exceptional growth is underpinned by the core benefits of ETFs, whereby investors can use these relatively simple investment tools for both strategic and tactical exposure.

CORE BENEFITS

Transparency – investors know exactly which securities are held by the fund at any given time.

Flexibility – ETFs are listed on stock exchanges and can be traded at any time the market is open, meaning investors access continuous, real-time prices.

Diversification – ETFs provide immediate exposure to a diversified portfolio of securities, while also providing access to a wide range of markets and asset classes that can help to diversify an existing portfolio.

Easy to use – ETFs are potent tools which are traded over the stock exchange, meaning that investors can buy and sell ETFs exactly as they would trade local shares – no additional operational setup is required, as is often the case with derivatives, and no new accounts need to be opened.

Liquidity – The unique primary and secondary market mechanism ensures that ETFs are highly liquid, and that liquidity will always be available for investors looking to buy or sell ETFs.

Cost effective – ETFs offer a cost effective route to diversified market exposure. The average total expense ratio (TER) for equity ETFs in Europe is 49 basis points, while the average TER for the average equity mutual fund in Europe is 120 bps (Fitzrovia 2006).

ASSET ALLOCATION

ETFs can be used for both strategic and tactical asset allocation. When making a strategic asset allocation, it will broadly be made between bonds and equities, based on a long-term view of market opportunities and the risk profile of the investor. This is sometimes called the "policy mix". The decision on how a portfolio's investments are allocated between stocks, bonds and cash has shown to have a considerable impact on the performance and risk profile of the portfolio.

Over the long run, a strategic asset allocation strategy may be constrained by its rigidity. Therefore, the process of Tactical Asset Allocation (TAA) using ETFs may be used to engage in short-term tactical deviations from the mix in order to capitalize on unusual or exceptional investment opportunities. Tactical asset allocation can be described as a moderately active strategy which can be used for the following:-

Value Creation / Capturing: this is where the investor would like to take advantage from certain situations in the markets, such as temporary stock undervaluation. To achieve this, an approach could be tilting with equity income, sector, or country specific ETFs.

Risk Alteration: this is where the investor would like to take the opportunity to alter or decrease their risk exposure (via changing their overall asset class mix, or adjusting the exposure within a particular asset class). A typical example of this approach could be the active management of fixed income ETFs, where the investor can change both weights and exposure within the fixed income allocation of the overall portfolio to decrease the temporary risk of the fixed income holdings and possibly achieve higher returns. This can be done while maintaining a stable overall allocation to fixed income.

BENEFITS FOR TAA USAGE

We will now explore some examples of where TAA is used by investors and how it can be implemented. The real life evidence of ETFs being used this way can be seen by looking back at the secondary market trading volumes for equity and fixed income iShares ETFs around August 2007. In this period of increased market turbulence there was an increase in trading volumes of iShares ETFs. During these types of market conditions which were considered far from normal, investors were more likely to adopt a TAA approach, and the key features of ETFs allowed them to do this quickly and efficiently:-

HOW CAN ETFS BE USED?

1)Value Creation / Capturing: as we mentioned earlier this may involve tilting with equity income, sector, or country specific ETFs.

Example:

■ An investor has a diversified portfolio consisting of broad-based European equity and fixed income ETFs.

■ By adding or by tilting the portfolio with equity income ETFs, the investor can gain specific exposure to companies that historically generate high dividends.

Outcome:

■ Tilting with a broad range of iShares ETFs allows investor to have specific exposure to different asset classes.

■ Effective diversification is particularly valuable during periods of volatility.

■ Tilting with iShares ETFs helps to diversify single-investment specific risk.

■ Significantly improves Risk-adjusted return of the portfolio.

■ Excellent means of concentrating exposure in a favorite sector while reducing the risk of being exposed to the fortunes of a few companies.

2)Risk Alteration: Our second example returns to risk alteration where the investor would like to take the opportunity to alter or decrease their risk exposure within a single asset class, while maintaining a stable overall allocation.

Planned approach:

■ The investor decides to use index-based fixed income ETFs, which can be used for TAA and can optimise portfolio allocation providing a rebalanced portfolio depending on the stage of business cycle .

■ The investor adjusts the allocation within the fixed income allocation of the portfolio (tactically moving from one type of fixed income exposure to another; for example from short-term bonds to long-term bonds)

■ Investors will consider different factors to estimate current / expected stage of the business cycle:

- Current and expected inflation
- Expected GDP growth
- Economic strength of major world markets
- Relationship between short- and long-term yields
- Undervalued and overvalued currencies

■ Depending on the estimates, the investor can respond by adjusting his or her portfolio.

Benefits for the investor:

■ Opportunity to actively use fixed income ETFs.

■ Enhance Portfolio Return / Risk profile.

■ Excess Return generated using Beta-products such as ETFs

MORE THAN FILLER

ETFs can therefore be a useful tool in TAA particularly as one of the key strengths of the ETF as an investment tool is the wide range of products available and the sheer breadth of equity and fixed income benchmarks they track. It must be noted that like all asset allocation strategies, TAA demands some discipline, as you must first be able to recognise when short-term opportunities have run their course, and then rebalance the portfolio to the long-term asset position.

We have identified just some of the key ways ETFs can be used. However what is clear is that ETFs are not just a 'filler' in a portfolio, but are powerful tools that can be used both strategically and tactically, and which enable more robust portfolio construction.