



## TRACKERS/ETFs

# A SIMPLE AND LOW COST ANSWER

Portfolio managers aiming to make the most of cash find inspiration in the special features of tracker funds

In April 2000, the first trackers – also referred to as ETFs (exchange traded funds) – were launched in Europe.

Since then, trackers have steadily become more popular among professional and retail investors and after four and a half years of development, 108 trackers have been launched in Europe, totalling around €22bn of assets under management.

In the US they have already proven their worth, and have become extremely popular in recent years. At the end of July 2004, there were 134 trackers in the US, based on a large number of indices and representing a total market capitalisation of approximately US\$180bn (source: Morgan Stanley – as end of July 2004).

If these products have the success they know in the US, and are growing in Europe and in Asia, it's because of their key features that allow investors, professional and retail, to implement a variety of strategies: core-satellite approach, hedging, arbitrage, transitional management, cash equitisation, etc.

In this article, we focus on managing excess cash. We first look at the special features of trackers and then, by studying the example of trackers listed at Euronext, describe the different costs paid by the investors to get instant exposure to a market tendency or an asset class. The conclusion is that trackers are a simple, transparent, instantaneous and low cost answer for managing excess cash.



**'If these products have the success they know in the US, and are growing in Europe and in Asia, it's because of their key features that allow investors to implement a variety of strategies'**

Nicolas Herchenroder, Euronext

## » KEY FEATURES

Trackers are tradable open-ended investment funds using a passive investment style. In essence they are shares that track the performance of an index or a pre-defined basket of shares. They enable investors to buy one share instead of all the individual index constituents in the correct quantities, which reduces costs and simplifies the administration of the investment.

They combine the advantages of investment funds (diversification) with those of shares (continuous trading and transparency). Trackers, ie, the shares in one of these funds, can be created and redeemed – the primary market – without restriction, so the fund is flexible as regards to the amount of invested capital but always reflects the composition and weighting of a specific index or basket of shares.

Trackers can be bought and sold on the exchange – the secondary market – at any time during a trading day, making them unique products in most countries.

## » PRIMARY MARKET

Trackers are open-ended investment funds in which fund management is passive. Most of the time, the creation and redemption of trackers is done by means of an 'investment in kind'. This means that market parties must hand in a basket of shares corresponding to the relevant index in order to receive trackers from the fund (creation). Conversely, to obtain a basket of shares they have to return trackers to the fund (redemption). This exchange facility ensures low management fees, the costs of exposure is taken on by the market makers that create and redeem tracker shares.

1

## FEATURES OF A SELECTION OF TRACKERS (RANKED BY TOTAL EXPENSE RATIO)

Product name	Underlying index	Asset class/ exposure	TER (basis points)	Dividend policy
EuroMTS Global Master Unit	EuroMTS Global	Euro zone govt bonds/all maturity band	16.5	Capi.
Diamonds	Dow Jones Industrial Average	US equity exposure	18	Monthly
iBoxx € Liquid Corporates	iBoxx € Liquid Corporates	Euro zone corp bonds/all maturity band	20	Quarterly
Fresco EURO STOXX 50 Bees	Dow Jones Euro Stoxx 50	Euro zone equity exposure	24	Half yearly
iShares DJ Euro STOXX 50	Dow Jones Euro Stoxx 50	Euro zone equity exposure	25	Quarterly
StreetTRACKS AEX-index ETF	AEX index	Dutch equity exposure	30	Cash – capi
CAC 40 Master Unit	CAC40	French equity exposure	30	Sept
SPDR Europe 350	S&P Europe 350	Large European equity exposure	35	Sept
Dow Jones Euro Stoxx 50 SMEX	Dow Jones Euro Stoxx 50	Euro zone equity exposure	40	June
Easy ETF Euro INSURANCE	Dow Jones Stoxx Insurance	Euro zone equity exposure/Insur. sector	45	Capi
TrackinDex DJ Stoxx Sustainability	Dow Jones Stoxx Sustain.	European equity exposure/SRI criteria	50	Sept
StreetTRACKS MSCI Pan Euro ETF	MSCI Pan Euro	Large European equity exposure	50	Cash - Capi

Source: Euronext – as at 20 July 2004

The management company of the tracker will then make the adjustments in order to follow, as closely as possible, the weightings of the shares in the underlying index. As a result, trackers show low tracking errors and a high correlation with their corresponding indices: by buying trackers, the investor will get the performance of the asset class he is looking for.

## » SECONDARY MARKET

Trackers are tradable open-ended investment funds. Tradable means that these products are listed on an exchange and can be bought throughout the trading day at the price offered on the market at any given instant.

The tracker's liquidity, apart from the turnover that is traded every day, can be measured by the ease with which an investor will see its buy or sell orders executed instantaneously and at stated market price. This is one of

the big differences between trackers and traditional investment funds: as they are traded on an exchange, the transparency of the price of execution is total. The investor is executed at the instantaneous market conditions which is not the case with traditional investment funds for which the investors will be executed on the official next Net Asset Value (NAV): by buying trackers on the exchange, investors master the price of their trade and have full transparency on the execution.

Theoretically, the concept behind trackers is straightforward: to give investors simple, transparent and instantaneous exposure to a whole country, region, sector, or other defined asset class in just one transaction. But, practically, what about the costs to get this exposure?

For trackers listed on Euronext, the total expense ratio varies from 16.5 basis points to 55 basis points a year depending on the asset class and type of index tracked. For an investor, this means that if he holds the tracker for a period of six months, he will pay half of the yearly management fees. The management fees are

2

## TRADING FEATURES OF A SELECTION OF TRACKERS (RANKED BY THE EFFECTIVE MARKET SPREAD OBSERVED ON THE MARKET IN JUNE 2004)

Product name	Daily average spread (basis points)	Average trade size (in '000 €)	Minimum order sizes at which LPs are required to give quotes	Number of LPs
EuroMTS 3-5Y Master Unit	7	242	€5,000,000	2
CAC 40 Master Unit	7	71	17,000 shares	7
EuroMTS Global Master Unit	9	33	€5,000,000	2
iShares DJ Euro STOXX 50	14	157	10,000 shares	6
StreetTRACKS AEX Index ETF	14	47	10,000 shares	5
Dow Jones Euro STOXX 50 EX	14	154	17,000 shares	5
Fresco EURO STOXX 50 Bees	17	587	10 shares	4
EasyETF Euro Automobile	49	1069	€100,000	3
TrackinDex DJ Stoxx Sustainability	49	420	10,000 shares	2
StreetTRACKS MSCI Pan Euro ETF	52	190	5000 shares	4
EasyETF Euro Energy	54	1215	€100,000	3
Diamonds	72	9	10,000 shares	2
SPDR Europe 350	84	370	5000 shares	3

Source: Euronext – June 2004

3

## UNDERLYING INDICES OF TRACKERS AT EURONEXT

	Broad	TRADITIONAL EQUITY INDICES Blue chips	Sectors	Other asset class Bond indices
Global		Dow Jones Global Titans 50		
Regional	SPDR Euro Aspi Eurozone	Dow Jones Euro Stoxx 50 FTSE Euro 100 FTSEurofirst80	Dow Jones EURO STOXX Auto, banks, constr, energy, insur, health care, media, tech, telecom, util	EuroMTS Global EuroMTS 3-5Y EuroMTS 10-15Y
	MSCI Pan Euro SPDR Europe 350 Dow Jones STOXX Sustainability	Dow Jones Stoxx 50 FTSE Eurotop 100	MSCI Europe Consumer Discretionary, consumer staples, energy, financials, health care, indust, info tech, materials, telecom services, utilities	iBoxx € Liquid Corporates
Country	S&P 500	AEX index, BEL 20, CAC 40 Dow Jones Industrial Average, FTSE 100	MSCI USA information technology	

deducted, on a daily basis, of the official NAV of the tracker which means that the investor will not pay them directly to the fund but will pay them in the price of the tracker.

Since trackers have been launched in Europe in April 2000, the tendency observed is a decrease of the yearly management fees. The decreases began in 2002, with Axa IM who has harmonised the management fees of its whole range of EasyETF (top 50 range and sector products) from 60 basis points to 45 basis points. In 2003 Lyxor AM decreased the management fee on the DJ Euro STOXX 50 Master Unit from 40 basis points to 35 basis points, and in July 2004, Barclays Global Investors, one of the key players of trackers in Europe, decreased by 10 basis points the annual fees of the iShares DJ Euro STOXX 50 tracker to make this product one of the cheapest trackers in Europe with 25 basis points in management fees. (See Chart 1.)

On the secondary market, the costs equal the sum of the spread that will be paid by the investors when buying the trackers plus the exchange commissions.

## EXAMPLE

If we take the example of NextTrack (the Euronext segment dedicated to trackers), a dedicated liquidity scheme has been implemented for trackers: official Liquidity Providers (LP) have to put prices in the order book, bid and ask, with a maximum spread and for minimum quantity. The spread and the number of shares provided by the LPs are fixed in the contract between Euronext and the LP.

As a result of this LP scheme and the experience gained by LPs for trackers, the spreads became tighter over the last two years. As an example, the CAC 40 Master Unit

tracker has seen its daily average spread decrease from 12 basis points in June 2002 to seven basis points in June 2004 when the EasyETF Euro Energy has seen its spread decrease from 91 basis points in June 2002 to 54 basis points in June 2004. (See Chart 2.)

When managing the excess cash of a fund, an asset manager looks for a simple, transparent, instantaneous and low cost solution. With their simple objective – give to the investors the performance of an index, their tradability, their low level of management fees and their secondary liquidity (low costs of trading), trackers/ETFs are an ideal product for managing excess cash.

The diversity of underlying indices and asset classes on which trackers (see Chart 3) have been created offer investors diversified solutions with a large number of possible combinations. From broad, blue chips and sector equity indices for a global, regional or country exposure to bond exposure (government and corporates) and in the near future real estate exposure, the European offer of trackers has been well developed in less than five years. Worldwide, the 304 trackers offer even more possible solutions for managing excess cash.

*Nicolas Herchenroder, trackers product manager,  
Euronext*

### NextTrack at a glance

- Number of trackers: 50
- Assets under management: €14.5bn
- Number of transactions for the first half of 2004 (double counted): 159,000
- Number of issuers: nine (American Stock Exchange; Axa Investment Managers; Barclays Global Investors; Crédit Lyonnais Asset Management; Dexia Asset Management; Indexchange Investment AG; Lyxor Asset Management; State Street Global Advisors; UBS AG)

*Figures as at 2 July 2004*

## CORPORATE STATEMENT

Euronext is the first cross-border exchange business, created in September 2000 by the merger of the stock and derivatives markets in Amsterdam, Brussels and Paris. Euronext offers a range of services including the listing of financial instruments, trading in securities and derivatives, clearing, data dissemination and IT support. In 2002, BVLP, the Portuguese exchange and LIFFE, the international derivatives exchange, joined Euronext.



#### Contact:

- Nicolas Herchenroder, trackers product manager, Euronext  
Tel: +33 (1) 49 27 16 03  
Email: trackers@euronext.com