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EXCHANGE-TRADED FUNDS

EXCESS CASH PUT TO WORK ON THE EXCHANGE

For investors who disapprove of too much cash sitting idly by in their portfolios, the advantages of using exchange-traded funds to soak up this cash are apparent: flexibility, diversification benefits and fair cost

Investors fortunate enough to have excess cash in their portfolios after stock markets lost 50 per cent of their value over the past three years face a dilemma. This dilemma is exacerbated if they want to place the excess cash in low-risk investments.

With interest rates in Europe looking as if they are more likely to dive over the next few months than rise, deposit accounts will not be increasing their rates of return in the immediate future.

Exchange-traded funds (ETFs) might not immediately spring to mind as a source of low risk investments for investors with excess cash in their portfolios but they can be a very useful tool for this purpose.

THE BASICS

ETFs are index tracking funds that are listed and traded on stock exchanges. They allow investors to buy and sell a whole index in one trade, can be bought and sold through any stockbroker.

ETFs hold stocks in the indices they are tracking and therefore are regarded as funds — not derivatives.

ETFs linked to fixed interest have been developed in the US (Barclays Global Investors offers one corporate bond and three Treasury bond ETFs in the US), and are set to follow in Europe shortly.

It might be considered too great a step to move from cash to an equity-linked investment with no downside protection for an investor only willing to take a low risk.

But Mark Roberts, head of iShares product strategy at Barclays Global Investors (BGI), believes the attractiveness of ETFs is that they can be as low or high risk and as active or passive as the client requires.

PROSPECTS

Despite falling stock markets and fears that this might deter Europeans from investing as they came to the equity party late, ETFs have proliferated on this side of the Atlantic.

There are now more ETFs listed in Europe (118) than in the US (113), where the first product was launched in 1993 on the American Stock Exchange.

Although there are far more assets under management in US-based ETFs ($102.3bn) than in Europe ($10.7bn), they were only introduced to this continent in 2000.

These assets are likely to grow significantly given that ETFs are now traded on the London, Frankfurt, Italian, Stockholm, Swiss and Euronext stock exchanges.

ETF advantages

For investors with excess cash in their portfolios, there are a number of advantages to using ETFs:

- **They are cheaper than index trackers and active funds**
- **They can be bought and sold at any time during the trading day**
- **The price is not affected by demand and supply from other investors**
- **Transparency of price and holdings**
- **They offer diversification across a whole index for the cost of one share**
- **Investors can short indices as well as go long**
- **They can be used for cash flow management**

CORPORATE STATEMENT

iShares is the world's leading provider of exchange-traded funds offering over 100 ETFs globally. In Europe, iShares are listed on the London Stock Exchange, Euronext and Virt-X. iShares are managed by Barclays Global Investors (BGI), the pioneers of index-tracking and one of the largest investment management companies in the world with assets of over £450bn.

iShares

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Mr Roberts at BGI says the key advantage of the ETF is that it is a hybrid product combining the best features of open-ended and closed-ended funds – while not having the disadvantages.

For example, closed-ended funds have the disadvantage that their price may be driven down because of a lack of demand from investors, creating a discount to the net asset value. This is obviously unattractive to investors because if they wish to redeem their shares they are receiving less than they are really worth.

Mr Roberts argues that long-term holders of open-ended funds are detrimentally affected by active investors who repeatedly come in and out of funds as this creates extra trading costs and therefore impacts on performance.

ETFs are "the next evolution of index trackers as they have some additional features built into the structure that allow them to be traded in real time," says Mr Roberts.

The problem with traditional index trackers is that "they are only available once a day, investors have to write to the fund company in many cases to trade in and out, often an investor can only go through select stockbrokers and there is a big fee."

ETFS AT WORK

To reduce the charges on ETFs to between 0.35 per cent and 0.4 per cent a year, the underlying stocks of an index are not bought and sold. If an investor wants to invest in or redeem from a fund, the ETF swaps the underlying shares with the market maker.

This is possible because both parties know the price of the underlying shares and it saves transaction costs for the fund. The holdings in the ETF and their value are transparent to everyone, including retail investors.

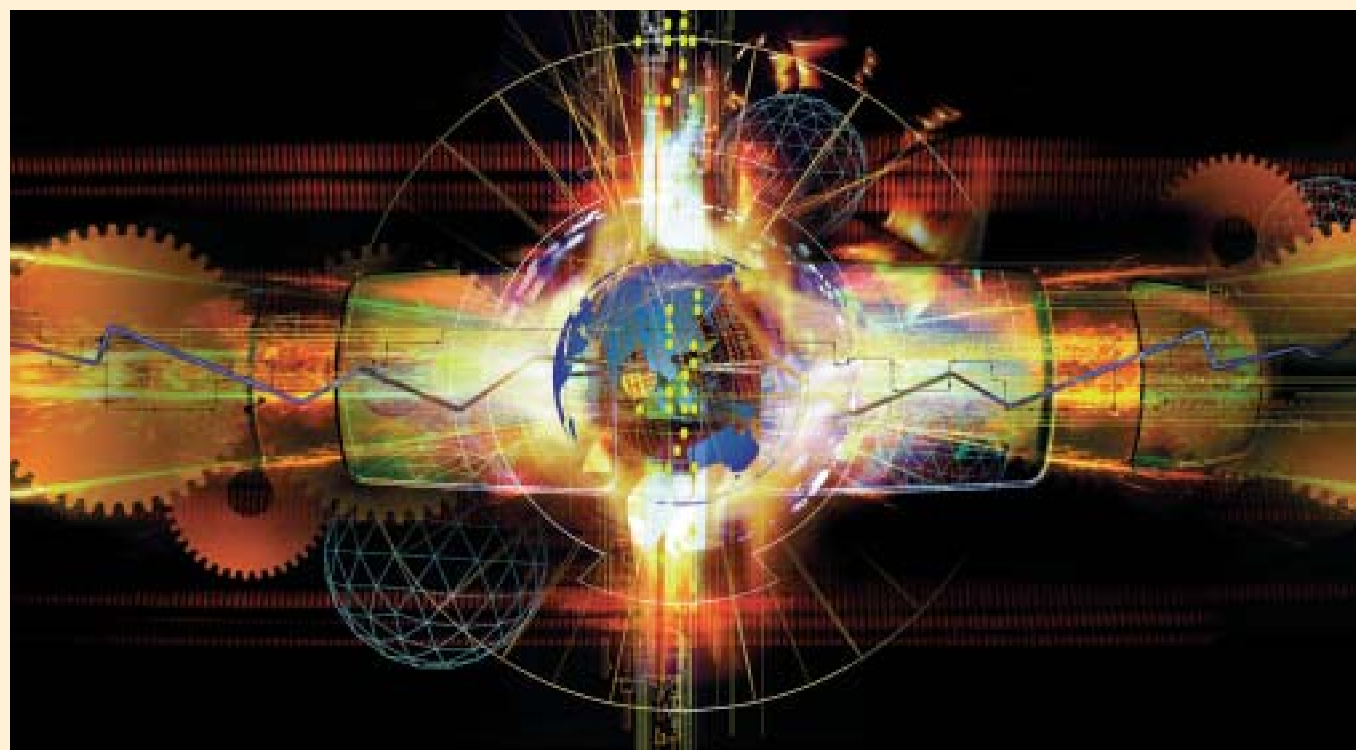
Allowing institutions and market makers to swap a basket of shares for an aggregation of shares in ETFs enables the ETF to be an open-ended fund listed on a stock exchange.

"A market participant dealing on the stock exchange can trade on the flow of ETF shares on the secondary market or tap the fund for more shares in an open ended mechanism free of payment," says Mr Roberts.

If the market maker wants to redeem his ETF shares, the fund hands him back the stocks equivalent to the value of the stocks held by the ETF.

Not only does this reduce transaction costs for the fund but it also means the price of the ETF is not affected by demand and supply from investors. The price of the ETF simply reflects the value of the shares in the index it is tracking. The cost of the ETF is also reduced because it does not need to keep details of shareholders as it is swapping stocks with market makers.

'To have excess cash within a portfolio is bad because cash is idle ... Investors can use an ETF to put their cash to work.'
Mark Roberts, iShares



	Apr 00	Jun 00	Sep 00	Dec 00	Mar 01	Jun 01	Sep 01	Dec 01	Mar 02	Jun 02	Sep 02	Dec 02
Assets $US bn	0.43	0.50	0.51	0.68	1.84	2.63	3.54	5.66	6.90	8.50	7.70	10.69
Number of ETFs	3	3	3	6	16	33	43	71	92	92	111	118

Source: Morgan Stanley research, Bloomberg and SsgA

APPLICATIONS

"To have excess cash within a portfolio is bad because cash is idle," argues Mr Roberts. "If a portfolio is benchmarked against the FTSE, it has 5 per cent in cash and a perfectly replicated basket of FTSE stocks underneath this, it is 95 per cent invested and will return about 0.95 per cent of the FTSE."

The investor may allocate 5 per cent of his portfolio to cash because he believes stock markets are going to fall and therefore wants some protection in a safe haven investment.

But the normal assumption, according to Mr Roberts, is that stock markets will go up over time and thus cash will underperform.

"Investors can use an ETF to put their cash to work. This is one of the applications perfectly suited to ETFs as they can be traded as frequently as the investor needs. They can be bought, paid for and sold within hours, days or months."

ETFs can be an important tool in portfolio management, especially in allocating excess cash, says Mr Roberts, because they deliver a known return.

ETF products deliver returns in accordance with the benchmark to which they are tied. Investors can use country or sector ETFs to make active bets about certain markets

An ETF product will deliver a return in accordance with the benchmark to which it is tied. Investors can use country or sector ETFs to make active bets about certain markets. They can thus be used as a hedge against the main markets held within an investor's portfolio.

ACCESS TO ETFs

Investors can buy or sell ETFs through any broker. This means an investor can access ETFs in real time and knows the exact price before he buys or sells the fund.

If an investor has excess cash in his portfolio and wants to gain access to a whole market for the price of one share, ETFs can be an effective way of achieving this.