Exchange Traded Funds

The latest innovations in the Indian financial market have been the Exchange Traded Funds (ETFs). They are the new species of the financial instruments market and have become the buzzword in the volatile Indian stock markets. However, in the international markets we come across many such ETFs such as VIPERS, SPIDERS, WEBS, DIAMONDS, CUBES, etc. VIPERS stands for Vanguard Index Participation Receipts, SPDRs is Standard & Poors Depository Receipts, pronounced "SPIDERS", CUBES is the name given for QQQ (called so because of its three 'Q's), and tracks the technology-laden NASDAQ 100 stocks. ETFs are a novelty only in India. Exchange Traded Funds have been in vogue in the global financial markets, especially the US financial markets for a long time. An index of their popularity can be gauged from the fact that about 60 per cent of the trading volumes on the American Stock Exchange comes from ETFs. It is only now that these funds are catching on in the domestic mutual fund market in India. The first ETF in India, "Nifty BeES (Nifty Benchmark Exchange Traded Scheme)" based on S&P CNX Nifty, was launched in January 2002 by Benchmark Mutual Fund. UTI has launched its own ETF called SUNDERS (S&P CNX Nifty UTI Notional Depository Receipts Scheme), after Benchmark's BeES like Liquid BeES, Nifty BeES, Junior Nifty BeES and Bank BeES.

The Concept

ETFs are index tracking open ended registered funds or unit investment trusts that invest in a portfolio of stocks designed to track the performance and dividend yield of a specific index. They are essentially mutual fund schemes or index funds that are listed and traded on exchanges like stocks. Due to this they offer the benefit of trading like a stock. They are priced continually and can be bought or sold throughout the trading day.

An Exchange Traded Fund, as the name itself suggests; is a financial instrument, tradable on a stock exchange that invests in the stocks of an index in approximately the same proportion as held in the index. An ETF is a hybrid financial product, a cross between a stock and a mutual fund. Like a stock it can be traded on a stock exchange, and like a mutual fund it behaves like a diversified portfolio. In many ways it is an index fund, with a few subtleties that put it in a separate league. Unlike an open-ended index fund, where an investor purchases units from the fund itself and to redeem them sells the units back to the fund and thereby expanding or shrinking its corpus on each entry or exit from the fund, in an ETF, it is listed on an exchange ensuring that the entry or exit of investors has no effect on the fund corpus. An ETF is transacted through a broker and held in dematerialized form. Availability of real-time quotes is another feature present in an ETF but absent in an Index Fund where the previous days NAV is applied for buying or redeeming. This feature makes the trading of the ETFs possible.

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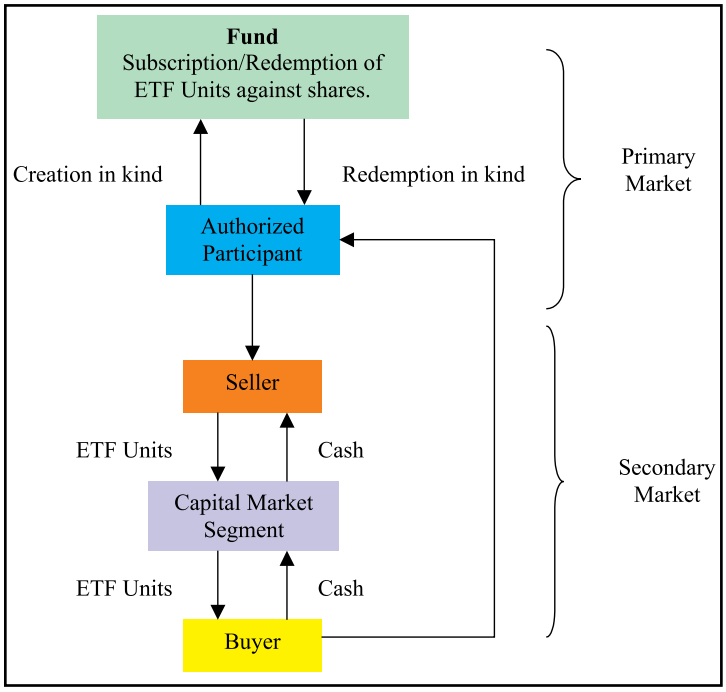
But first, let us see how one can buy an ETF. There are two ways in which one can buy an ETF. One is through the market and the other is through the fund house that has issued the ETF. Now for the pricing mechanism: if the demand of the ETFs in the markets soars, the ETF would start trading at a premium from its intrinsic value, which should be equal in proportion to the index that it is charting. This premium would make the buyers go to the fund house where they would have to redeem their shares in the proportion held



under each unit of the ETF. Such units that are bought directly from the fund house are called "creation units". But usually the lot size in which one can buy creation units is so high that only an authorized participant (market maker) or institutional investors may have the wherewithal to buy these. In such case the retail investor would have to go to the market itself to buy the units of the ETF, the decision in turn depending on the expectations of the future price movements of the ETF. In case of redemption in the market, the seller would get paid in cash and in case the fund units are taken to the issuer, the seller would get paid in kind that is the underlying shares that make up the index. ETF trading also opens up the flood gates for some more complex trading arrangements like arbitrage between the cash and futures market or simply put - short selling.

ETF Features

Tradability: ETFs provide investors a convenient way to gain market exposure viz. an index that trades like a stock. In comparison to a stock, an investment in an ETF index product provides a diversified exposure to the market. Depending on the index, investors may obtain exposure to countries / markets or sectors.

Transparency: ETFs typically track an index and this passive index management eliminates any bias resulting from a manager's style. The aim is to achieve greater control and therefore better long term results. As an ETF tracks an index at its NAV, there are no surprises of under or over performance. The tracking error is usually very small, although the measured tracking error can be greater for ETFs whose underlying stocks have different closing hours however, at creation or redemption this measured tracking error would disappear. In addition, the investor will know the identity and weighing of each of the stocks in the creation/redemption unit.

Cash Equitisation: Investors with idle cash in their portfolios may want to invest in a product tied to a market benchmark like an index as a temporary investment before deciding which stocks to buy or waiting for the right price.

Cash Flow Management: Investment managers who see regular inflows and outflows may use ETFs because of their liquidity and their ability to represent the market.

Diversifying Exposure: If an investor is not sure about which particular stock to buy but likes the overall sector, investing in shares tied to an index or basket of stocks provides diversified exposure and reduces stock specific risk.

Filling Gaps: ETFs tied to a sector or industry may be used to gain exposure to new and important sectors. Such strategies may also be used to reduce overweight or increase an underweight sector.

Dividends: Except for ETFs based on a total return index, which reinvests dividends, dividends are paid out to the investor.

Small denomination: ETFs are generally priced as a percentage of the value of their underlying index. The denomination is such that the investor can easily follow the tracking accuracy to the index. For instance, if the Nifty is at 2023, the related ETF should ideally trade at around 202.30 with a bid/offer on either side of this value. However, the trading value of ETF is also affected by the expectations of the buyer or seller.

Risks

All investments involve risk. Like other investments, index ETFs carry a certain level of risk for investors as follows:

Market Pricing: Given that the market share price is determined by the forces of supply and demand, not the underlying net asset value, investors may purchase shares at

a premium or discount to their net asset value.

Tracking Error: In some cases ETFs pay out dividends received from the underlying stocks on a quarterly basis. However, the underlying stocks pay dividends throughout the quarter. Therefore, these funds may hold cash for various time periods throughout the quarter, even though the underlying benchmark index is not composed of cash. In addition, due to transactions via market prices rather than at net asset value, the performance based on an index ETF may not completely replicate the performance of the underlying index.

Market Risk: Market prices for securities and index ETFs fluctuate daily based on a variety of factors such as economic conditions and global events, investor sentiment and security-specific factors. The degree of volatility in general in the markets has increased over the last several years. The prospect of a market decline and its impact on security and fund prices should be considered as general market risk.

Credit Risk: Credit risk refers to an issuer's ability to make payments of principal and interest when due. An interruption in the timely payment of principal and interest (such as on a corporate bond) may adversely affect a fund's net asset value and ability to pay dividends.

Interest Rate Risk: Prices of bonds tend to fall as interest rates rise, and as interest rates fall (bonds with longer maturities tend to fluctuate more in price in response to such changes). For index ETFs that hold bonds in their portfolios, this risk can be significant, although most funds hedge this risk through various market instruments.

Advantages and Disadvantages

Tradable and Diversifiable: ETFs have in them the twin feature of being tradable and diversifiable. One can trade a stock but then it is not diversifiable. Or, one can buy a mutual fund and thereby diversify but then the mutual fund would not be tradable. Alternatively, one can diversify one's risks by holding a portfolio of stocks and trade them but that would be too much of a botheration for the lay investor. These conflicts are reconciled by an ETF that is at once tradable and is a diversified portfolio too. It is these two features, working in tandem that makes it a financial product of choice.

Low cost: Due to reduced marketing, distribution and accounting expenses and the passive nature of index investing, the expense ratios are typically lower than those for

many traditional mutual funds. As the ETFs are listed on the exchange, the cost of distribution is low. Furthermore, exchange traded mechanism reduces minimal collection, disbursement and other processing charges.

Arbitrage with futures: ETFs being a versatile product can be used to exploit the pricing differences arising between Index futures and itself using the arbitrage strategies.

Transparency: Just like the index fund, the portfolio of an index fund has no mystery to it. Everybody in the participating market is aware of the stocks that it is tracking and therefore need not worry about a change in the stocks being traded in.

Continuous Pricing: Unlike traditional mutual funds, which are only priced at the end of each day, index ETFs are priced and can be purchased and sold throughout the trading day.

Portfolio Transitions: Many investors may move assets between funds and investment styles, but may wish to stay fully invested in the market. Rather than allowing assets to sit idle in cash, index ETFs provide a mechanism to stay fully invested in a particular market segment while evaluating options for further investment.

Absence of Prior Active Market: In India ETFs being a new instrument, there is no existing market that one could swim into immediately after buying the product. So for the liquidity to be reasonable, a large number of investors would have to buy into the idea to make adequate liquidity possible.

Large Investments: In order to deal directly with the fund houses large capital investments are required. For example in the case of Nifty BeES, a minimum creation unit size of 20000 units is required that would involve lakhs of rupees in investment. This makes ETFs a market where the institutional buyers and sellers become the big fish.

Broker Charges: Broker charges have to be paid anyway when trading in ETFs. This can be minimized by trading long but the very charm of ETFs is destroyed because it is meant for being traded more often than an index fund.

Premiums and Discounts: An ETF might trade at a discount to the underlying shares. This means that although the shares might be doing very well on the bourses, yet the ETF might be traded at less than the market value of these stocks.

ETFs and Mutual Funds – A Comparison

In essence, ETFs trade like stocks and therefore offer a degree of flexibility unavailable with traditional mutual funds. Specifically, investors can trade ETFs throughout the trading day as in stocks. In comparison, in a traditional mutual fund, investors can purchase units only at the fund's NAV, which is published at the end of each trading day. In fact, investors cannot purchase ETFs at the closing NAV. This difference gives rise to an important advantage of ETFs over traditional funds. ETFs are immediately tradable and consequently, the risk of price differential between the time of investment and time of trade is substantially less in the case of ETFs.

ETFs are cheaper than traditional mutual funds and index funds in terms of fees. However, while investing in an ETF, an investor pays a commission to the broker. The tracking error of ETFs is generally lower than traditional index funds due to the "in-kind" creation / redemption facility and the low expense ratio. This "in-kind" creation / redemption facility ensures that long-term investors do not suffer at the cost of short-term investor activity.

ETFs can be bought/sold through trading terminals anywhere across the country. Unlike Mutual Funds, ETFs can be used for hedging and arbitration other than that for equitising cash.

Investors are not exposed to the trading styles, personal agenda and sheer good luck of the fund manager.

For a long-term investor, there is no cost for the portfolio turnover so common to all conventional mutual funds, nor does the investor share the costs in buying and selling holdings to accommodate new investors or those who are liquidating.

ETFs and Futures

Even though ETFs and Futures allow investors exposure to an index, they are different in many regards. While Futures is a derivative product and trades in the F&O segment of NSE, ETFs are a cash market product and trade in the Capital Market segment of NSE. The maximum tenure available for futures is 3 months while ETFs can be held for as long as the investor wants.

As per William Sharpe, well known Economist, all active fund managers together can never outperform the market. Consequently, all classes of investors viz. institutional and retail are increasingly moving towards investing in well-defined indices, which are professionally managed. ❐