Alliance Trust Savings

Track down a return

It is easy to get lost amid all the acronyms that get thrown around in the financial markets but ETFs or exchange traded funds to give them their full name are actually a pretty simple product. They are a specific type of fund that, as their name indicates, can be traded like individual shares on an exchange such as the London Stock Exchange (LSE). Investing through ETFs can give you a cheap, easy and quick way to capture the returns from a range of different asset classes including bonds, shares and commodities.

The first ETF, tracking the FTSE 100 index, was issued in the UK in 2000. That year, 1,972 trades were struck on the LSE with a value of £403 million. In May 2015 alone 234,551 trades were executed worth upwards of £17 billion and there are now more than 800 ETFs listed in London. In the UK, well known providers of ETFs include iShares, Vanguard, Lyxor Asset Management, owned by Société Générale, db X-trackers, owned by Deutsche Bank, and ETF Securities.

There are a number of key advantages of ETFs. These include:

Transparency - Unlike traditional funds, which are priced on a daily basis, ETFs trade in the same way as a share. This means they can be bought and sold at any time during normal market hours (8.00am-4.30pm).

Cost - The Total Expense Ratios (TERs) on ETFs – which show the total amount paid out to cover the costs of fund management and other administrative fees – are typically lower than traditional actively-managed funds. There are no fund managers' salaries to pay and transaction costs tend to be more modest, since ETFs are passive instruments that simply seek to match the index.

Flexibility - ETFs are suitable for both long-term investors and short-term traders since they allow for straightforward changes to asset allocation across a portfolio. It is easy to create new positions to gain, for example, exposure to Asia or energy sources such as natural gas or oil. Though of course you need to ensure these are appropriate to your personal circumstances and risk appetite.

How to choose the right ETF for you

For mainstream products covering the major stock market indices heavy competition means costs, performance and the level of risk are unlikely to vary too widely but it is important to make sure the product you invest in is tracking the right benchmark. There can be significant differences - for example MSCI Emerging Markets includes South Korea - which accounts for 10% of the index - but the FTSE Emerging Markets index doesn't.

How ETFs work

Each ETF holds an interest in a group of assets, such as equities, commodities or bonds; and can attempt to replicate, or 'track', indices, sectors, stock exchanges both domestic and foreign, currencies and emerging markets, in addition to fixed-income and commodity indices.

For example, an ETF that tracks the performance of the FTSE 100 will represent a small interest in each of the 100 companies on the FTSE 100. The idea being that the ETF's price moves largely in step with the FTSE 100. This helps to create a diversified portfolio and protect your returns as if share prices in one company or industry sector fall, other companies' and sectors' prices should, ideally, remain stable.

Physical vs. Synthetic

There are two main types of ETF: 'physical' and 'synthetic'.

Physical, or cash-based, ETFs are those whose providers actually purchase and hold the assets or shares of the index they track. Should the provider go out of business, the investor can gain access to a ringfenced pool of assets.

Synthetic, or swap-based, ETFs, by contrast, hold no underlying assets, but are financed by a counterparty, usually an investment bank. While a synthetic ETF can be more accurate than the physical ETF in tracking an index, you are exposed to the risk of the counterparty hitting financial difficulty.

Safeguards

These risks are mitigated by regulation and there are safeguards in place to protect investors. The rules mean the maximum loss you could incur from the swap provider on a synthetic ETF going out of business is 10%.

Providers of synthetic ETFs also require their counterparties to put up collateral. This collateral is usually in the form of equities or bonds, and some – though not all - providers will give explicit detail on what lies behind their synthetic products.

Any given ETF can vary greatly from another, not only in terms of asset type but in complexity: ETFs are not created equally and one size does not fit all. However, because it is possible to find details about the underlying holdings of most ETFs, you can avoid the risk of having money in areas where you neither want nor expect to have exposure.

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