



**London**  
Stock Exchange Group

# ETFs for private investors

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**Simple products.  
Sophisticated strategies.**

# ETFs

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Exchange Traded Funds (ETFs) are instruments which track an index. Indices can be country or region specific and based on emerging markets, developed markets, fixed income, money markets and many other asset classes. These instruments give investors instant diversification as one unit represents an investment in multiple companies and sectors.

ETFs are listed on-exchange and are traded like shares. Market makers are committed to provide two-way prices throughout the trading day.

>650

equity ETFs across  
32 countries,  
14 regions and  
31 sectors

Most ETFs are passive instruments which means they aim to replicate the performance of the underlying index rather than outperform it. Other key features include:

- Professionally managed
- Open-ended
- UCITS compliant – regulated like funds
- Low tracking error
- Free of UK stamp duty when traded on the secondary market
- Can trade in multiple currencies
- Providers are authorised by the Financial Conduct Authority (FCA)
- No exit fees.

For a helpful overview of ETFs please visit [www.londonstockexchange.com/etfvideoresources](http://www.londonstockexchange.com/etfvideoresources)

## Diversity

**Developed markets** UK, USA, Germany, Japan

**Emerging markets** Africa, Brazil, China, India, Latin America, Middle East, Shariah Compliant

**Domestic indices** FTSE 100, FTSE 250

**Sector indices** Coal, metal, energy

**Fixed income** Treasury, corporate bonds

**Alternatives** Hedge funds, volatility index

## Regulation

ETFs are traded on London Stock Exchange's Main Market which means investors can be reassured that there is a high level of regulatory oversight and ongoing disclosure is adhered to. Here are some key facts:

- ETFs are traded on the Main Market so they are EU regulated under MiFID the European Union Directive.
- ETFs are UCITS (Undertaking for Collective Investment in Transferable Securities) compliant. Rules under UCITS apply to funds marketed to private investors. Subject to regulator recognition and approval, ETFs can cross-list within the European Economic Area (EEA).

<sup>1</sup> A measure of recurring costs at a fund level (e.g. management expense ratio, administration, custody and oversight, index licence fees, storage costs, collateral fees, insurance allowance). Does not include any external costs incurred in trading the product.

<sup>2</sup> Average of London listed emerging market equity ETFs and emerging market equity active funds (accumulating and retail share class only).

## How ETFs differ from other funds (passive vs active)

Broadly speaking, there are two investment methodologies used by fund managers: active and passive management.

Active fund managers make investments in selected assets (whether stocks, bond, commodities, etc.) with the goal of outperforming the market (usually a benchmark, like the FTSE 100).

A passively managed fund or investment does not seek to outperform a market. Instead, the passive fund manager tries to replicate the underlying benchmark performance as accurately as possible. The majority of ETFs are passive investments, since their aim is to track a benchmark or asset.

### Comparing product costs

Passively managed ETFs are typically cheaper to manage than actively managed funds and this difference is generally reflected in the cost passed on to end investors. Ongoing charges<sup>1</sup> have to be disclosed by all European UCITS funds and although not representative of total cost of ownership, this measure provides a good starting point for investors comparing product costs.

In figure 1 we have compared the costs associated with actively managed emerging market equity funds and passively managed emerging market equity ETFs.<sup>2</sup>

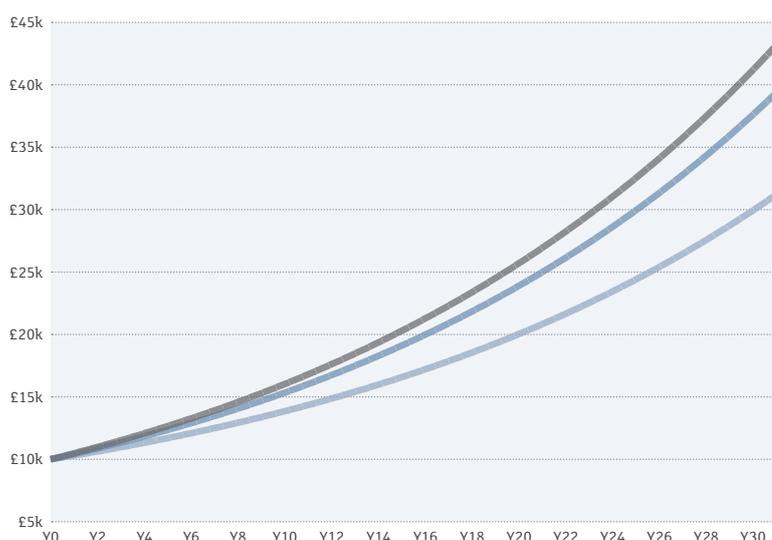
Figure 1: Product costs in active and passive funds

|                         | Emerging market equity funds | Emerging market equity ETFs |
|-------------------------|------------------------------|-----------------------------|
| Investment methodology  | Actively managed             | Passively managed           |
| Average ongoing charges | 1.76%                        | 0.56%                       |

Source: ETF Securities, Bloomberg

There will be a number of factors affecting the overall performance of a given fund, however the relatively low costs associated with ETFs can help protect investor returns, particularly when investments are held over time. In figure 2 (page 02) we have compared the returns of an investment of £10,000, assuming a 5% annual return, when ongoing charges of 1.76% and 0.56% are applied over a 30-year period. Over the full 30 year period the portfolio exposed to average ongoing costs of 0.56% would generate returns 26% higher than the portfolio exposed to average ongoing costs of 1.76%.

Figure 2: Impact of product costs on annualised returns



**Graph key**

- No costs
- 0.56% (passive)
- 1.76% (active)

Source: ETF Securities, hypothetical example



**Pricing and liquidity**

Actively managed funds are typically priced once a day, and sometimes less frequently, which means that orders may be placed without knowing the actual price of a given fund until some time after execution.

In contrast ETFs are traded intraday and priced on a continual basis, which means that live prices can be monitored and orders placed at any point whilst stock markets are open. Therefore like stocks, investors can choose the optimal time to execute, for example when the price of a security falls to a certain target level during a given trading day. Additionally, given that ETF prices are determined by trading activity on an open market as opposed to the fund company itself, as is the case with actively managed mutual funds, a greater level of pricing transparency is ensured.

Furthermore, as ETFs track an underlying benchmark, their liquidity is primarily derived from its underlying assets. Consequently large transactions can be executed without a significant impact on the price of an ETF. For example the average daily volume for all LSE listed FTSE 100 ETFs between November 2013 and February 2014 was approximately £47.5 million. The liquidity available to the FTSE 100 index was approximately £3.25 billion. Therefore during this period ETF volume represented only 1.4% of the underlying net asset volume indicating that liquidity is not limited.

**Combining active and passive strategies**

ETFs can be used as building blocks in a diverse investment portfolio. Ultimately, investors can benefit from combining active and passive investments in a single portfolio. For example, incorporating passive ETFs into the core of a portfolio will help to minimise the ongoing costs and volatility. Additional positions, known as satellites, may harness the ability of active funds to incorporate forward-looking projections and outperform the market in specific sectors.

**Different types of ETFs**

There are two types of ETFs:

**Cash-based (physical ETFs)**

A cash-based ETF physically holds the shares of constituent companies of the underlying index being tracked.

**Swap-based (synthetic ETFs)**

A swap-based ETF does not hold shares of constituent companies of the index being tracked but instead replicates the performance of the index via a swap arrangement. The ETF holds a basket of securities unrelated to the index and enters into a swap agreement with a counterparty who undertakes to deliver the performance of the index to the ETF and it will in turn deliver the returns of its basket to the counterparty.

All ETFs are open-ended which means that the issuer can create or redeem units in the fund according to investor demand.

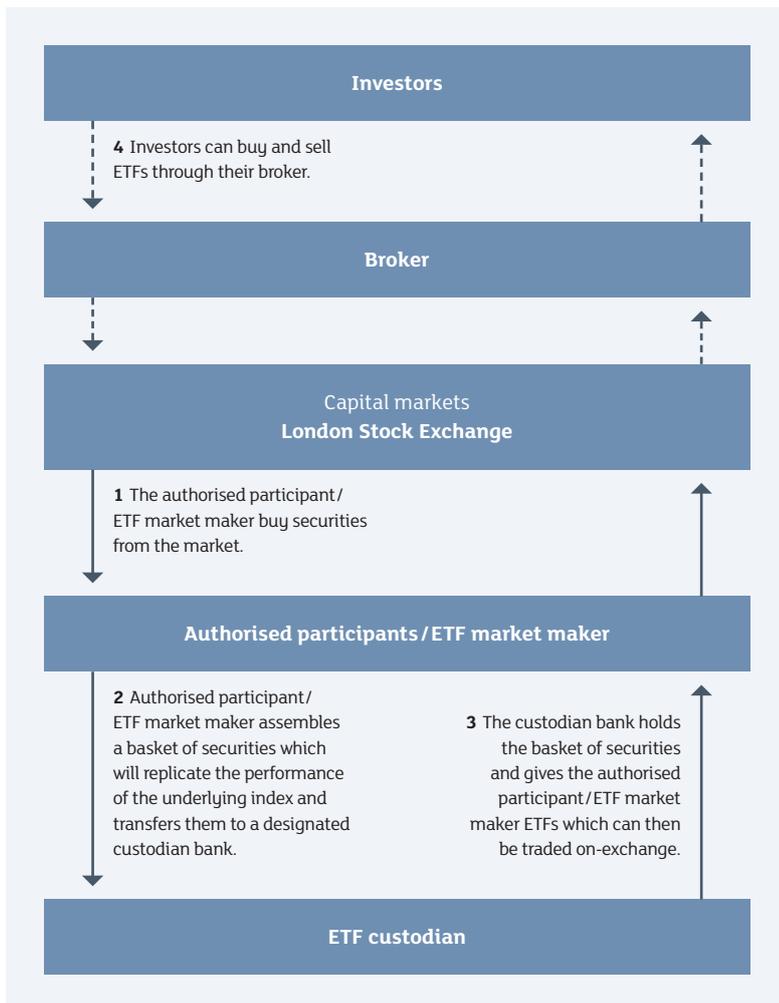
**UCITS**

Because swap-based ETFs rely on the swap counterparty to deliver the returns of the underlying index, this represents a degree of counterparty risk. Counterparty risk is also present for cash-based ETFs, due to the securities lending that may occur. Under UCITS, an ETF's derivative commitment may not exceed 10% of its net asset value (NAV) which means the maximum exposure to counterparty risk is limited to 10%. ETFs are also collateralised and some are over-collateralised to mitigate counterparty risk. The collateral is typically made up of assets like shares and must cover at least 90% of an ETF's NAV. Securities held as collateral are marked-to-market ensuring the value does not fall below the regulatory limit. Collateral levels can range between the 90% minimum and above 100% (over-collateralisation). Investors can find out about an ETF's collateral management policy by contacting the issuer. Cash-based ETF investors are also protected under UCITS collateralisation requirements. The collateral is ring-fenced so that investor assets are segregated to provide protection if ETF providers fail.

## Structure of cash-based ETFs

These ETFs are units of a fund which holds a portfolio designed to track the performance of an underlying index. The creation process for these ETFs starts with an authorised participant or a market maker buying securities from the open market which reflect the composition of the benchmark index. These securities are deposited with a custodian bank which will hold them and issue the authorised firm /market maker with ETFs. These ETFs are then traded on London Stock Exchange where private investors can buy and sell them through their broker.

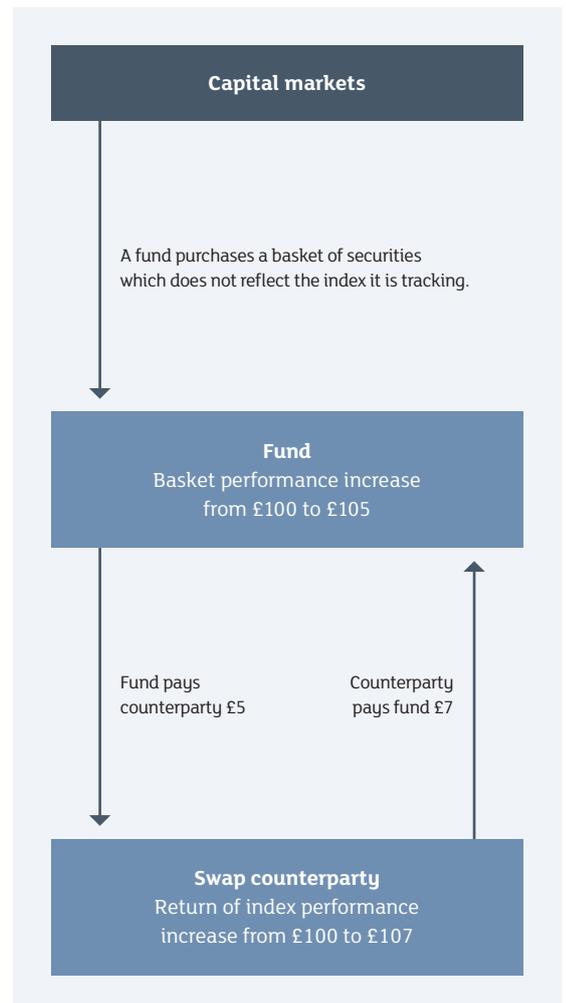
The redemption process is the reverse. The authorised participant /market maker will buy ETFs from the open market and swap these for the related underlying securities with the custodian bank and these securities can then be sold on the open market.



## Structure of swap-based ETFs

Swap-based ETFs do not hold securities of constituent companies which make up the index being tracked, but they are backed by physical assets. The ETF issuer instead enters into a swap agreement with a counterparty who is tracking the returns of the index and the two will swap the returns on the assets they hold.

This arrangement allows the ETF issuer to access markets overseas or international sectors which could otherwise be difficult or costly to reach. The swap counterparty will also benefit from the agreement in the same way.



**£280<sup>bn</sup>**

total ETF value traded in 2016

## Benefits of ETFs

### Cost-efficiency

ETFs have low management fees in comparison to actively managed unit trusts/mutual funds and are much cheaper than buying the underlying assets to obtain the equivalent level of exposure. Diversification – ETFs are not limited to European blue-chip companies. Investors can gain exposure to domestic and international sectors and markets which may otherwise be difficult to access in a cost-effective way.

### Flexibility

ETFs can be used on their own to gain exposure to an index or in combination with other investment products to form investment strategies within a portfolio.

### Liquidity

Traded like shares, ETFs can be as liquid as the underlying securities they represent. Market makers quote two-way prices with tight spread requirements set by the Exchange.

### Simplicity

ETFs are traded during the regular trading hours just like shares.

### Transparency

Components of the underlying are fully visible to the investor. Issuers produce a factsheet for their ETFs which state what investors are being exposed to. Tracking performance is also published.

### Investor-owned assets

Assets out of which ETFs are created, by law, is the exclusive property of ETF holders. Even in the case of insolvency by the ETF manager, administrator or issuer, these assets are protected.

## Growth of the ETF market

ETF trading has seen significant growth since they were launched on London Stock Exchange.

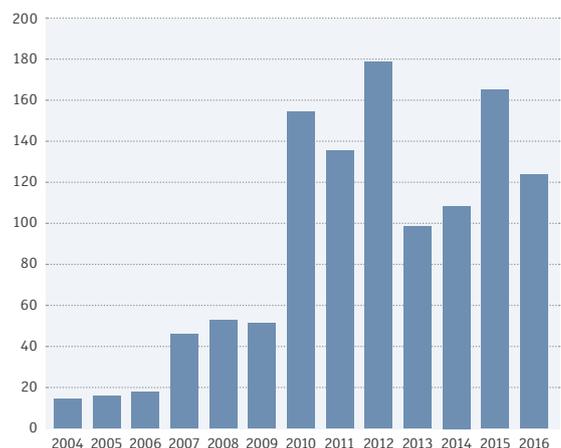
Figure 3: ETF value traded on LSE

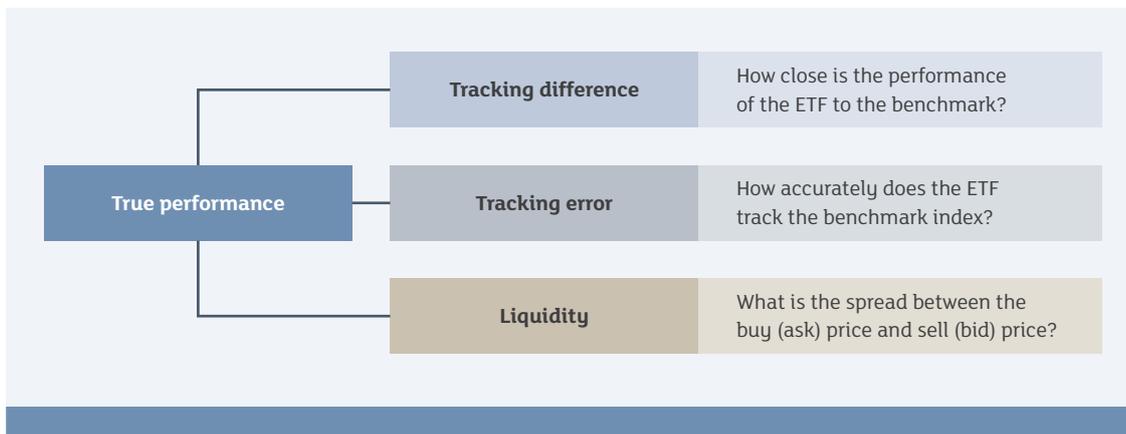


## Growth in the number of ETFs on London Stock Exchange

The Exchange has seen a steady increase in the number of ETFs listed and admitted to trading. Investors now have hundreds to choose from. The diversity of ETFs has also expanded with products tracking global regions, specific countries, money markets, government and corporate bonds, hedge funds and more. For a full list of ETFs available on London Stock Exchange please visit [www.londonstockexchange.com/etfandetpcategorisation](http://www.londonstockexchange.com/etfandetpcategorisation)

Figure 4: Number of new ETF product listings





## Portfolio construction: choosing and using ETFs

ETFs are leading the charge in a new democratic world of investment where investors are increasingly taking control of their own portfolio. Why? Firstly because they are simple to trade. Just like regular shares, ETFs can be purchased through a UK stock broker using a share dealing account, ISA or SIPPI. The second reason is diversification. ETFs are intrinsically diverse. For example, instead of building your own portfolio of UK equities, and paying costs and fees on multiple securities, you can purchase a single ETF that provides exposure to the top 100 UK companies through the FTSE 100 index.

Not only are the vehicles themselves diverse, but with a product range spanning different market sectors, regions, themes, commodity baskets or fixed income strategies, and the whole risk spectrum from government bonds to single country emerging markets, ETF investors can easily create a well diversified core portfolio. Furthermore, with both income paying (distributing) ETFs and growth (capitalising) ETFs available, they can capture both growth and income.

ETFs can also be used tactically to take advantage of short term trends. The combination of core and satellite allocations means that investors can build a portfolio to suit their specific views and investment budget. Small portfolios can be built with a handful of ETFs, and larger portfolios with very specific exposures can achieve even greater diversification.

The third major factor is cost. Passive ETFs are significantly cheaper than actively managed products and Total Expense Ratios (TERs) typically range between 0.15% and 0.85% per year. This TER is the annual charge that includes costs such as custody fees, marketing costs and index licensing costs. On top of this, investors will be charged a brokerage fee in the same way as when buying shares.

Importantly though, the TER is not a true measure of the Total Cost of Ownership (TCO). Although all ETFs share the same aim – to track an index as cost effectively and precisely as possible – some do it much better than others. Tracking difference and tracking error are two measures that describe how precisely and consistently the ETF tracks its benchmark. As anything less than the index performance is a cost to you, it is important to look at these variables. The bid/ask spread will also impact performance as the difference between buy and sell price is key to your trading cost.

As with any investment product, ETFs carry a number of risks. Most ETFs are index tracking funds, meaning the performance of an ETF will rise and fall with the underlying index which may be complex and/or volatile, exposing investors to market risk. Investors' capital is at risk, and you may not get back the amount originally invested. Investors may be exposed to counterparty risk resulting from the use of securities lending in physical ETFs, or from the use of an OTC performance swap with an investment bank for synthetic ETFs. If the index or the constituents of the index are denominated in a currency different to that of the ETF, investors are exposed to currency risk from exchange rate fluctuations.

## Accessing the market

Investors can access the market via a broker:

Execution-only brokers will buy or sell according to investor instructions providing no investment or trading advice. Advisory brokers provide advice and execute trading decisions made by the investor.

Discretionary brokers will execute trades on investors' behalf and may also make investment decisions without investors' prior approval.

Some brokers offer a Direct Market Access (DMA) service whereby member firms of London Stock Exchange can directly submit customer orders to the order book via their own systems.

DMA allows sophisticated investors to take greater control over their trades by enabling them to place buy and sell orders directly on London Stock Exchange's order books and execute with other market participants.

## Exchange Traded Products

Investors should be aware that other Exchange Traded Products (ETPs) like Exchange Traded Commodities (ETCs) and Exchange Trade Notes (ETNs) are structured and regulated differently to ETFs. For more information please see the [ETPs for private investors](#) brochure or contact the ETF/ETP Management team at [etps@lseg.com](mailto:etps@lseg.com) or your broker.

### Further information

For further information on how ETFs can benefit investors, contact [etfs@londonstockexchange.com](mailto:etfs@londonstockexchange.com) or visit [www.londonstockexchange.com/etfs](http://www.londonstockexchange.com/etfs)



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