

MARKETS IN MOTION

developments that matter in financial markets

Exchange-Traded Funds

"ETFs have become more complex in structure and types of strategies they employ in generating returns. These developments have created new opportunities and challenges for investors, market participants and regulators."

Reserve Bank of Australia

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Introduction

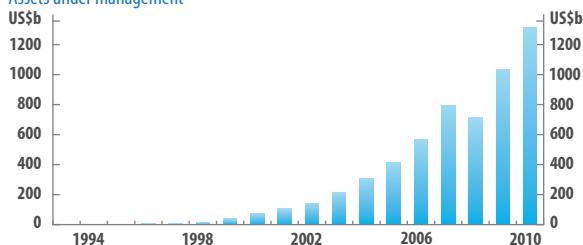
Exchange-traded funds (ETFs) are investment vehicles that are listed on a stock exchange. ETFs provide investors with the return of some benchmark, such as an equity index.

ETFs are different from mutual funds in the sense that ETF units are not sold to the public for cash. Instead, the Asset Management Company that sponsors the ETF takes the shares of companies comprising the index from various categories of investors like large investors and institutions and issues them a large block of ETF units. Since dividend may have accumulated for the stocks at any point in time, a cash component to that extent is also taken from such investors. In other words, a large block of ETF units called a 'Creation Unit' is exchanged for a 'Portfolio Deposit' of stocks and 'cash component'. Generally, the expense ratios of ETFs are consistently lower than actively managed mutual funds. The dividend income received from underlying stocks or bonds in an ETF portfolio is distributed to fund shareholders. ETFs have gained favour with individual investors, financial professionals and institutional investors because of their low expenses, tax efficiency, diversification, transparency, trading flexibility and intraday liquidity. ETFs are a convenient way to gain instant exposure to global markets. Net Asset Value (NAV) refers to an ETF's total assets minus its liabilities, whereas market price refers to the quoted price that an ETF is trading at on an exchange. At times the NAV and market price of ETFs may diverge.

The majority of ETFs track equity indices. Equity ETFs allow investors to buy a single security that aims to replicate the return of an entire portfolio of stocks, such as the S&P 500 index. The global ETF industry has grown strongly in a relatively short period of time, as shown in the graph.

Global ETFs*

Assets under management



*Excludes exchange-traded commodities
Source: BlackRock

Global ETF Investment

Globally, there are around 2,700 ETFs, with strong growth in total assets under management (AUMs) over the last decade. Equity ETFs have around \$1.1 trillion in AUMs and account for around three-fourths of the total ETF investment, followed by debt and commodity ETFs.

Global ETF Investment (as of end-February 2011)

Type	Number of ETFs	AUMs in \$ bn	%
Equity	1,895	1,067	74
Debt	365	217	15
Commodity	358	147	10
Others	86	12	1

Source: Bloomberg, RBA

ETFs by Region

ETFs domiciled in the US account for around \$1 trillion, or 70 percent of global ETF assets, with trading in US ETFs equivalent to around one-fourth of aggregate turnover in US equities. In Europe, ETFs have attracted investment of around \$300 billion, while those domiciled in Australia have assets of around US\$4 billion.

Physical vs. Synthetic ETFs

There are two common strategies employed by ETFs to achieve the target return: physical and synthetic. Physical ETFs hold the assets underlying a particular benchmark. For example, an equity-based ETF can hold all or a sample of the stocks underlying a benchmark equity index. The advantages of a physical replication strategy include greater transparency of the ETF's asset holdings and more certainty of entitlement for investors if the ETF is liquidated. Most ETFs in the US and the Asia-Pacific region use physical replication to track their underlying benchmark. In Europe, however, regulatory changes have seen the use of synthetic ETFs grow rapidly, with synthetic ETFs accounting for almost half of total ETF AUMs. The advantages of a synthetic strategy can include lower cost, improved accessibility to particular asset classes and investments, and greater accuracy in delivering the targeted return. A synthetic strategy can reduce tracking error as the ETF is contractually guaranteed to receive the same return as the underlying asset.

Commodity ETFs

Commodity ETFs are one of the most popular means of gaining exposure to commodity prices. Commodity ETFs represent a more cost-effective means of accessing this asset class than alternative investment vehicles. Commodity ETFs require a small minimum outlay and are more liquid than other forms of commodity investments. Investment in commodity ETFs has grown from around \$40 billion in 2008 to around \$150 billion in 2010, and it now accounts for 40 percent of total commodity investments.

ETFs enable investors to invest in a range of asset classes, including emerging market equities and commodities that might otherwise be difficult to access. However, ETF investment does not come without risks and ETFs are increasingly attracting the attention of regulators. Generally, concerns about ETFs stem from liquidity and counterparty risk and, in some cases, complexity and a lack of transparency.

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