OUR GUIDE TO

Exchange Traded Funds (ETF)

LONDON STONE SECURITIES

Content

What is an ETF?

An exchange traded fund (ETF) is an investment fund which is traded on a stock exchange in the same way as stocks and shares. ETFs often track an index, commodity or basket of assets like an index fund.

What can you hold in an ETF?

An ETF can hold various assets including stocks, commodities and even bonds which is why they are regarded as the most versatile type of fund product. In fact you can find ETFs on pretty much anything from commodities such as oil and gold right through to the S&P 500 index ETF (known as the Spyder).

How is the price of an ETF calculated?

ETFs trade in the same was as normal shares and so unlike a mutual fund an ETF does not have its net asset value (NAV) calculated every day. Instead the price of an ETF can go up or down during the course of the day as they are bought and sold by investors in exactly the same way as a company share price.

Why do investors like ETFs?

ETFs have a number of benefits over traditional mutual funds:

1 Lower cost

Passively managed ETFs tend to have much lower Total Expense Ratios (TER) than managed funds. That is because managed funds include management fees, shareholder accounting expenses at fund level, service fees such as marketing, paying a board of directors as well as load fees for sale and distribution. All of these costs must be absorbed by the fund and ultimately passed onto the investor through higher fees.

2 Price trade close to its net asset value throughout the day

ETFs trade at a price that is updated throughout the day whereas an open-ended mutual fund is priced at the end of the day at the net asset value. Therefore with an ETF you constantly know the value of your investment and you can sell at that price at any point during the day.

3 Diversification

One ETF can give exposure to a group of equities, market segments or styles. In comparison to a stock, the ETF can track a broader range of stocks, or even attempt to mimic the returns of a country or a group of countries. For example, you could focus on Brazil, Russia, India and China in a BRIC ETF. Of course mutual funds can also be diversified but with ETFs investors can choose only those investments which most closely satisfy their requirements.

4 Flexibility

By owning an ETF, investors receive the diversification of an index fund but with the ability to sell short, buy on margin and even purchase as little as one share. There are no lock-in periods, annual fees or redemption penalties. You simply buy and sell an ETF whenever you wish at the prevailing market price at any point during the day and so you know your price before you sell. This flexibility is a big reason as to their recent increase in popularity.

5 Tax-efficiency

ETFs are generally more tax-efficient than traditional funds because most of the tax on capital gains is paid on sale and of course the timing of that decision (i.e. when to sell) is completely up to the investor. Even if the ETF sells or buys shares within it while attempting to mimic the basket of shares that it is tracking, this does not result in a tax-charge because the capital gains from in-kind transfers are not recognised as a sale under HMRC rules. Mutual funds, on the other hand, are required to distribute capital gains to shareholders if the manager sells securities for a profit. This distribution amount is made according to the proportion of the holders' investment and taxable as a capital gain at the point of sale. If other mutual fund holders sell before the date of record, the remaining holders divide up the capital gain, and thus pay taxes even if the fund overall went down in value. Therefore you may find yourself with a capital gain that you hadn't planned for.

6 Greater Transparency & Control

ETFs also allow you to manage risk by trading futures and option just like a stock. Because they trade like a stock you can quickly look up the approximate daily change of a commodity or sector with the ticker symbol of a tracking ETF. Many stock websites also have better interfaces for manipulating charts than commodity websites and even provide applications for your mobile devices.

What are the risks of ETFs?

In comparison to traditional funds, ETFs are generally regarded by much of the investment community as superior products for the reasons stated above. However there are some potential downsides to also consider:

1 Commission

An ETF is like a share and so you pay commission when buying or selling. That's why it is important to compare a like for like scenario taking into account comparable mutual fund and ETF fees to ensure that you have the most cost-effective product available that can most closely match your requirements.

2 Market pricing

There is no guarantee that the market price of an ETF is the same as the market value of the securities held in the ETF as price movement is due to demand and supply (in the same way that a share price is not always reflective of the true value of the company). However large variations between the market value and price being quoted are mitigated through arbitrage trading.

3 Lack of liquidity

There are now literally thousands of ETFs on the market and so investors need to be careful that they don't invest in an ETF which has a wide spread or is generally illiquid. Some ETFs can also be geared so again caution should be observed before buying.

Is the ETF market still growing?

Yes it is. The statistics show that more and more investors are moving away from traditional funds towards ETFs. For example ETFs over the past five years have attracted $772 billion of new money whilst over the same period traditional mutual funds have lost $81billion. Clearly investors are now voting with their hard-earned cash and buying power. In fact ETFs now account for a staggering $1.8 trillion in assets and the expectation is for this trend to continue.

That's why at London Stone Securities we want our clients to be aware that there is now a genuine (and many would say) better alternative to the old world of traditional unit and investment trusts.

For more information including numerical examples, information and further reading material please speak to one of our advisors

6 Lloyds Avenue
Lloyds House
London
EC3N 3AX

+44 (0) 20 3697 1700
info@londonstonesecurities.co.uk
www.londonstonesecurities.co.uk

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