

Understand Exchange Traded Fund

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Exchange Traded Fund(ETF)

- Exchange Traded Funds (ETFs) are investment funds listed on the stock exchange.
- ETFs usually represent a portfolio of securities designed to track the performance of an index, offering investors an efficient way to obtain cost-effective exposure to specific markets or sectors.
- Investors could buy or sell ETFs through their brokers during the securities market's trading hours.
- ETFs offer the benefits of diversification and market tracking with the convenience, flexibility and cost effectiveness of stocks.

Benefits of Investing in ETFs

- Diversification
 - ETFs invest in a portfolio of securities, providing diversified exposure to selected markets or sectors.
- Low minimum investment
 - ETFs are traded in board lots and the minimum initial investment is usually set at an affordable level.
- Low transaction costs
 - The transaction fee for ETFs is the same as the fee for stocks. Unlike mutual funds, there is no subscription fee for ETFs.

Benefits of Investing in ETFs

- Global exposure
 - Some ETFs invest in overseas securities, providing an opportunity to invest in global markets.
- Close tracking
 - ETFs are passively managed funds, they tend to track closely the performance of the underlying index.
- Liquidity
 - ETFs usually have market makers to enhance liquidity
- Convenience
 - ETFs are traded through brokers in the same way as stocks and the settlement arrangements are the same

ETFs in Hong Kong

- Exchange Traded Fund (ETF) market developed rapidly in the recent years.
- There are total 65 ETF Listed in HKEX
 - ETFs with Hong Kong stocks as underlying ⇒ 8
 - ETFs with non-HK stocks as underlying ⇒ 52
 - ETFs with commodities as underlying ⇒ 2
 - ETFs with bonds + money market as underlying ⇒ 3
- ETF accounted for 3.5% of HK market turnover in 1H10. Of which, iShares A50(2823.HK) daily turnover often exceeds HK\$1bn.

ETFs in Hong Kong

- The principal objective of an ETF is to track the performance of an underlying index.
- ETF manager may adopt one or more of the following index replication strategies:
 - (i) investing in a portfolio of securities that fully replicates the composition of the underlying index
 - (ii) investing in a portfolio of securities featuring a high correlation with the underlying index, but is not exactly the same as those in the index
 - (iii) investing in financial derivative instruments, such as swaps and performance-linked notes, to replicate the performance of the index (synthetic replication)

Exchange Traded Fund(ETF)

- In both (i) and (ii), the ETF buys the actual securities
- In (iii), the ETF does not buy the securities but only derivative instruments
- 65 ETFs have been authorized by HKSFCA

Adopt (i) and/or (ii) strategies ETFs ⇒ 16

Adopt (iii) ETFs (synthetic replication) ⇒ 49

General Risks of Investing in ETFs

➤ Market risk

ETFs are exposed to the volatility of the underlying assets

➤ Currency risk

Underlying assets of some ETFs are priced in foreign currencies.

➤ Tracking error

Factors such as fees and expenses, market liquidity, changes to the underlying index, regulatory policies will result in ETF's NAV not fully reflect underlying assets performance.

General Risks of Investing in ETFs

➤ Deviation from net asset value

The ETF may trade at a premium or a discount to its net asset value due to market forces and volatility.

ETFs track the performance of markets that are subject to foreign investment restrictions may be more likely to deviate from the net asset value. (for example, China A-share market)

➤ Liquidity risk

Although most ETFs have market makers to provide liquidity, low turnover ETF will have higher spread which will result in liquidity risk and higher execution cost.

Risk for Synthetic Replication ETFs

- Due to restricted market access and limited investment quotas, such as China A-share market, some ETFs adopt synthetic replication through the use of financial derivative instruments.
- ETF managers might also choose synthetic replication for markets that do not impose restrictions, typically to raise efficiency and reduce cost.
- Synthetic ETFs invest in over-the-counter derivatives issued by counterparties, ETFs are exposed to the credit risk associated with derivatives.
- In the case of counterparty defaults, the ETF may suffer losses potentially equal to the full value of the derivatives.

How to protect yourself from Synthetic replication ETFs?

- ETFs managers will acquire financial derivatives from number of counterparties to diversify credit concentration risk.
- Within the context of a synthetic replication ETF, issuer or counterparties provide collateral in order to offset potential damage.
- Investors could visit ETFs' websites to obtain list of counterparties. One could also check creditability of counterparties by looking over credit agency ratings or CDS spread (credit default swap).

Summary

- ETFs is popular investment vehicle given its simplified structure. However, tools efficiency only if and when people are well-educated.
- Besides, for synthetic replication ETFs, which are exposed to investment risk of underlying assets and credit risks.
- Information of ETFs structure and counterparties risks are provided by ETFs managers on the websites.
- It is necessary that investors understanding related information in order to make sound investment decision on ETFs.

Useful Website Link

Leading ETF Managers Website

1. DB Platinum Advisors
<http://www.dbxtrackers.com.hk/EN/showpage.asp?pageid=132&forwardid=29>
2. Blackrock Asset Management North Asia Limited
www.ishares.com/
3. State Street Global Advisors Asia Ltd
www.trahk.com.hk/
4. Hang Seng Investment Management
www.hangseng.com/etf
5. Lyxor International Asset Management
www.lyxoretf.com.hk
6. BOCI-Prudential Asset Management
www.boci-pru.com.hk

Appendix- HK Listed ETFs (Buy Actual Securities)

ABF Pan Asia Bond Index Fund	2821
SPDR Gold Trust	2840
Tracker Fund of Hong Kong	2800
W.I.S.E. - CSI HK 100 Tracker	2825
Hang Seng H-Share Index ETF	2828
Hang Seng Index ETF	2833
Hang Seng FTSE/Xinhua China 25 Index ETF	2838
iShares BSE SENSEX India Tracker	2836
iShares MSCI China Index ETF	2801
iShares MSCI Asia APEX 50 Index ETF	3010
iShares MSCI Asia APEX Mid Cap Index ETF	3032
iShares MSCI Asia APEX Small Cap Index ETF	3004
iShares MSCI Emerging Asia Index ETF	2802
ABF Hong Kong Bond Index Fund	2819
Polaris Taiwan Top 50 Tracker Fund (H.K.)	3002
Value China ETF	3046

Appendix– HK Listed Synthetic Replication ETFs

W.I.S.E. - CSI 300 China Tracker	2827
W.I.S.E. - CSI SSE50 China Tracker	3024
LYXOR ETF Commodities CRB (Reuters/Jefferies CRB Index)	2809
LYXOR ETF FTSE RAFI Europe	2806
LYXOR ETF FTSE RAFI US 1000	2803
LYXOR ETF JAPAN (TOPIX)	2814
LYXOR ETF MSCI AC Asia-Pacific ex Japan	2815
LYXOR ETF MSCI Emerging Markets	2820
LYXOR ETF MSCI India	2810
LYXOR ETF MSCI Korea	2813
LYXOR ETF MSCI Taiwan	2837
LYXOR ETF MSCI World	2812
LYXOR ETF NASDAQ-100	2826
LYXOR ETF Russia (DJ RUSINDEX TITANS 10)	2831

Appendix– HK Listed Synthetic Replication ETFs (Con't)

Da Cheng CSI China Mainland Consumer Tracker	3071
db x-trackers CSI300 Banks Index ETF	3061
db x-trackers CSI300 Consumer Discretionary Index ETF	3025
db x-trackers CSI300 Energy Index ETF	3017
db x-trackers CSI300 Financials Index ETF	2844
db x-trackers CSI300 Health Care Index ETF	3057
db x-trackers CSI300 Index ETF	3049
db x-trackers CSI300 Industrials Index ETF	3005
db x-trackers CSI300 Materials Index ETF	3062
db x-trackers CSI300 Real Estate Index ETF	2816
db x-trackers CSI300 Transportation Index ETF	3063
db x-trackers CSI300 Utilities Index ETF	3052
db x-trackers MSCI Taiwan TRN Index ETF	3036
db x-trackers MSCI Korea TRN Index ETF	2848

Appendix– HK Listed Synthetic Replication ETFs (Con't)

db x-trackers S&P CNX NIFTY ETF	3015
db x-trackers MSCI USA TRN Index ETF	3020
db x-trackers FTSE Vietnam ETF	3087
db x-trackers FTSE/Xinhua China 25 ETF	3007
db x-trackers US Dollar Money Market ETF	3011
db x-trackers MSCI Emerging Markets TRN Index ETF	3009
db x-trackers MSCI EM Asia TRN Index ETF	3035
db x-trackers MSCI Brazil TRN Index ETF	3048
db x-trackers MSCI Russia Capped Index ETF	3027
db x-trackers MSCI World TRN Index ETF	3019
db x-trackers MSCI Pacific ex-Japan TRN Index ETF	3043
iShares FTSE/Xinhua A50 China Tracker	2823
iShares CSI 300 A-Share Index ETF	2846
iShares CSI A-Share Consumer Discretionary Index ETF	3001

Appendix– HK Listed Synthetic Replication ETFs (Con't)

iShares CSI A-Share Consumer Staples Index ETF	2841
iShares CSI A-Share Energy Index ETF	3050
iShares CSI A-Share Materials Index ETF	3039
iShares CSI A-Share Financials Index ETF	2829
iShares CSI A-Share Infrastructure Index ETF	3006
CICC-SZSE 100 Index Tracker	3051
PAragon CSI RAFI 50 ETF	2818

The End