

Exchange Traded Funds – popularity continues to grow

The growth in these low cost funds in Europe, Asia and Latin America is replication that already seen in the United States



Are ETFs nothing more than a cheap way in which to track an index or do they have more to offer the investment community?

The progress of Exchange Traded Funds (ETFs) from niche product to the big time continues unabated. In an increasingly volatile investment environment, the relative stability of ETFs is becoming more attractive by the day. While much of the financial media commentary in recent months has been devoted to alternatives and other high profile products, the trading volumes and array of products available within the ETF arena has continued to expand.

In their simplest form, ETFs are straightforward, listed funds that invariably track the performance of an underlying index at low cost. They are most popular among institutional money managers seeking low cost access to a broader array of markets and asset classes. In recent months, the range of products offered through ETFs has grown to cover less accessible emerging markets and diverse asset classes such as commodities, credit and property.

The question that arises is – are ETFs nothing more than a cheap way in which to track an index or do they have more to offer the investment community? The answer would appear to be that the growing breadth and depth of the ETF product range indicates that the market supports ETFs' move into areas previously considered the domain of active management.

Make no mistake, however, low fees are attractive to many in the current cost-sensitive environment. With many ETFs carrying a Total Expense Ratio as low as 0.10%, the desire of investors to gain exposure to a specific market, region, sector or asset class at a cost significantly less than market, means that these products are certainly here to stay.

What about Tracking Error?

Much has been made of the extent to which ETFs truly track the underlying index. There is no doubt that tracking error is a reliable measure of volatility between an ETF and the underlying index. But not all ETFs set out to track an index in full. The fact is that an ETF may opt for full or partial replication of its underlying index.

While the market is more familiar with full replication ETFs, i.e. where all the stocks are held by the ETF, partial replication is becoming more popular. Partial replication is where an ETF sets out to hold less than 100% of the stocks in index. For example, in a global market index, an ETF may hold no more than 60% of the underlying stock. Many ETF portfolio managers do this in an attempt to reduce trading costs, or to avoid specific securities lacking market liquidity (e.g. emerging market debt).

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Geographical Outlook

From their inception, ETFs enjoyed spectacular popularity in the US. Recently, however, we have seen significant growth in Europe, with Ireland, France and Luxembourg all acting as domiciles of choice. The index managers who had chosen Ireland and Luxembourg for their pan-European products have continued to add ETF strategies to their range, and are now successfully selling ETFs across a range of different markets in Europe, Latin America and Asia. Industry commentators note that significant growth in ETFs is likely in the international arena in future years, thus replicating the US experience. Indeed, Morgan Stanley predicts global ETF assets under management will reach US\$2 trillion by 2011, a threefold increase from current levels.

The requirement that investors can only buy and sell through participating brokers rather than directly with the funds themselves does not appear to have impacted in any meaningful way the popularity of ETFs among institutional investors. Indeed, the fact that ETFs are products that offer liquidity in a secondary market is becoming increasingly important in the current environment and bodes well for the future of ETFs around the world.