HSBC Asset Management

Understanding Equity ETFs

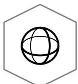
For Professional Clients only

What is an ETF and how do they work?

Exchange Traded Funds (ETFs) are investment funds which track an underlying index.

Traded on an exchange

Can contain all types of investments (e.g. stocks, commodities, bonds) as a basket of securities


Indices can be country/region specific and based on a diverse range of asset classes

- An ETF is a collection of securities, similar to a pooled index fund that trades on the stock exchange
- ETFs offer intraday pricing and liquidity like an equity stock

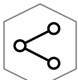
What is inside an ETF?

- Most ETFs track an index: a basket of securities that are weighted according to the market and strategy they represent. Typically, these securities will be equities or bonds
- The objective of tracking an index means that ETFs also replicate the behaviour of that index, including re-balances and corporate actions

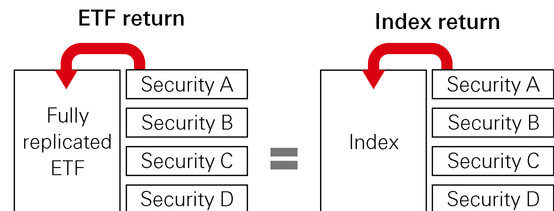
There are three types of ETF structures when it comes to replication methods:

Full replication: a fully replicated ETF owns all securities in the same proportion as the index it tracks

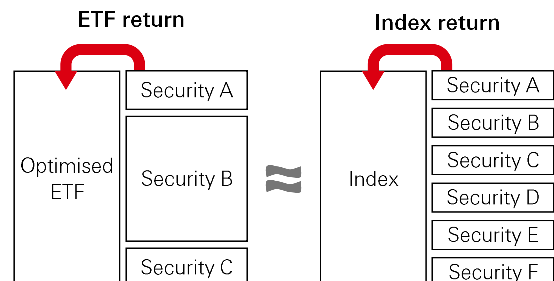
Physical optimisation: an optimised portfolio buys a sample of securities which represents the characteristics of the index, aiming to produce similar returns. Optimisation is typically used for broad indices with a large number of constituents, where full replication would be either difficult or costly and inefficient


Synthetic replication: the index is replicated with a swap transaction. The ETF enters into a swap contract with a financial institution (swap counterparty) which delivers the index total return in exchange for a swap fee. The funds of the synthetic ETF are invested in a basket of securities that serves as a collateral for the swap counterparty

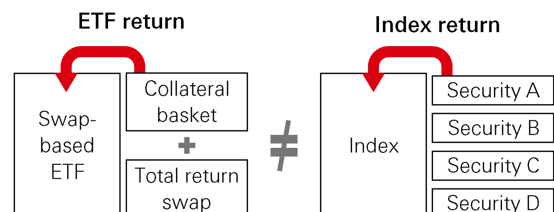
Full replication



Physical optimisation



Synthetic replication



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What are the benefits of ETFs?

Liquidity

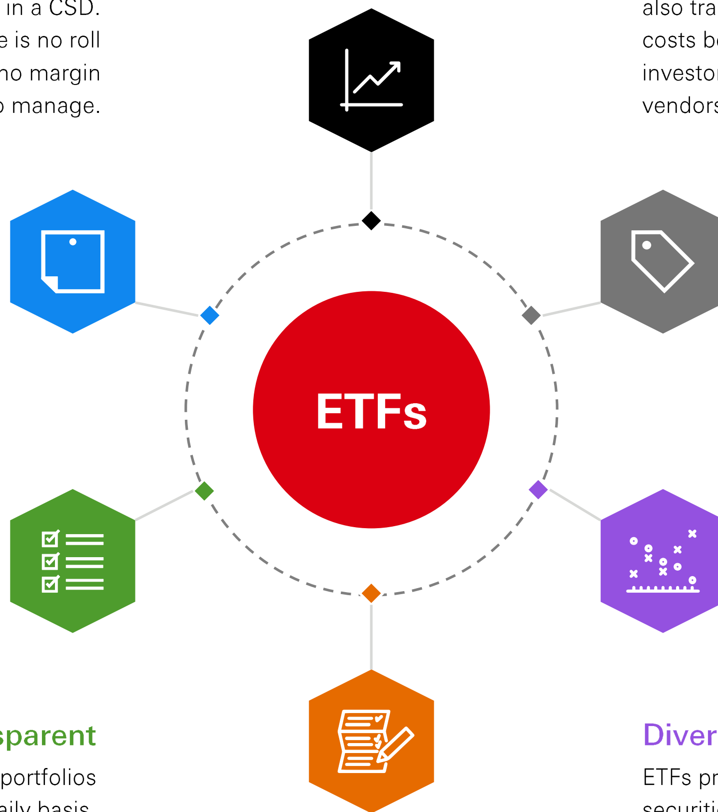
ETFs are listed on stocks exchanges and can be bought and sold throughout the trading day. They reflect the liquidity of the underlying securities they track and can provide additional liquidity thanks to their secondary market trading. This means investors can exchange ETF units on the exchange with no trading required in the underlying securities.

Simplicity

ETFs can be more simple to use than other investment vehicles. Compared to a mutual fund, ETFs are traded and settled in the same way as shares. This means they are simple to transact, listed on the stock exchange, do not require specific accounts with the fund manager and are settled in a CSD. Compared to a future, there is no roll process and no margin to manage.

Cost efficient

ETFs and mutual funds have different cost structures. Generally speaking, the annual TER cost for ETFs is lower than for equivalent mutual funds. Costs are also transparent, with TER and trading costs being openly available to investors on many websites and data vendors.



Transparent

Most ETFs disclose their full portfolios on public websites on a daily basis. This allows investors to know what they are invested in on an individual security basis. Combined with the ability to see the full holdings of the index an ETF is aiming to track, this provides an extremely high level of disclosure.

Diversified

ETFs provide access to a portfolio of securities in a single trade. They can track a broad range of stocks or bonds or replicate the returns of a country, group of countries or even a global benchmark. In this way, the investor can gain broad exposure to a market or theme through one single security.

Tax efficient

ETFs can be more tax efficient than mutual funds. Withholding tax on dividends can reduce returns, but some ETFs have beneficial tax arrangements due to their structure and domicile, which can lessen the impact of withholding tax versus the benchmark.

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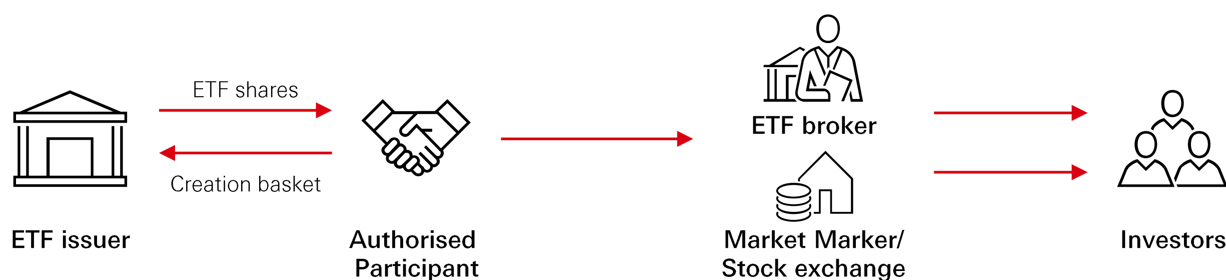
How are ETF shares created and distributed?



- ETF shares are created when an Authorised Participant (AP) exchanges a basket of securities or cash with the ETF issuer. The basket directly matches the securities required by the ETF to replicate the index, or the ETF portfolio manager uses cash to purchase the securities needed
- The AP receives the equivalent value of ETF shares from the ETF Issuer. APs are a smaller subset of the broader ETF broker community (broker / dealers, banks and specialised ETF liquidity providers)
- The AP can then sell ETFs to investors on the secondary market. This is usually via the exchange or OTC (over-the-counter) via an RFQ (request for quote) platform
- The redemption process is the reverse transaction with ETF units being returned to the issuer in exchange for securities or cash

How are ETFs used?

Application	Objective	ETF solution
Asset allocation	Build a portfolio of low cost diversified exposures with specific risk tolerance goals	Core and satellite building blocks across asset classes that are easy to access and create accurate exposure
Tactical adjustments	Over or underweight certain market segments based on short term outlook	ETFs represent virtually every asset class and offer efficient vehicles for implementing a tactical idea
Transitions	Maintain market exposure while searching for a new manager	Invest the proceeds of a manager liquidation in an ETF which tracks the appropriate benchmark until new manager has been selected
Cash equitisation	Remain fully invested while maintaining liquidity	ETFs are an attractive alternative solution to futures due to their transparency, lack of documentation and roll slippage
Rebalancing	Increase the speed and efficiency of rebalancing across the asset allocation	ETFs can make rebalancing more efficient due to their intraday liquidity than moving assets from illiquid managers
Asset class exposure	Establish exposure to a difficult to reach market segment	There are a variety of ETFs which provide exposure to difficult to reach asset classes
Liquidity management	Increase liquidity in overall asset allocation without changing allocation	Use ETFs for a given percentage of each asset class to provide a liquidity buffer across the asset allocation
Portfolio completion	Fill any asset allocation holes without engaging a new investment manager	Use an ETF to gain exposure to an asset class that is underrepresented in the asset allocation
Fixed income duration and credit adjustments	Tweak duration and credit exposure to meet specified targets	Fixed income ETFs provide an efficient means to adjust duration and credit exposure
Small Institutional plans	Implement desired asset allocation regardless of plan size	Implement an asset allocation efficiently using ETFs. Advantages include no minimum fees and simplified rebalancing

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Key risks

The value of an investment in the portfolios and any income from them can go down as well as up and as with any investment you may not receive back the amount originally invested.

- **Concentration Risk:** The Fund may be concentrated in a limited number of securities, economic sectors and/or countries. As a result, it may be more volatile and have a greater risk of loss than more broadly diversified funds
- **Counterparty Risk:** The possibility that the counterparty to a transaction may be unwilling or unable to meet its obligations
- **Derivatives Risk:** Derivatives can behave unexpectedly. The pricing and volatility of many derivatives may diverge from strictly reflecting the pricing or volatility of their underlying reference(s), instrument or asset
- **Emerging Markets Risk:** Emerging markets are less established, and often more volatile, than developed markets and involve higher risks, particularly market, liquidity and currency risks
- **Exchange Rate Risk:** Changes in currency exchange rates could reduce or increase investment gains or investment losses, in some cases significantly
- **Index Tracking Risk:** To the extent that the Fund seeks to replicate index performance by holding individual securities, there is no guarantee that its composition or performance will exactly match that of the target index at any given time ("tracking error")
- **Investment Fund Risk:** Investing in other funds involves certain risks an investor would not face if investing in markets directly. Governance of underlying assets can be the responsibility of third-party managers
- **Investment Leverage Risk:** Investment Leverage occurs when the economic exposure is greater than the amount invested, such as when derivatives are used. A Fund that employs leverage may experience greater gains and/or losses due to the amplification effect from a movement in the price of the reference source
- **Liquidity Risk:** Liquidity Risk is the risk that a Fund may encounter difficulties meeting its obligations in respect of financial liabilities that are settled by delivering cash or other financial assets, thereby compromising existing or remaining investors
- **Operational Risk:** Operational risks may subject the Fund to errors affecting transactions, valuation, accounting, and financial reporting, among other things
- **Real Estate Investments Risk:** Real estate and related investments can be negatively impacted by any factor that makes an area or individual property less valuable

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