

Exchange Traded Funds (ETFs): A Rising Investment Avenue



Finance

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ABSTRACT

Investment is the commitment of funds by buying securities or other monetary or paper (financial) assets in the money markets or capital markets, or in fairly liquid real assets, such as gold, real estate, or collectibles. An investment can be described as perfect if it satisfies all the needs of professional investors. There are large numbers of investment avenues for savers. Some of them are marketable, liquid, while others are non-marketable. This paper addresses Exchange Traded Funds (ETFs), the index investments that are a cross between exchanges listed corporate securities and open-ended mutual funds. While ETFs are now competing with mutual funds, they have a very different history and operational structure. It is important for investors to know the difference between mutual funds and ETFs and few investors fully understand ETFs. This paper focuses on conceptual and theoretical aspects of ETFs in India. It covers its comparison with mutual funds.

ETFs In India

One of the major trends in the asset management industry currently is the relentless rise of exchange-traded funds. ETFs now account for over a trillion dollars in assets, up from only about \$75 billion in the year 2000. ETFs have gained huge popularity over the last decade as they can be used to gain exposure to a number of asset classes including equity, fixed income, commodities and currencies. ETFs have several advantages over index funds: In the types of asset classes covered and ability to short as well as their ability to offer intra-day liquidity, being traded on the secondary markets.

ETFs have now started becoming very popular in India as well, with over 25 per cent of all secondary market FII flows into India coming through this route in 2009 (about 15-20 per cent of total FII flows including primary market issuance, Credit Suisse estimate). Despite this accelerated flow through ETFs into India, single-country India ETFs are still extremely small compared to China or Brazil. Brazil single-country ETFs, for example, are almost seven times the size of India ETFs, giving a sense of how much bigger India ETFs can become.

Concept of ETF:

ETFs are just what their name implies: baskets of securities that are traded, like individual stocks, on an exchange. Unlike regular open-end mutual funds, ETFs can be bought and sold throughout the trading day like any stock. Most ETFs charge lower annual expenses than index mutual funds. However, as with stocks, one must pay a brokerage to buy and sell ETF units, which can be a significant drawback for those who trade frequently or invest regular sums of money.

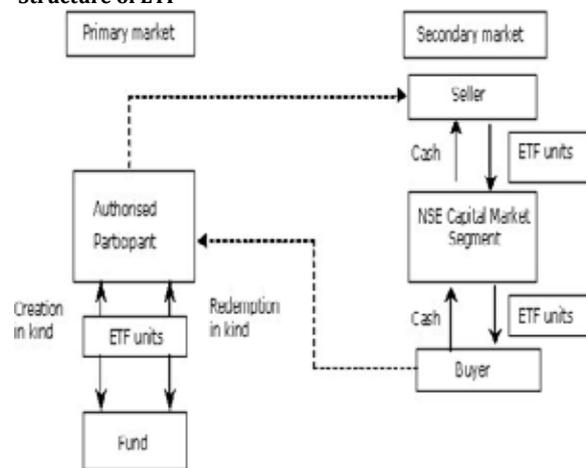
Table 1
Key Product features of ETF vis-à-vis Index Fund and Stock

Attribute	ETF	Index MF	Individual Stock
Diversification	Yes	Yes	No
Traded through the day	Yes	No	Yes
Can be bought on margin	Yes	No	Yes
Can be sold short	Yes	No	Yes
Tracks an index or sector	Yes	Yes	No
Tax efficient as turnover is low	Yes	Possibly	No
Low expense ratio	Yes	Sometimes	Not a factor

Structure of ETF

If one wants to buy ETF units, he/she must go to broker, not your mutual fund distributor. There are no forms to fill. You just tell your broker and he will buy it and credit the units to your demat account. That makes them like shares, but their real nature is that of an index fund.

Chart-1
Structure of ETF



- ETFs are index funds in the sense that they, too, track a specific index, with their portfolio replicating the stocks that make up that index.
- The difference is that ETFs are listed and traded on stock exchanges. And you can't sell it back to your mutual fund, unless you want to take a huge discount. Asset management companies usually charge a hefty load for buying back EFT units to encourage you to buy and sell them on the exchange.
- If this makes ETFs sound suspiciously like those closed-ended funds which traded at huge discounts to NAV, rest easy. This doesn't happen due to the unique manner in which ETF units are created and redeemed.
- Unlike closed-end fund where units, once issued, remain static till the fund offers to repurchase or redeem them, the number of units in an ETF scheme keep fluctuating.
- Instead of a one-time initial public offer, an ETF creates and redeems units continuously through designated institutions called "Authorized Participants."
- In short, the fund takes in a basket of Nifty stocks in designated quantities from APs, allots them units in return, and these units are in turn bought and sold by retail and other investors. When an AP wants to redeem his units, he can return them to the fund in exchange for his basket of index shares.
- The net asset value of an ETF, expressed on a per unit basis, is the value of the underlying components of the benchmark index held by the ETF, plus the accrued dividends, less the accrued management fee.
- Although the price at which an ETF trades is subject to the same market rules of supply and demand as are ordinary shares, the creation and redemption process described above ensures that the price trades very close to the NAV.
- Any discrepancy can be arbitrated away. Since ETFs can be traded through the day - unlike index-funds that can be

bought and sold only on the basis of the day's closing NAV - they tend to track the index much more closely.

10. In technical terms, the "tracking error" in an ETF is usually significantly lower than that seen in index funds, since funds allot units for consideration in kind. And this money has to be invested in index stocks at a later date and time.

Comparison of ETFs with Mutual Funds

In essence, ETFs trade like stocks and therefore offer a degree of flexibility unavailable with traditional mutual funds. Specifically, investors can trade ETFs throughout the trading day as in stocks. In comparison, in a traditional mutual fund, investors can purchase units only at the fund's NAV, which is published at the end of each trading day. In fact, investors cannot purchase ETFs at the closing NAV. This difference gives rise to an important advantage of ETFs over traditional funds: ETFs are immediately tradable and consequently, the risk of price differential between the time of investment and time of trade is substantially less in the case of ETFs.

ETFs are cheaper than traditional mutual funds and index funds in terms of fees. However, while investing in an ETF, an investor pays a commission to the broker. The tracking error of ETFs is generally lower than traditional index funds due to the "in-kind" creation / redemption facility and the low expense ratio. This "in-kind" creation / redemption facility ensures that long-term investors do not suffer at the cost of short-term investor activity. ETFs can be bought / sold through trading terminals anywhere across the country. Table No. 2 presents a comparative view of ETFs vis-à-vis other funds.

Table No. 2
ETFs Vs. Open Ended Funds Vs. Close Ended Funds

Parameter	Open Ended Fund	Closed Ended Fund	Exchange Traded Fund
Fund Size	Flexible	Fixed	Flexible
NAV	Daily	Daily	Real Time
Liquidity Provider	Fund itself	Stock Market	Stock Market / Fund itself
Sale Price	At NAV plus load, if any	Significant Premium / Discount to NAV	Very close to actual NAV of Scheme
Availability	Fund itself	Through Exchange where listed	Through Exchange where listed / Fund itself.
Portfolio Disclosure	Monthly	Monthly	Daily/Real-time
Uses	Equitising cash	-	Equitising Cash, Hedging, Arbitrage
Intra-Day Trading	Not possible	Expensive	Possible at low cost

(Source:www.nseindia.com)

Advantages of ETFs

The initial investment in ETF is low so, retail investors find it simple and convenient to buy / sell. They facilitate FIIs, Institutions and Mutual Funds to have easy asset allocation, hedging, equitising cash at a low cost. They enable arbitrageurs to carry out arbitrage between the Cash and the Futures markets at low impact cost. ETFs provide exposure to an index or a basket of securities that trade on the exchange like a single stock. They offer a number of advantages over traditional open-ended index funds as follows:

1. While redemptions of Index fund units takes place at a fixed NAV price (usually end of day), ETFs offer the convenience of intra-day purchase and sale on the Exchange, to take advantage of the prevailing price, which is close to the actual NAV of the scheme at any point in time.
2. They provide investors a fund that closely tracks the performance of an index throughout the day with the ability to buy/sell at any time, whereby trading opportunities that arise during a day may be better utilized.
3. They are low cost.
4. Unlike listed closed-ended funds, which trade at substantial premia or more frequently at discounts to NAV, ETFs are structured in a manner which allows Authorized Participants and Large Institutions to create new units and redeem outstanding units directly with the fund, thereby ensuring that ETFs trade close to their actual NAVs.
5. ETFs are like any other index fund, wherein, subscription / redemption of units work on the concept of exchange with underlying securities instead of cash (for large deals).
6. ETFs protect long-term investors from inflows and outflows of short-term investors. This is because the fund does not incur extra transaction cost for buying/selling the index shares due to frequent subscriptions and redemptions.
7. Tracking error, which is divergence between the NAV of the ETF and the underlying Index, is generally observed to be low as compared to a normal index fund due to lower expenses and the unique in-kind creation / redemption process.

The first ETF in India, "Nifty BeEs (Nifty Benchmark Exchange Traded Scheme) based on S&P CNX Nifty, was launched in January 2002 by Benchmark Mutual Fund. It may be bought and sold like any other stock on NSE. Its symbol on NSE is "NIFTYBEEs".

Disadvantages of investing in ETFs

- SIP in ETF is not convenient as you have to place a fresh order every month
- Also SIP may prove expensive as compared to a no-load, low-expense index funds as you have to pay brokerage every time you buy & sell
- Because ETFs are conveniently tradable, people tend to trade more in ETFs as compared to conventional funds. This unnecessarily pushes up the costs.
- You can't automatically re-invest your dividends. Secondly, you may have to pay brokerage to reinvest dividends in ETF, whereas dividend reinvestment in MFs is automatic and with no entry-load
- Comparatively lower liquidity as the market has still not caught up on the concept

Conclusion

ETF units are continuously created and redeemed based on investor demand. Investors may use ETFs for investment, trading or arbitrage. The price of the ETF tracks the value of the underlying index. This provides an opportunity to investors to compare the value of underlying index against the price of the ETF units prevailing on the Exchange. If the value of the underlying index is higher than the price of the ETF, the investors may redeem the units to the Sponsor in exchange for the higher priced securities. Conversely, if the price of the underlying securities is lower than the ETF, the investors may create ETF units by depositing the lower-priced securities. ETFs have different types also like, Index ETFs, Commodity ETF or ETCs, Bond ETFs, Currency ETFs or ETCs, Actively managed ETFs, etc.

REFERENCE

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