London Stock Exchange

Exchange Traded Funds

Simple products.
Sophisticated strategies.

London Stock Exchange Group

ETFs

Exchange Traded Funds (ETFs) are essentially straightforward index-tracking instruments but in the hands of a skilful professional investor they become the building blocks of sophisticated investment strategies. Institutional use of ETFs has grown almost exponentially in the US over the past decade – and European institutions are now driving similar growth across the EU. As the range of ETFs available on London Stock Exchange has grown, so too has the potential for executing more interesting and intricate strategies.

Capabilities and strengths

1000+
ETFs and ETPs listed

ETFs are now tracking global, country-specific and asset-specific indices, covering a variety of asset classes including commodities, high-yield equities and bonds – bringing simplicity, flexibility and cost-effectiveness in their wake. It's no surprise that ETFs are being used more widely by creative investment professionals everywhere.

Flexibility
ETFs can be used in a number of ways – either on their own to gain exposure to an index, or in combination with other products as part of more complex strategies. One of their key strengths is that they free you up to focus on your area of core expertise by providing broad exposure to an index. ETFs can play a key part in core-satellite strategies and tactical asset allocation, as well as having many other uses, as outlined on page 03.

Wide range of underlying
ETFs are not restricted to European blue-chip indices – they bring a wide range of investments within reach that might otherwise be difficult to access efficiently. This makes it cost-effective to trade emerging markets over a short time horizon, or to swap out of UK and into Eurobonds in just two trades, for example. A full list of current ETFs traded on London Stock Exchange is available on our website.

Trades like a share, as liquid as the underlying
ETFs offer full exposure to international and domestic indices with just one trade, and settle in Euroclear UK & Ireland Limited (formerly CREST Co) with on-book trades offering the protection of the central counterparty service.

Furthermore, the liquidity of the ETF itself is immaterial – ETFs are as liquid as the underlying index constituents because you can exchange the underlyings for ETFs on a daily basis (see diagram on page 02). This means that an ETF can provide easily accessible exposure to many indices where the future is illiquid. There is also usually full dividend participation, with income paid via Euroclear.

> "ETFs bring a wide range of investments within reach that might otherwise be difficult to access efficiently."

Capabilities and strengths

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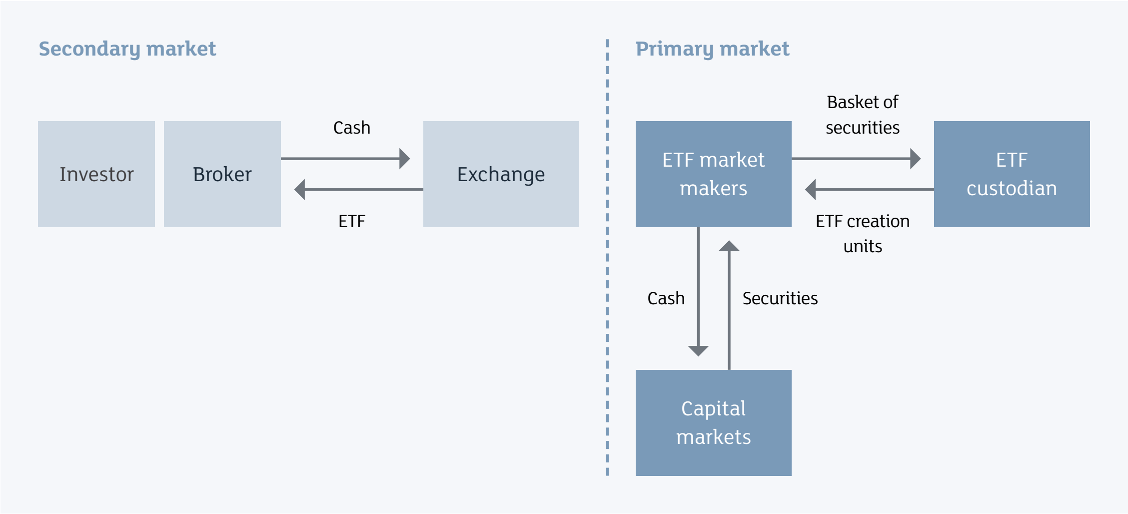
stamp duty

ETF mechanics



Low tracking error
ETFs combine the tradability of investment trusts with the tracking precision of unit trusts – this minimal tracking error is achieved through the arbitrage opportunities which arise when the ETF trades away from Net Asset Value (NAV). This is a function of the creation/redemption process whereby the basket of securities that makes up the index can be exchanged for an ETF on a daily basis, and vice versa (see diagram, above).

ETFs are not derivatives
Fund managers without a derivatives mandate may have difficulty finding a means of investing in an index whilst avoiding the cost and complex settlement often associated with program trades. ETFs are classified as a regular security and are Collective Investment Schemes. In addition, most ETFs are UCITS III compliant.

Because ETFs are not derivatives, they do not require any daily margin calculation or mark-to-market, and can be traded using existing systems without the need for further risk assessment tools.

No stamp duty
Trading is tax efficient as ETFs are free of UK stamp duty in the secondary market.

ETFs – the simple trade behind sophisticated strategies

ETFs trade like an equity, buy and sell on the same day

More investment professionals are discovering new ways in which ETFs can form the building blocks of investment strategies. Some of the ways ETFs can be used to enhance returns are outlined below.

Core-satellite strategy

This common asset allocation strategy involves investing a large portion of a portfolio (the 'core') in a passive product to achieve beta – profiting from the systematic risk or volatility inherent in a particular index – whilst actively investing the remaining assets (the 'satellite') to achieve abnormal returns attributable to manager skill. Owing to their low tracking error, ETFs have been popular as the 'core' element for some time; but now, with ETFs based on narrower and more specific indices, managers can actively trade ETFs as elements of the satellite to gain alpha returns. In fact, some managers invest exclusively in ETFs.

Cash equitisation

Because they are so easily tradable, ETFs can be used to eliminate the cash drag which often results from unexpected or significant capital inflows. Additionally, ETFs can be an efficient way of achieving instant investment in an index whilst you seek out the specific opportunities within it.

Tactical asset allocation

ETFs make tactical asset allocation easy. It's possible to gain instant access to a whole index with a single trade. This extends a fund manager's investment capabilities to a wide variety of different markets such as Japan, emerging markets, high yield stocks or corporate bonds. Swapping between Europe and the emerging markets, for example, can be achieved in just two trades.

Recover the management fee through lending

Lending ETFs to institutions that have taken short positions mitigates the management fee, whilst still maintaining exposure to the index. The income generated from this can cover a very significant portion of the annual management fee.

Shorting

Because ETFs trade just like a share, it's possible to short a whole index simply by shorting the ETF. The SB&L market for ETFs is constantly growing, ensuring ETFs are readily available to borrow in order to meet shorting obligations.

Pairs trading

With such a wide range of ETFs now available, there are many ways they can be used in pairs trading strategies. Shorting the stock whilst going long on the ETF, or vice versa, captures the relative outperformance of the long position over the short. You can even use ETFs for both legs: if it is predicted that Taiwan could outperform the emerging markets index for example, then it's possible to go long on the MSCI Taiwan ETF and short on the MSCI Emerging Markets ETF (for illustrative purposes only).

Hedging

ETFs are perfect for hedging long or short exposure, by going short or long on the ETF respectively. Hedging using the wide variety of ETFs available on London Stock Exchange can be both effective and efficient, particularly where the future is relatively illiquid. Additionally, ETFs do not require quarterly rolls or margin maintenance, reducing the administrative burden and cost of hedging.

>30%

of European on-exchange ETF turnover is on London Stock Exchange

ETFs versus futures

Liquid and cost-effective

There are many instruments which provide exposure to indices, but few provide the simplicity and flexibility of ETFs. As outlined in the table below, ETFs have a number of key advantages over futures:

— There is no need to roll the contract each quarter – the associated savings often significantly outweigh an ETF's annual management fee

— There is no need to calculate daily variation margin

— Liquidity is limited only by the liquidity of the underlying index constituents.

	ETFs	Futures
Financial instrument	Stock indices	Derivatives
Pricing	Continuous	Continuous
Market liquidity	Equal to liquidity of underlying stocks	Variable – based on demand/supply
Matuarity	None	Limited lifespan
Reinvestment risk	None	Yes
Short sales	Yes	Yes
Costs for purchase/sale	Normal Exchange fees	Initial and variation margin payments and rollover costs
Minimum order size	1 ETF (ca £30)	£10 × index (ca. £50,000)
Dividend payment	Generally quarterly payment via Euroclear	Cash settlement at maturity
Margin management	No	Required
Management fee	Yes	No
Potential for lending revenue	Yes	No

Conclusion

ETFs. Simple products. Sophisticated strategies.
This brochure presents just some of the opportunities ETFs offer the skilful investment professional. The flexibility of ETFs is shown in their many uses – and is tempered only by your imagination.

Contact
For further information on how ETFs can benefit the professional investor contact the product manager at etfs@lseg.com

Largest ETF Exchange in Europe by volume

Recognised by Global ETF Awards 2015

London
Stock Exchange

London Stock Exchange
London Stock Exchange plc
10 Paternoster Square
London EC4M 7LS
Telephone +44 (0)20 7797 1000
www.lseg.com