

ETF

**Exchange Traded Funds:
simple products, sophisticated strategies**



“ETFs have become successful for Italian investors because of their fundamental characteristics – simplicity, transparency, flexibility and economy.”

ETF Exchange Traded Funds

Introduction

Simplicity and transparency

Originating in the United States in the early 1990s, Exchange Traded Funds first became available to Italian investors in September 2002. Since then they have achieved impressive growth, demonstrated by increases in the volumes traded on exchange, the assets under management and the number of ETFs traded on the ETFplus market (the regulated market managed by Borsa Italiana that is dedicated to these instruments).

Simplicity

ETFs are passive instruments, exclusively aimed at replicating the performance of a benchmark index, which provide investors with a way of gaining immediate exposure to an investment market (stocks, bonds, commodities, etc.) or of pursuing an objective strategy in a market (through structured ETFs, e.g. short and leveraged). In addition, ETFs trade throughout the day on the stock exchange and can be bought or sold like stocks, through a bank or broker.

“ETF: an instrument good for every investment strategy.”

Transparency

By replicating well-known market indices, ETFs allow investors to be perfectly aware of the risk/reward profile of their investment as well as the security portfolio to which they are exposed. Furthermore, the ETF price is updated constantly in response to the movements of the reference index's components, so investors are always aware of the value of their investment in the ETF. This is also supported by daily publication of the official net asset value (NAV) of the ETF.

Exchange Traded Funds

Flexibility

ETFs do not expire and can be traded throughout the day on the stock exchange; investors can therefore control the length of the investment based on their specific objectives, from short term intraday trading to medium or long term investment planning. In addition, given that the minimum trading lot is only one share/unit, it is possible to take positions in a wide range of indices, even for smaller amounts.

Economy

The policy of passive management common to all ETFs combined with a stock exchange listing allows ETFs to operate without some of the typical costs of actively managed funds (e.g. analyst teams and costs linked to distribution). This provides investors with low cost access to markets and investment strategies that would otherwise incur high management commissions.

Reducing issuer risk

ETFs are funds or Sicavs whose assets are, by law, the exclusive property of the holders of the ETF shares/units. As a consequence even in the event of the ETF manager, administrator and promotion company becoming insolvent, the assets of the ETF are protected.

Despite its simplicity and flexibility of use, the ETF is a sophisticated and innovative instrument which is constantly developing. The specific characteristics of these products need to be understood in order to grasp both the potential ETFs that offer and their limitations. To this end, the following pages describe the features and investment methods of ETFs and structured ETFs.

Main features of ETFs

What they are

ETF is the acronym for Exchange Traded Fund, a term which identifies a particular type of mutual investment fund or Sicav whose main features are that:

- it is traded on the stock exchange like a share
- it tracks a reference index (benchmark) through totally passive management.

An ETF combines the typical characteristics of a fund and a share, enabling investors to benefit from the strengths of both instruments:

- diversification and reduced risk - typical of funds
- flexibility, transparency of information and real-time trading - typical of shares.

Main features

ETFs allow investors:

- **to take a position in the target market with one transaction at any time during the trading session.** By purchasing an ETF it is possible to take a position in a market index (for example FTSE MIB, DAX, Nasdaq100, S&P500) for a price that perfectly reflects the value of the index components at that time. As the minimum trading quantity is always one unit/share, the investor may purchase ETFs by investing only a few hundred euros
- **to track the performance of the benchmark index.** The ETF allows investors to obtain a return equal to that of the reference benchmark through 'totally passive management', by replicating exactly the composition and weight of the index to which it refers. However, if the reference currency of the index is different from the trading currency (which is always the euro), the return on the ETF may be different from that of the benchmark as a result of currency fluctuations
- **to achieve a price that is constantly aligned to the iNAV.** Due to the creation/redemption process which enables the authorised participants to create and redeem ETF units by exchanging them for the underlying stock of the reference index and vice versa (primary market), the price on the stock exchange is constantly aligned to the real-time value of the ETF, the indicative Net Asset Value (iNAV). This reduces the risk of buying (selling) an ETF with a higher (lower) price than the NAV, although such a risk can't be excluded. Moreover, an ETF modifies its assets automatically in order to follow changes to the weighting and constituents of the reference index. As a result the investor is never involved in re-balancing the assets

“The wide range of ETFs available on ETFplus offers investors a great opportunity to diversify the composition of their own portfolio, thereby reducing overall risk whilst maintaining cost efficiency.”

“Traded on the stock exchange like a share, the ETF tracks the reference index through totally passive management.”

More than 650 ETFs listed on ETFplus market

— to obtain a broad diversification.

Investing in ETFs is an easy way to take a position on a whole market index which in general consists of a large basket of securities, thus diversifying and decreasing the investment risk. Consider the simplicity of this compared to the transaction costs and capital that would be required to purchase all the securities making up the FTSE MIB index in the proportions stated by the operating rules of the index

— to reduce the costs of one's own portfolio.

ETFs are subject to a low total expense ratio (TER) applied automatically in proportion to the holding period, and the investor is charged no 'entry', 'exit' or 'performance' fees. Investors only need to consider the trading fees applied by their own bank/broker

— to benefit from periodical proceeds.

The dividends or interests that an ETF collects in relation to the shares/bonds included in its assets (as well as the proceeds from their re-investment) may be redistributed periodically to the investors or permanently capitalised in the assets of the ETF. In both cases, the only beneficiary is the investor

— to reduce exposure to issuer risk.

The ETFs listed on ETFplus are, depending on the instrument, mutual investment funds or Sicavs (UCITS). UCITS have segregated assets with respect to those of the companies which are involved in their creation, management, administration and marketing activities. Therefore ETFs are not subject to insolvency risk in the event of an associated company defaulting.

Investment modalities

ETFs allow investors to access their desired market by tracking indices covering a wide range of investment categories:

— fixed income and liquidity indices.

Italian government bonds segmented according to maturity. Government bonds denominated in Euro, US Dollar and Sterling. Emerging markets government bonds. Corporate bonds from the Euro, USD and emerging regions. Liquidity indices linked to Euro, US Dollar, Sterling, Australian Dollar and Canadian Dollar overnight interest rates

— equity indices representing single markets and wider geographic areas.

Italy, UK, Germany, Switzerland, Japan, Europe, USA, Australia, Canada, etc.

— equity indices from emerging markets.

China, India, Russia, Brazil, Turkey, Korea, Taiwan, Vietnam, South Africa, Select frontier, Malaysia, Thailand, South East Europe, Mexico, Chile, Indonesia, etc.

— equity indices relating to market sectors.

Automotive, technological, telecommunications, utilities, banks, energy, financial services, infrastructure, etc.

— style equity indices.

Mid cap, small cap, value, growth, select dividend, etc.

— commodities indices

— indices relating to real estate companies or private equity

— fundamental and quantitative indices.

Indices composed of stocks selected using fundamental criteria (sales, cash flow, book value, dividends, etc.) and/or momentum criteria



— thematic indices.

Indices related to particular sectors such as water, clean energy, timber, etc.

— minimum variance indices.

Indices which aim to select the most liquid components of the base index so that the expected volatility of the portfolio obtained is minimised and a minimum sector diversification is guaranteed.

As ETFs are available to trade on the stock exchange, they are suitable for a range of investment strategies:

— short-term trading (intra-day trading).

Due to the high liquidity of ETFs, they can be traded exactly like shares, allowing investors to exploit intra-day movements in the reference index

— long-term investment.

As ETFs do not expire, it is possible to take a position in the target market over the long-term, as part of an investment strategy or within CAP (Capital Accumulation Plans)

— short selling.

If a broker offers this service, it is possible through securities lending to profit from a decrease in the reference index for longer than one day.

Structured ETFs

Main features of structured ETFs

What they are

Structured ETFs are UCITS i.e. funds or Sicavs that can be traded like shares and that mirror structured indices, enabling objective strategies to be:

- leveraged
- short (with or without leverage)

What structured ETFs and standard ETFs have in common is the investment policy: both types track a reference index (benchmark) through totally passive management.

In addition, as with standard ETFs, the units of structured ETFs may be created and redeemed continuously by authorised participants, ensuring that the market price is always aligned to the real-time value of the ETF, the indicative Net Asset Value (iNAV). This reduces the risk of buying (selling) an ETF with a higher (lower) price than the NAV, though such a risk can't be excluded.

Main features

Structured ETFs allow investors:

- **to maximise the performance of each strategy.**
Tracking a structured index, they enable investors to access more complex investment strategies than simply tracking a benchmark index will permit
- **to reduce the costs of managing the portfolio.**
They are subject to a low total expense ratio (TER), which is applied automatically in proportion to the holding period and the investor is charged no 'entry', 'exit' or 'performance' fees. Investors only need to consider the trading fees applied by their own bank/broker

- **to benefit from periodical proceeds.**

The dividends or interests that the structured ETF collects may be redistributed periodically to the investors or permanently capitalised in the assets of the structured ETF. In both cases the only beneficiary is the investor

- **to reduce exposure to issuer risk.**

Structured ETFs listed on ETFplus are, depending on the instrument, mutual investment funds or Sicavs (UCITS) and are therefore not subject to insolvency risk in the event of issuer default.

Investment modality

Structured ETFs allow the investor to access different strategies and risk profiles on the desired market through one transaction. The transparency and liquidity provided by the ETFplus market make it easy for investors to invest:

- with leveraged effect, to increase exploitation of movements in the markets
- with an inverse relationship between the index performance and the performance of the ETF, through a 'short' ETF with or without leverage.

“With structured ETFs the investor can access different strategies and risk profiles on the desired market through one transaction.”

ETFplus market

ETFplus: segmentation and microstructure

ETFplus is the regulated market of Borsa Italiana that is wholly dedicated to the trading of ETFs and structured ETFs, diversified instruments which share the same trading mechanism.

To aid investors in selecting the ETF which best meets their expectations and their risk-return profile, three segments are provided. These use the same trading modalities and are divided into distinct classes:

- ETF segment, divided into following:
 - class 1: ETFs with bond based reference indices
 - class 2: ETFs with equity based reference indices
- Structured ETF segment, divided into the following:
 - class 1: structured ETFs without a leverage effect
 - class 2: structured ETFs with a leverage effect
- Active ETF segment, divided into the following:
 - class 1: bond ETFs
 - class 2: equity ETFs
 - class 3: structured ETFs

Microstructure

Liquidity

The liquidity of a financial instrument is directly linked to the availability of both bid and ask prices on the trading book, along with competitive spreads and high tradable quantities – in other words the provision of adequate width and depth. In order to guarantee the maximum liquidity for each ETF and structured ETF listed on the ETFplus market, Borsa Italiana requires the constant presence of:

- at least one specialist, who agrees to meet obligations both in terms of minimum bid/offer quantities and the maximum spread between bid and ask prices, and who is obliged to restore quotes in the event of a total or partial hit on the book. The presence of the specialist is also mandatory during the closing auction. Borsa Italiana monitors the performance of these obligations on a continuous basis
- different liquidity providers who may also supply additional liquidity to these instruments by displaying their own prices, even though they have no quotation obligations.

Trading hours

The continuous trading of ETFs and structured ETFs takes place non-stop from 9.00 am to 5.25 pm. Following the migration to the Millennium platform, a closing auction phase from 5:25 pm to 5:30 has been introduced, plus a variable interval of up to one minute. Contracts are executed through automatic matching of bid and ask orders according to price/time priority criteria.

During trading, orders may be added to the book through an intermediary with or without a price limit (although orders without a price limit aren't allowed during closing auction) and with various specifications on the duration – for example 'good till day' which allows orders with a maximum maturity of 30 days to be inserted.

To ensure proper operation of the market, as with shares, maximum limits are fixed for the movement of prices.

A maximum price variation limit is established for orders inserted onto the order book compared to a control price; also a maximum variation limit for the execution price compared against the control price; and, finally, a maximum limit to the movement of prices between two consecutive executions. These limits vary depending on the segment and the specific volatility of the instruments. Clearing of contracts is managed by Monte Titoli, the company responsible for centralised administration, clearing and settlement at Borsa Italiana/ London Stock Exchange Group. Final settlement is guaranteed by the Central Counterparty (Cassa di Compensazione e Garanzia). The smallest quantity that can be traded is one share/unit so it is possible to purchase the instruments listed on ETFplus in very small amounts.

Transparency of information

A continuing flow of up to date information is a fundamental requirement for guaranteeing the proper operation of the market, so Borsa Italiana requires that issuers make the following information available to the market:

- the value of the NAV
- the number of outstanding units or shares
- for structured ETFs, if applicable: the protection and guarantee levels and the value of the multiplier
- the dividend amount, ex date and payment date
- the information provider or the website, and any possible change that may occur, by means of which the value of the reference index, of the cushion (where expected by the ETF) and of the value of iNAV expressed in Euro are made available to the public and regularly updated.

In addition to the above information, statistics, relating to the market (trading statistics, dividends, performances and spreads), prospectuses and the issuers' brochures are available on the Borsa Italiana website www.borsaitaliana.it/ETF.

Contacts

ETFs Listing Italy

Telephone +39 02 72426 1

etftaly@borsaitaliana.it

www.borsaitaliana.it

This document contains text, data, graphics, photographs, illustrations, artwork, names, logos, trade marks, service marks and information ("Information") connected with Borsa Italiana S.p.A. ("Borsa Italiana"). Borsa Italiana attempts to ensure Information is accurate, however Information is provided "AS IS" and on an "AS AVAILABLE" basis and may not be accurate or up to date. Information in this document may or may not have been prepared by Borsa Italiana but is made available without responsibility on the part of Borsa Italiana. Borsa Italiana does not guarantee the accuracy, timeliness, completeness, performance or fitness for a particular purpose of the document or any of the Information. No responsibility is accepted by or on behalf of Borsa Italiana for any errors, omissions, or inaccurate Information in this document. The publication of this document does not represent solicitation, by Borsa Italiana, of public saving and is not to be considered as a recommendation by Borsa Italiana as to the suitability of the investment, if any, herein described. No action should be taken or omitted to be taken in reliance upon Information in this document. We accept no liability for the results of any action taken on the basis of the Information.