Educate Yourself

An initiative by SSL Research Centre

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ETF

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Exchange Traded Fund (ETF)

What are ETFs?

An alternative to mutual funds are ETFs. For those unaware, an Exchange Traded Fund (ETF) is a type of investment fund which trades on the stock exchanges. An ETF can be bought or sold throughout the day as the price keeps changing, similar to stocks. ETFs track an index, and the goal is to perform as close to the index as possible. An Exchange-Traded Fund (ETF) is an investment fund that holds assets such as stocks, commodities, bonds, or foreign currency. They often track indexes, such as the NIFTY and SENSEX. Investors in these funds do not directly own the underlying investments, but instead, have an indirect claim and are entitled to a portion of the profits and residual value in case of fund liquidation. Their ownership shares or interest can be readily bought and sold in the secondary market.

What are the Different Types of ETFs?

There are many types of Exchange-Traded Funds. Some of the most common ETFs include:

Stock ETFs – these hold a particular portfolio of equities or stocks and are similar to an index. They can be treated like regular stocks in that they can be sold and purchased for a profit, and are traded on an exchange throughout the trading day.

Index ETFs – these mimic a specific index, such as the S&P 500 Index. They can cover specific sectors, specific classes of stocks, or foreign or emerging markets equities.

Bond ETFs – an exchange-traded fund that is specifically invested in bonds or other fixed-income securities. They may be focused on a particular type of bonds or offer a broadly diversified portfolio of bonds of different types and with varying maturity dates.

Commodity ETFs – hold physical commodities, such as agricultural goods, natural resources, or precious metals. Some commodity exchange-traded funds may hold a combination of investments in a physical commodity along with related equity investments – for example, a gold ETF might have a portfolio that combines holding physical gold with stock shares in gold mining companies.

Currency ETFs – these are invested in a single currency or a basket of various currencies and are widely used by investors who wish to gain exposure to the foreign exchange market without directly trading futures or the forex market. These exchange-traded funds usually track the most popular international currencies such as the U.S. dollar, Canadian dollar, Euro, British pound, and Japanese yen.

Inverse ETFs – An inverse exchange-traded fund is created by using various derivatives to gain profits through short selling when there is a decline in the value of a group of securities or a broad market index.

Actively Managed ETFs – these ETFs are being handled by a manager or an investment team that decides the allocation of portfolio assets. Because they are actively managed, they have higher portfolio turnover rates compared to, for example, index funds.

Leveraged ETFs – Exchange-traded funds that mostly consist of financial derivatives that offer the ability to leverage investments and thereby potentially amplify gains. These are typically used by traders who are speculators looking to take advantage of short-term trading opportunities in major stock indexes.

Real Estate ETFs – These are funds invested in real estate investment trusts (REITs), real estate service firms, real estate development companies, and mortgage-backed securities (MBS). They may also hold actual physical real estate, including anything from undeveloped land to large commercial properties.

How does ETF differ from Mutual Fund?

The biggest difference is that an ETF has no active fund manager, unlike a mutual fund. On the other hand, different schemes of a Mutual Fund have different fund managers. Some may also have specific lock-in periods, which means you cannot sell your mutual funds without paying a fixed fee before it expires.

An ETF tracks a particular index. The index can be a benchmark or belong to a specific sector or asset class. Yes, crude, gold, metals, all have their respective ETFs. Benchmark indices have their respective ETFs too.

Another factor that differentiates a mutual fund from an ETF is cost. Most ETFs tend to have a lower cost than the corresponding MFs. This is because ETFs don't need to pay expensive active management fees and are focused on mirroring the underlying indices.

By investing in ETFs, you can focus on the theme in its entirety instead of having to go through the trouble of sifting through the multiple stocks that the sector is composed of. Moreover, a sectoral ETF does not involve an exit load as mentioned above, and you can take short-term positions in sectors through the ETF.

ETFs and Close-Ended Funds

ETFs and close-ended funds are like close cousins because both financial products can be bought or sold over the stock exchanges. However, unlike close-ended funds, an exchange-traded fund is not actively managed. Instead, the securities in an ETF fund simply form a basket of investments intended to replicate an index as closely as possible. You can think of ETFs as close-ended index funds that are traded over exchanges.

Things to consider while investing in ETFs:

Underlying Index: While investing in an index ETF, you need to first decide on the market you wish to invest in. Once you decide that, you either determine whether you wish to invest in the benchmark index as a whole or a specific sectoral index. A benchmark ETF would generally buy all the stocks that are part of the index, but a thematic or sectoral ETF would focus only on the stocks in that particular sector.

Total Expense Ratio (TER): An expense ratio is an annual fee a fund charges to cover its expenses. For example, if an ETF has an expense ratio of 0.20%, it means the fund uses 0.20% of the assets to cover the expenses. Different funds tracking the same index can have different expense ratios.

Tracking Error: ETFs must closely track the benchmark. Traditionally, tracking error is defined as the standard deviation of the difference in returns between the ETF and the index. An ETF with lower tracking error to its benchmark should be preferred to others.

Liquidity: One of the most crucial factors of an ETF. When considering ETFs, other than TER and Tracking Error, liquidity is also very important. As ETFs are traded intraday on an exchange, those ETFs with greater liquidity can be expected to have a lower bid-ask spread, while low liquidity ETFs shall have wider spreads. Thus, one should prefer ETFs with greater liquidity.

AUM: AUMs or Assets Under Management of an ETF is calculated by multiplying the shares outstanding by the market price per share. The AUM of an ETF is subject to change based on the changing value of the underlying security as well as the creation of new shares or redemptions of the existing ones. ETFs with greater AUM tend to have more liquidity. Thus, one can use AUM as a proxy for liquidity.

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