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# An Introduction to Exchange Traded Products

Investment vehicles come in a number of forms in the UK, of which Exchange Traded Products (ETPs) are one. Understanding the differences between the vehicles will help investors to determine which is the most suitable for their needs.

## What is an ETP?

An Exchange Traded Product (ETP) is a financial instrument traded on a stock exchange, like shares. Typically the aim is to provide the same return as a specified benchmark or asset (before fees). The relatively low costs associated with managing ETPs make them a cost effective way for investors to gain access to a wide range of assets.

## ETPs are divided into three categories

### Exchange Traded Products (ETPs)

#### Exchange Traded Funds (ETFs)

Structured as a fund, which issues shares.

Generally UCITS and governed by the EC Directive for collective investment schemes.

Safeguards include: segregated assets and limited liability between sub-funds; Increased transparency; investment diversification limits; robust risk management.

#### Exchange Traded Commodities & Currencies (ETCs)

Structured as zero-coupon debt securities issued by a special purpose vehicle.

Not UCITS themselves, however can be eligible for investment by UCITS.

Often governed by the EU Prospectus Directive. Can be structured to be bankruptcy remote with protections under English Law.

#### Exchange Traded Notes (ETNs)

Non-UCITS investments that are designed to track the return of an underlying benchmark or asset.

Generally issued by banks and reliant on the credit worthiness of the issuing entity.

## ETP Structures

ETPs can be structured in two ways: physically or synthetically.

When considering an investment in an ETP, the structure is an important consideration. A product's structure impacts its risks, its costs and how accurately it tracks its underlying.

**Physical Replication**

Performance and security by holding the underlying asset

**Synthetic Replication**

Performance through swap agreement

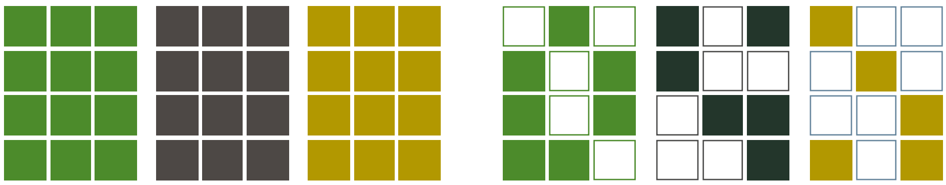
Security through collateral (i.e. assets provided by a swap provider to secure payment obligation)

**RESULT** ETP aims to track an underlying index or asset less fees

## Physical ETFs

A physically replicating ETF either owns all (full replication), or a sample (sample replication), of the assets that comprise the underlying benchmark.

**Full Replication** | **Sample Replication**



### Full Replication

All the underlying assets are held in the same proportion as their weighting in the index being replicated. This method is employed if the underlying assets are readily available, reasonably small in number and do not significantly alter (e.g. the 101 shares listed on the FTSE 100, reviewed quarterly).

### Sample Replication

Instead of holding all assets that constitute an index, the product holds a sample of some of the index constituents. This approach might be used if the benchmark contains a large number of assets which change frequently (e.g. the MSCI World Index, with more than 1,600 constituents, sometimes changing over 300 shares annually).

## Physical ETCs

**Physical Commodity ETC Structure**

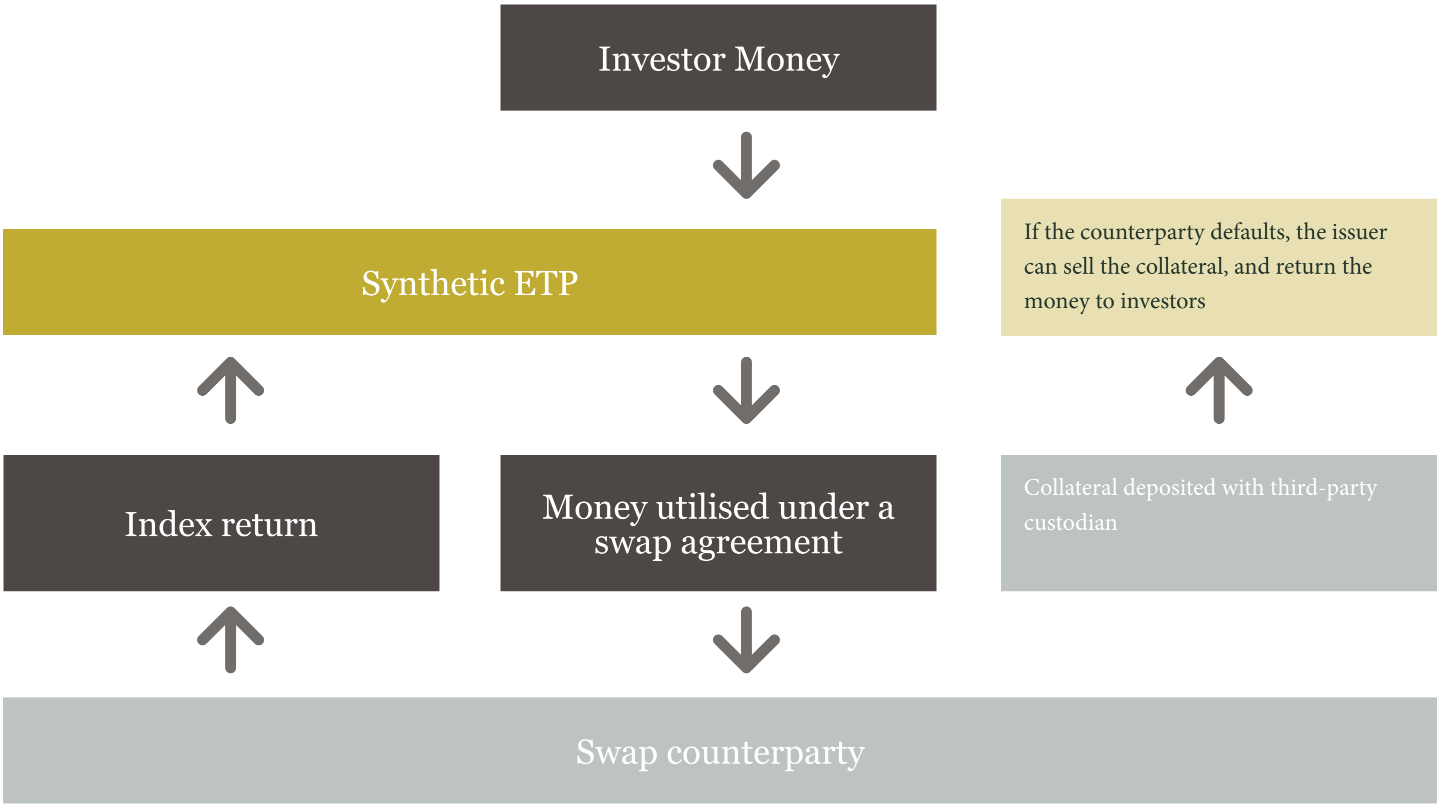
| | | | |
|---|---|---|---|
| Physical commodity ETCs are backed by a specific quantity of commodity | This is only possible if the asset can be easily stored for long periods | Possible for precious and industrial metals | Allocated metal means that uniquely identifiable physical metal (e.g. gold bullion bars) cannot be moved or used for any other purpose |

## Synthetic ETPs

The ETP issuer enters into a swap agreement with a counterparty that contracts to provide the return (performance) of the underlying assets. A swap is an agreement where the parties swap the return of one investment for another; or, alternatively, one party pays a fee for the performance return of a particular investment.

For example: An ETP may agree to pay a fee for the performance of the FTSE 100. If FTSE rises 1%, the swap counterparty pays 1% (less swap fee) to the ETP.

If a swap counterparty defaults on an ETP that does not have collateral arrangements in place, it is likely that all or a portion of the cash paid to the counterparty will be not be returned. The provision of collateral can help mitigate this risk. Collateral is the assets provided by swap providers to secure their payment obligations under a swap agreement.




## How do advisers purchase ETPs for investors?

01 Login to wrap platforms

02 Identity ticker code for desired ETP

03 Input ticker code and number of securities

04 Finalise and place order

05 Confirm purchase from wrap

## Total cost of ownership

- Costs are one of the most important factors for an investor to consider when investing in ETPs
- The most widely reported cost figure is the total expense ratio (TER), or ongoing charge figure, but this is often misleading with respect to 'total cost of ownership' as the definition of TER can vary and can neglect a number of internal and external expenses
- Instead, investors should look at the total cost of ownership detailed below:

| Ongoing Charges | + | Portfolio Transaction Costs | + | Trading and post-trade costs | = | Total Cost of Ownership |
|---|---|---|---|---|---|---|
| Management fees<br>Administration fees<br>Index license fee<br>Custody | | Rebalancing costs<br>Swap fee<br>Securities lending fee | | Bid/ask spread<br>Trading fees<br>Reoccurring brokerage/ platform fees | | Tracking difference (adjusted for performance) |

## What are the benefits of investing in ETPs?

### 01 Simple
ETPs are listed and trade like shares through the same brokers and platforms

### 02 Diversified
ETPs can provide access to an entire index, or alternative asset classes (such as commodities), with a single trade

### 03 Cost-Effective
ETPs provide a cost-effective way to gain diversification through a benchmark or exposure to assets previously difficult to access

### 04 Transparent
Unlike other investment vehicles, ETP constituents are published on a daily basis

### 05 Flexible
ETPs can be used to achieve numerous investment strategies

## Some due diligence considerations when investing in ETPs

### Market Risk
ETPs replicate the price movements of their underlying benchmark or asset so their performance is affected by the volatility of their underlying markets

### Currency exposure
Any investment involving a non-local currency will be affected by exchange rate fluctuations (unless the product incorporates a currency hedge)

### Tax
As with the majority of investments, ETPs will usually incur some form of taxation. Investors should obtain independent tax advice before investing in ETPs

### Costs
Investors in ETPs incur two types of costs: internal costs (related to the product) or external costs (incurred in trading the product)

### Tracking difference
The structure and cost of an ETP means it may not track its underlying exactly

### Counterparty Risk
The introduction of swap and securities lending counterparties is an added risk. It is important to ensure counterparties are independent and collateral is provided

# Glossary of Terms

| | |
|---|---|
| Bid/Ask Spread | The difference between the bid and ask price of a given security. Bid – price at which a buyer is willing to purchase an asset. Ask – the market price at which an ETP can be bought. |
| ISAs (Individual Savings Account) | An investment account available to retail investors in the United Kingdom with tax benefits designed for saving. If an individual saves cash or stocks in an ISA they are entitled to keep all that they receive from an investment without having to pay tax on any gain, until such point any money is removed from the ISA. |
| Passive Investment | An investment methodology that attempts to replicate, as closely as possible, the performance of a specified benchmark but does not involve any active management of assets. On the contrary, Active Investment- is a methodology whereby a fund manager attempts to generate above-benchmark returns by actively selecting assets in which to invest. |
| Rebalancing Costs | In the context of a portfolio, buying and selling assets in order to return a portfolio to a desired asset allocation percentage. |
| SIPPs (Self-Invested Personal Pension) | A personal pension scheme available in the United Kingdom. Allows people to make their own investment decisions from a wide range of investments, as well as having certain tax benefits. In exchange, there are limits on how much and when the money can be withdrawn. |
| Special Purpose Vehicle (SPV) | A legal entity created to fulfill a particular purpose or role which has a distinct legal personality from the parties that set it up. |
| Stamp Duty | A tax levied on electronic purchases of UK listed shares, as well as some OEIC and unit trusts. |
| Tracking Difference | The total return difference between an ETP and its benchmark index over a given period. |
| UCITS (Undertakings for Collective Investment in Transferable Securities) | A set of European directives that impose a common framework for regulating collective investment schemes throughout the European Union. UCITS are entitled to a number of cross-border marketing and distribution rights throughout the European Union. ETPs that are not UCITS in themselves, for example ETCs which are issued as debt securities, may still be eligible for investment by UCITS. |

*For more information about ETPs please visit www.etpedia.com

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