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etf Securities

ETP Due Diligence Guide

Step-by-step guide to selecting the right products for your clients

The exchange traded product (ETP) industry has undergone significant transformation since the first product was listed on the London Stock Exchange in 2000. Today there are over 1,000 listings covering a multitude of exposure types.

Alongside the vast universe of ETPs, new product structures using more complex replication methods have been introduced highlighting new challenges for intermediaries and investors looking to navigate through the ETP selection process.

At ETF Securities we understand the importance of conducting thorough due diligence into ETPs. The following framework is designed to assist with the fund selection process, ensuring that the right products are chosen to meet clients' objectives.

ETPs: The UK Regulatory Framework

The Retail Distribution Review (RDR) implemented in 2012 introduced new regulatory requirements resulting in significant changes to the manner in which financial products are distributed to retail investors in the UK. It is worth noting that the Financial Conduct Authority (FCA) prohibition on the marketing of non-mainstream pooled investments to retail investors does not apply to ETPs (Policy Statement PS13/3). The table below outlines the current position for FCA permission, appropriateness and RDR as they relate to ETPs.

Product	Permission framework	Appropriateness	RDR
ETFs	As UCITS, ETFs are considered units of collective investment schemes	UCITS ETFs are generally considered non-complex. Certain UCITS ETFs that track strategy indices may be deemed complex	ETFs are within the scope of the RDR rules on commissions
Physical ETCs	Per current FCA policy, these are considered debt securities	Physical ETCs are not UCITS in themselves but are generally deemed non-complex	ETCs are within the scope of the RDR rules on commissions
Synthetic/swap-backed ETCs	Per current FCA policy, these are considered transferable securities and CFDs	Swap-backed ETCs are not UCITS in themselves and are deemed complex	ETCs are within the scope of the RDR rules on commissions

1. Evaluating the underlying exposure

Understanding the underlying benchmark is fundamental to conducting due diligence on an ETP and in ultimately answering the question of whether a product meets a client's objective.

FACTORS TO CONSIDER	WHY IS THIS RELEVANT?
☐ **What is the market risk of the underlying benchmark?**	ETPs generally passively track an underlying and therefore derive the majority of their performance from that underlying benchmark. Understanding the drivers of benchmark performance is the most important element of understanding the drivers of ETP performance.
☐ **How concentrated is the underlying exposure?**	Underlying benchmarks can offer broad based exposures or very specific exposures to a single asset. Identifying the focus of the underlying benchmark will help in assessing whether an ETP meets a client's objective.
☐ **What is the index type?**	Different types of indices can perform differently despite holding the same assets. Total return indices track the price movement of its underlying assets plus any associated collateral yield or cash distributions in the form of dividends and interest payments. In contrast price return indices only take into account the capital appreciation of the underlying.
☐ **What is the weighting methodology?**	Financial indices can be weighted in a number of ways (e.g. market capitalisation, price weighted, equally weighted). Broad-based commodity indices will also have varying constituent weights. Different weighting methodologies can result in varying product performance and risk/return characteristics.
☐ **How often does index rebalancing take place?**	If underlying components are frequently added and removed from an index this can affect how tightly a product tracks the underlying benchmark due to rebalancing costs.
☐ **How often does the underlying index report holdings?**	If the underlying holdings are reported on a daily basis in a transparent fashion it will help in comparing the tracking difference between the product and benchmark.
☐ **If holding an underlying physical metal, are quality standards met?**	For ETPs that track an underlying physical asset, like precious or industrial metals, industry quality standards may apply. These standards will typically be defined by a relevant trade association.
☐ **Are there any other factors affecting the underlying index/asset returns?**	When ETPs track indices, it is important to understand the components of the index. For example, withholding tax rates for equity indices can make a difference to the performance. In the case of total return commodity indices, the roll yield and collateral yield can impact returns and consequently product.

2. Understanding the product structure

ETPs can be structured in different ways. It is important to examine specific product structures and understand the associated risks as well as how these are mitigated.

FACTORS TO CONSIDER	WHY IS THIS RELEVANT?
☐ **Is the product a UCITS?**	UCITS are generally considered to be non-complex and are thus widely used by product issuers. However not all underlying assets, like commodities and currencies, can be wrapped in a UCITS fund. Therefore alternative structures like ETCs are used. ETCs are not restricted by UCITS requirements and can offer very specific exposures.
☐ **What is the investment approach?**	ETPs can implement a number of different replication methods – physical full replication, physical optimisation replication, synthetic replication, active replication strategies. These different methods can influence how closely an ETP tracks an underlying benchmark.
☐ **Does the structure involve credit risks? How are they mitigated?**	Both physical and synthetic structures may in some circumstances introduce credit risks through either securities lending or swap agreements respectively. These risks can be mitigated through the provision of collateral. Important considerations include the type of collateral used, how the collateral is held and the extent to which it covers the credit exposure to a counterparty.
☐ **What, and how well diversified, are the product holdings?**	When investing in physical ETPs analysis into the product's holdings is important when taking into consideration a client's objective or risk appetite. Physical ETFs using optimisation methods to replicate an underlying benchmark will hold a sample of the index constituents, which could impact the way in which the product performs relative to the benchmark.
☐ **How well does the fund track the underlying index?**	The structure will determine the costs and performance of an ETP and thus how closely it tracks the underlying benchmark. The tracking difference will indicate how well a product is tracking its underlying benchmark.
☐ **Does the product provide long or short exposure? Is there an added leverage factor?**	ETPs can either provide a long or short exposure and may involve an additional leverage factor. Products involving short exposure or a leverage factor will carry additional market risk.

3. Considering tax liability

Tax can impact the accuracy of an ETP's tracking of an underlying benchmark as well as the total cost of owning a product.

FACTORS TO CONSIDER	WHY IS THIS RELEVANT?
☐ **Where is the product domiciled?**	The ETP's domicile will determine the tax treatment at the product level. Many ETPs are domiciled outside of the UK and are therefore subject to tax regimes external to the UK.
☐ **Does the ETP have UK Reporting Fund Status?**	ETPs should have UK Reporting Fund Status. For ETPs that do not have UK Reporting Fund Status, UK investor gains will be treated as income as opposed to capital and may therefore result in certain investors incurring a proportionally higher UK taxation charge.
☐ **Is an investor liable to pay stamp duty or Stamp Duty Reserve Tax (SDRT)?**	Generally, ETPs are exempt from stamp duty and SDRT in primary and secondary markets. Importantly this means that investors do not incur either tax when they buy and sell ETPs.
☐ **Is the ETP eligible for ISAs and SIPPs?**	Generally, ETPs are ISA and SIPP eligible, however this should be reviewed on a case-by-case basis. In some specific instances ISA eligibility may be restricted.

4. Gauging liquidity

There are two sources of ETP liquidity – primary market and secondary market liquidity. This will determine the tradability of an ETP and can impact the total cost of ownership.

FACTORS TO CONSIDER	WHY IS THIS RELEVANT?
☐ **How to measure the underlying liquidity?**	The true liquidity of an ETP is directly related to the liquidity of the underlying benchmark that it tracks. The liquidity of the underlying is primarily determined by the level of its trading activity.
☐ **How robust is the creation and redemption process?**	Authorised participants can trade directly with the issuing entity in the primary market, which means that securities can be created and redeemed based on market demand. A robust creation process should be transparent and increase trading cost efficiency.
☐ **What levels of on-exchange demand are there for the ETP?**	Secondary market (on-exchange) liquidity stems from the presence of multiple independent market makers willing to quote prices to buy and sell the ETP on-exchange. This will ensure that the arbitrage mechanism functions efficiently and the price of the ETP tracks the price of the benchmark as accurately as possible. For investors trading on-exchange, secondary market liquidity will impact bid/ask spreads that they will pay to trade the ETP. Volume traded on exchange is a reflection of the demand for the ETP itself.

5. Calculating the total cost of ownership

There are a number of factors that influence the total cost of owning financial products. It is therefore important to look beyond the ongoing charges.

FACTORS TO CONSIDER	WHY IS THIS RELEVANT?
☐ **What are the ongoing charges?**	The ongoing charges figure is a measure of the reoccurring costs in a product (previously referred to as the TER). Ongoing charges will typically cover the cost to manage a product, administration, custody and oversight and may also include index licence fees, storage costs and collateral fees.
☐ **What are the portfolio transaction costs?**	Portfolio transaction costs are variable. They cover costs incurred when a product issuer buys or sells securities or assets being held by the ETP. This can include quantifiable costs such as commissions paid to stockbrokers and transaction taxes. Other portfolio transaction costs include swap fees, security lending fees and the costs incurred when rebalancing and/or reweighting a portfolio.
☐ **What are the trading and post-trade costs?**	Trading costs include the bid/ask spread for a product when traded on-exchange, as well as any other dealing charges (platform charges) at the time of purchase or reoccurring fees thereafter. These costs are external to the product but impact the total cost of owning a product.
☐ **What is the tracking difference and tracking error of the ETP?**	The tracking difference is ultimately a measure of cost and will generally illustrate the impact of ongoing charges and portfolio transaction costs on product returns over time. Tracking error is the variability of ETP returns in reference to underlying benchmark returns and is a useful short-term indicator of how consistent an ETP has been in replicating an underlying benchmark.

6. General product details

There are other general product details that should be acknowledged prior to selecting an ETP, which includes an analysis of the issuing entity itself.

Factors to consider	Why is this relevant?
Who are the managers and administrators?	It is important to clarify who the issuing entity of the product is. It is also important to note the key independent parties – for example the registrar, custodian, trustee, collateral manager.
Is there any other key legal information to consider?	This may include identifying the securities regulator and domicile, as well as rechecking the legal structure and form. It is also important to clarify whether a product is a UCITS or not and if it is eligible for investment by UCITS.
Is there a currency exposure?	The total returns of an investment might be affected by the exchange rate between the base currency (the currency the underlying assets are priced in) and the investor's home currency.

Glossary of Terms

ETP	An umbrella term for investment vehicles traded on exchange that track an underlying benchmark. This can encompass ETFs, ETCs and ETNs.
ETF	Structured as a fund that issues shares and commonly structured as UCITS in Europe.
ETC	Typically structured as a special purpose vehicle that issues debt securities.
Roll Yield	The positive or negative return generated when a futures contract near expiry is sold, and the proceeds reinvested in another futures contract whose expiry is further in the future.
Collateral Yield	The hypothetical interest that an investor would have received on cash equal in value to the underlying futures contracts.
Full Replication	A physical replication method where the ETF holds all the underlying securities in the same proportion as their weighting in the index being replicated.
Optimisation	A physical replication method where the ETF holds a sample (rather than all) of the securities in the underlying benchmark.
Collateralisation	Assets provided by swap providers to secure their payment obligations under a swap agreement.
Authorised Participant	Banks or other financial institutions that act as intermediaries between issuers of securities and other investors or intermediaries.
Tracking Difference	Tracking difference is the difference between a product's return and that of the benchmark over a specific time period.
Tracking Error	The volatility of the difference between the return of an ETP and its benchmark or asset.

For more information about ETPs please visit www.etpedia.com and www.etfsecurities.com

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