Selecting the right ETF: Not just a question of cost

The exchange traded funds (ETF) universe is becoming more crowded, with a wide range of new products emerging in recent years. It is therefore crucial for anyone evaluating ETFs to understand the differences between these products. Cost is certainly one consideration, but this article also sets out other criteria to take into account when choosing the right ETF.

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One key to evaluating ETFs is to understand their unique structure, which combines the broad diversification benefits of a fund with the tradability of an individual security. When selecting an ETF, the cost is certainly an important consideration. But there are at least five criteria to take into account:

1. Consider total costs: The total expense ratio (TER) is only one cost factor to consider when owning or managing ETF portfolios.
2. Know what is inside the ETF: What securities does the chosen ETF index contain and how will this impact portfolio performance?
3. Look at liquidity: The liquidity of an ETF can be a significant contributor to total costs.
4. Assess the structure: There are different types of ETFs, which carry their own unique exposure, risk and tax implications.
5. Evaluate the provider: Does the ETF provider have extensive experience managing index investments?

Consider total costs
Costs are a key consideration when selecting an ETF and there is no question that costs such as the TER, the total paid to cover the costs of fund management, trustee's, licensing and operational costs, are important. However, an ETF's expense ratio forms just one component of its total costs.

Since ETFs are traded on exchanges, commissions are the most obvious example of associated costs. Other implicit costs, such as trading costs, portfolio rebalancing and tracking error, can, in some instances, contribute more to total costs than expense ratios, especially for short-term investors.

Trading costs: The market price of an ETF is typically reflected in the bid/offer spread. While most ETF investors trade on the secondary market within a few cents of the bid/offer, larger transactions (typically the higher of 20% average daily volume or 5 times the average order book) may require one to trade over-the-counter (OTC), directly with a market maker. Factors to consider when evaluating trading costs include: spread, market depth and the construction of the underlying basket of securities.

Tracking error: Tracking error (the difference between the fund's gross performance and the underlying index's performance) can represent a drag on or a boost to performance and is also reflected in the implicit costs for a portfolio. Tracking error does not incorporate a fund's expense ratio.

Rebalancing costs: Index providers such as FTSE or S&P regularly rebalance their indexes to reflect securities entering or departing from their indexes. In rebalancing, index providers do not take into account the costs and timing considerations of buying and selling securities, for which the ETF promoter will need to account. Rebalancing costs vary depending on the ETF structure.

A further consideration are activities the ETF provider undertakes that can generate income to offset the costs of owning an ETF. An example is "securities lending". The combination of potential lending revenue from within and of the ETF share can help investors partially, or in some cases completely, offset the total expense ratio incurred while holding an ETF position.

Know what securities the ETF owns
Indexes indicate the health of a market on a daily basis. They also form the benchmark for an ETF's performance.

Given the key role that indexes play, it is important to remember that every index is unique. Two indexes which cover similar areas of the market – even with similar sounding names – can differ greatly from each other and will possess their own unique risk/return profile. It is therefore essential to understand the characteristics of an ETF's underlying index and whether this index is the most appropriate for a client's investment objectives.

Each index provider creates its own set of requirements to define an index universe. For equity ETFs, key differences in index construction methodologies can include a number of constituents, such as market capitalization, style and sector composition. For fixed income ETFs, providers build indexes around criteria such as credit quality and maturity. Understanding differences such as these can help ensure that portfolios contain the correct ETF for a client's investment requirements.

In many cases, there is no right or wrong index to use. There are five criteria to consider:

1. Completeness: Does the index (or ETF) accurately reflect the overall investment opportunity set?
2. Index rules: Are the rules governing the index's constituents transparent and publicly available? Objective rules allow a fund manager to predict, more or less accurately, which stocks will be added to or deleted from an index, allowing the fund to track its index more closely.
3. Data: Is return data for the index accurate, complete and readily available? Access to reliable data allows fund managers to evaluate and compare indexes both within and across market sectors.
4. Investor acceptance: How well known and widely used is the index?
5. Turnover and related costs: What is the turnover of the index? Are the resulting rebalancing costs appropriate for the ETF? In general terms, the lower the turnover, the lower the rebalancing costs for the fund provider.

Well constructed indexes (or ETFs) would tend to score well on most or even all of these criteria.

Look at liquidity
The liquidity of an ETF is another key consideration. The more liquid an ETF, the easier and more cost-effective it will be to trade. Conversely, poor liquidity can translate into difficulties in entering and exiting positions, alongside higher trading costs. There are two questions to ask when deciding the best way to trade an ETF:

1. What is the spread? The spread on the ETF is the difference between the bid and the ask; it is the cost to the investor, imposed by the market maker, of buying or selling the ETF. The spread should be as tight as possible around the mid price to make the purchase/sale competitive.
2. What is the depth of the market? The depth refers to the size of an order an investor can execute. If the order book indicates an investor can buy/sell 10,000 units, then up to that amount units can be bought without a need to consider any other method of execution. Larger transactions (typically the higher of 20% average daily volume or 5 times the average order book) may require one to trade OTC directly with a market maker.

Assess the structure
The rapid growth of the ETF market in recent years has led to a range of new products emerging. Each product has its own unique exposure, risk and tax implications, so investors need to research these areas before selecting the most suitable product. There are two major constructions of ETFs: in-specie based ETFs (or cash-based) and swap-based ETFs. In addition, there are other exchange traded products which are often confused with ETFs, the most significant being Exchange Traded Commodities (ETCs), also known as Exchange Traded Notes (ETNs).

Evaluate the provider
Experience matters. Size, scale, expertise and commitment can vary significantly between ETF providers, and these differences can impact performance across several areas. Investors should evaluate a provider's

- scale of operations to minimize costs and manage market impact,
- track record in index portfolio management, minimizing tracking error and trading costs,
- dedication to providing servicing support and resources to investors, intermediaries and market participants,
- knowledge of index construction and methodology,
- commitment to product development.

ETF providers should have extensive experience in managing index investments, proven portfolio management skills and dedicated research teams. However, just as important should be the ETF provider's commitment to educating primary and secondary market investors on new developments within the sector.

Finding the right ETF
Evaluating ETFs often involves trade-offs. For example, a client may prefer to invest in an ETF which is very liquid, with a low trading spread, in order to lower trading costs, regardless of a higher tracking error. All clients have their own investment requirements and their own tolerance of risk vs. return. The question investors should ask is not: "What is the best ETF?" but "What is the right ETF for this client's portfolio?" *www.ishares.ch*