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EXCHANGE TRADED FUNDS

A guide to investing in ETFs

ETFs thrive against backdrop of tough market conditions

What was once the City's best-kept secret is now one of the financial world's fastest-growing products, with the London Stock Exchange recently breaking its record for new ETF listings on a single day.

BY RAFFAELE JERUSALMI, DIRECTOR OF FIXED INCOME & DERIVATIVES OF LONDON STOCK EXCHANGE GROUP

It gives me great pleasure to introduce this guide to Exchange Traded Funds. Long-established in the US and in continental Europe, ETFs are relative newcomers to the UK investment market, but are fast outgrowing their status as the City's best-kept secret. This makes it an excellent time to investigate the ETF universe, and discover how these flexible index-tracking fund can be used to advantage in almost any investment from a sophisticated algorithmic trading strategy to a long-term, balanced, private investor portfolio.

The UK's first ETF listed on the London Stock Exchange just eight years ago. Since then the number of ETFs available to UK investors has expanded rapidly, so that there are now 166 ETFs on our UK market, 59 from this year, with 19 arriving on a single day in August, the UK's busiest day for ETF admissions. Approximately £13 billion worth of assets are now managed by the UK's ETF industry, while the value of ETFs traded on the London Stock Exchange in the first six months of 2008 reached £13.6 billion, an increase of 46 per cent on the value traded during the first half of last year.

ETFs have flourished against a backdrop of difficult conditions in equity markets because they combine the transparency and instant diversification of traditional index tracker funds with the flexibility and low cost associated with share trading. Unlike traditional index tracking funds, ETFs trade on the Exchange's electronic order books throughout the trading day, helping experienced investors to capitalise on volatile market conditions. Like shares they can also be short-sold, giving them potential to be used in a whole range of trading strategies.

Moreover, because ETFs are bought and sold through a broker rather than through tied sales forces or through banks, extra marketing, commission and promotion costs are minimal. This means that ETFs offer some of the lowest annual charges of any collective investment scheme, making them a suitable option for institutional investors, particularly as trading is stamp duty free, and the costs of long-term ownership can be offset by fees from stock-lending, as with shares. In addition, private investors can hold ETFs in tax-efficient wrappers such as ISAs and SIPPs.

ETFs' appeal is also down to the innovation of the UK's growing number of providers, all competing to offer access to a wide range of assets, including bonds and commodities and companies across the world.

ETFs offer access to a comprehensive range of equity indices enabling investors to gain broad exposure to a particular economy or sector in one single trade. All of the major developed world indices, such as the S&P 500, can be bought and sold through ETFs, as well as specialist Small and Mid Cap indices, and ETFs also offer an efficient way to invest in developing markets such as Brazil, Russia, China, India, and Vietnam, where buying stock directly can be complicated by regulatory restrictions and gaining an understanding of individual companies is challenging.

A recent development in the UK market is the arrival of ETFs covering a comprehensive range of industrial sectors, including banking, basic resources, food & beverages, healthcare, industrial goods, insurance, oil & gas, technology and telecommunications. This introduces the possibility of using ETFs in more sophisticated strategies such as pairs trading in sectors where you feel that performance is interlinked - selling the sector that you think is overvalued, and buying the sector that you think is relatively cheap - or hedging your position in an individual stock by going short or long on its industrial sector.

ETFs are also being developed as a substitute for a research-intensive stock-selection approach. For example, investors looking for a strong income from their holdings can use an ETF to buy into an index that contains companies specifically selected on the basis of their track-record in paying strong dividends, while other ETFs aim to outperform the major equity indices by mirroring indices based on proprietary stock-screening formulas. Another stock screening approach enabled the launch of the UK's first shari'ah compliant ETFs last year, allowing British Muslims and the growing number of investors from the Middle East accessing the Exchange's markets to invest in a range of ETFs that are consistent with Shariah principles.

The ETF universe and the opportunities it presents are expanding rapidly, but as with every investment product, the real advantage lies in making ETFs fit with your individual investment strategy and appetite for risk. If this guide has made you want to research ETFs further, ETF issuers provide comprehensive information on their own funds, while www.londonstockexchange.com/etfs provides an overview of the market and all the latest price information.

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EXCHANGE TRADED FUNDS

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EXCHANGE TRADED FUNDS ETFs explained

Familiarity breeds respect as investors become comfortable with ETF concept

ETFs have been around for eight years in Europe and even longer in the US, but only in the past couple of years has interest in them soared as investors begin to understand their many virtues.

In the current turbulent economic climate, the first priority of many nervous investors is to reduce risk, which means they are looking for balanced portfolios that spread their asset allocations.

Exchange Traded Funds (ETFs) possess precisely those attributes. Many investors will be unfamiliar with ETFs, but their share of the market is growing so fast that before long everyone will be forced to take notice of them.

Widely acclaimed as the most innovative product to hit the market in the past 20 years, exchange-traded funds (ETFs) are passively managed securities which closely resemble index funds, but can be bought and sold during the day like common stocks. They allow investors to purchase a broad basket of securities in a single transaction. Unlike single stocks, however, ETFs offer the diversification of mutual funds.

They provide broad exposure to whole investment markets at low cost and possess a host of other advantages we will look at shortly.

They were introduced in the United States back in 1993, when there were three ETFs trading US$0.81 billion, and didn't take off in Europe until 2000, when six European ETFs traded US$1.54 billion. Even as recently as 2005 they were relatively small bait in the financial sector, but their attractiveness to investors has seen a recent boom in popularity.

By the end of July 2008, there were 81 managers worldwide of 1,416 ETFs with 2,352 listings on 42 exchanges. There were 272 new ones this year until the end of July, nearly the same number as the 280 issued in the whole of 2006.

Stacy Fuller, Investment Management Practice Group at American law firm, K&L Gates, said: "They didn't catch on initially. Their continued growth since 2001 is partly down to their familiarity. Investors have become less scared of them now they are more commonplace.

"But it's also down to Barclays. They eyed a market opportunity in the early 2000s and created a broad swathe of ETFs in different asset classes, like domestic, foreign and fixed-income. They poured investment into ETFs and made a big push for the education of investors, which triggered a lot of interest."

The recent acceleration of interest in ETFs has been such that the London Stock Exchange (LSE) broke its record for the number of new ones listed in a single day just a few weeks ago on the first Tuesday in August, when 19 fresh ETFs came onto its main market covering a range of equity and bond indices. They took the total number of ETFs on the Exchange to 166, from five different issuers.

Pietro Poletto, Head of ETF and ETC Markets at London Stock Exchange Group, said: "So far in 2008 we have seen the four busiest ever days in ETF trading on our order books and listed a total of 59 new ETFs on our Main Market. The arrival of 19 new ETFs in just one day reflects the dynamism of the UK ETF market and means that these highly efficient instruments can now be used to execute an even broader range of investment strategies."

Analysts expect the ETF market to more than double in size by 2011 to two trillion dollars from around US$900 billion today. They anticipate that more and more institutional and retail investors will use them for low-cost Beta exposure and more and more indices will be covered. Regulatory changes in hitherto troublesome markets will also help, such as those recently introduced in Japan.

> "Investors have become less scared of ETFs now they are more commonplace"

The European market has rapidly expanded both in terms of product offering and investor understanding and usage. At the end of July 2008, European ETF AUM (assets under management) stood at €108 billion and is growing faster than the US.

Nick Shellard, head of sales and business development for iShares UK and Switzerland, said: "Investor usage of ETFs in Europe is both diverse and increasing with both institutional and wealth investors employing ETFs to help them construct and manage their portfolios across equity, fixed income and the alternative asset classes.

"We have already experienced strong growth in the European ETF market this year and expect this to continue. The increased understanding of the benefits of ETFs, the enhanced innovation around product solutions, the growing exchange liquidity and the shifts currently taking place in the European regulatory environment all contribute to this growth."

Ishares is the largest manager globally, with 335 products and AUM of US$373.49bn, 47.5 per cent of market share. State Street Global Advisors is second with 98 products and US$132.75 billion, or 16.9 per cent, and Vanguard is third. The most popular indices tracked at the end of July were S&P indices (Standard and Poors) which accounted for assets under management (AUM) of US$180.7 billion, 23 per cent of market share, and those tracking MSCI BARRA indices with AUM of US$172.9 billion, or 22 per cent.

So why should investors choose ETFs?

Aside from their low cost and ease of function, they are transparent and possess significant tax advantages (for more on these strengths, see page 6). They are also extremely liquid, although their liquidity is often misunderstood. Because they trade like shares it is assumed that their true liquidity is reflected in trading volume. But ETFs also possess a second source of liquidity - the underlying basket of securities (see page 9 for more on this).

A further innovation is that ETF shares are built by creation/redemption brokers in block-size creation units. The market maker purchases a basket of shares for cash. This basket is then exchanged with the ETF custodian for a set number of ETF shares, a process labelled 'creation'. The market maker then has an inventory of ETF shares through which to satisfy market demand for buy and sell orders.

Redemption is simply this process in reverse. A market maker swaps a defined number of ETF shares with the ETF custodian for the underlying basket of shares, which can then be sold for cash in the secondary market. The key difference with ordinary shares is that price formation has nothing to do with market supply and demand, but rather the creation/redemption process.

The process might seem cumbersome, but it allows for transparency and liquidity at modest cost. Everyone can see what goes into an ETF. Investors know the fees will be modest and that they can exit at any time.

So what are the different types available?

Every year brings new products and the pace of change is quickening. The following are some of the most relevant in today's economy.

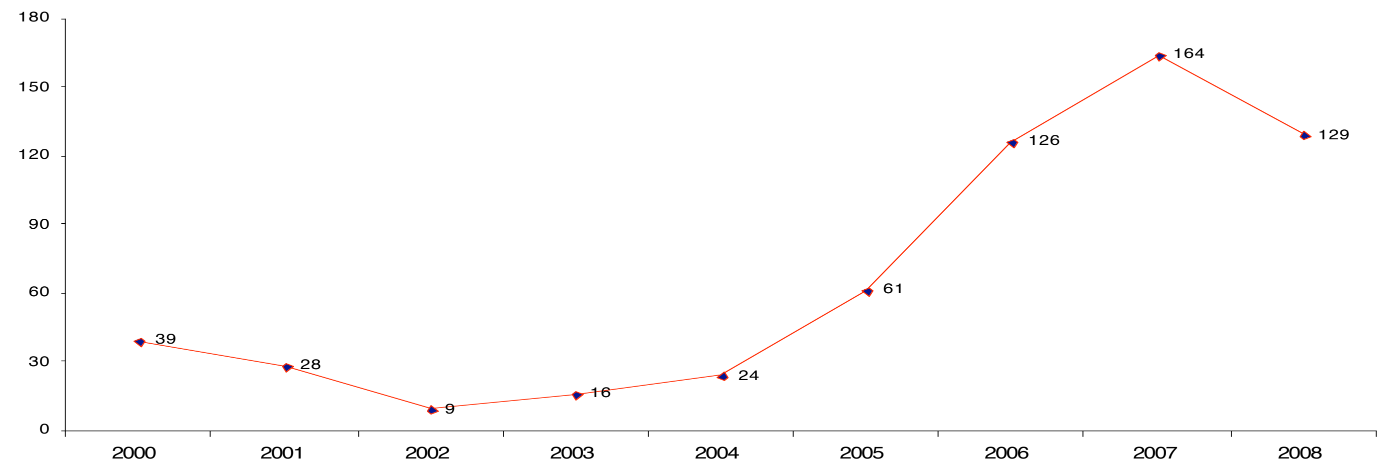
Emerging Markets ETFs, which were launched back in 1996, are only now coming into their own as

> "So far in 2008 we have seen the four busiest ever days of ETF trading"

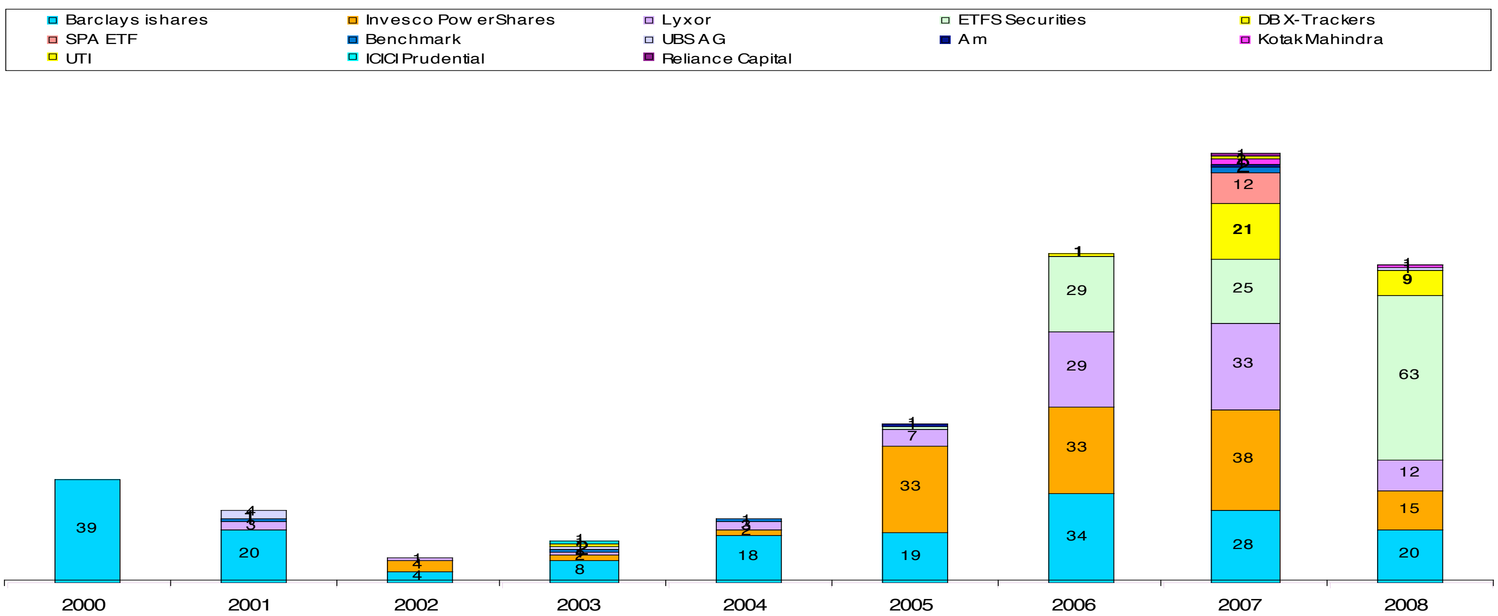
investors focus on difficult-to-access equity markets, such as the developing markets in East Asia. Fixed Income ETFs, which were introduced in 2000, are also proving attractive in Europe. In this market, asset growth since the start of the year

Manager Name	2000	2001	2002	2003	2004	2005	2006	2007	2008 Jan-Aug	Total
Barclays ishares	39	20	4	8	18	19	34	28	20	190
Invesco PowerShares	.	.	4	2	2	33	33	38	15	127
Lyxor	.	3	1	1	3	7	29	33	12	89
ETFS Securities	.	.	.	.	.	1	29	25	63	118
DB X-Trackers	.	.	.	.	.	.	1	21	9	31
SPA ETF	.	.	.	.	.	.	.	12	.	12
Benchmark	.	1	.	2	1	.	.	2	.	6
UBS AG	.	4	.	1	.	.	.	.	1	6
UTI	.	.	.	1	.	.	.	1	.	2
Am	.	.	.	.	.	1	.	1	.	2
Kotak Mahindra	.	.	.	.	.	.	.	2	1	3
ICICI Prudential	.	.	.	1	.	.	.	.	.	1
Reliance Capital	.	.	.	.	.	.	.	1	1	2
ETFlab	.	.	.	.	.	.	.	.	5	5
Quantum	.	.	.	.	.	.	.	.	2	2
Total	39	28	9	16	24	61	126	164	129	596

ETFs 2000 - 2008 Aug



ETFs by Managers 2000 - 2008 Aug



▲ ETFs listed on Trustnet

has been more than 60 per cent.

Other important launches have been the first Inverse, or Leveraged, ETFs in 2005, and the first shari'ah ETFs in 2007. The latter are compliant with shari'ah principles derived from the Quaran, and are characterised by shares they must exclude, such as ones issued by producers of alcohol. Also in 2007, the first Infrastructure ETFs came onto the market, providing diversified exposure to three clusters: Energy, Transportation and Utilities. They are coveted because of the current high prices of oil and gas.

The main trend in equity ETFs, however, has been in the Short ETF area, with over one fifth of new listings offering exposure to returns from short indices. They are ideal for investors who wish to go short, but are constrained by not being able to trade futures or borrow stock for the purpose.

"Product innovation has been a response to the interest of investors as investor confidence in ETFs has grown," says Ms Fuller. "Initially, they were slow to get off the ground because of their scary unfamiliarity, but now they are more commonplace. Right now there is a lot of interest in commodity-based ETFS, which is a function of the market. Oil and energy-based ETFS are doing very well, and certain currencies linked with them."

So who might these products appeal to? Who would benefit from them most?

Ms Fuller believes their structure works best for investors wanting to round out their portfolios with specifically targeted assets, which reach a broad swathe of the market. Although the European market has lagged behind the US in retail investment, Ms Fuller expects that to change as worldwide markets converge. The biggest imminent change in global markets, she believes, will involve active management.

"In the next three to five years there will be a focus on creating an actively managed ETF. Lots of resources will be devoted to them and there will be a great deal of innovation in that sector. They may well be more costly but investors must expect to pay more for outperformance, for funds which beat the market," she says.

Simplicity is key to ETFs' success

Ease of operation is one of ETF's great plus points.

What are the key benefits of ETFs?

Ease of operation

ETFs are as easy to buy and sell as any large company stock. Because they can be traded intraday, speculative investors can bet on short-term market movements, increasing exposure to, say, energy, or China, with a click of a mouse. Mutual funds can't be used for speculative trading strategies, such as short selling and trading on margin in the same way as ETFs.

Axel Lomholt said: "From what I call the 30,000-foot viewpoint, the operational ease is a major reason for ETFs taking off. They are similar instrument to futures, but much easier to operate. You don't need a backup team of middle management, or complex risk-management strategies."

Transparency

ETFs reveal exactly where your money is invested, publishing a list of holdings every trading day so it's easy to find out its exact components. ETFs are equally open about annual fees. Axel Lombart: "The transparency of ETFs is a big selling point. You get complete insight into fund holdings on a daily basis. You also have full transparency of all costs. This openness was one of the reasons they took off in the US, especially after the Mutual Fund Scandal in 2003, which provoked a major shift to ETFs."

Low cost

ETFs are much cheaper than actively-managed funds, although there is a gradual move towards more active management. Total costs also compare well with conventional index-based funds. Since you buy them like a stock, you can select the cheapest. In contrast, index mutual funds can lock you into a single family of products. Axel Lomholt, head of ETF product for BGI Europe and Asia, said: "They are a very cost-effective way of getting full market exposure."

Diversification

A single ETF brings exposure to an entire investment market, helping to spread risk widely. ETFs also allow you to diversify into specialized asset classes, such as emerging markets, water and private equity, which are traditionally difficult to access. Most ETFs include dozens of securities, so there's less risk than with a big investment in one stock. The growing number of ETF choices allows a diversified portfolio between small cap stocks, international stocks, the price of oil, bonds, commodities, and other choices, which reduces risk. Hundreds of ETFs cover every major index and sector of the equities market.

Tax Efficiency

The unique structure of ETFs minimizes potential capital gains. Unlike traditional mutual funds, ETFs trade on an exchange insulating investors from taxable events generated by other investors. Since ETFs do not have to sell securities to cover investor redemptions, this increases tax efficiency while reducing potential capital gains.

Liquidity

(see page 9 for more on this subject)

Complex servicing operation has major impact on returns

JPMorgan is one of the ETF industry's major service providers, playing a vital behind-the-scenes role in ensuring that everything is automated and low-cost, keeping fees down to a minimum for the investor.

A CONVERSATION WITH SUSAN EBENSTON, GLOBAL FUNDS SERVICES BUSINESS EXECUTIVE, JPMORGAN INVESTOR SERVICES

▲ Susan Ebenston

For investors, ETFs are simple: You buy and sell them just like stocks, and they provide easy, low-cost access to entire asset classes - stocks, bonds, commodities and more.

Behind-the-scenes, however, a lot of work goes into making ETFs function smoothly. JPMorgan is a leading service provider to the ETF industry, helping develop new and innovative fund structures, and providing global custody, fund accounting and administration, transfer agency and basket settlement services.

Who is investing in ETFs?

It runs the gamut. Institutions were the first to embrace ETFs in the early 1990s. Traders and fund managers realized that ETFs were the perfect tool to execute tactical asset allocation strategies, equitize cash and create low-cost core positions in a portfolio.

Today, hedge funds are the largest traders of ETFs. They use ETFs to gain quick access to the market, particularly on the short side.

More recently, the retail market has really taken off. Retail investors now hold more than half of all ETF assets in the US.

Why have ETFs grown rapidly in popularity?

They're low-cost, highly liquid, and provide an easy way to gain targeted exposure to the market.

In a lot of ways, ETFs combine the best of both stocks and mutual funds. Like mutual funds, they offer quick diversification, often with lower costs. Like stocks, you can buy and sell ETFs throughout the trading day, whereas mutual funds can only be traded once-per-day, after the market closes.

ETFs are also fully transparent: they publish their holdings on a daily basis, so you know exactly what you're buying.

Finally, there's been a huge amount of innovation in the ETF market. There are a number of areas where ETFs offer the only liquid way to access a particular asset class.

Are there still significant differences between the US and UK markets?

Yes, but they're narrowing. In general, the US market is bigger and more mature: There are more funds, with more assets, and generally more trading volume. In the US, ETFs hold about 4 per cent of all assets invested in mutual funds; in Europe, that figure is closer to 1 per cent.

But the European market is growing faster than the US market, and European ETF providers have been quite innovative. For instance, the first commodity and credit index ETFs were launched in Europe, not in the US.

In general, the European market is more institutional - like the US market in its early days. It's also more fragmented, with multiple exchanges and multiple country listings.

What are some of the challenges to servicing ETFs?

ETFs require everything from a servicing standpoint that a conventional mutual fund requires, and then some. You have the core responsibilities of trade settlement, custodian work and record keeping. But because ETFs trade throughout the day, you also have to constantly calculate and publish the indicative value of the portfolio, accrue dividends, interest and stock lending revenue, and more.

How well the service provider handles these tasks can determine the tax efficiency and internal costs of the portfolio. It has a real impact on returns.

Remember: ETFs are a low-cost vehicle, so services must be highly automated and low-cost.

What are the most important recent innovations?

Over the past few years, we've seen an explosion of new ETFs. The first leveraged and short ETFs launched in February 2005, and they now have over $20 billion in assets. We've seen ETFs open up important new asset categories like private equity (October 2006), infrastructure (January 2007) and frontier markets (May 2008).

That's just the tip of the iceberg. Everything from hedge fund strategies to international fixed-income funds are in the works. Active management is coming, too. The growth trajectory is huge.

> "The European market is growing faster than the US market and European ETF providers have been quite innovative"

JP Morgan Chase

EXCHANGE TRADED FUNDS Overseas

ETF issuers capitalise on growth in emerging markets

Five years ago there were only basic vanilla ETFs on well-known indices, but the market's innovative providers have not been blind to the potential of developing markets and overseas products are now proliferating.

As investors lick their wounds following the volatility in the US and British markets, many are beginning to turn their attention to other regions and non-equity funds that may be less affected by the subprime fallout and offer more diversification for their portfolios.

The issuers of exchange traded funds are capitalising on this interest by developing products that invest in overseas markets, in developed and emerging economies. Institutional investors have already seized on the phenomenon: a survey by Lyxor of the UK's largest pension funds showed that more than half are planning to boost their exposure to the Middle East alone.

So Lyxor moved to launch a Middle Eastern ETF, Europe's first, last month. Claus Hein, executive director at Lyxor Asset Managment, said: "The Middle East is a booming market right now and we're hoping that this new ETF would allow investors to capture the growth in that region."

Lyxor is just one provider that is moving to develop new products to attract intrepid investors, while stock exchanges around the world are providing a platform for the funds to list. In July, for example, Invesco Powershares listed its Middle East and North Africa ETF on the Nasdaq, giving investors access to Egypt, Morocco, Jordan, Oman, Kuwait and the United Arab Emirates; on August 19, the Swiss Exchange announced that it had added 10 products to its ETFs segment covering Latin America, South Africa, China, Taiwan and Korea.

> "The Middle East is a booming market right now"

The US is a much more mature market in terms of retail investor exposure to ETFs, with up to 50 per cent of ETF trades driven by retail investors. James Ross, a Boston-based senior managing director with State Street Global Advisers, believes the interest has been driven by financial advisers, who have sought to diversify their own product offering to clients by using ETFs.

Across the Atlantic, that trend is just starting to hit. Mr Hein said that emerging market ETFs, in particular, have gained popularity in Europe in recent months, giving retail and institutional investors unprecedented access to markets that are very difficult to invest in directly.

Alain Picard, the product and relationship manager for ETFs at the Swiss Exchange, agrees that retail investor interest is growing in emerging market ETFs, reflecting the level of innovation in the market.

He said: "Five years ago there were just plain vanilla ETFs on well-known indexes like the eurostock 50, the Dow Jones industrial average and the S&P 500. But now you're getting a nice range with the emerging markets, and different indexes. It's really evolving."

Although the trend was initially generated by institutional investors, Mr Picard said that there is a greater understanding among retail investors of the opportunities in different markets. "[Product development] is much more investor-driven; they want to go into markets that are not that developed."

However by their nature, less-developed markets can offer less liquidity than mature benchmarks, and are more vulnerable to inflationary and geopolitical pressures. Although ETF supporters argue that investing in a basket of equities or countries mitigates that risk, some investors are a little gun-shy when it comes to the share market.

Exchange traded commodities (ETC) are ETF-like funds that track the commodities markets, and are not correlated to equities. Mr Ross said: "As the equity markets got battered over the last year, what we've seen is that the desire of investors to find investment options that were non-correlated [to equity markets] has been significant. Commodities is one thing they look at."

Commodities, such as oil, gold, platinum and silver actually had a negative correlation to equities as their trajectory rose, said Will Rhind, UK head of sales at ETF Securities. "Commodity prices have been rising faster than companies can pass them on to their customers, and that has a negative impact for the companies, which results in a drop in their share price."

Despite the recent falls in commodities, Mr Rhind said that opportunities still exist for investors to profit, by buying short ETC products, particularly in crude oil and industrial metals ETCs. For other commodities, such as gold, Rhind said that the outlook is bullish with most investors buying up long ETCs.

But the uptake of ETCs by retail investors is still small; Rhind estimates this segment at about 5 per cent. "A reason for that is that a lot of retail investors don't know that [ETCs] exist," he said.

Similarity to shares means investors may overlook ETFs' second source of liquidity

It's easy to assume that ETFs' liquidity is measured by average trading volumes, but that is only one source – the liquidity of the positions that make up the fund must also be taken into account.

A misconception surrounds ETFs, which can cause potential investors to underestimate their liquidity. Because they trade like shares, the natural assumption is that liquidity will be measured by average daily trading volume and market, but ETFs don't work like that.

Each ETF represents exposure in an underlying basket of securities that reflects a specific market index. In effect, trading an ETF is equivalent to trading each of the underlying stocks. That's why the true liquidity of an ETF is only partly reflected in its trading volume. It's also a function of a second source of liquidity – the liquidity of the positions that make up the fund.

Henrik Noren, managing director of XACT Fonder, the Nordic ETF provider, said: "The true liquidity of ETFs is underlying, which is something people often misunderstand. When they look on screen, or in the paper and see that there haven't been many trades in one day they assume liquidity is bad. But if the spread is narrow, then the liquidity is actually good. The spread will be narrow if the underlying spreads are narrow as well. That is what determines the ETF's liquidity."

Mr Noren argues that the ultimate key to the liquidity of an ETF is the creation/redemption process. Unlike stocks and closed-end funds, the number of issued and outstanding shares for each ETF can be increased or decreased daily according to investor demand. This flexibility is a result of the creation/redemption process, which allows large blocks of ETFs to be issued, or redeemed, by the delivery of stocks from Market Participants (MPs) to the fund, or vice versa.

> "The ture liquidity of ETFs is underlying, which is something people often misunderstand"

It is the ability of MPs to create and redeem outstanding shares which provides ETFs with liquidity above that which may be indicated by secondary market volume. The MPs help to determine the liquidity of the underlying stocks, which is ultimately the true liquidity of ETFs.

"Liquidity is a good selling point for ETFs," says Mr Noren. "Of course, it depends on what an investor is looking for. A big institution might sometimes be better off buying futures, but even for them it's actually less expensive to hold ETFs if they are planning to hold them two or three months, or more. But if you are trading them back and forth and you're a big institutional investor, then futures may also be an option. For small investors without the option of futures, ETFs have a big advantage when it comes to liquidity when compared with buying the underlying basket."

Range of ETFs is mind-boggling so investors must stick to fundamentals

Experts say potential investor in ETFs should shop around for the right products from the wide variety on offer and bear in mind the three factors determining a sound investment: risk, return and liquidity.

"Risk comes from not knowing what you're doing," said Warren Buffet, the world's richest man. It may seem like simple advice, but, given the level of innovation and choice in the investment market, it makes sense to know the right questions to ask when deciding where to put your money.

Exchange traded funds (ETFs) have evolved since the 1990s into one of the most flexible forms of investment. They offer the opportunity to invest in a grouping of equities or bonds in local or foreign indexes, using national or international currencies. While the range of ETF products may be mind-boggling, it pays to come back to the three fundamentals of investing, say ETF experts: return, liquidity and, of course, risk – what is it that you don't know about a stock, manager, or a market?

Alain Picard is the product and relationship manager for ETFs at the Swiss Exchange. He recommends that potential investors shop around for the right ETF products and providers. "What I always say to retail investors is look at the products. Not all are the same. There are different fund structures; they can be Irish, Swiss, [from] Luxembourg; there can be different management fees, different indexes behind it. There can be a very broad index but also smaller indexes, so you have to do your research."

He said that ETF investing should be approached in two steps: first, understand what ETFs are and how they are traded; second, talk to a financial adviser or broker about specific products. Keep asking questions until you get clear explanations and feel comfortable with the advice you receive.

But even before you take that first step, Which?, the consumer organisation, recommends reducing your debts and ensuring that you have up to six months' worth of rainy day funds.

Martyn Hocking, editor of Which?, said: "If you can't stand the thought of your investment losing money as well as making money, don't buy investments that can lose money. It's not worth losing sleep over. On the other hand, if you are prepared for the fact that your investments might go up or down, there are ways of spreading the risk you take."

> "There are ways of spreading the risk you take"

Getting the right advice

Your financial adviser or broker must be able to explain to you the particular structure of the ETF you are considering, and the costs that are involved beyond the total expense ratio.

Given that an ETF is traded on a stock exchange, and that its assets reflect the price movements of the index that it is tracking, it is important to research the characteristics of that underlying index and to know whether this is the most appropriate for your investment goals.

Adam Richards-Grey, from the retail division of the Financial Services Authority, said that this means getting to grips with the risk profile of the index that you are considering investing in, and knowing your rights.

"Investors must be aware that ETFs are ultimately collective investment schemes, and investment via a regulated market, such as the London Stock Exchange, does not affect the risk profile of the underlying scheme," he said.

"Investors should be aware of the ETF's investment objectives and, as most ETFs, including those traded on the London Stock Exchange, are based on non-UK domicile collective investment schemes, any applicable investor protection and compensation rights."

ETF structure

There are two main types of ETFs: cash-based and swap-based. Another fund type that is often confused with ETFs is the Exchange Traded Commodities (ETC) fund, which tracks commodity indexes rather than securities.

The cash-based ETF buys all of the securities in the underlying index and holds them as fund assets, a process known as full replication. In broad benchmarks, or those with small, illiquid stocks, a fund may hold a smaller group of shares in that index to better reflect the overall performance of the underlying index. This is known as "optimisation", and is reliant on the asset manager or broker's selection methods.

Cash-based ETFs allow more than one market maker to create and redeem shares, because they can bring securities directly to the fund. Cash-based ETFs are therefore more appealing to market makers, generating competition.

Swap-based ETFs have a higher risk profile than cash-based funds. They use total return swaps to emulate an index performance. In total return swaps, instead of holding the underlying security, two parties swap the total return (any income generated by the security plus its capital appreciation or depreciation) of the basket of securities. Proponents say that this type of ETF reduces tracking error, and is of most interest to short-term investors or those who are using ETFs for hedging. Swap-based ETFs can, however, expose the fund to counterparty risk, which is less of a concern in cash-based ETFs.

Cost of an ETF

Much of the focus on the benefits of ETFs is concerned with the total expense ratio – the total paid to cover the costs of fund management, licensing and operation costs, which tend to be lower for ETFs than unit trusts and investment trusts.

However, investors should compare the other inherent costs between EFTs, which can make a product with a lower expense ratio more expensive in the long-run. Broker commissions and trading costs are easily determined, but rebalance costs - generated by a change of stocks in a given index - and bid-ask spread costs can be overlooked.

Again, advisers should be able outline these structural differences and associated risks, and the less obvious costs. Mr Richards-Grey said: "We would expect any investors sold ETFs on advice to be treated in the same manner as those investing in any other collective investment scheme -- that recommendations are based on an assessment of suitability, and that information and promotions are clear, fair and not misleading."

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