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ETF Investment: How it can be used to benefit retail investor

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Abstract

Exchange Traded Funds can be bought and sold just like any other stock. An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value. ETFs provide several avenues to participate in different instruments within the country and foreign investments**,** ETFs provide lot of benefits when compared to ETNs, Stocks, Mutual Funds etc., ETFs are much safer than other modes of investments ETFs are very nascent in Indian Markets. The study looked at transparency, risk, tax, fees, leverage, returns, profits, benefits to name a few and the understanding is that ETFs provide an excellent opportunity for retail investors in parking their investments.

Keywords: ETF, Investments, Instruments Funds, Stock. ETN

Introduction

Exchange Traded Funds ("EFTs") are the newest form of index-based investment vehicle. ETFs are similar to index funds and sector funds in that they are designed to track specific market indexes or industry sectors. An exchange-traded fund (or ETF) is an investment fund traded on stock exchanges, much like stocks. An ETF holds assets such as stocks or bonds and trades at approximately the same price as the net asset value of its underlying assets over the course of the trading day. Most ETFs track an index, such as the S&P 500 or MSCI EAFE. ETFs may be attractive as investments because of their low costs, tax efficiency, and stock-like features. The difference is that Exchange Traded Funds are listed on a stock exchange and are traded all day, just like an individual stock. In contrast, mutual funds are not listed securities and only trade once daily, based upon their end-of-day, net asset values (NAV). Exchange Traded Funds can be bought and sold just like any other stock. An ETF combines the valuation feature of a mutual fund or unit investment trust, which can be bought or sold at the end of each trading day for its net asset value, with the tradability feature of a closed-end fund, which trades throughout the trading day at prices that may be more or less than its net asset value. Closed-end funds are not considered to be ETFs, even though they are funds and are traded on an exchange. ETFs have been available in the US since 1993 and in Europe since 1999. ETFs traditionally have been index funds, but in 2008 the U.S. Securities and Exchange Commission began to authorize the creation of actively managed ETFs.

Objectives of the Study

1. To study the evolution of ETFs (Exchange Traded Funds) in India as well as Globally
2. To understand how ETFs are structured and traded
3. To understand types of ETFs traded globally, type of funds available in India and benefits of investing in ETFs

Review of Literature

When and where the first ETF came to market is somewhat debatable. A variation of an exchange traded product was introduced in Canada in 1989 to track the largest stocks traded in Toronto, known as the Toronto Index Participation Fund, but most financial historians would point to the introduction of the SPDRs in 1993 as the true beginning of the ETF industry. SPDRs are ETFs that tracks the S&P 500 index.

Trading under the ticker "SPY," SPDRs is still around today and is the largest ETF by assets traded on U.S. exchanges. In terms of product offerings, the ETF business got off to a relatively slow start. Asian markets didn't begin featuring ETFs until 1999 and Europe didn't arrive on the scene until 2001. By 2002, there were just 246 ETFs available around the world and nearly half of them traded on European exchanges.

Fast-forward a few years and you'll see just how popular (and important) ETFs are. At the end of 2009, there were nearly 1,000 exchange traded products trading on U.S. exchanges. This number includes over 100 exchange-traded notes (ETNs), a product related to but different from ETFs. Most industry followers estimate the number of ETFs available to U.S. investors will reach 1,000 sometime in 2010.

Index ETFs, Commodity ETFs or Etcs,Bond ETFs, Currency ETF, Actively Managed ETFs Leveraged ETFs Gold ETFs

ETF Investing Strategies

	Strategy Type	Description
1	Risk Management	- Hedge against risk of portfolios held in a particular sector - Counter risk by taking opposite position with the correlating ETF
2	International Exposure	- Exposure for growing markets - Purchase foreign ETF that follows index - Use foreign currency ETFs in a portfolio
3	Industry Exposure	- Focus on industries which are growing by purchasing those ETFs - This will allow to participate in a specific industry segment rather than purchasing specific stocks in the industry
4	Cash Flow Utilization	- Extra money can be used to purchase short term ETF - During cash flow deficit, ETFs can be easily liquefied with on single trade
5	Price Discrepancy	- Buy or sell of an ETF can take advantage because of volatile market conditions such as currency and interest rates price differences
6	Management Transitions	- Purchase and sale of short term ETF can help compensate for any risk exposure during management transitions of fund or portfolio managers
7	Market Analysis	- Use certain market forecasts - A combination of bullish and bearish can be balanced using ETFs

ETF Risk

The popularity of Exchange Traded Funds has grown exponentially. Like any investment, there are a number of risks associated with these ETFs. Knowing the details of your ETF can go a long way to improving your overall return. Tracking Error, Fees, Index Matching, Liquidity, closely Focused ETF Double Coverage, Creation and Delivery of ETF

ETF construction some

People are happy to simply use a range of devices like wrist watches and computers and trust that things will work out. Others want to know the inner workings of the technology they use, and understand how it was built.

ETF Creation

The creation and redemption process for ETF shares is almost the exact opposite of that of mutual fund shares. When investing in mutual funds, investors send cash to the fund company, which then uses that cash to purchase securities and in turn issue additional shares of the fund. When investors wish to redeem their mutual fund shares, the shares are returned to the mutual fund company in exchange for cash. The creation of an ETF, however, does not involve cash.

ETF markets history (Global)

ETFs had their genesis in 1989 with Index Participation Shares, an S&P 500 proxy that traded on the American Stock Exchange and the Philadelphia Stock Exchange. This product, however, was short-lived after a lawsuit by the Chicago Mercantile Exchange was successful in stopping sales in the United States. A similar product, Toronto Index Participation Shares, started trading on the Toronto Stock Exchange in 1990. The shares, which tracked the TSE 35 and later the TSE 100 stocks, proved to be popular. The popularity of these products led the American Stock Exchange to try to develop something that would satisfy SEC regulation in the United States. Nathan Most and Steven Bloom, executives with the exchange, designed and developed Standard & Poor's Depositary Receipts (NYSE: SPY), which were introduced in January 1993. Known as SPDRs or "Spiders," the fund became the largest ETF in the world. In May 1995 they introduced the MidCap SPDRs (NYSE: MDY).Barclays Global Investors, a subsidiary of Barclays plc, entered the fray in 1996 with World Equity Benchmark Shares, or WEBS, subsequently renamed iShares MSCI Index Fund Shares. WEBS tracked MSCI country indexes, originally 17, of the funds' index provider, Morgan Stanley. WEBS were particularly innovative because they gave casual investors easy access to foreign markets. While SPDRs were organized as unit investment trusts, WEBS were set up as a mutual fund, the first of their kind. In 1998, State Street Global Advisors introduced the "Sector Spiders", which follow the nine sectors of the S&P 500 Also in 1998, the "Dow Diamonds" (NYSE: DIA) were introduced, tracking the notable Dow Jones Industrials Average. In 1999, the influential "cubes" (NASDAQ: QQQQ) were launched attempting to replicate the movement of the NASDAQ-100. Since then ETFs have proliferated, tailored to an increasingly specific array of regions, sectors, commodities, bonds, futures, and other asset classes. As of May 2008, there were 680 ETFs in the U.S., with $610 billion in assets, an increase of $125 billion over the previous twelve monthsNYSE Alternext US lists ETFs on more than 180 broad stock market, stock industry sector, international stock, U.S. Treasury, and corporate bond indexes and commodities, providing a wide array of investment opportunities. ETFs provide a simple and effective way to invest in markets worldwide. Investors can establish long-term investments in the market performance of the leading companies in the leading industries in the United States or abroad, or tailor asset allocations using diversified investments in stocks in particular industries or countries or in U.S. bonds or commodities.

ETF markets history (India)

Exchange trade fund lists have been increasing in India as well since their inception in India with history starting in 1990 in Toronto stock exchange. Various global finance institutions offer Exchange Traded Funds like Wisdom Tree ETF dividend fund, ETF iShares by Barclays Banking Institution, Vanguard's Vipers that are ETF index funds or ETF version of index funds for trading as stocks.

The ETF advantages include the flexibility they offer in terms of trading along with the pros of mutual funds securities. ETF funds are available in different forms and can be selected as per the requirements. These include ETF bond funds, ETF dividends, ETF hedge fund, ETF junk bonds, ETF mutual

funds, ETF real estate stocks, ETF iShares, and many more forms. Fund managers do have to keep cash in hand in order to meet redemption pressures. The returns and yields of ETF India have created huge ETF emerging markets.
There are various ETFs available in India, such as
Nifty Bees: An ETF launched by Benchmark Mutual Fund
Junior Bees: An ETF on CNX Nifty Junior, launched by Benchmark MF
Sunder: An Exchange Traded Fund launched by UTI
Liquid Bees: An Exchange Traded Fund launched by Benchmark Mutual Fund
Bank Bees: An ETF launched by Benchmark Mutual Fund

Data Analysis and Interpretation
The study looks 2 pronged approaches for making it simpler for investors to participate in ETFs. This would also provide some basic education for investors of how to go about in purchasing different types of ETFs and benefit from doing so.
Step 1: Comparison of ETF vs Other Investment Instruments (similar to ETFs)
Step 2: Advantages and Disadvantages of Investing in ETFs
Step 3: Step-by-step process for investing in ETFs

ETF v/s Stocks
It's important for investors to understand the key differences between individual stocks and exchange-traded funds (ETFs). Each has its advantages and disadvantages. This knowledge can translate into making informed investment decisions. Let's focus on the key points.

Diversification

Individual stocks vs. ETFs	Individual Stocks	Exchange-Traded Funds
Continuous trading and pricing throughout the day?	Yes	Yes
Can be bought on margin?	Yes	Yes
Can buy/sell options?	Yes	Yes
Can be shorted on a downtick?	Yes	Yes
Can be purchased through a traditional or online broker?	Yes	Yes
Can use in an IRA, 401(k), or another retirement plan?	Yes (1)	Yes (1)
Traded on what exchanges?	Amex, Nyse Arca, Nasdaq	Amex, Nyse Arca, Nasdaq

Leverage, Options, Shorting, Tax Loss Harvesting

ETFs V/s Exchange traded notes n ETN Basics
ETNs are registered as debt instruments that pay a return linked to the performance of a single security or index the operating structure of ETNs is particularly suited for specialized asset classes such as commodities and emerging markets. ETNs are typically registered under the Securities Act of 1933.
Familiar features Comparing ETFs and ETNs will reveal many similarities. For example, ETFs and ETNs track commodity, currency, and equity market indexes. Also, ETNs are bought and sold with a traditional brokerage account just like ETFs.

Calculating the Indicative Value of an ETN
Indicative Value = Principal Amount per Unit x Current Index Level/Initial Index Level minus Current Investor Fee

ETFs vs. ETNs	Exchange-Traded Funds (ETFs)	Exchange-Traded Notes (ETNs)
Continuous trading and pricing throughout the day?	Yes	Yes
Can be purchased through a traditional brokerage account?	Yes	Yes
Can they be bought on margin?	Yes	Yes
What recourse do investors have?	Portfolio of Securities	Issuer Credit
Can they be shorted?*	Yes, on an uptick or a downtick	Yes, on an uptick or a downtick.
What are the risks to principal?	Market Risk	Market and Issuer Risk
How are they registered?	Investment Company Act of 1940	Securities Act of 1933

Exchange-traded funds (ETFs) vs. Exchange-traded notes (ETN)
Exchange-traded funds (ETFs) are one of the most popular investment choices for investors looking to diversify their portfolios. ETFs are investment funds traded on stock-markets. They are not mutual funds yet they offer all of the benefits of diversification that you would expect from a mutual fund. ETFs also enjoy all of the benefits of liquidity that you have from trading individual shares.

Risks Associated With Exchange-Traded Notes (Etns)
Exchange-traded notes (ETNs), just like any other investment, carry risk. However, ETNs carry the following two risks that ETFs don't:

-Credit risk; Call risk

ETFS Vs Mutual fund

Mutual funds vs. ETFs	Mutual Funds	Exchange-Traded Funds
Continuous trading and pricing throughout the day?	NO	YES
Can be bought on margin?	YES	YES
Can buy/sell options?	NO	YES
Sold by prospectus?	YES	YES
Can use in an IRA, 401(k), or another retirement plan?	YES	YES(1)
Can be purchased through a traditional or online broker?	YES	YES
Minimum investment or share amount required ?	YES (2)	NO(3)
Redemption Charges for Early Withdrawals	YES	NO
Traded on what exchanges?	NA	Amex, NASDAQ NYSE Arca

Closed-End Funds VS. ETFs	Closed-End Funds	Exchange-Traded Funds
Continuous trading and pricing throughout the day?	YES	YES
Can be bought on margin?	YES	YES
Can buy/sell options?	NO	YES
Sold by prospectus?	YES	YES
Can use in an IRA, 401(k), or another retirement plan?	YES(1)	YES(1)
Can be purchased through a traditional or online broker?	YES	YES
Minimum investment or share amount required?	NO	NO(2)
Traded on what exchanges?	Amex, NYSE Arca, NASDAQ	Amex, NYSE Arca, NASDAQ

Advantages & disadvantages of ETFs

	Advantages	Description
1	Tax efficiency	▪ Tend to offer greater tax benefits ▪ Fewer capital gains ▪ Low portfolio turnover ▪ Can simply sell to other investors, not requires to generate capital gains tax ▪ Only transfer of securities is involved which is not taxable
2	Lower costs	▪ Require only few portfolio changes as its index based ▪ Lower operating expenses, lower management fees, lower annual expense ratios and others ▪ Lower trading costs, spreads are very narrow. Some ETFs may have wider spreads
3	Transparency	▪ Composition file for each ETF creation unit is published daily ▪ Investors will eventually know the securities held under the index and their weightage
4	Buying and selling flexibility	▪ Bought and sold at intraday market prices ▪ Purchased on margin ▪ Sold short ▪ Traded using stop orders and limit orders ▪ All day tracking and trading
5	Diversification	▪ each ETF represents a basket of stocks or bonds, it inherently provides diversification across an entire index ▪ the expanding universe of ETFs available at NYSE ▪ US offers exposure to a diverse variety of markets, including: ▪ broad-based equity indexes ▪ broad-based international and country-specific equity indexes ▪ industry sector-specific equity indexes ▪ U.S. bond indexes
6	Dividend opportunities	▪ Dividends paid by companies and interest paid by bonds held in an ETF are distributed to ETF holders, less expenses, on a pro rata basis ▪ There may also be opportunities for reinvestment of distributions

ETF Disadvantages

Disadvantage	Description
Broker Commission	ETF investing typically requires paying a commission to a broker, investing small amounts of money on a regular basis can be cost prohibitive
Relatively New	ETFs are relatively new, they do not adequately cover all investment options number of fixed income ETFs is only a fraction of equity ETFS
Specialized Funds	specialized funds such as leveraged and inverse ETFs are very powerful investment tools that can do a lot of damage if not used wisely

The following steps can be used by investors before leaping into ETFs

S. No.	Steps	Details
1	Step I	Role of ETF in an individuals portfolio Look for an ETF which mirrors an index or industry or sector There are lot of foreign ETFs to choose from
2	Step II	Decide exact number of ETFs to buy Pay a broker fee every time you buy or sell type of security The commission is same no matter how many shares you buy or sell Small trades can sometimes cost more (avoid)
3	Step III	Set buy, sell and hold orders on ETFs to protect investment Tell broker to automatically sell your ETFs if price drops a certain value Most folks recommend to sell after 10% drop in value
4	Step IV	Diversity ETF investment Have no more than 15% invested in one industry and a maximum of 10% of total investment into one single ETF These are portfolio management suggestions for risk protection Exceed these limits only if the trend is good and be short term
5	Step V	Investigate the contents of each ETF before you invest. Some ETFs represent shares of many different companies and you'll want to know exactly what you're buying. You can usually get a detailed breakdown of the contents by visiting the issuer's website or reading the prospectus

Interpretation

As seen from the comparison between the ETFs to other investment instruments such as ETNs, Stocks, Mutual Funds and Closed End Funds there are clear demarcations in differentiating the ETFs. The project study looked at different parameters in each of the investment instrument and compared the same against the ETFs. The step-by-step process gives a basic education for any retail investor in making an educated decision making. The study looked at transparency, risk, tax, fees, leverage, returns, profits, benefits to name a few and the understanding is that ETFs provide an excellent opportunity for retail investors in parking their investments. There are also suggestions on how much ETFs needs to be in any given portfolio and reduce the portfolio risk. The study gives a different avenue called ETFs as a very safe investment strategy for anyone who is trying to reap long term benefits. There are lots of strategies and each individual needs to adapt the right choice for their investment based on their need.

Findings

There many forms of ETFs and an ETF can be formed for anything which is trading either its index, currency, bonds etc., ETFs provide several avenues to participate in different instruments within the country and foreign investments**,** ETFs provide lot of benefits when compared to ETNs, Stocks, Mutual Funds etc., ETFs are much safer than other modes of investments ETFs are very nascent in Indian Markets Not many ETFs products are introduced in Indian Market ETFs concept has not been a great hit in Indian Market and it will take some more time before people couple participate. In ETFs, companies are more focused on the Gold ETFs when compared to other ETF products in India

Suggestions

1 Identify the benefits and risks of ETFs 2. Find out different types of ETFs.3. Decide on the most excellent ETF Investing strategy4. Recognize how ETFs will affect your tax return5. Consider a few more things before you Invest in ETFs 6. Set up a brokerage account

If after due diligence and lots of research you feel you are ready to add ETFs to your investment portfolio, it’s as easy as calling your broker. Or opening an online brokerage account will work just as well. If you are interested in learning more about brokers and brokerage accounts, these articles may help.

The following steps will help for individuals to build portfolio with ETFs

If you are knowledgeable in investments, you may be able to handle this yourself. If not, seek competent financial counsel. In determining the right allocation, consider the following:

1. What is your objective (purpose) for the portfolio (e.g., retirement versus saving for a child's college tuition)?
2. What are your risk/return objectives?
3. What is your time horizon? The longer it is, the more risk you can take.
4. What are your distribution needs for the portfolio? If you have income needs, you will have to add fixed income ETFs and/or equity ETFs that pay higher dividends.
5. Do you have any legal or tax issues that will have an impact on allocation?
6. How does this portfolio fit in with your overall plans and unique situation? It is important to know how this portfolio ties in with your other investments and how much of your net worth will be invested in this portfolio.

Finally, consider some data on market returns. Research by Eugene Fama and Kenneth French resulted in the formation of the three factor model in evaluating market returns.

The three-factor model says the following:

1. Market risk explains part of a stock's return. (This indicates that because equities have more market risk than bonds, equities should generally outperform bonds over time).
2. Value stocks outperform growth stocks over time because they are inherently more risky.

Conclusion

The study provides education around variety of ETF products available in world markets. The same will be made available to Indian investors and these can be used in individual’s portfolio. The project study also understood that ETFs can be formed against any instrument which trades daily and how its different compared to stock market or mutual funds or bonds or metals etc., There are lot of benefits by investing in ETF products as shown in the literature.

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