What is an Exchange Traded Fund (ETF)?

An exchange traded fund or ETF as it is popularly called is a fund comprising of a basket of securities that provides exposure to the market. ETF is traded on the stock exchange like a share. The Index ETF are based on index which can be specific or broad market or international market. They track the performance of an index. The difference in performance between the index it tracks is called tracking error. ETF's are gaining popularity because they are transparent, easy to use and low cost way to create a well diversified portfolio.

What are the benefits of ETFs?

ETFs are modern day Mutual funds which have several advantages over traditional funds. The ke advantages of investing in ETFs are the following:

Low cost: Both traditional funds and ETFs charge fund management charges and operating expenses to the Scheme. However, due to the very nature of ETFs, both the expenses are streamlined and much lower as compared to open ended mutual funds charges. ETFs protect th interest of the long term investor from the inflows and outflows of short-term investors.

Portfolio Diversification: ETFs provide exposure to the market through a basket of securities which results in portfolio diversification and better risk management. They provide wide variety of sector, style, industry and country specific funds thereby giving a wide choice of diversificatio to the investor.

Convenience of Investing: ETFs provides you the convenience of trading during market hours an makes it very convenient to buy and sell at any point of time between 9 am and 3.30 pm (curren trading hours). Unlike traditional mutual funds, one need not wait till the closing of market hour to know the price at which the trade is executed. Thus, Investors invests in real-time prices as opposed to end of day prices. If you have brokerage account, all you have to do is either go online and place order or call your broker and place an order. It is as simple as buying any share/stock of a Company.. The procedure is same if you want to redeem your investments partially or fully.

Arbitrage Opportunities: Since ETFs are easy to buy and sell, it also helps an investor to manage his portfolio actively and reduce risk. For example if the investor's exposure is high on banking stocks and he wants to have a hedge, he can technically short Banking sector ETF or other simila sector ETFs to actively create a portfolio using underlying ETFs.

Transparency: ETFs are as transparent as clear glass. The indicative NAVs are available real time to an investor and so is the basket of securities that consists the portfolio. This will help investor to understand what he is investing into and at what price, thereby making the investment decision an informed one.

What are risks of ETFs?

Market risk: Like any other market related investment product, ETFs also carry the market risk. Though you cannot mitigate the risk you can always reduce it by investing across markets and sectors.

Trading cost: There is a trading cost to be incurred every time you buy or sell ETFs. The rates will depend on the overall volume that you do across securities with your brokerage firm.

BID – ASK price spread: There is a spread between the bid price (highest price a buyer is willing to pay for a share) and ask price (lowest price a seller is willing to accept for a unit). The amount of spread varies from one ETF to another. The same is neutralized by higher liquidity.

Tracking Error: Index ETFs tracks the underlying index. The returns generated by ETFs can marginally be more or less than the index it tracks. This is due to the fact that the ETFs will maintain some cash in the portfolio unlike the index.

History of ETFs

The first ETF was launched in 1993 in the United States by State Street Global Advisors to track the S & P 500 index. In the last 15 years + of its existence, ETFs have grown quickly to over $ 1 trillion spread across 750 funds as at the end of 2009. This has been the fastest growing investment product globally especially during 2008 meltdown. The various advantages like convenience, low cost, and most importantly, it is the transparency that has drawn lot of attention from the investors across geographies. Initially, all the ETFs products were launched tracking various equity indices. As the confidence of the investors grew and the industry matured, the product basket has also expanded. Besides equity ETFs, there are many different types of funds tracking Bond, Commodities, Currency, Sector, Country specific etc.

How does ETFs work?

An ETF is bought and sold much like a share during the trading hours in the stock exchange. Based on the purchases of new units and redemption of existing units, there is continuous creation of new units thus resulting in change of number of outstanding units. Since ETFs can issue and redeem units on an ongoing basis, it keeps the market price of ETFs in line with the NAV of the Scheme.

Besides the fund management team, one of the important entity is the Authorized Participant (AP). They are normally referred to as market makers. An agreement is signed between the fund house and several independent APs.

How are ETFs different from Mutual funds?

ETFs have many advantages over traditional mutual funds. In fact they have managed to convert all the disadvantages of mutual funds into advantages for themselves. The key differences between ETFs and Mutual Funds are the following:

Feature	ETFs	Mutual Fund
Liquidity	Can be traded on the exchange during trading hours and hence making them very liquid.	Purchase or Redemption has to be lodged with the fund house which is processed at the end of the day.
NAV or Price	The price is available live and one knows the price at which one is buying/ selling	The NAV at the end of the day is applicable and hence not known at the time of execution of the transaction.
Portfolio Transparency	The portfolio is disclosed daily thereby making it very transparent.	The portfolio is disclosed on a periodic basis as per the regulatory requirement.
Impact of large clients	Purchase or sale of units on the exchange will have no impact on the NAV of the ETF	Large purchase or redemptions impacts the NAV of the fund.
Investment Management Fees	The charges are much lower with a maximum limit of 1.5 %, as prescribed under SEBI	The charges are relatively higher with a maximum limit of 2.5%, as prescribed under SEBI (Mutual Funds) Regulations, 1996
Operating expenses	Lower due to the very nature of the product	Relatively higher
Intraday Liquidity	Possible	Not Possible
Arbitrage opportunity	Provides arbitrage opportunities	Does not provide any such opportunities
Margin Money	Can be bought and sold on margin money thereby allowing investors to take a larger exposure	No such facility is available.

Does ETF means investing into passive index only?

ETFs had started as a passive style of fund management in 1993. However over the years, lot of innovation has taken place and the regulators in markets like US have issued guidelines allowing managers to launch funds following active management of index. Products like fundamentally enhanced index are finding favors with investors.

Who all can invest into ETFs?

All class of investors having a demat account can invest in ETFs – Individual investors (Retail & HNI), Corporate, Financial Institutions, Mutual Funds, Arbitrageurs, Traders etc. What is important to be a successful investor is to have the goal in mind. Any investor who is looking to participate across asset classes and create wealth over a period of time in a very cost efficient manner, ETFs comes across as the perfect modern day investment tool.