ETFs – A Leading Financial Innovation

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1. Introduction

In a relatively short period of time, the market for Exchange Traded Funds (ETFs) has become popular, especially in Europe, and has established itself firmly in the minds of investors. ETFs have been growing faster in Europe than in the US. This is attributed to the fact that many European managers were already familiar with the concept of ETFs before they were made available in Europe. ETFs are now widely used investment vehicles and considered to be an integral component of the overall asset allocation. ETFs might well be considered the leading financial innovation of the past decade.

During the last few years, ETFs have clearly conquered Europe. At the end of October 2004, there were 326 ETFs with assets of US$ 260 billion, managed by 38 managers and listed on 29 exchanges around the world. Year to date, the overall assets under management of ETFs increased by 5% – the US increased by 4.6%, Europe by 15.7%, while Japan declined by 3.9%. During 2004, 45 new ETFs were launched, a further 66 are planned and six ETFs were delisted. The average daily trading volume in US dollars has increased 50.6% to US$ 13.4 billion. This represents a dramatic increase from 1993, when there were just three ETFs with US$ 811 million in assets. January 29, 2003 marked the 10th anniversary of the first ETF listing in the US.[1]

The attraction of an ETF is that it provides access to a whole index, market or predefined portfolio strategy, but is much less complicated. An ETF behaves like an ordinary share that can be traded on a daily basis, but its un-

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[1] Source: Morgan Stanley ETF Worldwide Guidebook, Global Summary as of October 29, 2004.

derlying assets are an entire index or portfolio, thereby providing diversification. Their investment objective is to replicate the price and yield performance of an independently published index. This explains why they are often described as index shares.

ETFs allow investors to gain broad exposure to specific segments of equity and fixed income markets with relative ease, on a real-time basis, and at a lower cost than many other forms of investing. Essentially, ETFs opened a new, broad range of investment opportunities in large-cap, mid-cap, small-cap, value, growth, domestic, international, country and regional equity indices as well as in corporate and government fixed income indices. Additionally, a trend towards setting up sector ETFs could eventually include style-based offerings and actively managed funds.

Key benefits of return enhancement and the ability to offset custodial and administrative fees help funds squeeze a few extra basis points out of their performance. This can be anywhere between five and thirty basis points on a portfolio, and can often mean the difference between first and second quartile performance.

2. Characteristics

It is believed that growth in the use of ETFs reflects their superior characteristics. The characteristics of ETFs essentially are comparable to index tracker funds that are listed and trade on-exchange like stocks. Most ETFs are structured as open-ended mutual funds, registered under the local jurisdiction. The open-ended mutual fund structure allows ETFs to lend stock, which may generate extra income. In addition, these funds can hold other securities and financial instruments, including cash, fund equivalents, and futures. Dividends are reinvested in the fund on the day of receipt and are paid to ETF investors quarterly, semi-annually or annually.

Since the objective of exchange-traded funds is to give exposure to indices, ETFs may be useful to investors who want to passively track an index. Factors such as fees and expenses, taxes, corporate actions, differences in trading hours between the ETFs and the underlying stocks and adjustments to the underlying index may cause tracking error to the benchmark. ETFs can be bought and sold on margin or a commission basis like any other share – at market, limit or stop order. Further, ETFs are lendable and they are used as underlyings for derivatives. Index-linked ETFs have distinctive