

Ireland well placed to benefit from the onward march of ETFs

In recent years exchange traded funds (ETFs) represent one of the fastest growing sectors in the funds industry. Earlier this year global ETF assets broke through the \$1 trillion barrier, highlighting the importance of this sector within the funds industry.

The sector has developed significantly since the first ETFs were launched on the US market in 1993. ETFs were initially a US product and it was not until 2000 that the first ETFs were launched in Europe. More recently, ETFs have gained greater global significance and an increased market share in Asia and Latin America has been experienced. As at August 2010, the US market still accounts for over 66% of the global assets in this sector, while Europe accounts for approximately 20% and the remainder is split among the other global regions.

As assets continue to increase in the ETF sector the competition is also becoming more intense with the increased number of ETF providers and product offerings. ETF providers are split on a geographical basis with US and European providers inclined to focus solely on their own region. iShares, which was acquired by Blackrock last year, is the largest ETF provider in both the US and European market and is the only ETF provider which has a significant presence in both markets.

The attraction of ETFs is the combination of the investment features of a fund with the trading features of a standard security. The growth of the ETF sector can be largely attributed to the advantages which ETFs have over standard mutual funds, which are predominantly lower costs and greater liquidity.

The costs associated with ETFs are significantly lower than those of traditional mutual funds. The total expense ratio (TER) of a fund is the primary indicator of the cost of investing in a fund and the TER associated with an ETF is lower than that of a traditional mutual fund. This is mainly due to the fact that ETFs are usually passive products which track an index or a sector, which results in lower operating costs than those associated with actively managed funds. Transactions costs, which do not form part of the TER, are also typically lower for an ETF due to the low turnover of assets. Active ETFs, where the portfolio is actively traded, may not offer the same cost benefits due to the increased level of trading and active management involved in these products. However, active ETFs, while becoming more common, still represent a small portion of the ETF market.

ETFs also provide greater liquidity as intra-day trading is available on the relevant exchange in comparison to the daily liquidity provided by traditional mutual funds. An additional attraction is the ability to 'short' ETFs which enables investors to use them as part of a trading strategy to hedge against a particular market or sector.

Most ETFs are index tracking funds that aim to provide a return consistent with a specific index. This return can be achieved by replicating the index or by synthetically creating the return using derivative instruments. Replicating the index involves purchasing a representative sample of underlying index constituents which are rebalanced in line with any changes made to the index. Synthetically creating the return involves purchasing securities along with entering a total return swap which provides the return of the securities purchased in exchange for the return on the specified index.

The attraction of the swap based approach is that a more static portfolio can be maintained by the ETF resulting in lower transaction costs. The management fees are also usually lower as this is a more passive product. Tracking error is reduced with a swap based return on the index as sampling error, which results from trying to replicate an index return by holding a representative sample of index constituents, is avoided. However, the swap based approach has increased counterparty risk due to the use of derivatives by the ETF. While collateral is held by the ETF for the swap, the exposure to the counterparty of the swap is an additional risk for the ETF. Some swap based ETFs will look to spread this exposure by using multiple counterparties.

Ireland has established itself as a preferred jurisdiction for many of the European based ETFs. As at September 2010, 28% of European based ETFs are domiciled in Ireland and have been established in Ireland since the very early ETF launches in Europe ten years ago. In this time both the service providers and the Central Bank have established a vast knowledge of ETF products. As the range of ETF products becomes more diversified the experience and the performance record of Irish service providers in providing solutions for ETF platforms is a key factor in attracting future products to Ireland. The absence of any annual net asset tax on the ETFs' assets in comparison to other European jurisdictions is an additional benefit of using Ireland as a domicile for an ETF.

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Many ETFs established in Ireland to date have been structured as UCITS funds. This provides an additional layer of regulation for these ETFs which is an attraction for potential investors, especially in the retail market. Marketing of a UCITS fund throughout Europe is easier and the introduction of UCITS IV will further facilitate this process by streamlining the passporting and notification procedures across EU member states.

The range of ETF products continues to evolve as the market becomes more competitive. While a large percentage of ETFs are still equity based there is growing market share being obtained by fixed income and commodity based ETFs. ETF providers are expanding the possibilities of index tracking products by working with the index providers to create new indices where they perceive an investor demand. The marketing of index tracking ETFs has moved beyond the provision of ETFs which track the major indices such as the S&P or the FTSE. The number of ETFs tracking specific industry or geographical indices has increased significantly this year. Such ETFs are attractive for institutional investors as they can short these ETFs for hedging purposes as part of their trading strategy.

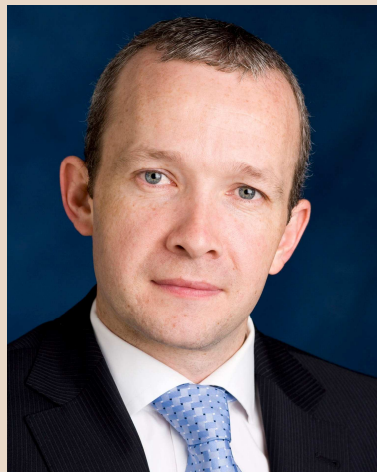
The introduction of products such as leveraged ETFs and inverse ETFs displays the innovation of ETF providers and their commitment to continuing the development of their product offering to meet investor demands. Inverse ETFs are constructed using various derivatives for the purpose of profiting from a decline in the value of an underlying benchmark. Investors can gain from a falling market without physically holding a short position. Leveraged ETFs continue to increase in popularity but the need for daily rebalancing of the exposure to the index requires more management which can result in higher costs. Leveraged ETFs can also add to the uncertainty of a volatile market by providing returns which are a multiple of the market movement.

Recently, some ETF products have begun providing exposure to hedge funds by investing in several indices to replicate the return of a reference hedge fund. This strategy enables investors to gain exposure to hedge funds but through a more liquid investment.

As the sector continues to evolve to meet the ever changing demands of both retail and institutional investors and the ETF providers compete to bring more innovative opportunities to the market the range of products will continue to develop. An important factor with such product development is that the liquidity and the transparency of these products are maintained at a high level which will benefit sector as a whole.

As the ETF sector continues to grow, Ireland offers an attractive location for new products, both in terms of the established regulatory framework and the experience

and knowledge of its service providers. Ireland is also an established location for UCITS funds and many of the European ETFs are established as UCITS products for the enhanced regulation and marketing benefits which it provides. These attributes ensure that Ireland has the experience and credentials to play a significant part in the development of the ETF sector.



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