Summary

- Exchange-traded products (ETP) are effectively securities that hold within them other securities, and which can be traded on stock exchanges like stocks and shares.
- Exchange-traded funds (ETF) are a kind of ETP, a passive fund that tracks an index or benchmark.
- Unlike classic mutual funds, ETFs behave like stocks and shares, and can be traded on the stock exchange whenever the exchange is open for business.
- They started out as equity-only funds, but today there are ETFs containing anything from bonds through to a whole range of alternatives – including blends of asset classes.
- There are around 1,500 ETFs listed on the London Stock Exchange, including more than 400 ESG ETFs.
- Their transparency, low cost and ease of trading has made ETFs a popular choice for asset owners, including pension schemes.
- But the broad choice can make selecting the correct ETF a challenge.

The world of ETFs

Sandra Haurant provides an overview of the ETF market

The first-ever exchange-traded fund (ETF) was launched in 1993 by State Street Global Advisors, in collaboration with the American stock exchange. Thirty years on, what is the state of play for ETFs, and how does the pensions universe use them?

What exactly is an ETF?

Perhaps the first question should be 'what is an ETP'? An ETP is an exchange traded product, a kind of security that holds within it other securities. There are different kinds of ETP, and they typically track an index, and can be traded on the stock exchange in the same way that stocks and shares can be bought and sold.

Coming back to the ETF, an ETF is a kind of ETP. It is, according to the *Financial Times*: "A basket of different securities that are pooled together into one fund, which is traded on a stock exchange."

ETFs hold a little of every share in their chosen index, allowing investors to own a piece of a broad range of securities, all of which are held in one place. The majority of ETFs track an index or a benchmark, rising and falling in line with the underlying index's performance. The aim of the game for those ETFs is to replicate the performance of a given index – in the same way that a classic passive mutual fund follows the market's fortunes. A bit like a passive mutual fund, then, but different.

"ETFs can be thought as part of the family of passive vehicles, which many pension schemes have been allocating more and more assets to," says PiRho Investment Consulting's director, Phil Irvine. And, he explains, there are a number of common traits shared by traditional index funds and ETFs. "Both index funds and ETFs have many similarities: A systematic approach to matching the return of a specified index, low fees, diversification, etc," says Irvine.

But there are key differences, too, and the way in which ETFs are traded is perhaps top of the list. With mutual funds, pricing, buying and selling only happens once a day. ETFs, on the other hand, "typically trade throughout the day", says Irvine. Their prices continue to rise and fall for as long as the stock

exchange they are listed on is open, just like equities.

This means decisions can be made quickly and trading can be carried out with little delay – something that can serve pensions well in certain situations. “The advantage of an ETF can be that there may be occasions when, say for hedging purposes, investors want to ensure that the time out of the market is minimised,” says Irvine.

A one-stop diversification shop

To take the example of the first-ever ETF, State Street Global Advisors’ ETF, known as SPDR (usually pronounced spider) follows the S&P 500, giving investors exposure to all 500 securities listed on that index. While companies come and go from the S&P 500, and different sectors may rise and fall in terms of the proportion they make up of the index, it is broadly speaking considered to be a well-diversified index. As a result, asset holders buying a piece of the index through the SPDR ETF get ready access to that diversification.

What’s more, the changing ETF landscape now gives investors access to an even greater range of underlying assets. At the beginning, ETFs contained only equities, but today they can be found in almost every colour and flavour of asset, from fixed income through to a range of different alternatives. There are also blended ETFs, offering exposure to a combination of asset classes. And with this scope comes the possibility of finding funds that not only meet investment aims, but which can give pensions the opportunity to pursue their vital environmental, social and governance (ESG) objectives, too – and this through an investment structure that, by its passive nature, remains relatively low cost.

“There is an enormous range of ETF products that have been created to follow specialist indices,” says Irvine. “This greater diversity can allow pension schemes using ETFs to access certain sub-indices in a cheaper way than via active managers, whilst there may not be an index fund that offers this same exposure.”

Gaining ground

Since their beginning in 1993, ETFs have grown not just in terms of range, but in popularity among institutional investors. “In recent years we have seen rapid growth in ETF adoption by asset owners, including pension schemes,” says BlackRock head of institutional iShares sales EMEA, Kirst Kuipers. “Asset owners are becoming increasingly aware of the benefits ETFs offer – allowing them to reallocate at scale, particularly in fixed Income, both tactically and at the core of portfolios.”

“The changing ETF landscape now gives investors access to an even greater range of underlying assets”

The ETF market is constantly evolving, and so are the digital developments that help investors build portfolios and react to market changes. “Improvements in technology are revolutionising the way investors access markets, creating efficiencies and more granular exposures to express their investment views,” says Kuipers.

Changes within the pensions sphere also bring about different requirements, and the current growth of new defined contribution (DC) pensions is, says Kuipers, fuelling ETF usage. “These schemes typically start from scratch, while participants need diversified exposure from day one with a requirement to manage inflows and outflows,” says Kuipers. “The daily liquidity, transparency and convenience of ETFs can provide a flexible solution.”

Horses for courses

But what works for one fund may not work for another. While that triple whammy of liquidity, transparency and convenience can make ETFs a solid choice in a multitude of situations, they are not always the right container for index funds. For one thing, costs should be compared. “Very large index funds covering mainstream indices can be cheaper than the equivalent ETF,” says Irvine. “Many pension schemes would probably choose the index fund rather than an equivalent ETF if they wished long-term exposure to the particular market beta. In practice, pension schemes probably need to carefully think about their likely holding period to decide whether an ETF or equivalent index fund is most appropriate.”

And the sheer volume of ETFs out there can leave investors spoilt for choice. The first US ETF was launched in 1993, but the first on the London Stock Exchange came along in 2000. Now, on the London Stock Exchange alone, there are 48 issuers listing more than 2,100 ETPs in total. Of those, there are 1,500 ETFs listed in London, including over 400 ESG ETFs (according to the London Stock Exchange). Irvine cautions: “The huge number of ETPs means that investors need to take care in selecting an appropriate ETF for their needs.”

ETFs may have advantages, but they are not for everyone. Barnett Waddingham head of manager research team, Mark Parry, says the firm does not typically favour ETFs for its DB and DC clients. “The argument for ETFs is the constant trading, low minimum investment amounts and flexibility,” he says. “However, these are not typically required for these long-term investors and do not overcome the challenges around custodian, tax treatment and other long-term drags on returns. That said, many pension funds will hold some exposure to ETFs via actively managed funds that they hold.”

Written by Sandra Haurant, a freelance journalist