

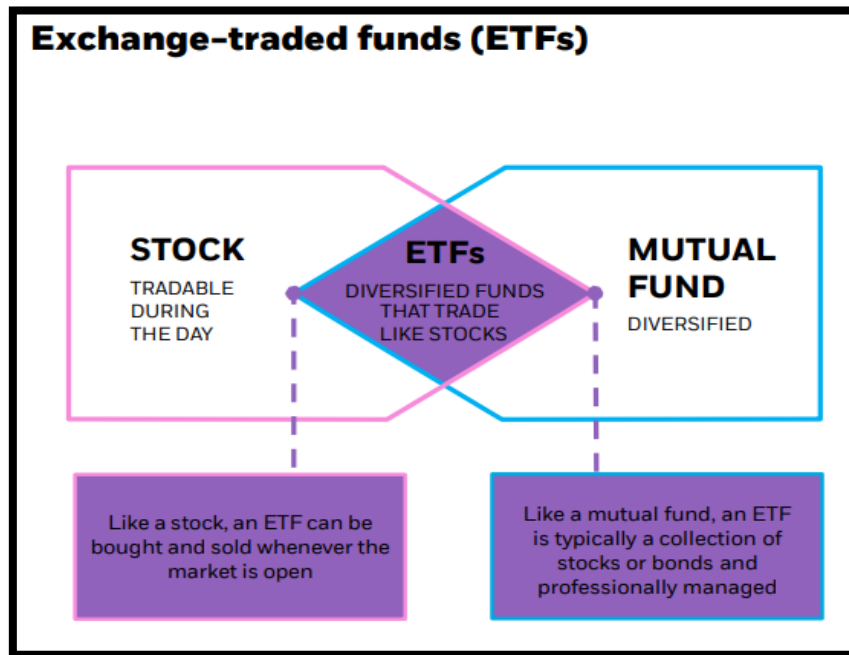
How to choose the right ETF

- What would be in your ETF's?
- What goes inside your fund?
- What an ETF would cost to an investor?

For advisers aiming to develop cost-effective portfolios, ETFs have become the go-to investing alternative. This article will shed light on the basic questions important while selecting the right ETF for an investor. This article raises critical questions that must be considered while selecting the appropriate exchange-traded funds (ETFs).

Exchange Traded Funds

ETFs (Exchange Traded Funds) are a type of mutual fund that allows you to invest in a variety of bonds or stocks all in one place. They usually follow a certain market, such as the FTSE 100. In this way, they're similar to index funds, which track the performance of a market. So, what's the difference between the two? Well, it all boils down to two factors: how they're traded (bought and sold) and the fees they charge.



Source: Choosing the right ETF's, Fidelity 2021

An ETF can be purchased and sold whenever the market is open because its attributes are derived from both equities and like a mutual fund, is a professionally managed collection of stocks or bonds.

The iShares market cap and S&P 500 style box ETF has outperformed 80% of the peers in all nine style boxes over the past 5 years.

According to the Morning Star, iShares are as low as 1/3rd the price of a normal mutual fund and just 6% of iShares ETF's paid capital gains distributions on average during the last 5 years compared to 58% of mutual funds.

What would be in your ETF's

All indexes seek to achieve the same goal. Each index provider, however has its own construction technique and means of assessing value and growth. Three major equity index providers employ quite different approaches to style classification, ranking U.S. stocks in their size indexes based on separate growth and value parameters.

FIG. 4
Index provider value and growth metrics

Index provider	Key size indexes used as basis for style indexes	Value metrics	Growth metric
S&P	<ul style="list-style-type: none"> • S&P 500 • S&P MidCap 400 • S&P SmallCap 600 	<ul style="list-style-type: none"> • Price to earnings • Price to book • Price to sales 	<ul style="list-style-type: none"> • 3 years earnings to price growth • 3 year sales growth • 12 month price momentum
Russell	<ul style="list-style-type: none"> • Russell 1000 • Russell MidCap • Russell 2000 	<ul style="list-style-type: none"> • Price to book 	<ul style="list-style-type: none"> • Forecasted 2 year growth • 5 year sales growth
Morningstar	<ul style="list-style-type: none"> • Morningstar US Large-Mid Cap • Morningstar US Mid Cap • Morningstar US Small Cap Extended 	<ul style="list-style-type: none"> • Price to forward earnings • Price to book • Price to sales • Price to cash flow • Dividend yield 	<ul style="list-style-type: none"> • Long-term projected earnings growth • Historical earnings growth • Sales growth • Cash flow growth • Book value growth

Source: S&P, Russell, Morningstar

Source: BlackRock ,2021

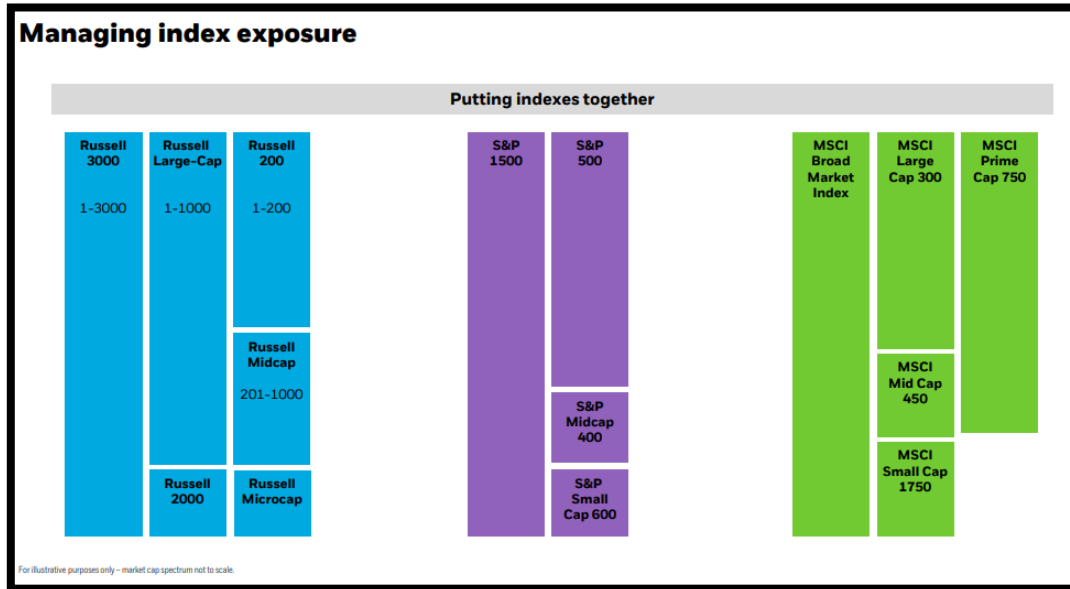
Parameters for evaluating an ETF

It's critical to ask questions like:

- How long has the firm been designing, administering, and supporting ETFs?
- What are the total assets under management and ETF assets of the firm?
- How does the company deal with market participants and index providers in terms of risk management?

What's inside your fund?

To put it another way, 'manage the exposure' when evaluating an ETF. According to different index methods, different cap sizes and mix are proposed. It's crucial to figure out what the index's acceptability level is. Understand the index's logic, such as how it selects components, rebalances, and so on. What are the differences in methodology between index funds and what technique does the ETF use? What does the ETF use to track the market and how closely has the ETF followed its benchmark? All these are important when analysing an ETF.

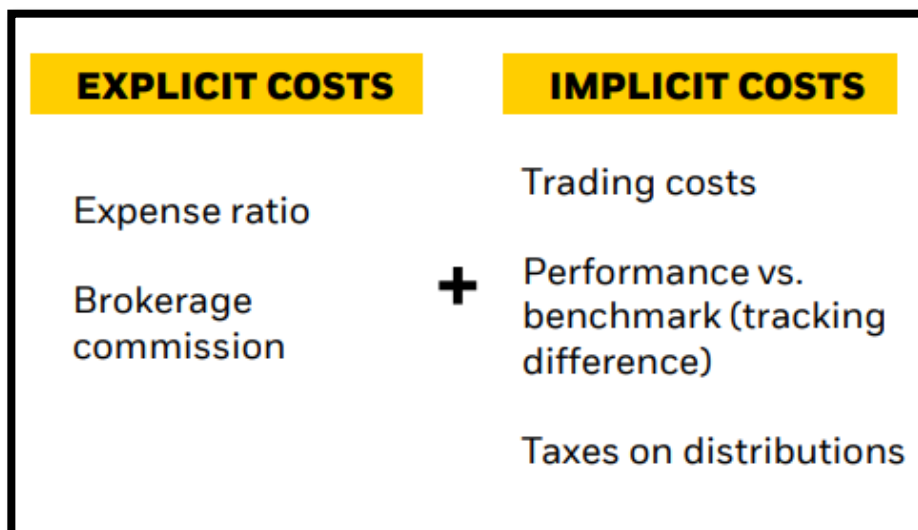


Source: Fidelity, 2021

All these questions are important in order to create a framework that offers the unitholder with transparent rewards while minimizing unforeseen risks or expenses. An investor can create a product design that strikes a balance between intended exposure and cost, tax, and liquidity considerations. A dedicated, independent ETF structure that protects ETF unitholders from unwanted tax effects and inherent conflicts of interest.

What would it cost to an investor?

Investors must go beyond management fees when evaluating the cost of an ETF. While management costs are significant, other costs such as trading, market effect, and rebalancing should also be considered when calculating the ETF's true overall cost.



Source: Fidelity, 2021

Overall, there are multiple levels of liquidity benefit ETFs, resulting in possibly lower entry/exit costs. It's crucial to look at the ETF's true liquidity in terms of market volume and underlying security liquidity, as well as how accessible liquidity is amid tumultuous market conditions. Strong ties with index providers should demonstrate the ETF provider's support for liquidity.

Summary

It is important to realize if the exchange-traded fund (ETF) is a separate entity or a share class of a classic mutual fund? Effect the process of creation/redemption have on tracking, spreads, and internal transaction costs are an important consideration as well. The possibility to reinvest dividends as they are received in an ETF. The tax implications of the ETF structure and how do the spread and volume factor into overall cost on a trade and per annum basis.

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Our Research & CPD focuses on multi-asset strategies, index funds and ETFs.

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