



Elston CPD: UK Equity Income

#InvestWithETFs

in association with:



CPD Progress

The Assigned Reading and this CPD Workbook count as unstructured CPD if completed on a standalone basis.

By completing the relevant CPD Test these materials count as structured CPD.

CPD Module Components	For Structured CPD
Assigned Reading	60 minutes
CPD Workbook	60 minutes
CPD Test	30 minutes
TOTAL	2.5 hours

Learning Outcome Review

Aims & Objectives

Aims

The aim of this CPD module is to understand how to evaluate and access UK Equity Income exposure using indices and ETFs.

Objectives

By completing, this CPD module, readers should be able to:

- A. Contrast and evaluate the different methodological approaches to income index construction
- B. Understand how to evaluate ETFs performance relative to their respective indices
- C. Summarise key due diligence considerations when selecting an ETF

Objectives

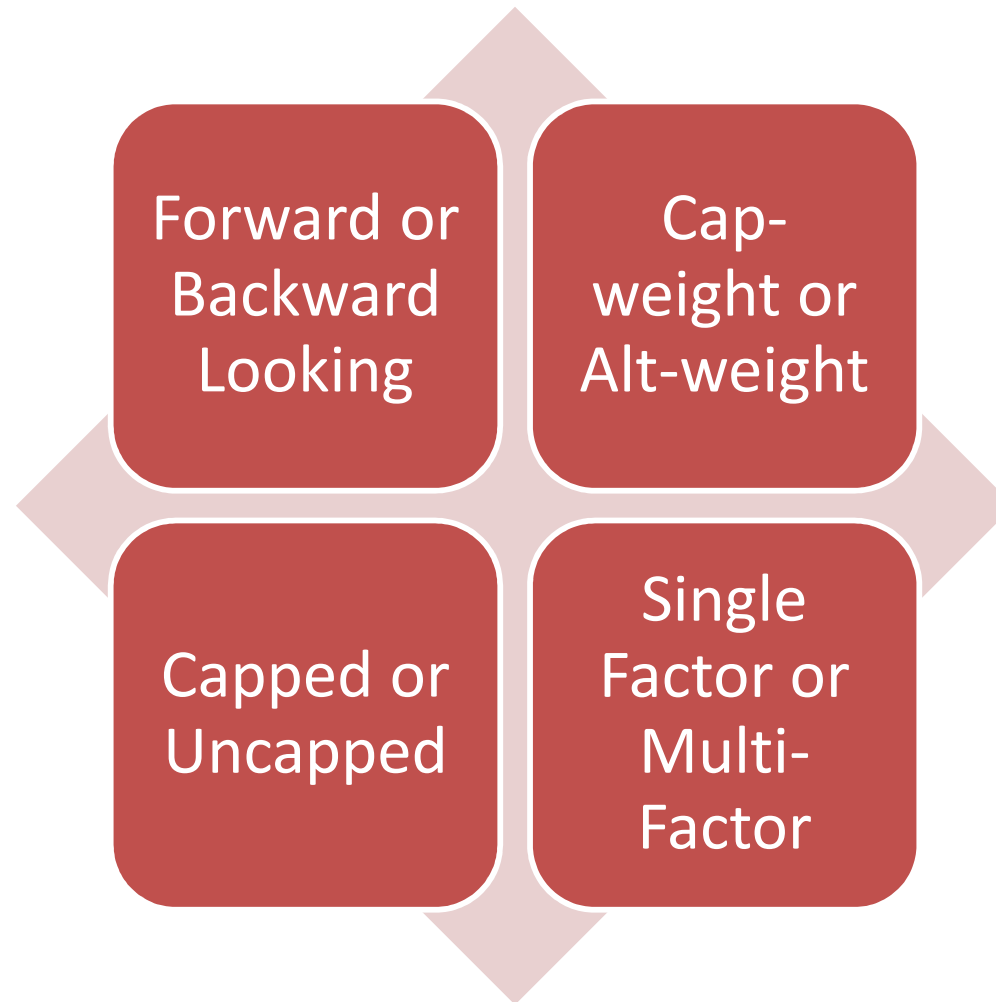
- A. Contrast and evaluate the different methodological approaches to income index construction
- B. Understand how to evaluate ETFs performance relative to their respective indices
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LOS.1. Identify key index construction techniques

Each index methodology discloses certain index construction techniques which have a material impact on the results of index rules as applied. Key index construction techniques include:

- **Forward- or backward- looking:** when evaluating a security for inclusion in an index against a key criterion, e.g. ranked on dividend, is the data used an estimate (forward-looking) or historic (backward-looking).
- **Cap-weight or alt-weight:** when allocating a weighting of a security for inclusion in an index, should the weighting be determined by market capitalisation (cap-weight), or by some other factor (e.g. dividend, contribution to index dividends, dividend growth) (alt-weight).
- **Capped or uncapped:** when allocating weightings of eligible securities within an index, should those weightings be capped (at security level or sector level) or uncapped (no constraints). Capped weightings can help avoid any unintended biases.
- **Single factor or multi-factor:** when including securities in an index, should this be based on one factor alone (e.g. dividend income), or a number of factors (e.g. dividend income and the security's volatility)

LOS.1. Identify key index construction techniques



LOS.2. Outline the impact of methodology on performance

Different index methodologies result in different performance characteristics and inherent biases.

- **Cap-weight or alt-weight:** cap-weighted approaches create an inherent bias to size and greater similarity to traditional reference indices. Alt-weighted approaches will emphasise that chosen weighting characteristic.
- **Single factor or multi-factor:** selection of a single factor (e.g. income) or combination of factors (e.g. income, quality and volatility) will have a material impact on performance characteristics
- **Capped or uncapped:** the use of capping can screen out sector and/or geographic biases. This can help reduce impact on performance from security selection/idiosyncratic factors.
- **forward- or backward- looking:** the impact of using forward or backward looking factor data will have an impact on performance but is difficult to assess

LOS.3. Summarise key index comparison metrics

Outline different evaluation metrics for assessing similarity or difference between indices.

- **Total return:** the cumulative or annualised total return of an index is the simplest measure of evaluation
- **Risk-adjusted returns:** plotting annualised total return against volatility, or by evaluating an index's Sharpe Ratio for a given time-frame enables comparison of Risk-Adjusted Returns.
- **Beta:** beta can be used to measure the risk of one index relative to another.
- **Correlation:** correlation can be used to measure the relationship between the performance of one index relative to another.
- Similar total returns or risk-adjusted returns implies similarity by result.
- High beta/high correlation implies similarity by relationship.

LOS.3. Summarise key index comparison metrics

R

Return

σ

Volatility

β

Beta

ρ

Correlation

Objectives

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LOS.4. Describe the key measures of replication quality

The key measures for the replication quality of an ETF relative to the index it tracks are

Tracking Difference: the difference in annualised returns

- Tracking Difference is defined as the difference between annualised performance of an ETF (based on its official Net Asset Value (NAV)) and that of the index it tracks, over a given period. A lower difference is better.

Tracking Error: the volatility of excess returns

- Tracking Error is an indicator of relative risk and corresponds to the annualised volatility of the daily return difference between the ETF and the index it tracks, over a given period. A lower tracking error is better.

LOS.5. Describe more complex measures of replication quality

Additional, more complex measures for replication quality include:

Hurst Exponent: Long-term persistence of excess returns

- This indicator captures the degree of long-term autocorrelation in excess returns of an ETF. The higher the Hurst coefficient, the higher the likelihood that past excess returns will be followed by similar excess returns. A score >0.50 is better.

Kurtosis: Width of extreme excess returns

- The width of extreme excess returns, or (excess) kurtosis of daily return difference between the ETF and its corresponding tracked index, quantifies tail weight of excess returns distribution. High kurtosis means infrequent extreme return deviations are observed on the ETF with respect to its benchmark index. A lower score is better.

LOS.6. Discuss the importance of qualitative assessment

Qualitative assessment is essential to link back performance to portfolio objectives. Questions could include:

1. Which performance characteristics are the primary objective: income yield, total return, or volatility?
2. What level of concentration risk to a security, sector or factor is acceptable to achieve such performance?
3. Should the selected index behave similarly (complement) or differently (diversify) relative to the exposure it is replacing or supplementing?

Objectives

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LOS.7. Outline due diligence criteria regarding structure

Key due diligence criteria relating to structure include:

Legal Structure	OEIC, SICAV or ICVC
Approvals	UK Distributor/HMRC Reporting Status
Domicile	Ireland, Luxembourg
Underlying exposure	Physical or synthetic

LOS.8. Outline due diligence criteria regarding liquidity and trading

Key due diligence criteria relating to liquidity and trading include:

Internal liquidity	Liquidity of underlying holdings
External liquidity	Level and range of bid-ask spread
Flows	Gross/net flows and AUM of each fund
Base currency	Base currency of the ETF
Share class	Trading currency of the ETF
Hedged/Unhedged	Whether returns are unhedged or hedged into a currency

LOS.9. Outline qualitative due diligence criteria

Key qualitative due diligence criteria also apply:

Counterparty risk	Particularly for synthetic ETFs
Reputation	Quality of managers and team
Experience	Experience in ETF manufacture and management

Feedback

For any feedback on this or any other CPD module, please email
cpdfeedback@elstonconsulting.co.uk

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