



ETF due diligence Separate the wheat from the chaff

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Risk alert

Official reports

- G20 Financial Stability Board: http://www.financialstabilityboard.org/publications/r_110412b.pdf
“Potential **financial stability issues** arising from recent trends in Exchange-Traded Funds (ETFs)”
April 2011
- IMF: <http://www.imf.org/external/pubs/ft/gfsr/2011/01/pdf/text.pdf>
Global financial stability report
Durable financial stability: getting there from here
“Exchange-Traded Funds: Mechanics and **Risks**”
April 2011
- Bank for International Settlements: <http://www.bis.org/publ/work343.pdf>
“Market structures and **systemic risks** of exchange-traded funds”
April 2011

Source: Global ETF Research and Implementation Strategy Team, BlackRock. As at end January 2011

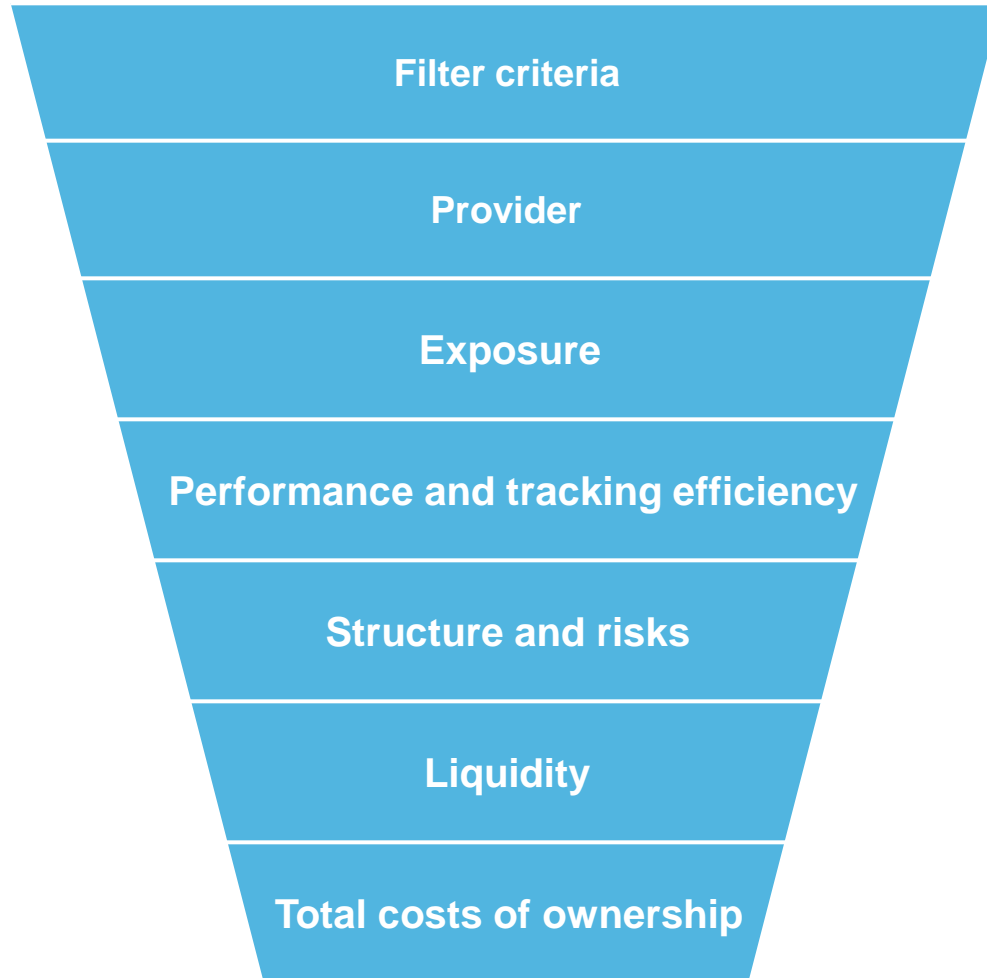
Main concerns

- **Disclosure**
- **Transparency**
- **Conflict of interest from swap-based ETFs**
- **Collateralisation**
- **Securities lending**

Source: Global ETF Research and Implementation Strategy Team, BlackRock. As at end January 2011

The importance of due diligence

ETF due diligence framework



- Exclusion criteria mainly depending on client type and jurisdiction
- How well do you know your provider?
- What's in your ETF?
- How closely is the index performance replicated?
- What are the implications and risks of ETF structure?
- Can you trade when you need to?
- What does it really cost?

1. Filter criteria

Critical questions

- In which countries is the fund registered for sale?
- Which Swiss and/or European tax reportings are provided?
- Is the fund UCITS III compliant?
- Is the fund/fund domicile tax-efficient for the investor?
- What is the legal structure of the fund?

Key considerations

- For advisory: registration in the country of sale and preferably the client domicile (for advisory)
- Swiss and European tax reporting (potential adverse tax consequences in the form of a lumpsum taxation)
- Reporting for EU savings tax purposes (20% (35% from 1 July 2011) withholding tax on distributions of US fixed income ETFs to European investors)
- Tax-efficiency depends on the exposure, the client domicile, the fund domicile and legal structure (and needs to be assessed on a case by case basis)

BlackRock ETF Landscape provides information on filter criteria for all ETFs worldwide

2. Provider

Critical questions

- What is the level of the firm's investment professional expertise and experience?
- How experienced is the firm in developing, managing and supporting ETFs?
- What are the firm's total assets under management (AuM) and total ETF AuM? What is the competitive market share of each?
- **What is the provider's service model? What kind of services are offered?**
- Does the website publish: daily NAV, NAV history, total return NAV, index performance versus benchmark, fund holdings, ETF factsheets?

Key considerations

- Experience in the ETF market
- Size, scale, expertise, track record and level of commitment to the ETF industry
- A business model that supports and advocates the role of fund selectors and portfolio managers as the key to investor success e.g.
 - Local presence
 - Education
 - Capital Markets
 - Tax-related questions
 - Analytical support

The trend in the industry is to focus on 3-4 preferred ETF providers to reduce complexity and increase efficiency of fund selection units

3. Exposure

Critical questions

- What is the name of the index the ETF seeks to track?
- Does the index accurately reflect the overall investment opportunity set?
- What is the index methodology (e.g. weighting methodology, component selection criteria, rebalancing)?
- How accepted or widely followed is the index?
- Are index and fund holdings available on a sufficiently frequent basis?
- What is the benchmark type (price, total return net, total return gross)?

Key considerations

- Targeted exposure
- Index name recognition. The most widely recognized and respected benchmarks in the industry are supported by index providers who ensure that their indexes are trackable, complete and accurately represent the investment opportunity
- Frequency of disclosure and level of transparency. While some indices report holdings on a daily basis, not all do – which impacts investor ability to see exactly what is inside the ETF on a given day
- Price indices do not consider dividends, total return gross indices do not consider withholding taxes

Equity and fixed income guides from iShares provide all the relevant information on the indices tracked by iShares ETFs

4. Performance and tracking efficiency

Critical questions

- What is the ETF's method for tracking the index (replicated, sampling/optimization, synthetic)?
- What is the tracking difference (1 year, 3 year, 5 year, since inception)?
- What is the tracking error (1 year, 3 year, 5 year, since inception)?

Key considerations

- Replication methodology strongly affects risks and tracking quality of ETFs
- Data quality is crucial for performance and tracking efficiency analysis (NAV and dividends: ETF provider, etfinfo, etfexplorer; index data: Bloomberg)
- Joint assessment of performance and tracking error
- For optimized or sampled ETFs: assessment of tracking difference over the long-term

Tracking difference and tracking error has to be calculated by fund selectors to ensure comparability

5. Structure and risks (1 of 2)

Critical questions

- What is the ETF's method for tracking the index (replicated, sampling/optimization, funded swap, unfunded/TRS swap)?
- For synthetic ETFs
 - Swap counterparties including credit rating
 - Composition of the security basket (unfunded swap structures)
 - Is the swap exposure collateralized?
 - Collateral schedule
 - Collateral posting (pledge versus transfer of title)
 - Name of custodian of swap collateral
 - Minimum/average swap collateralization level
 - Are collateral holdings, swap pricing, counterparties and level of over-collateralization disclosed on a daily basis?

Key considerations

- Product design that balances desired exposure and helps to ensure cost and liquidity
- Physical ETFs do not incur counterparty risks from swap transactions but utilize securities lending
- Unfunded swap structure with counterparty risk up to 10% (UCITS III limit)
- Funded swap structure with fully collateralized counterparty risk
- External custodian and transfer of title ensures direct and fast access to collateral
- Lack of transparency still a wide-spread issue of synthetic ETFs: high swap pricing, low quality of security basket, lack of diversification of collateral possible

Structure and risks (2 of 2)

Critical questions

- Securities Lending
 - Is securities lending utilized?
 - What are the collateral parameters?
 - Is there an independent risk oversight unit?
 - Maximum/average securities lent out
 - Minimum/average degree of collateralization
 - Collateral posting (pledge versus transfer of title)
 - Name of the custodian
 - % of securities lending revenues allocated to the fund
 - Additional costs associated with securities lending

Key considerations

- Independent (from securities lending function) risk oversight avoids conflicts of interest
- External custodian and transfer of title ensures direct and fast access to collateral
- Joint assessment of allocated securities lending revenues and additional costs charged to the fund

Neither BlackRock nor its clients have ever suffered a loss as a result of a borrower default since the inception of the securities lending programme in 1981

6. Liquidity

Critical questions

- What is the average daily volume of both the ETF and the underlying basket of securities?
- What is the average on-exchange spread?
- What is the screen depth of the market?
- Does the ETF provider offer resources to help clients achieve the best possible execution?

Key considerations

- Tight bid/offer spreads and sufficient market depth lower the cost for investors to enter and exit ETF positions
- It's critical to examine the real liquidity of the ETF through both its market volume and the liquidity of the underlying securities
- Stock exchanges such as SIX Swiss Exchange or Deutsche Börse provide liquidity measures for ETFs

The iShares Capital Markets can help match flows, minimise market impact, provide information on optimal execution and sources of liquidity

7. Total costs of ownership

Critical questions

- What is the Total Expense Ratio?
- What are the trading costs (spread, average daily trading volume, fee at NAV trading)?
- How are internal transaction costs minimized?
- What are the securities lending revenues?
- What is the swap pricing/fee?
- What is collateral cost?
- Are any costs incorporated in the index?

Key considerations

- Expense ratios are important; however all implicit costs such as trading, market impact, rebalancing should be factored in to determine the total cost of ownership
- Some ETFs providers show management fees which is only a part of the TER
- Transactions costs such as rebalancing costs and swap fees are not included in the TER

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