

 **Portfolio Management**

ETFs are different from Mutual funds because of their inherent structure and how they are created and redeemed.

While **mutual fund** shares must be purchased or sold at the end of the day from the fund manager, or via a broker at the closing NAV, an **ETF** trades intraday, or during the trading day, just like a stock.

ETF shares are created or redeemed in kind, in a shares-for-shares swap.

Creation/redemption enables ETFs to operate at a lower cost and with greater tax efficiency than mutual funds and generally keeps ETF prices in line with their NAVs. Unlike stocks, which come to market via an initial public offering

of fixed size, ETFs can be created or redeemed continuously.

### Example of an ETF, Bharat 22 ETF



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| **Bharat Bond ETF**Cabinet approves launch of India’s first corporate bond ETF |
| FEATURES | Each ETF to have fixed maturity dateETF will track underlying Index on risk replication basis3-yr and 10-yr plan**Edelweiss AMC will be the firm issuing the Bharat Bond ETF** |
| Fund to help CPSEs ETF units will |
| raise funds from debt be listed on the |
| markets exchanges. |
| Small unit Transparent NAVsize (Periodic live NAV$1,000 during the day) |
| Transparent Portfolio |
| (Daily disclosure on |
| website) Low Cost **(0.0005%)** |

The trading process of ETFs is very similar to the stocks and like stocks, they also trade in the secondary markets.

ISSUER

INVESTORS IN PRIMARY MARKET

PARTICIPATING DEALER

SECONDARY MARKET

WHEN INVESTOR IN THE SECONDARY MARKET SELLS ETF UNITS WHEN INVESTOR IN THE SECONDARY MARKET BUYS ETF UNITS

MARKET MAKER

BURSA MALAYSIA

INVESTORS IN SECONDARY MARKET

The **National Security Clearing Corporation (NSCC)** in the United States is the one that guarantees the performance of parties to trade on an exchange.

The **Depository Trust Company** (DTC), of which the NSCC is a subsidiary, holds the book of accounts — the actual list of security holders and ownership. This is maintained better at the member level rather than at an individual investor level.

Market Makers receive special treatment on the settlement requirements as their role is to make a continuous market in a given security by standing ready to buy or sell the security on the basis of demand/supply imbalances, they are more likely to end up truly short at the end of a given day. Market Makers are given up to six days to settle their accounts.

Majority of ETF owners in Europe are institutional investors. The market is also fragmented across exchanges, jurisdictions, and clearinghouses. This fragmentation leads to the use of many different trading strategies.

The two kinds of tax-based evaluations that must be made for all ETFs are as follows:

* First, an investor must consider the likelihood of an ETF distributing capital gains to the shareholders.
* Secondly, the investor must consider what happens when the investor sells the ETF.

These two actions are distinct; the tax efficiency of a fund regarding its capital gains distributions has no relation to its tax efficiency at the time of investor sale.

**1) Capital Gains Distribution**

Funds must distribute any capital gains to their investors which can be done annually or quarterly. However, ETFs are said to be more ‘Tax fair’ and ‘Tax efficient’, mainly because of two primary reasons:

**2. Other Distributions**

Other events, such as security dividend distributions, can also trigger tax liabilities for investors. In most markets, ETFs distribute their accumulated dividends; however, in some jurisdictions—notably in Europe—ETFs may have share classes that accumulate and automatically re-invest dividends into the fund.

**3. Taxes on Sales**

ETFs are taxed according to their underlying holdings. For example, in the United States, an ETF holding equities or bonds will itself be subject to the same capital gain, dividend, and return-of-capital tax rules that apply to its underlying stock or bond holdings. However, there can be specific nuances like for example, in the US, exchange-traded notes tracking commodity indexes are treated differently from exchange-traded funds holding commodity futures contracts, creating a preferential tax treatment.

**ETF risks include**

***Counterparty risk***

ETFs may expose investors to a counterparty risk where one of the counterparties involved in a transaction might default in its contractual obligation. Exchange-Traded Notes (ETNs) have a higher counterparty risk.

***Settlement risk***

ETFs using OTC derivative contracts as part of their strategy expose investors to the settlement risk of such contracts. ETFs mitigate settlement risk by frequent (e.g., daily, or weekly) settlement, and/or by requiring collateral to be posted.

***Security Lending***

ETFs are eligible to be lent to short sellers for a fee, these agreements are overcollateralized and the collateral is invested in short term risk free securities.

***Fund closures***

ETF closures involve selling the underlying holdings and making cash distributions to the investors, potentially with adverse tax consequences for them. *Soft closures* entail creation halts and changes in investment strategy. Closures may be triggered by changes in regulation, competitive pressures, or issuer merger. Increased competition may force ETFs that fail to attract sufficient capital to close prematurely.

***Investor related risk***

ETFs based on complex strategies (e.g., inverse or leveraged ETFs) may introduce the investor to risks that they may not fully comprehend (i.e., the outcomes may differ from investors’ expectations). These complex ETFs might use derivative products to implement their investment strategy that must reset daily (i.e., have daily settlement).

**ETF Strategies**

ETFs are used for a wide range of strategies ‒ some strategic, some tactical, and some dynamic. In these strategies, the timing of changes is based on market conditions.

**Primary applications are**

**Portfolio Efficiency**

To better manage a portfolio for efficiency or operational purposes this efficiency is important. Applications include cash or liquidity management, rebalancing, portfolio completion, and active manager transition management.

**Asset Class Exposure Management**

To achieve or maintain core exposure to key asset classes, market segments, or investment themes on a strategic, tactical, or dynamic basis is included.

**Active and Factor Investing**

To target specific active or factor exposures on the basis of an investment view or risk management need is a part of the investment.

**Portfolio uses of ETFs**

***1. Efficient Portfolio Management***

***Portfolio Liquidity Management***

Managers can quickly equitize excess cash by investing it in ETFs to reduce cash drag on the portfolio. Because of their superior liquidity, ETFs have a lower transaction cost as compared to other securities; portfolio allocations to ETFs can be used to cover future cash outflows.

***Portfolio Rebalancing***

ETFs can be used to cost-effectively rebalance portfolios to target specific asset class weights. ETFs can also be shorted to quickly reduce the weight of a specific sector or asset class.

***Portfolio Completion***

ETFs can be used to fill the temporary gaps in portfolio allocation. Gaps can arise due to the manager turnover (when the new manager has different macro views) or when the allocation differs of an existing manager from the desired exposure of the investor.

***Transition Management***

A new manager might temporarily invest in the ETFs as she winds down the portfolio allocations of the old manager to maintain market exposure during the transition period.

***2. Asset Class Exposure Management***

***Core exposure to an asset class or sub-asset class***

Portfolio allocations to passive indices of various asset classes/subclasses can be cost-effectively implemented using ETFs. Portfolios can be broadly diversified by investing in different sectors of equity asset class, commodities, bonds, etc. Targeted strategic allocation to a specific subsector can also be implemented for an investor based on suitability.

**Tactical strategies**

Managers can temporarily rotate money in or out of the sectors expected to perform better or worse using ETFs. Thematic ETFs can also be used to select subsectors (e.g., ecommerce versus the broad technology sector) that are expected to outperform. ETFs selected for short-term tactical strategies are selected based on lower trading cost and liquidity rather than low management fees. (Liquidity is evaluated using the ratio of average dollar volume to average the assets—higher is better).

***3. Active Investing***

***Factor (Smart Beta) ETFs***

The ETF strategy is based on return drivers (i.e., factors such as size and momentum). Within a single factor, competing ETF managers’ offerings may differ based on the factor chosen or the weights assigned to portfolio holdings (e.g., equal weighted versus cap-weighted). Long-term buy-and-hold investors seeking a desired factor exposure may choose to invest in these ETFs, expecting those factors to outperform.

***Risk Management***

Some ETFs are constructed to provide higher or lower risk relative to a passive index. Low volatility ETFs, for example, use rules to construct portfolios with low relative return volatility. Some ETFs may be constructed to hedge specific risks; currency-hedged global equity ETFs provide international equity exposure but without the added currency risk. Similarly, duration-risk-hedged high-yield corporate bond ETFs only provide exposure to credit risk while hedging the interest rate risk.

***Alternatively Weighted ETFs***

These ETFs are constructed using portfolio weights that differ from standard market cap weights (e.g., equally weighted, weightings based on fundamentals).

***Discretionary Active ETFs***

These are actively managed and are similar to closed-end mutual funds. The largest of these are fixed-income ETFs, which include exposures to senior bank loans, mortgage securities, and floating rate notes.

***Dynamic Asset Allocation and Multi-asset Strategies***

Dynamic top-down asset allocation ETFs that invest in stocks and bonds based on risk/return forecasts. These are popular among global asset managers and hedge funds for their discretionary asset allocation.

* + diversification
	+ risk



Thank You!