A spotlight on synthetic ETFs

Nick Good of BlackRock discusses the main characteristics and risks of synthetic ETFs, explaining why it is so important for advisers and investors to clearly understand these products.

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Interview

Nick Good

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- Investors need to fully understand exactly how they replicate the index, how they create the leveraged or inverse structures, and what this all means for the returns
- In terms of specific issues with synthetic ETFs, there are counterparty risks as well as other risks beyond those related to investing in emerging markets
- The most obvious thing which can go wrong with synthetic ETFs is the default of an issuer of the derivatives within the product

According to Nick Good in an interview, the biggest issue with synthetic ETFs is whether investors fully understand the risks which are associated with them.

ETFs are traditionally thought of as holding the underlying securities, he explained, which they typically do, especially in the US where the industry was started.

In Asia, however, especially as a lot of the markets are considered to be access markets, Good said that is not possible.

What to understand with synthetic ETFs

Synthetic ETFs are in high demand, and can be very attractive for those investors who want to use them.

However, warned Good, investors need to fully understand exactly how they replicate the index, how they create the leveraged or inverse structures, and what this all means for the returns, especially for long-term holders to ensure they encounter no surprises.

At the same time, he said some ETFs offer difficult-to-access products and asset classes, for example commodities currencies, where the nature of the product does what it is supposed to do, but many investors might not naturally understand what exactly the index is supposed to be tracking or how that portfolio is created.

Good said he would advise those investors who don't understand the more exotic products to either make sure they are fully educated, or look to make the returns they are looking for through vehicles which they can understand.

In terms of specific issues with synthetic ETFs, there are counterparty risks as well as other risks beyond those related to investing in emerging markets, explained Good.

In response, he said iShares has developed various mechanisms to minimise risks to investors, for example a dynamic counterparty management model to try to manage the exposures and diversify counterparty risk across multiple counterparties.

Importantly for investors, he added ETF providers which maintain a deep and liquid market through multiple market-makers enable investors to make decisions to sell their products at any time, rather than going back to the same provider who sold them the ETF to get their money back.

What can go wrong

According to Good, the most obvious thing which can go wrong with synthetic ETFs is the default of an issuer of the derivatives within the product.

Depending on the nature of the fund, he said there are different ways to deal with this. That is why Good said he encourages investors to fully understand the fund structure and the provider behind it.

He said it is important to iShares that for every product it puts out in the market, that product operates the way it is supposed to, and as far as possible tracks the indexes it is supposed to track.

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