Separating ETF myth and reality

Anthony Chan of BlackRock looks at some of the common myths in relation to ETFs, and explains the issues that investors should think about to distinguish fact from fantasy.

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Interview

Anthony Chan

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Anthony Chan

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- A lot of recent press about ETFs has been negative, highlighting a lack of understanding about how they work, and in turn creating a lot of misconceptions
- It is important for people to understand how ETF structures have evolved over time, as well as issues over liquidity, tracking error and short interest
- For more effective analysis on ETFs, investors need to look at qualitative and quantitative factors
- People should only buy an ETF if the exposure it offers matches what they want

According to Anthony Chan in an interview, despite a lot of initial discussion and commentary focusing on the benefits of ETFs and their innovative nature, a lot of recent press has a been a bit more negative.

This has gathered momentum, he said, with a growing number of people looking at potentially what is wrong with the product and whether there are any scandals to reveal.

Although some of these reports do raise important questions which investors and advisers should be asking, Chan said that a lot of the details in the discussions highlight a lack of understanding about how ETFs work, in turn creating a lot of misconceptions.

As a result, people need to be clear on the facts and fantasies of ETFs, he added.

Myths to address

According to Chan, it is important for people to understand how ETF structures have evolved over time, because they have become a lot more complex than their original form.

Liquidity is another key area which has had a lot of attention, he said, so it is important to understand how liquidity has evolved and the impact it has on investors.

And tracking error is another aspect of ETFs where there are a lot of questions, and also a lot of misunderstanding.

Short interest must also be understood, added Chan, especially since this has been the focus of a lot of recent negative publicity surrounding ETFs in the US, and the fact that a lot of ETFs do have short interest which is much higher than 100%. The question, therefore, is whether investors should be concerned about this.

Effective due diligence

For investors to be able to do more effective analysis on ETFs, Chan said BlackRock has broadly tried to create a due diligence framework which is split into two buckets – qualitative factors and quantitative factors.

On the qualitative side, he said it is important to look at the structure and provider. For example, at its simplest level, any due diligence that should be done on a fund should also be done on an ETF. Structural issues also include legal domicile and subsequent tax implications.

In terms of providers, Chan said it is important to look at the services provided, the size of the firm and the risk controls in place.

On the quantitative side, he said it is critical to look at: cost, including management expense ratios; at investment strategy and benchmark exposures; and also at the trading side of ETFs, which incur costs like commissions and bid-offer spreads.

All elements need to be considered in parallel for investors to reach a final conclusion, Chan explained.

Importance of investment strategy

According to Chan, before buying an ETF, investors must think about their investment strategy.

People should never buy an ETF just because it has been launched, he warned. Instead, they need to look at the exposure it offers, and consider whether that exposure is something they want.

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Contact the editor:

T 852 2563 8683
E editor@hubbis.com
W www.hubbis.com

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