Exchange Traded Funds and Investment Strategies

Interview with Marcel Wagner, Head Index Selection Mandates, Credit Suisse, Zurich

Mr Wagner, together with Daniel Niedermayer, you have written a comprehensive book spanning over 400 pages that looks at Exchange Traded Funds and investment strategies. What is the aim of the book?
Our book aims to provide a solid overview of the world of ETFs and explain how these financial instruments can be used to make sensible investment decisions. It should give readers the knowledge they need when it comes to tackling the ever-increasing product range. ETFs are primarily understood and treated as tools that you have to know how to use properly. The principle for the technical details is "as much as required, but not too much". One main goal of the book is to address the practical implementation of investment strategies using ETFs. This means we have had to make a link between the products and how they are used. The practice book is intended as both a fundamental book as well as a work of reference aimed at interested private investors, client advisors, but also students or journalists.

How well do investors understand the way ETFs work?
Increasingly well. The fundamental principle behind ETFs is easy to understand, but on closer inspection, investors require knowledge of a number of different areas to use what appears a relatively simple instrument. To understand how they work, aspects of both the world of funds and the world of equities are important. The "hybrid character" of ETFs, for example, is key when it comes to understanding the various valuation options for them. The terms bid/ask price and closing price come from the world of equities, as does the tradability during the day. NAV and premiums come from the world of investment funds. In terms of possible structures, for a long time many investors barely knew whether ETFs engaged in securities lending and borrowing, or if they used a fully-funded or total return (unfunded) swap. This sort of discussion was the preserve of professionals.

Is this not the case anymore?
Private investors have been aware of this issue since a number of critical reports in 2011. Whether they can make proper use of these, however, remains to be seen. It must be remembered that in legal terms, ETFs are ring-fenced assets, which provides a high degree of security for investors. Interestingly, very few people know that these techniques can also be employed with active investment funds. I think it is very important that investors understand the fundamental way in which ETFs work and their structure, so that they know how to correctly select such products and use them within the context of their portfolios.

Where are the gaps in private investors' knowledge when it comes to ETFs?
I often get the impression that investors are not aware that ETFs incur real investment costs. It is not a given that an ETF will replicate a benchmark perfectly, as unlike ETFs, a benchmark is a paper portfolio. Many investors also expect the TER (total expense ratio) to include all the costs. This is unfortunately not the case. Transaction costs in the ETF, for example, are not contained. Another point is the tracking error, which is defined as the standard deviation of an ETF's return differential from its benchmark index.

How well do private investors perceive the tracking error?
How to interpret the tracking error is not always obvious for many investors. Given the mathematical nature of the figure, a significant out- or underperformance is possible even with a low tracking error. If this value is high, you can expect high return differentials from the index. With a low tracking error, however, deviations from the index are not necessarily small, as is often expected. A tracking

error of zero does not necessarily mean that an ETF perfectly replicates the index returns. If a fund systematically underperforms, for example due to management fees or swap costs being deducted on a daily basis, a low tracking error is possible even in the event of underperformance. As such, the tracking error on its own is not enough to properly assess the tracking of an ETF.

What should private investors pay attention to when trading?
If investors are aiming for optimum execution, mainly on the timing and the spread. It is also recommended that they work with limits. These points are not as important if news is expected that may impact the price or if investors cannot otherwise wait before making the trade. Ideally, the underlying securities should be being traded at the time an ETF is bought or sold. This enables a price to be found efficiently for the ETF.

What are the consequences of a closed underlying market?
If the market is closed, the market maker must take responsibility for pricing and hedging, for example by using traded futures or similarly correlated (but traded) securities. While this pricing method is usually very good, it cannot replace the underlyings. If investors, for example, want to buy an ETF based on the S&P 500 on SIX Swiss Exchange, in principle, they should not do this until after the US markets have opened at 3:30 pm. An exception to this rule is ETFs based on global emerging market indices. By the very nature of things, there is no point at which all markets around the world are open at the same time. Investors should focus on whether and when an ETF is traded in high volumes. As a rule, this is most likely to happen when US markets are open, as that is when the most hedging opportunities are available.

Next to timing you mentioned the spread. How can private investors evaluate whether the spread is tight?
Before executing a trade, the current spread should be evaluated. In practice, the absolute figure is usually given (price paid less the bid price), but this is less significant. To evaluate the ETF, the percentage spread is key. The easiest way to judge whether a spread is high or not is to compare the spreads of similar ETFs on the same or other exchanges. The Internet sites of the relevant exchanges can help in doing so. If available, the historic spreads of the same ETF can be compared. For a meaningful comparison of historic and current spreads to be possible, there must be similar market conditions. In general, the more liquid the underlying index is, the simpler it is in operational terms for the ETF trade to be settled for the market maker, and therefore the lower the bid/ask spread will be. To make trade-relevant information available to private investors, the Swiss exchange, for example, periodically publishes liquidity data. The Swiss exchange's "Market Quality Metrics" include the average spreads (time-weighted), the spread availability rate and additional figures for all ETFs listed on SIX Swiss Exchange on a daily basis.

Can you give an indication on average spreads?
In our book we analyzed spreads on SIX Swiss Exchange and for 2010, for example, we found a median spread of 0.3% for equity ETFs and 0.2% for bond ETFs. At over 1%, the 90th percentile for equities is relatively high. This group contains an above-average amount of ETFs based on emerging markets, inverse and leveraged indices and small-cap equities. High spreads are also possible for bond ETFs. Some corporate and emerging market bond ETFs can have spreads of 2% or more. Under certain circumstances, such costs can completely wipe out the return expected from the instrument. There is a particular risk of this occurring in a low interest rate environment. If the high spread is only temporary and is not likely to last, it can be a good idea to wait for more favorable trading conditions.

The following table shows the average expected spreads. These figures should only be used as a guide for an average amount not exceeding the volume of the market maker.

ETF based on	Normal	Low	High

ETF based on	Normal	Low	High
EUR government bonds 1–3	10 – 15	< 10	> 20
EUR government bonds 7–10	20 – 40	< 20	> 40
USD government bonds 1–3	10 – 15	< 10	> 20
USD government bonds 7–10	15 – 25	< 15	> 30
Corporate bonds	30 – 40	< 30	> 50
Large-cap/blue-chip equities	10 – 20	< 10	> 30
Small-cap equities	30 – 60	< 30	> 60
Emerging market equities	40 – 70	< 30	> 70

Legend: Average expected spreads in basis points. In practice, these values can vary significantly depending on conditions. The values are based on the Market Quality Metrics of SIX Swiss Exchange and personal experience.

Prior to concluding a transaction, the iNAV (indicative NAV) can be compared with the current price. However, investors must also understand the characteristics and limitations of the iNAV calculation, which is of particular relevance for bond ETFs or different time zones.

In your book you describe how to implement various investment strategies using ETFs. Just how well can this work for private investors?

I think it can work very well. ETFs help to broadly diversify risk and maximize returns – and they are relatively cheap and simple to acquire. In addition to simpler strategies, ETFs also allow investors very precise "views" and can be used in core/satellite strategies. As ETFs also remain aligned with their strategies, there is no manager risk. Nevertheless, unlike active funds, you cannot rely on managers, expecting them to react to market conditions. This is where investors have to act. If global allocations or sophisticated strategies are implemented, this requires careful selection and a knowledge of a variety of investment themes. Investing takes a great deal of discipline and patience. In practice, many investors start off believing that they can do it themselves, but are then often quickly overtaken by reality. When it comes to defining and implementing an investment strategy, it can be a very sensible idea to seek the assistance of a specialist. The process is anything but straightforward and is often underestimated.

Authors

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Marcel Wagner works as a portfolio manager at Credit Suisse AG in Asset Management in Zurich and is the Head of Index Selection Mandates. He studied economics at the University of St. Gallen (lic.oec.HSG), is a Certified International Investment Analyst (CIIA) and Chartered Alternative Investment Analyst (CAIA).

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Exchange Traded Funds and Investment Strategies
The ETF Practice Book (German only)
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A new, comprehensive work on Exchange Traded Funds, "The ETF Practice Book", is now available. It was written by practitioners for practitioners. In 430 pages, the authors Daniel Niedermayer and Marcel Wagner explain how to use ETFs in a targeted manner and what issues investors should pay attention to. The book is ideal for anybody wanting to know more about ETFs, indices and investment strategies. It contains 100 pages on ETFs, 100 pages on indices, and 150 pages on asset allocation, investment strategies and how to implement them.