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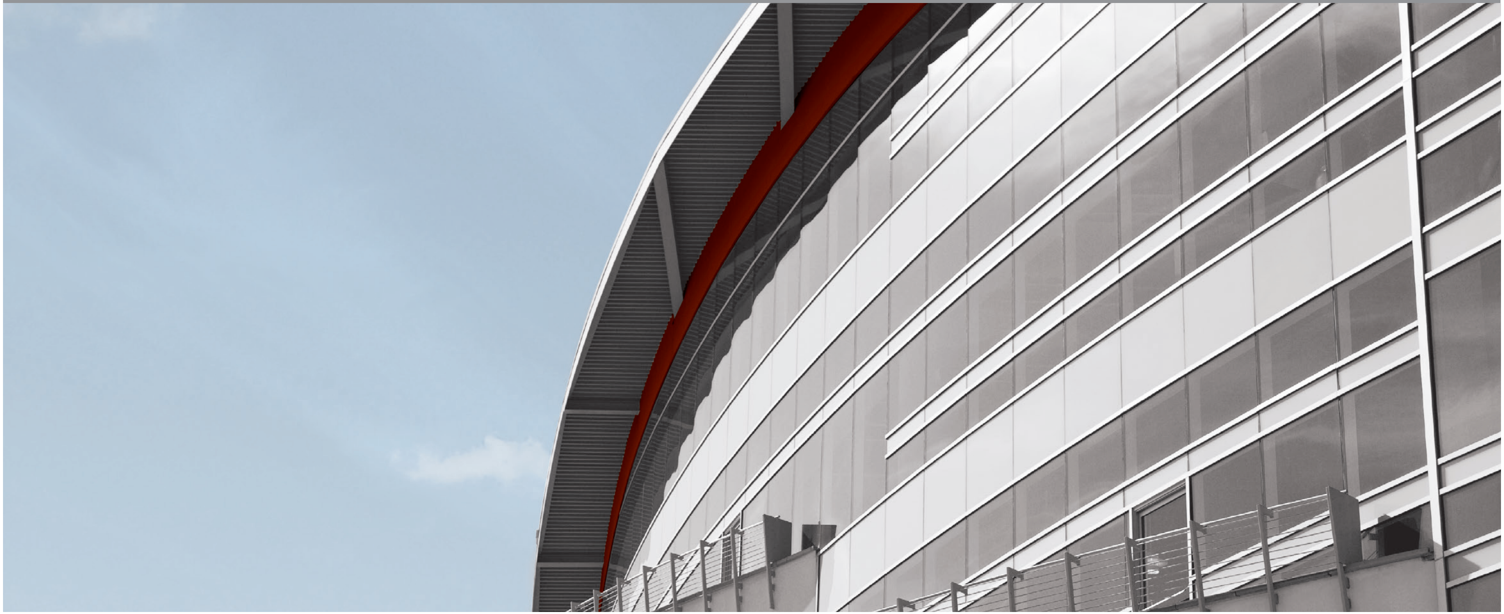
# Exchange Traded Funds (ETFs)
## Understanding index ETFs and how they work



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**The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.**

This guide aims to give you a better understanding of Exchange Traded Funds (ETFs), and the increasing number of options your adviser has when recommending an investment strategy for you.

This guide:

1. Provides a straightforward introduction to ETFs.
2. Explores ETFs and their role in investing.
3. Describes how ETFs work.
4. Outlines the reasons why an adviser may choose to recommend ETFs over other types of fund structures.
5. Lays out what you, with the help of your adviser, may want to consider before investing.

This guide should help you to gain an understanding of the basics of ETFs and how they work. It may also help you to understand how and why a financial adviser might include ETFs in your investment portfolio. You will find a glossary of terms later in this guide.

# Contents

# Why consider ETFs?

There are a number of reasons why your adviser might recommend an ETF (based on your circumstances and risk profile) including flexibility, transparency or cost.

## Diversification

Like other index funds, a basic index ETF offers broad diversification across an entire market by holding all or most securities in the index. Holding a broad base of assets helps ensure that an investor is exposed to the best-performing market segments, which also helps to offset weakness in others.

## Targeted investing

Some ETFs track indices in specific market segments, such as large US companies or specialist types of bonds, for example. This can be an important tool that your adviser can use when constructing a portfolio to meet your investment objectives.

**What is an index?**
An index is a collection of shares or bonds chosen to represent a particular part of the market. Index investors use indices to track market performance. In fact, a change in the return of an index should produce an almost identical change in the price of a fund that tracks it.

## Flexibility

ETFs can be bought and sold quickly and easily. As a result, your adviser can use them to restructure your portfolio swiftly following a change in your life circumstances or goals.

## Transparency

If your adviser selects a straightforward index ETF, it's a very transparent investment because it simply holds most or all of the stocks in an index and the holdings are disclosed daily. That way your adviser truly understands the market risks that they are exposing you to and can explain them to you.

## Potentially lower annual costs

Many ETFs have lower annual costs than traditional index funds. This can have a significant impact on the investment returns your portfolio earns over the long term. However, ETFs have some up-front trading costs that traditional index funds don't, which are explained later in this guide. You and your adviser will need to carefully consider the full cost of investing to make sure you're getting the best deal possible for your particular circumstances.

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# What are Exchange Traded Funds (ETFs)?

The number of ETFs available to UK investors is growing rapidly and many advisers are recommending ETFs for their clients' portfolios. ETFs can be a useful tool for constructing broadly diversified long-term portfolios, as long as both investor and adviser clearly understand what they are and how they work.

## Another type of pooled investment fund

ETFs are usually nothing more than another type of pooled investment fund. They differ from other pooled funds in that shares in an ETF trade on a stock exchange like listed company shares, rather than through an investment manager. The most popular ETFs simply track major indices, such as the FTSE All-Share Index in the UK or the S&P 500 Index in the US.

Most of these index ETFs track their respective indices by investing in all, or a representative sample, of the companies included in the underlying index. Some, however, use specialist financial instruments to track the index. If your adviser recommends an index fund for you, they should clearly explain how the fund tracks an index and all the risks involved.

Because ETFs are easily tradeable and sometimes offer cheaper annual charges than other types of pooled funds, they are attractive to many types of investors. This guide covers several important factors you and your adviser will need to consider before investing in ETFs.

## Some key terms

**Active management** – An investment management approach where the manager selects securities from the investment universe prescribed by a fund's investment objective. The goal of an actively managed fund is to beat, rather than simply match, the return from a particular market index or benchmark.

**Asset** – An item of economic value that can be converted into cash, such as real estate, bonds or shares

**Bond** – A loan certificate issued by a government, public company or other body. The issuer agrees to repay the original amount borrowed after an agreed time (when the bond matures). Bonds usually repay a fixed interest rate (known as the coupon) over a specified time.

**Bid-offer spread** – The difference between the buying and selling (or offer and bid) price of a unit in a fund. The size of the spread is affected by factors such as current trading volumes and market conditions.

**Diversification** – A strategy for helping to protect against risk by spreading investments across different types of investments.

**Equity/share** – A share is a stake in the ownership of a company. Also known as a stock.

**Index** – A portfolio of securities assembled with the goal of closely matching a market or economy.

**Index or passive management** – An investment approach aiming to closely match the returns of an index or other benchmark.

**Mutual or pooled investment fund** – An investment vehicle where a number of individual investors pool their money to create a large, professionally managed fund.

**Net asset value (NAV)** – The value of a fund's assets less its liabilities.

**Open-ended fund** – A pooled investment scheme where the number of units in the fund varies according to the number of investors buying and selling holdings in the fund.

**Portfolio** – A combination of investments held in one place. A portfolio is frequently created to meet particular investment objectives, such as providing capital growth or regular income.

**Security** – Freely tradable assets that are quoted on an exchange including shares, bonds and derivatives.

**Stock** – An investment that represents an ownership interest in a company. As owners, stockholders are entitled to a proportionate share of the profits of a company. Stocks are traded on the stock exchange and their value fluctuates depending on the success of the business.

**Stockbroker** – An agent dealing in the stock market on behalf of individuals or institutions. Sometimes they offer investment advice, other times they simply execute the trades their client wants. There are also online low-fee stockbrokerage services.

**Stockmarket** – Secondary markets, such as the London Stock Exchange, where previously issued securities are bought and sold.

**Unit** – a proportion or share of a fund based on the net asset value (NAV) of the fund that can be bought or sold.

# ETFs: another way to invest in index funds

Most, but not all, ETFs use 'index' strategies, which means they usually track a major equity or bond index.

## What is index management?

Index (also known as passive) managers generally believe it is difficult to out-think the market, so they try to match the performance of the market (or their chosen sector) as a whole.

They tend to do this by closely following or tracking an investment index, such as the FTSE All-Share Index, which tracks the combined performance of nearly all the stockmarket shares traded in the UK.

That's why passive investments are often called index funds or tracker funds. They have a simple, precise objective: to seek to match the performance of a specific index, rather than to try to beat it.

Passive managers do this by buying and holding all or a representative sample of the securities in the index. The advantage of this approach is that it spreads risk widely within a market, avoiding the losses that can follow a dramatic decline in any one specific company or industry sector. However, risk is spread rather than avoided. The passive approach cannot protect against broad market declines. If the index goes down, the index fund will go down by the same degree.

Please see the guide in this series called *Active and passive investing: What you need to know*, for a more detailed understanding of the nature of index management. The guide is available free on our website.

## Another type of pooled fund.

ETFs simply provide a way to access the return of a market index, in the same way as any other type of pooled or mutual fund that tracks an index. But there are some differences.

With a pooled fund, investors combine their money in a fund, which then invests in a range of securities. Each investor shares proportionally in the fund's investment returns including any income. Every pooled fund has a manager who invests according to the fund's objective. Depending on this objective, a fund may invest in equities, bonds, property, cash or a combination of these assets.

ETFs are a type of pooled fund.

- Buying shares in an ETF is done through a stockbroker or an online platform, rather than directly with the fund management company.

- The share price is continually updated by the stock exchange throughout the day, rather than provided by the fund manager once per day.

- The annual charges are, on average, cheaper for ETFs because they are slightly cheaper to run. But because they are bought and sold through a stockbroker, there are some trading costs, such as stockbroker commission, that can offset this saving, which you and your adviser need to take into account.

- Most ETFs hold all (or a representative sample) of the underlying securities in the target index. Some, however, use specialist financial instruments to track the index. No one technique is better than the other, but it's important that you discuss this with your adviser to ensure you understand the type of fund you are investing in and the risks involved.

- Most ETFs disclose the securities in the underlying portfolios daily, which means investors always know what the ETF holds.

# ETFs in context

Index funds come in a number of different types, of which ETFs are only one. Understanding the differences can help you to work with your adviser to make the choices that are right for you.

## Exchange Traded Funds (ETFs)

A pooled investment with shares that trade on a stockmarket like an individual share or bond. ETF shares are priced and traded throughout the business day, and they can be bought and sold through a stock broker or online broker platform. ETFs can be actively managed or indexed, although the vast majority of ETFs currently available are indexed.

## OEIC (Open-Ended Investment Company)

A pooled investment fund similar to a unit trust, but established under company law, rather than trust law. As such, it issues shares, rather than units, but these are not traded on a stock exchange, they are issued by the OEIC itself. The OEIC increases or reduces the numbers of shares issued in response to demand from buyers and sellers, which is why it's called `open ended'.

## Unit Trust

A pooled fund established as a trust. A unit trust is an open-ended investment. This means that the manager can create or cancel units depending on public demand.

## Investment Trust

A closed-ended fund (a fund with a limited number of shares) established as a company, with the aim of producing returns by investing in other companies. Investment trusts trade like shares on stock exchanges and are priced and traded throughout the business day. They can be bought and sold through a stockbroker.

## Summary of differences

| | ETF | OEIC | Unit Trust | Investment Trust |
|---|---|---|---|---|
| **Structure** | Open ended | Open ended | Open ended | Closed ended |
| **Pricing** | Price linked to Net Asset Value (NAV), but can also be affected by market movements | Single price, linked directly to NAV | Bid-offer spreads apply, with price directly linked to NAV | Price indirectly linked to NAV and driven by market |
| **Trading** | Any time during market hours at real-time prices | Once a day on unknown future prices | Once a day on unknown future prices | Anytime during market hours |
| **Access** | Purchased and sold on stock exchanges through stockbrokers | Directly with fund manager, online platform or adviser | Directly with fund manager, online platform or adviser | Purchased and sold on stock exchanges through stockbrokers |
| **Investment style** | Active or index | Active or index | Active or index | Active (small number of index) |
| **Can it be used in an ISA?*** | Yes | Yes | Yes | Yes |

*ISA – A tax-efficient savings or investment wrapper created by the British government. You can only invest up to a set limit in each tax year. For more information please see the HMRC website at http://www.hmrc.gov.uk/isa/

# How to invest in an ETF

Investing in an ETF differs from investing in conventional funds, which can increase their appeal in certain circumstances. However, it also means there are a number of things you and your adviser need to consider carefully before investing.

## ETFs trade on the stockmarket

ETFs are traded on a stock exchange, so they can be bought and sold through a stockbroker or online platform anytime the market is open. Like all investment funds, ETFs entail the same risks and potential rewards of the markets. The value of ETF shares will rise and fall with the wider stockmarkets, so an ETF can gain or lose value over short or long periods. This means that an investor could get back less than they invest. Your financial adviser can work with you to establish an asset mix with a risk/reward profile that suits you.

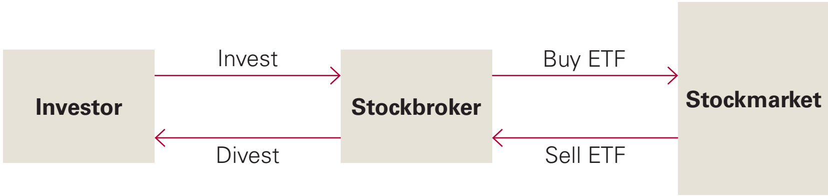
## Investing in an ETF

Investing in ETFs entails stockbroker commission and a bid- offer spread which should be considered fully before investing. Your adviser will work with you to find out if your portfolio would benefit by including one or more ETFs.

Your adviser will then place an order to buy ETF shares on your behalf with a stockbroker or online platform with a stockbroker link. The broker will then initiate the trade in the stockmarket. A stock exchange, such as the London Stock Exchange, will complete the trade with the stockbroker on your behalf. When the transaction is complete, the ownership of the ETF shares will transfer to you.

## Investing in an ETF

ETFs are bought and sold through a stockbroker or online broker/platform, which can be arranged by your financial adviser.




**Stockbroker**
An agent dealing in the stockmarket on behalf of individuals or institutions. Sometimes they offer investment advice, other times they simply execute the trades their client wants. There are also online low-fee stockbrokerage services.

# Things to think about before investing in an ETF

Your adviser will consider a number of factors before selecting an ETF for you. This section outlines some of those factors so that you can discuss them with your adviser when they work with you to construct your investment portfolio.

## What your adviser will consider

Your adviser will help you determine if ETFs are right for you based on the following:

- Your investment objective
- Your full risk profile
- Investment time horizon
- Transaction amounts
- Costs, including trading costs and annual charges.

Trust your financial adviser to answer any questions you may have about ETFs and to explain how they can be used to help you achieve your financial goals.

## Your investment objective and risk profile

One of the first things your adviser will do is work with you to understand your investment objective(s), investment time horizon and risk profile. This should form the basis of any investment recommendation they may make. You can use the series of educational guides available free on our website at **vanguard.co.uk** to help you understand the process your adviser will go through.

## ETF costs in context

Unlike other types of mutual funds (except Investment Trusts), ETFs trade through a stockbroker with stockbroker charges and other trading costs involved when you invest. These costs will affect the decision your adviser makes about when and how to recommend using ETFs in your investment portfolio.

## Transaction amounts

Some stockbrokers or online broker platforms charge a flat fee for each trade, whether buying or selling. Your adviser will consider how high this fee is relative to the amount that you are likely to invest in an ETF. If the trade is relatively small, it might not make sense to use an ETF, but with larger trades, it might.

## Regular savings

Again, because of stockbroker charges on buying and selling ETFs, it might not make sense to use ETFs for regular investing. Your adviser will need to consider whether those charges offset the generally lower annual charges of ETFs.

## Time horizon

Even though ETFs generally have lower annual charges, the trading costs of dealing in stockmarket shares can make the initial investment costs more expensive than a traditional index mutual fund. It might take some time for the cheaper annual charges to result in a lower cost of investing for an ETF vs. a traditional index mutual fund. Your adviser will need to calculate the full cost of investing so that they ensure that you fully understand the costs of investing up front and over time.

# What next?

This guide has explored how ETFs work and what you and your adviser need to know about before selecting an ETF as part of a broadly diversified investment portfolio.

You should now have a better understanding of when and why your adviser might recommend an ETF for your portfolio and how they may use them to help you meet your financial goals.

Visit our website at **vanguard.co.uk** to access the entire suite of investment education materials that we have produced to help you work with your adviser to gain a deeper understanding of investments.

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The value of investments, and the income from them, may fall or rise and investors may get back less than they invested.

ETF shares can be bought or sold only through a broker. Investing in ETFs entails stockbroker commission and a bid- offer spread which should be considered fully before investing.

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