

Selecting the most suitable ETF

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THERE are a number of factors to consider when investing in Exchange Traded Funds (ETFs). Here are a few important factors used by investors to select the best "fit" ETF. ETFs offer investors a cheap and easy way to invest. Listed on a stock exchange, ETFs trade like shares but offer diversification and exposure akin to an index unit trust fund. The performance of an ETF and an index fund depends on its underlying index but ETFs are cheaper to acquire and can be bought or sold at their current value. In comparison, unit trust funds impose sales charges or redemption fees and priced once a day. There are a few factors unique to ETFs which investors should consider when deciding on which to invest in. This minimises the chances of acquiring an ETF that does not meet specific needs, preferences or complements a portfolio. To find the best "fit" ETF, consider the following points: **Determine what the ETF offers** There is a wide array of ETFs in the market and this makes it possible to construct a portfolio using ETFs as core holdings (refer to box below). ETFs can also be used as tactical investments if investors acquire specific industry ETFs. After establishing an investing strategy and the role that the ETF plays in a portfolio, read the ETF's description and objectives to ensure that it fulfills your overall investment plan. Look at the underlying assets held by the ETF and its top holdings are already in your portfolio perhaps as individual stocks or via unit-trust funds. Basic information about the ETF value and portfolio composition is available on its website. **Examine fees involved** The cost to invest has a significant impact on the returns of a portfolio. Much like shares, ETFs trade on a stock market and investors must pay for brokerage fees, stamp duty and clearing cost. The manager fee, however, depends on the ETF issuer and can differ. Malaysia's first equity ETF, FMB30etf managed by AmInvestment Services Bhd has a manager fee of 0.5 per cent per annum. Asia's first Islamic ETF, MyETF-DJIM25 which is managed i-VCAP Management Sdn Bhd levies a manager fee of 0.4 per cent per annum. The country's first ETF, ABFMY1, is a bond ETF with a manager fee of 0.1 per cent per annum. **Consider liquidity and size** Unlike stocks, all ETFs have a creation and redemption process that keeps its market price in line with its underlying net asset value. This process creates new ETF units when demand increases. The reverse of the creation process occurs when authorised market participants redeem large blocks of ETF units, usually after many investors sell their ETF investments, in exchange for its underlying basket of securities. Due to this structure, the degree of the ETF's liquidity depends primarily on the trading volume of its underlying securities. Generally, ETFs that invest in large-cap stocks, broad market indexes and investment grade bonds are more liquid than ETFs that invest in narrow niche industries. Trading volume of the actual ETF indicates investor's interest in that particular ETF. Extremely low liquidity can have a minimal impact on the ETF's bid-ask spread. Higher spreads, the difference between the "bid" and "ask" price of an ETF cost a little bit more to trade. The more illiquid ETFs tend to have wider bid-ask spread.

Investors should consider the size of the ETF as issuers may close and liquidate their smaller, unpopular ETFs. American ETF issuers, Claymore Securities Inc closed 11 of their 37 ETFs last year while Invesco PowerShares Capital Management LLC closed 19 ETFs in early 2009.

Although investors get their capital back once the ETF's underlying assets have been liquidated, this situation is far from ideal for those planning to hold ETFs for long-term. Investors should decide on which factor is more important than others. For example; some may find the ETF's investment objective and index exposure to be the most important criteria while fees and size are secondary considerations. But all criterions must be

known to make an informed decision. *The article is written for general information purposes only. The information contained does not constitute legal, financial, trading and/or investment advice and neither does it make any recommendation or endorsement regarding the services mentioned herein.*

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