ETP Due Diligence Guide

Step-by-step guide to selecting the right products for your clients

The exchange traded product (ETP) industry has undergone significant transformation since the first product was launched in 1993. Today the European ETP industry has over 7,000 listings with assets of $599 billion[1] covering a multitude of exposure types.

Alongside the vast universe of ETPs, varying investment strategies and product structures have been introduced highlighting new challenges for intermediaries and investors looking to navigate through the ETP selection process.

At ETF Securities we understand the importance of conducting thorough due diligence on ETPs. The following framework is designed to assist with the product selection process, ensuring that the right solutions are chosen to meet client objectives.

ETPs: The UK Regulatory Framework

The Retail Distribution Review (RDR), implemented in 2012, introduced new regulatory requirements resulting in significant changes to the manner in which financial products are distributed to retail investors in the UK. It is worth noting that the Financial Conduct Authority (FCA) prohibition on the marketing of non-mainstream pooled investments to retail investors does not apply to ETPs (Policy Statement PS13/3). The table below outlines the current position for FCA permission, appropriateness and RDR as they relate to ETPs.

Product	Permission framework	Appropriateness	RDR
Exchange Traded Funds (ETFs)	As UCITS, ETFs are considered units of collective investment schemes	UCITS ETFs are generally considered non-complex. Certain UCITS ETFs that track strategy indices may be deemed complex	ETFs are within the scope of the RDR rules on commissions
Physically backed exchange traded commodities (ETCs)	Per current FCA policy, these are considered debt securities	Physical ETCs are not UCITS in themselves but are generally deemed non-complex	ETCs are within the scope of the RDR rules on commissions
Synthetic/swap-backed ETCs	Per current FCA policy, these are considered transferable securities and CFDs	Swap-backed ETCs are not UCITS in themselves and are deemed complex	ETCs are within the scope of the RDR rules on commissions

[1] ETFGI, Europe ETF and ETP Industry Insights, January 2017 (February 2017)

1. Evaluating the underlying exposure

Understanding the underlying benchmark is fundamental to conducting due diligence on an ETP and in ultimately answering the question of whether a product meets a client's objective.

Equities

Factors to consider	Why is this relevant?
☐ **What is the exposure?**	To understand the underlying risks of investing in equity ETPs, investors should look at how a given index is tilted in respect to factors like geography (e.g. the MSCI World Index has a significant weighting towards the United States), sector (e.g. the FTSE 100 is heavily weighted towards energy related companies) or market capitalisation.
☐ **What is the weighting methodology?**	The way in which the index constituents are weighted can vary. For example, the FTSE 100 is a market capitalisation-weighted index, whereas the Dow Jones Industrial Average (DJIA) is a price-weighted index. The weighting methodology of an index can impact its risk profile.
☐ **What is the index return profile?**	Equity indices typically come in two return profiles – Total Return (TR) and Price Return (PR). Total return indices provide an exposure to price movements in the underlying companies plus the dividends that these companies may pay out. In contrast, price return indices only track the price movements of the underlying companies, they do not take dividends into account.
☐ **How are dividends dealt with?**	Total return equity indices can either accumulate or distribute dividends. If the ETF distributes income, it is important to understand the frequency of the distributions as well as the underlying currency in which distributions are paid out in.

Fixed Income

Factors to consider	Why is this relevant?
☐ **What is the exposure?**	Fixed income ETFs aim to track the performance of fixed income indices, which provide exposure to different types of bonds (i.e. sovereign or corporate bonds) across different geographies, sectors and maturities.
☐ **What is the weighting methodology?**	Typically, the majority of fixed-income indices are weighted based on market value (total outstanding debt issuance). However, some indices now select their holdings based on fundamental factors such as size, indebtedness and issuer dynamics.
☐ **What is the index return profile?**	The majority of fixed income indices provide a total return (TR) exposure, meaning that they provide an exposure to both movements in bond prices and distributions.
☐ **How is income distributed?**	As with equity indices, fixed income indices can either accumulate or distribute income. It is important to understand the frequency of distributions as well as the underlying currency in which distributions are paid out.

Commodities

Factors to consider	Why is this relevant?
☐ **What is the exposure?**	Precious metal exchange traded commodities (ETCs) will generally be backed by physical metal and provide an exposure to movements in spot prices. In contrast, most other commodity products (e.g. crude oil or agricultural ETCs) will provide an exposure to price movements in futures contracts that are rolled on a predetermined schedule. It is important to recognise that a futures exposure is different to a spot exposure.
☐ **What to do with physical metal commodity products?**	If securities are backed by physical metal, investors should consider where the metal is vaulted, whether the metal is held in allocated form and how of en it is independently audited.
☐ **What to do with futures based commodity products?**	Most other commodity products will provide a total return exposure to commodity futures. The total return exposure comprises of the futures contract return, the roll return (cost or benefit of rolling futures contracts) and the collateral yield. It is important to recognise that the roll yield (reflecting the cost of carry) can be both positive and negative and will of en be the primary factor driving the divergence between spot and futures returns.

Currencies

Factors to consider	Why is this relevant?
☐ **What is the exposure?**	The currency spot market is primarily an over-the-counter (OTC) market, therefore currency ETCs track currency indices that provide exposure to single currency pairs or baskets of currencies. These indices will be exposed to currency forwards that are usually rolled on a daily basis.
☐ **What are total return currency indices?**	Currency indices will generally provide a total return exposure that comprises of the daily spot price movements (obtained by buying and selling forward contracts), the interest rate differential (the difference in interest rate between a pair of currencies) and the collateral yield. Although not a spot exposure itself, the daily rolling of currency forwards can provide an exposure close to the spot price.

Other Exposure Considerations

Factors to consider	Why is this relevant?
☐ **Is there any unintended currency exposure?**	It is important to be aware of any underlying currency risks associated with holding assets denominated in a foreign currency. For example, if a sterling based investor purchases a gold product (gold typically being based in US Dollars), they will also be exposed to movements in the sterling/dollar exchange rate. Investors can mitigate currency risk by using currency hedged products.
☐ **Is the ETP leveraged?**	Leveraged investments present additional considerations for investors, particularly as losses are multiplied as well as gains. Short & Leveraged products generally reset on a daily basis, therefore returns are path dependent and may be impacted positively or negatively by compounding. Investors should actively monitor their investments at least as regularly as the ETP resets.
☐ **How frequently is the index rebalanced?**	Frequently adding and removing underlying constituents within an index can affect how tightly an ETP tracks its underlying benchmark. Frequent rebalancing can ensure a more accurate and up-to-date replication of the index, whereas the cost of buying and selling these securities can have an impact on returns.

2. Understanding the product structure

ETPs can be structured in different ways. It is important to examine specific product structures and understand the associated risks as well as how these are mitigated.

Factors to consider	Why is this relevant?
☐ **How do UCITS ETFs and ETCs differ?**	The UCITS ETF structure is generally considered to be non-complex and is widely used by product issuers. However not all underlying assets, like individual commodities and currencies, are eligible for investment in UCITS due to diversification and eligibility requirements. Alternative structures like ETCs, which are regulated by the EU Prospectus Directive, provide access to certain asset classes and individual exposures that have typically been hard to access.
☐ **What is the replication method?**	ETPs can implement a number of different replication methods – physical full replication, physical optimisation replication and synthetic replication. These different methods can influence how closely an ETP tracks an underlying benchmark.
☐ **How is potential credit risk mitigated?**	Both physical and synthetic structures may, in some circumstances, introduce credit risks through either securities lending or swap agreements respectively. These risks can be mitigated through the provision of collateral. Important considerations include the type of collateral used, how the collateral is held and the extent to which it covers the credit exposure to a counterparty.
☐ **How well does the fund track the underlying index?**	The structure will determine the costs and performance of an ETP and thus how closely it tracks the underlying benchmark. The tracking difference and error will indicate how well a product is tracking its underlying benchmark (for further information, see 'Costs' section below).

3. Gauging liquidity

There are two sources of ETP liquidity – primary market and secondary market liquidity. This will determine the tradability of an ETP and can impact the total cost of ownership.

Factors to consider	Why is this relevant?
☐ **How is underlying liquidity measured?**	The true liquidity of an ETP is directly related to the liquidity of the underlying benchmark that it tracks. The liquidity of the underlying is primarily determined by the level of its trading activity.
☐ **How robust is the creation and redemption process?**	Authorised participants can trade directly with the issuing entity in the primary market, which means that securities can be created and redeemed based on market demand. A robust creation process should be transparent and increase trading cost efficiency.
☐ **What levels of on-exchange demand are there for the ETP?**	Secondary market (on-exchange) liquidity stems from the presence of multiple independent market makers willing to quote prices to buy and sell the ETP on-exchange. This will ensure that the arbitrage mechanism functions efficiently and the price of the ETP tracks the price of the benchmark as accurately as possible. For investors trading on-exchange, secondary market liquidity will impact bid/ask spreads that they will pay to trade the ETP. Volume traded on exchange is a reflection of the demand for the ETP itself.

4. Calculating the total cost of ownership

There are a number of factors that influence the total cost of owning financial products. It is therefore important to look beyond the ongoing charges.

Factors to consider	Why is this relevant?
☐ **What are the ongoing charges?**	The ongoing charges figure is a measure of the recurring costs in a product, also known as the total expense ratio (TER). Ongoing charges will typically cover the cost to manage a product, administration, custody and oversight and may also include index licence fees, storage costs and collateral fees.
☐ **What are the portfolio transaction costs?**	Portfolio transaction costs are variable. They cover costs incurred when a product issuer buys or sells securities or assets being held by the ETP. This can include quantifiable costs such as commissions paid to stockbrokers and transaction taxes. Other portfolio transaction costs include swap fees, security lending fees and the costs incurred when rebalancing and/or reweighting a portfolio.
☐ **What are the trading and post-trade costs?**	Trading costs include the bid/ask spread for a product when traded on-exchange, as well as any other dealing charges (platform charges) at the time of purchase or recurring fees thereaf er. These costs are external to the product but impact the total cost of owning a product.
☐ **What is the tracking difference and tracking error of the ETP?**	The tracking difference is ultimately a measure of cost and will generally illustrate the impact of ongoing charges and portfolio transaction costs on product returns over time. Tracking error is the variability of ETP returns in reference to underlying benchmark returns and is a useful short-term indicator of how consistent an ETP has been in replicating an underlying benchmark.

5. Regulation & Tax

Regulatory and tax matters are important to consider when selecting various products, particularly given the foreign domicile of most ETPs.

Factors to consider	Why is this relevant?
☐ **Where is the product domiciled?**	The ETP's domicile will determine the tax treatment at the product level. Many ETPs are domiciled outside of the UK and are therefore subject to tax regimes external to the UK. The domicile of an ETP will also impact the relevant protections afforded to investors.
☐ **Who are the managers and administrators?**	It is important to clarify who the issuing entity of the product is. It is also important to note the key independent parties – for example the registrar, custodian, trustee, collateral manager.
☐ **Is the ETP eligible for ISAs and SIPPs?**	Generally, ETPs are ISA and SIPP eligible, however this should be reviewed on a case-by-case basis. In some specific instances ISA eligibility may be restricted.
☐ **Is an investor liable to pay stamp duty or Stamp Duty Reserve Tax (SDRT)?**	Generally, ETPs are exempt from stamp duty and SDRT in primary and secondary markets, meaning that investors do not incur either tax when they buy and sell ETPs.
☐ **Does the ETP have UK Reporting Fund Status?**	ETPs should have UK Reporting Fund Status. For ETPs that do not have UK Reporting Fund Status, UK investor gains may be treated as income as opposed to capital and may therefore result in certain investors incurring a proportionally higher UK taxation charge.
☐ **Is the ETP eligible for investment in offshore bonds?**	Offshore bond investments are limited to collective investment schemes and cash. The collective investment scheme definition links back to the Financial Services Market Act ("FSMA") definition. Since, under FSMA, ETCs are debt securities and not collective investment schemes, they are not eligible. In contrast UCITS ETFs are generally eligible for investment in offshore bond investments as they fit the definition for collective investment schemes.
☐ **Is there any other key legal information to consider?**	This may include identifying the securities regulator and domicile, as well as rechecking the legal structure and form.

Glossary of Terms

Authorised Participant (AP)	Banks or other financial institutions that act as intermediaries between issuers of securities and other investors or intermediaries.
Bid/ask spread	The difference between the bid and ask price of a given security. Typically a spread will be quoted as a percentage. For example, if the bid price for ETP 1 is 100p and the ask price is 102p, the bid / ask spread will be 2p (or 0.02% expressed as a percentage). Typically the more liquid products will have narrower spreads, reflecting more active buying and selling of a security by market makers.
Collateralisation	Assets provided by swap providers to secure their payment obligations under a swap agreement.
Collateral yield	The hypothetical interest that an investor would have received on cash equal in value to the underlying futures contracts.
ETC (Exchange traded commodities & currencies)	Typically structured as a special purpose vehicle that issues debt securities.
ETF (Exchange traded fund)	Structured as a fund that issues shares and commonly structured as UCITS in Europe.
ETP (Exchange traded product)	An umbrella term for investment vehicles traded on exchange that track an underlying benchmark. This can encompass ETFs, ETCs and ETNs.
Full replication	A physical replication method where the ETF holds all the underlying securities in the same proportion as their weighting in the index being replicated.
Market capitalisation weighted index	Also called a market value weighted index. Constituents are weighted in relation to the total market value of their outstanding shares.
Optimisation	A physical replication method where the ETF holds a sample (rather than all) of the securities in the underlying benchmark.
Price weighted index	An index where each constituent influences the index in proportion to its share price.
Roll yield	The positive or negative return generated when a futures contract near expiry is sold, and the proceeds reinvested in another futures contract whose expiry is further in the future.
Swap	A derivative contract where two parties agree to swap the return of one investment for another, or alternatively, where one party makes cash payments to another in exchange for the return of an investment or benchmark.
Tracking difference	Tracking difference is the difference between a product's return and that of the benchmark over a specific time period.
Tracking error	The volatility of the difference between the return of an ETP and its benchmark or asset.
UCITS (Undertakings for Collective Investment in Transferable Securities)	A set of European directives that impose a common framework for regulating collective investment schemes throughout the European Union. UCITS compliant funds are entitled to a number of cross-border marketing and distribution rights throughout the European Union.

Important Information

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